INVENTORY VALUATION

MISTAKES TO AVOID THAT COULD COST YOU MONEY

(In accordance with Sec. 142 of the Income Tax-61 & Sec. 148 of the Companies Act 13)

INTRODUCTION

Inventory valuation is an important process for businesses of all sizes, as it affects the accuracy of financial statements and the ability to make informed business decisions. Under the Income Tax Act, businesses are required to value their inventory using an appropriate method and standards. The method that a business chooses can have a significant impact on **its taxable income**.

In this article, I will discuss the importance of inventory valuation under **income tax** & latest changes (Section 142 of Income Tax Act 1961) in respect of the valuation of Inventory by the **Cost Accountants (CMA)** at any stage of the proceedings before the Assessing Officer and how it is connected with the **Companies Act 2013**. I will also provide some of the key points that should be keep in mind about the Inventory Valuation by **Taxpayers/businesses** as well as professionals such as **Cost Accountants (CMAs)** who perform the inventory valuation and **Chartered Accountants (CAs)** who perform the statutory audit/tax audit of the taxpayers for ensuring accurate and compliant with the Income Tax Act.

THE INCOME TAX ACT & FINANCE ACT 2023

The Income Tax Act 1961 (the "Act") requires taxpayers to value their inventory at the lower of cost or market value or we can say as per Indian Accounting Standards-2, which deals with 'Inventory Valuation' provide the lower of cost or net realizable value. and, the Act does not specify how the cost of inventory should be calculated. This has led to some taxpayers undervaluing their inventory to reduce their taxable income. (However, Accounting Standards specify to provide the guidelines on what should be considered in the cost of inventory)

To address this issue, the **Finance Act 2023** amended Section 142A of the Act to allow the Assessing Officer to direct an assessee to get their **inventory valued by a Cost Accountant (known as CMA).** The cost accountant will then prepare a report setting out the value of the inventory following the prescribed guidelines.

In the past, the CBIC (The Central Board of Indirect Taxes) frequently asked for the Cost Audit or Cost of Production by the CMA at the time of Excise & Service tax assessment, because the levy of excise was based on production cost. Similarly, a **Cost Records and Audit** is provided under the **Companies Act 2013**. Section 148 of the Companies Act 2013, provides the class of companies engaged in the production of such goods or providing such services (List of Industries Specified) to maintain the Cost Records & Cost Audit subject to threshold limit of turnover.

THE COMPANIES ACT, 2013

A summary of the applicability of Cost Records & Cost Audits on the companies under the Companies Act 2013,

Cost Records to be maintained

By the Companies, including Foreign Companies engaged in the production of the goods or providing services**,** **specified in the Table**, having an **overall turnover** from all its products and services of **Rs. 35 CR** or more during the immediately preceding financial year.

Cost Audit Provision

The company engaged in activities specified in Table A or B and fulfilled **BOTH** the following **conditions** specified

Companies Specified	Overall Annual Turnover	Turnover of the individual product (Which cost records are to be maintained)
Table (A) Known as **Regulated Sectors** for Section 148 of the Companies Act	**Rs.50 Cr. or more**	**Rs. 25 Cr. or more**
Table (B) Known as **Non-Regulated Sectors** for Section 148 of the Companies Act	**Rs.100 Cr. or more**	**Rs. 35 Cr. or more.**

(The List of activities/industries which are covered under the Cost Audit Rules)

TABLE A (REGULATED SECTORS)

TABEL B (NON-REGULATED SECTORS)

The relation between Cost and Inventory is directly associated and due to that, every change in the relevant element of cost will affect the value of inventory. **For example,** wage rate increases then production cost will also increase and as production cost increases, the value of inventory must be changed.

The amendment to **Section 142 (2A) (ii)** is a significant step towards ensuring that taxpayers **accurately value their inventory**. The use of cost accountants, who are experts in inventory valuation, will help to ensure that the valuation is fair and accurate. This will in turn help to prevent tax evasion and ensure that the government collects the correct amount of tax revenue.

