Change in Method of Valuation of Inventories

A Taxation Aspect

M.K. Tewatia

< EXECUTIVE SUMMARY >

◆ Valuation of inventory is an essential exercise which is required to be carried by a person to show true and fair view of its financial statements as well as for correctly deducing the income of the assessees at the end of accounting year. Though the valuation of inventories /closing stock at the end of year does not result into any commercial transaction of sale or otherwise which may result into the generation of cash or its equivalent but the valuation of inventories /stock at the year end definitely affect the process of computing the correct assessees income of an assessees . It was rightly observed by the Supreme Court in the case of CHAINRUP SAMPATRAM Vs CIT [1953]24 ITR 431 [HEAD NOTE] that "it is misconception to think that any profit arises out of the valuation of the closing stock and the situs of its arising on accrual is where the valuation is made . Valuation of unsold stock at the close of an accounting year is a necessary part of the process of determining the trading results of that period and can in no sense be regarded as the source of such profit " Any over or under valuation of closing stock shall result into overstatement /understatement of income of the assessees thus affecting the payment of taxes to the revenue department .

It is of utmost importance to select a bonafide and recognised method of valuation of inventories at the commencement of business by the adoption of which the income of the assessees at the end of accounting year can be deduced correctly . However, sometimes despite the best efforts the need arises in the future to change the method of valuation if the method of valuation previously adopted was not a recognised or accepted method of valuation as per the prevalent business practices and accounting standards in vogue and now the assessees wishes to adopt the recognised and accepted method of valuation and the change in the method of valuation is bonafide and the new method of valuation is purported to be used consistently in future . Sometime the change in method of valuation of closing stock is as per the requirement of the statute.

In the present article we restrict our discussion upon the taxation aspect of change in method of valuation of inventories under what circumstances the change in method of valuation of inventories is allowed by the income tax authorities notwithstanding the fact that change in method of valuation may result in the loss of revenues to the revenue department in the year of

**The author is a member of the Institute. The views expressed herein are the personal views of the author and do not necessarily represent the views of the Institute.*

change and other related aspects . To discuss this point in detail it is essential to go through the provisions of Sec.145 of the Income tax Act,1961

SALIENT FEATURES OF SEC,145 OF I.T.ACT REGARDING METHOD OF ACCOUNTING:

➨ Sec. 145 of Income Tax Act, 1961 deals in the method accounting to be followed by the assessee for computing income under the head "Profit and gains of business or profession " or "Income from other sources "either on cash basis or on mercantile basis to be regularly followed by the assessees subject to the provisions of Sec 145(2).

➨Sec. 145(2) deals with the power of Central Govt.to notify the Accounting standards to be followed by the assessee from time to time the preparation and presentation of its financial statements . Till now the Central Government has prescribed two accounting standards wide notification No.9949[F.NO.132/7/95TPL] Dated 25-1-1996] which are to be followed by the assessee in the preparation and presentation of its financial statements .

➨The two notified accounting standard are: The accounting Standard which requires the disclosure of all significant accounting policies used in the preparation and presentation of financial statement and Accounting Standard II which requires the disclosure of prior period and extraordinary items as wells as material effects of change in accounting policies used by the assessee .

➨Further under the provisions of Sec. 145(3) of the Income Tax Act the Assessing Officer has right to do the best judgement assessment under Section 144 if the assessing officer is not satisfied with the correctness or completeness of accounts or where the method of accounting provided in Sec.145(1) or accounting standards as notified under sub section (2) of Section 145 have not been regularly followed by the assessee.

WHETHER CHANGE IN METHOD OF VALUATION OF INVENTORIES IS ALLOWABLE:

It is pertinent to note from the provisions of Section 145(2) and 145(3) that neither the Income Tax Act nor the rules made thereunder prescribes the accounting policies to be used in regards to method of valuation of inventories while preparing the financial statements except the requirement of disclosure of accounting policies used in the preparation and presentation of accounts. Further, the Sect.145(3) of the Income Tax Act gives power to the AO for rejection of accounts if he is not satisfied for the correctness of accounts or where the method of accounting prescribed in Sec.145(1) or the accounting standards notified under Sect.145(2) are not regularly followed by the assessee.

To discuss the crucial point of allowability of changes in method of valuation it is essential to study the requirement of Accounting Standards I & II notified under sub-section (2) of Section 145 of Income Tax Act.

➨As per requirement of para 3 of AS I any change in an accounting policy which has material effect in the previous year or in the years subsequent to the previous year shall be disclosed. The impact of change which is material should be shown in the Financial Statements of the period in which such change is made to reflect the effect of such change.

➨Further para 4 of above standard specifically mention that the accounting policy adopted by an assessee should be such so as to represent a true and fair views of the state of affairs of the assessee 's business, profession or vocation.

