

Query No. 23

Subject: *Disclosure of changes in inventory of scrap in the statement of profit and loss.*¹

A. Facts of the Case

1. A Company (hereinafter referred to as ‘the Company’) is a listed central public sector company and its net worth as on 31.03.2020 was Rs. 29180 crore. The Company is an integrated power plant equipment manufacturer engaged in design, engineering, manufacture, construction, testing, commissioning and servicing of a wide range of products and services for the core sectors of the economy, viz., power, transmission, industry, transportation, renewable energy, oil & gas and defence.

2. Scrap is predominantly generated from the Company’s manufacturing operations. Being in an Engineering Procurement Construction (EPC)/Boiler Turbine Generator (BTG) project environment, some scrap gets generated during fabrication and assembly also. Further, with regard to the nature of the scrap in the extant case, the querist has separately clarified that the majority of the items are ferrous cut-bits emanating during the course of machining, fabrication, assembly etc. The material is not usable and there is no other use of such items except disposal as scrap. It also does not have an active market and can be sold as scrap only. Further, the material is not being deliberately produced and the production process is not modified in order to produce such material.

Exiting practice:

3. The querist has informed that the scrap income is being shown separately under ‘Other Operational Income’ and it includes scrap sale as well as accretion/ decretion in scrap stock i.e. difference of closing stock and opening stock. The closing stock of scrap is disclosed under ‘Note 10: Current Assets (Inventories)’ at estimated realisable value.

4. The querist has further informed that the rationale for the existing practice is as follows:

- a. 9.5.3 of the Guidance Note on Division II- Ind AS Schedule III to the Companies Act, 2013, issued by the Institute of Chartered Accountants of India (ICAI) requires disclosure of difference in opening and closing inventories of finished goods (FG)/work-in-progress (WIP)/stock-in-trade only in ‘changes in inventories of finished goods and work in progress’.
- b. No guidance is available regarding disclosure of change in scrap inventory in the Guidance Note or in the Standard.
- c. In the absence of any specific guideline for disclosing the accretion/decretion of scrap, the same is being consistently shown as part of scrap income.

5. The querist has mentioned that the Comptroller and Auditor General of India (C&AG Audit) has raised an issue on inclusion of change in inventory of scrap as part of scrap income under other operational revenue. In their opinion, such change in inventory should be clubbed with ‘change in inventory of WIP/FG’. The observation of C&AG on this issue is as given below:

“Statement of Profit and Loss

Revenue from Operations (Note No.29) - Rs. 21490.01 crore

Other Operational Income Rs. 995.42 crore

¹ Opinion finalised by the Committee on 10.11.2020.

The above includes income from sale of scrap amounting to Rs. 168.99 crore. During the year 2019-20, actual sale of scrap was only Rs.142.12 crore and remaining Rs.26.87 crore was the change in valuation of opening and closing stock of scrap which was also recognized as income from sale of scrap. Rs. 26.87 crore should have been disclosed under the heading 'Change in Inventories' in the statement of profit and loss.

This resulted in overstatement of Other Operational Income by Rs. 26.87 crore and understatement of Change in inventories by Rs. 26.87 crore.”

B. Query

6. The querist has sought the opinion of the Expert Advisory Committee as to whether the change in inventory of scrap can be continued to be shown as part of scrap income being disclosed under 'Other operational income' or whether it has to be disclosed under the item 'Changes in inventories of finished goods and work in progress'.

C. Points considered by the Committee

7. The Committee notes that the basic issue raised by the querist relates to presentation of change in the inventory of scrap in the Statement of Profit and Loss. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, revenue recognition from scrap, valuation of inventory of scrap (initial and subsequent), accounting treatment in respect of any other item, evaluation of 'materiality' in the context of inventory of scrap, using the nomenclature 'other operational income' instead of 'other operating revenue' as per the requirements of Schedule III to the Companies Act, 2013, etc. The Committee wishes to point out that the Accounting Standards referred hereinafter are Indian Accounting Standards, notified under the Companies (Indian Accounting Standards) Rules, 2015, as amended/revised from time to time. Further, the opinion expressed hereinafter is purely from accounting perspective and has not examined any legal, taxation or financial management issues.