Extract of section 142 (2A)

*At any stage of the proceedings before him, the Assessing Officer, having regard to the nature and complexity of the accounts, the volume of the accounts, doubts about the correctness of the accounts, multiplicity of transactions in the accounts, or specialised nature of the business activity of the assessee, and the interests of the revenue, is of the opinion that it is necessary so to do, he may, with the previous approval of the Principal Chief Commissioner or Chief Commissioner or Principal Commissioner or Commissioner, direct the assessee to **get either or both** of the following,*

> *(i) to get the accounts audited by an accountant, as defined in the Explanation below sub-section (2) of section 288, nominated by the Principal Chief Commissioner or Chief Commissioner or Principal Commissioner or Commissioner in this behalf and to furnish a report of such audit in the prescribed form duly signed and verified by such accountant and setting forth such particulars, as may be prescribed, and such other particulars as the Assessing Officer may require;*
>
> *(ii) to get the **inventory valued by a cost accountant**, nominated by the Principal Chief Commissioner or Chief Commissioner or Principal Commissioner or Commissioner in this behalf and to furnish a report of such inventory valuation in the prescribed form91 duly signed and verified by such cost accountant and setting forth such particulars, as may be prescribed, and such other particulars as the Assessing Officer may require.*

Provided that the Assessing Officer **shall not direct the assessee** to get the accounts so audited or inventory so valued unless the assessee has been given a **reasonable opportunity of being heard.**

KEY POINTS

Here are some of the key points that should be keep in mind about Inventory Valuation by Taxpayers / Businesses as well as professionals such as Cost Accountants (CMAs) who perform the inventory valuation and Chartered Accountants (CAs) who perform the statutory audit/tax audit of the taxpayers.

FOR TAXPAYERS / BUSINESSES

- It is to be a must that proper accounting & records should be maintained to support the inventory valuation method used.

- Must follow consistency in the method of inventory valuation from year to year, unless there is a change in circumstances.

- The Calculation of the NRV (Net Realizable Value) of inventory should be based on the ordinary course of business and proper records should be maintained to support the NRV.

- Proper disclosures shall be maintained at the time of change of Valuation Method and the impact of changes should be incorporated in the Income statement.

- All the relevant records are to be maintained for any future need such as u/s special audit or valuation u/s 142A of the Act.

FOR THE COST ACCOUNTANTS (WHO PERFORM THE INVENTORY VALUATION)

Cost accountants, who are experts in inventory valuation, will help to ensure that the valuation is fair and accurate and some key points should keep in mind while doing the valuation of inventory.

- ❖ The Cost of Inventory should be determined in accordance with the **Cost Accounting Standards** issued by the **Institute of Cost Accountants of India**. It is also advisable that the valuation should not be contradictory with IND AS 2, if so, made proper justification should be available.

- ❖ Must obtain a **deep understanding** of the client's inventory management system and the nature of the production process. (Production flow chart)

- The cost of inventory should be based on the **actual cost of acquiring** the inventory, including the purchase price, net of taxes & duties, and other costs incurred to bring the inventory to its present location and condition.

- The value of inventory should be determined based on the **first-in, first-out (FIFO)** method unless another method is more appropriate. This method is generally considered to be the most accurate method of inventory valuation, but it may vary from case to case.

- The cost of inventory should be determined on the basis of the **lower cost or market (LCM)** method. The LCM method assumes that the inventory should be valued at the lower of its cost or its market value. This is the method that must be used if the FIFO method does not produce a reasonable result.

- The cost of inventory may change over time due to inflation or other factors. In this case, the cost of inventory should be determined based on the **cost as it was acquired.**

- The value of **NRV** should be based **Ordinary course of business** in normal circumstances and which shall be in line with current trends. **For example**, the current NRV of the portable Walkman (Audio Player) will not be matched with the past, as there are very big technological changes that happened in the last decade.

- The **Method of valuation** & other relevant factors should be taken care of based on the nature of industries and business activities.

- CMA should be considered the Industry Norms or fundamentals while performing the inventory valuation.

- Documents & work should be kept for a sufficient period for future reference.

- CMA should also be made **proper disclosure & disclaimer** in their valuation report regarding data availability, the correctness of data, the method adopted, and other relevant factors.

- If any **material factors** are found, they should be disclosed separately in the report, such as any Non-Moving stock, Slow moving stock, etc.

- At the time of valuation of any **Work in Progress (WIP)** inventory, the stage of completion must be taken care of properly, and allocation of overhead should be following the completion stage.

- In addition to the above points according to the **nature and type of industries**, CMAs should keep in mind.

FOR CHARTERED ACCOUNTANTS (WHO PERFORM THE STATUTORY AUDIT/TAX AUDIT OF THE TAXPAYERS)

Chartered Accountants (CAs) play a very vital role in Income Tax matters, so the following points should be keep in mind **about the Inventory Valuation.**

- If the taxpayer is a **Company**, first check whether **Cost Records and Audit** rules are **applicable** or Not on the Company.

- If Cost Records Rules and Audit Rules are **applicable**, the Valuation of inventory should be the same or the minimum difference should be there, and the reason for that difference shall justifiable.

- The said applicability should be checked **year on year basis**, sometimes the Cost Records & Audit rules are duly applicable to the Companies in accordance with section 148 of the Companies Act 2013 but it has been missed in reporting. This negligence causes result in **serious problems** for taxpayers as well as professional too.

- If Cost Records Rules and Audit Rules are not applicable, the Value of Inventory shall be determined in accordance with IND AS-2.

- While ascertaining the value of inventory, it must be taken care that **expenses** which are being taken as cost of inventory should be **associated** with that **inventory elements**.

- Some expenses/cost elements which **are not associated** with the production process, these expenses **should not be loaded** on Inventory. (Such as **Donation**, **Asset write-off**, **CSR expenses**, etc.)

- Proper disclosures should be made in **CARO and 3CA-3CD** about the applicability of Cost Records and Cost Audits on Companies.

- As Cost Records & Audit applicability is based on different criteria such as companies' activities, product, turnover, location, etc., therefore it would be better to take the **opinion of Cost Accountants** on applicability to avoid any disputes / **non-compliances**.

- Sometimes due to Inventory valuation deference, the income tax departments raise the demands of **additional taxes** on incremental profit due to that valuation.

- **Proper disclosures** should be made in the Audit report and the Method of Inventory Valuation also be mentioned.

CONCLUDING REMARKS

Inventory valuation is an important process for businesses of all sizes. By accurately valuing their inventory, businesses can ensure that their financial statements are accurate and reliable. In addition, proper inventory valuation can help businesses to make better decisions about **pricing**, **inventory** levels, and **cash flow**.

And on the other side the tax revenue authorities whether it is **Income Tax or Indirect taxes**, the Inventory is very sensitive for them, therefore the Tax dept always keeps **an eye on the Valuation of the Inventory.**

There are several different methods for inventory valuation, and the best method for a particular business will depend on a few factors, such as the type of inventory, the cost of inventory, and the volatility of inventory prices. It is important to choose a **method that is accurate**, **compliant** with applicable accounting standards, and defensible in the event of an audit.

Businesses should also have a strong inventory management system in place to track inventory levels and costs. This will make it easier to calculate the cost of inventory at any given time and to identify any potential problems with inventory valuation.

By following the tips in this article, businesses & professionals can ensure that they are accurately and effectively valuing their inventory. This will help them to make better financial decisions, better compliance and to improve their overall profitability. Therefore, we should **avoid mistakes in inventory valuation that could cost money.**

I hope this article may be useful to us.

Your feedback is most welcome and you may reach out or write to me at pankaj@kannaujiya.com

Best Regards
CMA (RV) Pankaj Kannaujiya

Table (A) Known as Regulated Sectors

Sl. No.	Industry/ Sector/ Product/ Service	Customs Tariff Act Heading (wherever applicable)
1	Telecommunication services made available to users by means of any transmission or reception of signs, signals, writing, images and sounds or intelligence of any nature and regulated by the Telecom Regulatory Authority of India under the Telecom Regulatory Authority of India Act, 1997 (24 of 1997); including activities that requires authorization or license issued by the Department of Telecommunications, Government of India under Indian Telegraph Act, 1885 (13 of 1885);	**Not applicable.**
2	Generation, transmission, distribution and supply of electricity regulated by the relevant regulatory body or authority under the Electricity Act, 2003 (36 of 2003);	**Generation-2716; Other-Activity Not Applicable**
3	Petroleum products; including activities regulated by the Petroleum and Natural Gas Regulatory Board under the Petroleum and Natural Gas Regulatory Board Act, 2006 (19 of 2006);	**2709 to 2715; Other Activity-Not Applicable**
4	Drugs and pharmaceuticals;	**2901 to 2942; 3001 to 3006.**
5	Fertilisers;	**3102 to 3105.**
6	Sugar and industrial alcohol;	**1701; 1703; 2207.**