8. The Committee notes the current accounting treatment and disclosure made by the querist in the financial year (F.Y.) 2019-20 as follows:

“The closing stock of scrap is disclosed under Inventory as 'Scrap Inventory'. 'Income from Scrap', is being shown separately under 'Other Operational Income' and it includes scrap sale as well as increase/decrease in scrap stock i.e. difference of closing stock and opening stock. The closing stock of scrap is disclosed under Inventories at estimated realizable value.”

9. At the outset, the Committee examines the nature of scrap in the extant case in the context of accounting requirements. In this context, the Committee notes the following paragraphs of Indian Accounting Standard (Ind AS) 2, 'Inventories':

“6 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.”**

“14 A production process may result in more than one product being produced simultaneously. This is the case, for example, when joint products are produced or when there is a main product and a by-product. When the costs of conversion of each product are not separately identifiable, they are allocated between the products on a rational and consistent basis. The allocation may be based, for

example, on the relative sales value of each product either at the stage in the production process when the products become separately identifiable, or at the completion of production. Most by-products, by their nature, are immaterial. When this is the case, they are often measured at net realisable value and this value is deducted from the cost of the main product. As a result, the carrying amount of the main product is not materially different from its cost.”

From the above, the Committee notes that during a production process, more than one product may be produced simultaneously which, for example, may either be joint products or a main product and a by-product. Although, what can be treated as a joint product or a main product and a by-product has not been explicitly defined in Standard, it states that most by-products are by their nature immaterial. Further, although the Standard does not mention about the scrap or waste products; sometimes the production process also results in scrap or waste products. The Committee is of the view that whether a product/material is to be classified as joint product/co-product or by-product or waste product/ scrap depends on facts and circumstances of the case and based on a number of factors like objective of manufacture, whether the material was deliberately produced, certainty of use of the products, readiness for use without further processing, whether the intended use of the material is lawful, etc. In this context, the Committee notes that the scrap material/item produced during the course of manufacturing process in the extant case has no other use; does not have an active market and can be disposed as scrap only. Considering this, the Committee is of the view that the material generated during manufacturing process is not deliberately produced, it is a production residue but cannot be further used or sold in an active market except as scrap. Hence, the Committee believes that the material is in nature of scrap and not a by-product/joint product. However, in the absence of any specific accounting requirements in respect of scrap /waste products in Ind AS 2 or any other Ind AS and considering the requirements of paragraphs 10 and 11 of Ind AS 8, ‘Accounting Policies, Changes in Accounting Estimates and Errors’, the Committee is of the view that although the inventory of scrap is incidentally generated in the production/manufacturing process, since it is produced and sold in the ‘normal course of business’, these are of the nature of ‘inventory’ as per Ind AS 2 and the accounting prescribed in respect of by-product under paragraph 14 of Ind AS 2 may be applied. The Committee notes that this view is also supported by the requirements of Accounting Standard (AS) 2, ‘Valuation of Inventories’, notified under the Companies (Accounting Standards) Rules, 2006². Although, the Committee understands that the requirements of Accounting Standards, notified under the Companies (Accounting Standards) Rules, 2006 may not be applicable in the context of Indian Accounting Standards; however, since AS 2 deals with the accounting for ‘scrap’ and the definition of ‘inventories’ under both the Standards are similar, the Committee notes the requirements of AS 2 as follows:

“10. A production process may result in more than one product being produced simultaneously. This is the case, for example, when joint products are produced or when there is a main product and a by-product. When the costs of conversion of each product are not separately identifiable, they are allocated between the products on a rational and consistent basis. The allocation may be based, for example, on the relative sales value of each product either at the stage in the production process when the products become separately identifiable, or at the completion of production. Most by-products as well as scrap or waste materials, by their nature, are immaterial. When this is the case, they are

² Subsequently, in respect of accounting periods commencing on or after April 1, 2021, Companies (Accounting Standards) Rules, 2006 (as amended from time to time) have been superseded by Companies (Accounting Standards) Rules, 2021.

often measured at net realisable value and this value is deducted from the cost of the main product. As a result, the carrying amount of the main product is not materially different from its cost.”

10. Now, the Committee examines the issue raised by the querist relating to disclosure of change in the inventory of scrap under ‘Other operational income’ by including it with ‘sale of scrap’ or separately under the item ‘Changes in inventories of finished goods and work in progress’ in the Statement of Profit and Loss. In this context, the Committee notes that Part II, ‘Statement of Profit and Loss’ under Division II of Schedule III to the Companies Act, 2013 requires the aggregate of the following expenses to be disclosed on the face of the Statement of Profit and Loss:

- Cost of materials consumed
- Purchases of Stock-in-Trade
- Changes in inventories of finished goods, work in progress and Stock-in-Trade
- Employee benefits expense
- Finance costs
- Depreciation and amortization expense
- Other expenses

The Committee further notes the following paragraphs of Guidance Note on Division II- Ind AS Schedule III to the Companies Act, 2013 (July 2019 Edition)³ (hereinafter referred to as ‘the Guidance Note’), issued by the ICAI:

“8.1.13. Inventories

(i) **Inventories shall be classified as:**

- (a) Raw materials;
- (b) Work-in-progress;
- (c) Finished goods;
- (d) Stock-in-trade (in respect of goods acquired for trading);
- (e) Stores and spares;
- (f) Loose tools;
- (g) Others (specify nature).

(ii) Goods-in-transit shall be disclosed under the relevant sub-head of inventories.

(iii) Mode of valuation shall be stated.

...

The heading Finished goods should comprise of all finished goods other than those stock-in-trade acquired for trading purposes.”

“9.1. Revenue from operations

...

³ The Guidance Note on Division II – Ind AS Schedule III to the Companies Act, 2013 (July 2019 Edition) has been subsequently revised in January 2022.

9.1.1. Note 3 of General Instructions for the Preparation of Statement of Profit and Loss require that revenue from operations is to be separately disclosed in the notes, showing revenue from:

- (a) Sale of products (including Excise Duty);
- (b) Sale of services; and
- (c) Other operating revenues”

“9.1.8. The term “other operating revenue” is not defined. This would include Revenue arising from a company’s operating activities, i.e., either its principal or ancillary revenue-generating activities, but which is not revenue arising from sale of products or rendering of services. Whether a particular income constitutes “other operating revenue” or “other income” is to be decided based on the facts of each case and detailed understanding of the company’s activities.”

“9.1.10. To take other examples, sale of Property, Plant and Equipment is not an operating activity of a company, and hence, profit on sale of Property, Plant and Equipment should be classified as other income and not other operating revenue. On the other hand, sale of manufacturing scrap arising from operations for a manufacturing company should be treated as other operating revenue since the same arises on account of the company’s main operating activity.”

“9.5. Expenses

The aggregate of the following expenses are to be disclosed on the face of the Statement of Profit and Loss:

- Cost of materials consumed
- Purchases of Stock-in-Trade
- Changes in inventories of finished goods, work in progress and stock in trade
- Employee benefits expense
- Finance costs
- Depreciation and amortization expense
- Other expenses

9.5.1. Cost of materials consumed

This disclosure is applicable for manufacturing companies. Materials consumed would consist of raw materials, packing materials (where classified by the company as raw materials) and other materials such as purchased intermediates and components which are ‘consumed’ in the manufacturing activities of the company. Where packing materials are not classified as raw materials the consumption thereof should be disclosed separately. However, intermediates and *components which are internally manufactured are to be excluded from the classification.*

9.5.1.1.For purpose of classification of inventories, internally manufactured components may be disclosed as below:

- (i) where such components are sold without further processing they are to be disclosed as 'finished products'.
- (ii) where such components are sold only after further processing, the better course is to disclose them as 'work-in-progress' but they may also be disclosed

as 'manufactured components subject to further processing' or with such other suitable description as 'semi-finished products' or 'intermediate products'.