Table (B) Known as Non-Regulated Sectors

Sl. No.	Industry/ Sector/ Product/ Service	Customs Tariff Act Heading (wherever applicable)
1	Machinery and mechanical appliances used in defence, space and atomic energy sectors excluding any ancillary item or items; Explanation. – For the purposes of this sub-clause, any company which is engaged in any item or items supplied exclusively for use under this clause, shall be deemed to be covered under these rules	**8401; 8801 to 8805; 8901 to 8908.**
2	Turbo jets and turbo propellers;	**8411**
3	Arms, ammunitions and Explosives;	**3601 to 3603; 9301 to 9306.**
4	Propellant powders; prepared explosives (other than propellant powders); safety fuses; detonating fuses; percussion or detonating caps; igniters; electric detonators;	**3601 to 3603**
5	Radar apparatus, radio navigational aid apparatus and radio remote control apparatus;	**8526**
6	Tanks and other armoured fighting vehicles, motorised, whether or not fitted with weapons and parts of such vehicles, that are funded (investment made in the company) to the extent of ninety per cent or more by the Government or Government agencies;	**8710**
7	Port services of stevedoring, pilotage, hauling, mooring, re-mooring, hooking, measuring, loading and unloading [services rendered for a Port in relation to a vessel or goods regulated by the Tariff Authority for Major Ports under the Major Port Trusts Act, 1963 (38 of 1963)];	**Not applicable.**
8	Aeronautical services of air traffic management, aircraft operations, ground safety services, ground handling, cargo facilities and supplying fuel rendered [at the airports] and regulated by the Airports Economic Regulatory Authority under the Airports Economic Regulatory Authority of India Act, 2008 (27 of 2008);	**Not applicable**
9	Iron and Steel;	**7201 to 7229; 7301 to 7326**
10	Roads and other infrastructure projects corresponding to para No. (1) (a) as specified in Schedule VI of the Companies Act, 2013 (18 of 2013);	**Not applicable.**
11	Rubber and allied products; including products regulated by the Rubber Board constituted under the Rubber Act, 1947 (XXIV of 1947);	**4001 to 4017**
12	Coffee and tea;	**0901 to 0902**
13	Railway or tramway locomotives, rolling stock, railway or tramway fixtures and fittings, mechanical (including electro mechanical) traffic signalling equipment's of all kind;	**8601 to 8608 [8609]**
14	Cement;	**2523; 6811 to 6812**
15	Ores and Mineral products;	**2502 to 2522; 2524 to 2526; 2528 to 2530; 2601 to 2617**

16	Mineral fuels (other than Petroleum), mineral oils etc.;	**2701 to 2708**
17	Base metals;	**7401 to 7403; 7405 to 7413; 7419; 7501 to 7508; 7601 to 7614; 7801 to 7802; 7804; 7806; 7901 to 7905; 7907; 8001; 8003; 8007; 8101 to 8113.**
18	Inorganic chemicals, organic or inorganic compounds of precious metals, rare-earth metals of radioactive elements or isotopes, and organic chemicals;	**2801 to 2853; 2901 to 2942; 3801 to 3807; 3402 to 3403; 3809 to 3824.**
19	Jute and Jute Products;	**5303, [5307,] 5310**
20	Edible Oil;	**1507 to 1518**
21	Construction Industry as per para No. (5) (a) as specified in Schedule VI of the Companies Act, 2013 (18 of 2013);	**Not applicable.**
22	Health services, namely functioning as or running hospitals, diagnostic centres, clinical centres or test laboratories;	**Not applicable.**
23	Education services, other than such similar services falling under philanthropy or as part of social spend which do not form part of any business;	**Not applicable**
24	Milk powder;	**402**
25	Insecticides;	**3808**
26	Plastics and polymers;	**3901 to 3914; 3916 to 3921; 3925**
27	Tyers and tubes;	**4011 to 4013**
28	Pulp and Paper	**[4701 to 4704,] 4801 to 4802.**
29	Textiles;	**5004 to 5007; 5106 to 5113; 5205 to 5212; 5303; [5307;] 5310; 5401 to 5408; 5501 to 5516**
30	Glass;	**7003 to 7008; 7011; 7016**
31	Other machinery and Mechanical Appliances;	**8402 to 8487**
32	Electricals or electronic machinery	**8501 to 8507; 8511 to 8512; 8514 to 8515; 8517; 8525 to 8536; 8538 to 8547.**
33	**Production, import and supply or trading of following medical devices, namely:-** (i) Cardiac stents; (ii) Drug eluting stents; (iii) Catheters; (iv) Intra ocular lenses; (v) Bone cements; (vi) Heart valves; (vii) Orthopaedic implants; (viii) Internal prosthetic replacements; (ix) Scalp vein set; (x) Deep brain stimulator; (xi) Ventricular peripheral shud; (xii) Spinal implants; (xiii) Automatic impalpable cardiac [defibrillators]; (xiv) Pacemaker (temporary and permanent); (xv) Patent ductus arteriosus, atrial septal defect and ventricular septal defect closure device; (xvi) Cardiac re-synchronise therapy ; (xvii) Urethra spinicture devices; (xviii) Sling male or female; (xix) Prostate occlusion device; and (xx) Urethral stents:	**9018 to 9022**