(iii) *where such components are sometimes sold without further processing and sometimes after further processing it is better to disclose them as 'manufactured components'.*”

“9.5.3. Changes in inventories of finished goods, work-in-progress and stock-in-trade

This requires disclosure of difference between opening and closing inventories of finished goods, work-in-progress and stock-in-trade. The difference should be disclosed separately for finished goods, work in progress and stock in trade.”

(Emphasis supplied by the Committee.)

From the above, the Committee notes that Part II of Schedule III to the Companies Act, 2013 does not specifically mention about the disclosure of inventory of scrap in the Statement of Profit and Loss.

The Committee also notes that the Guidance Note requires only sale of manufacturing scrap to be disclosed as ‘other operating revenue’ under the head ‘Revenue from operations’ and does not specifically mention about the disclosure of ‘change in the inventory of scrap’ under this classification or any other classification. However, drawing analogy from other items under ‘Revenue from operations’, viz., sale of goods and sale of services, the Committee is of the view that only sale of scrap should be disclosed under ‘other operating revenue’ and not the changes in inventory of scrap.

11. Further, the Committee notes from the requirements of Guidance Note in the context of disclosure of ‘Expenses’ in the Statement of Profit and Loss, as reproduced above, that internally manufactured components that are sometimes sold without further processing and sometimes after further processing may be disclosed as 'manufactured components' for the purpose of classification of inventories (although there is no such classification prescribed under Schedule III). Drawing an analogy from this and since in the extant case, the inventory of scrap can be accounted for as by-product inventory under Ind AS 2 (as discussed in paragraph 9 above), the Committee is of the view that ‘change in the inventory of scrap’ should also be disclosed separately under the classification, ‘Changes in inventories of finished goods, work in progress and stock in trade’. In this context, the Committee also notes that the ‘General Instructions for Preparation of Financial statements of a Company required to comply with Ind AS’ in Division II of Schedule III to the Companies Act, 2013 provides as follows:

“3. The disclosure requirements specified in this Schedule are in addition to and not in substitution of the disclosure requirements specified in the Indian Accounting Standards. Additional disclosures specified in the Indian Accounting Standards shall be made in the Notes or by way of additional statement or statements unless required to be disclosed on the face of the Financial Statements. Similarly, all other disclosures as required by the Companies Act, 2013 shall be made in the Notes in addition to the requirements set out in this Schedule.”

Further, paragraph 85 of Ind AS 1, ‘Presentation of Financial Statements’ states that additional line items, headings and subtotals in the statement of profit and loss shall be presented, when such presentation is relevant to an understanding of the entity’s financial performance.

Thus, the Committee is of the view that Schedule III permits the use of additional line items, heads etc. in the presentation of Statement of Profit and Loss, if these are relevant to an

understanding of the entity's financial performance. Accordingly, in the extant case, separate disclosure of 'change in the inventory of scrap' under the classification, 'Changes in inventories of finished goods, work in progress and stock in trade' is permissible under the requirements of Schedule III to the Companies Act, 2013.

D. Opinion

12. On the basis of the above, the Committee is of the opinion that 'change in the inventory of scrap' in the extant case should also be disclosed separately under the classification, 'Changes in inventories of finished goods, work in progress and stock in trade', and not under 'other operational revenue/income' in the Statement of Profit and Loss, as discussed in paragraphs 10 and 11 above.