As per AS I & AS II Accounting policy is defined as the specific accounting principles and the method of applying those principles adopted by the assessee in the preparation and presentation of financial statements

➨Further as per AS II any change in Accounting polices is allowed only under the following two conditions:

- if the adoption of different policy is required by the statute, or
- if it is considered that the change would result in a more appropriate preparation or presentation of the financial statement by an assessee .

➨Further as per para 10 of AS II disclosure of any material change resulted in due to change in accounting polices ,such disclosure should be made the in the financial statements of the year in which such change is made.

Thus on close reading of Sec 145 and the requirement of relevant accounting standard I&II notified above, following conclusions can be drawn.:

➨A change in accounting policy regarding valuation of inventoried is allowable if the proposed change is as per the requirement of statue for example the changes to be made in the valuation of closing stock of inventories valued as per the accounting policy regularly followed by an assessee , and further adjusted to include the amount of 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 ,pursuant to the provisions of Sec 145(A)of Income Tax Act 1961. or

➨If the assesses was earlier using a method of valuation which was not a rational /recognised method of valuation as per prevalent business practices in vogue and wishes to

switch over to a new method of valuation which is more bonafide ,rational and recognised method of valuation of inventories to be regularly followed thereafter in preparation and presentation of financial statements by the assessees.

RECOGNISED METHOD OF VALUATION :

The well settled principle for valuation of closing stock is to value at cost or market price whichever is lower . It was held by the Supreme Court in the case of CIT Vs BRITISH PAINTS INDIA LTD. 188 1TR 44 that cost or market price which ever less are generally accepted and recognised method of valuation .It was held by the Hon'ble court in the case of K.MOHAMMED ADAM SAHIB Vs CIT[1965]56 ITR 360 {MAD} that the assesses has right to value its goods at nil value in case of goods meant for sale in foreign market and not having its demand in the foreign market . It was further held that the assessee is not bound to show the tax authorities that he took steps to sell goods in foreign market or in local market before valuing the stock at nil value. The Institute of Chartered Accountants of India a statutory body dealing in preparation and publication of accounting standard and accounting framework to be followed by its members in the preparation and presentation of the financial accounts has issued Accounting Standard 2 upon Valuation of Inventories . As per above standard subject to certain exceptions ,the inventories should be valued at lower of historical cost or net realisable value .As per above standard:

Historical cost means an appropriate combination of

a) cost of purchase
b) cost of conversion and
c) other costs incurred in the normal course of business in bringing the inventories up to their present location and conditions .

Net realisable value means the actual estimated selling price in the ordinary course of business ,less cost of completion and cost necessarily to be incurred in order to make the sale

CHANGE SHOULD BE BONAFIDE AND REGULARLY FOLLOWED THEREAFTER:

Once a new method of valuation is adopted by the assessee the same must the followed on constant basis in the near future though in the year of change the valuation will have impact upon the valuation of closing stock but the same shall be ironed out in the subsequent years due to valuation of opening and closing stock on the same basis . The above finding were observed by the Hon'ble Court in the case of CIT Vs CORPORATION BANK 174 ITR 616 (Karnataka) .In this case the bank was valuing the securities held as stock in trade on "Cost basis " and subsequently changed the method of valuation to Cost or market price whichever is lower.It was held by Hon'ble Court that the assessee has right to change the method of valuation of closing stock provided the change is bonafide and the same method is regularly followed thereafter. The plea of the revenue that the change method of valuation should be applied for both opening and closing stock was rejected by the Court. It was held by the Hon'ble Court that in the year of change there shall be some impact upon profit of the company but the same shall be ironed out in the subsequent years due to adoption of new method of valuation on permanent basis thereafter . The Hon'ble court relied upon the following rulings of various courts while delivering above judgement .

i) CHAINRUP SAMPAT RAM Vs CIT 1953 24 ITR 481 SC
ii) INDO COMMERCIAL BANK Vs CIT 1962 44 ITR 22 MAD
iii) BANK OF COCHIN LTD. Vs CIT 1974 ITR 93
iv) CIT Vs CARBORUNDUM UNIVERSAL LTD. 1984 149 ITR 759 MAD

Similarly in the case of CIT Vs DELTA PLANTATION LTD[1993] 71 TAXMAN 329(CAL) it was held that the change in method of valuation must be bonafide and such method must not be restricted to a particular year.

PLEA OF DEPARTMENT FOR OPPOSING THE ADOPTION OF CHANGED METHOD OF VALUATION REJECTED :

Generally it is the tendency of the revenue department to oppose the change in method of valuation with their plea that once that particular method of valuation is adopted by the assessee it is not open to him to change the same in near future . In the case of TRIVENI ENGG. WORKS LTD.Vs CIT 167 ITR 742 Allahabad, the company was initially using the market price as method of valuation of closing stock of sugar irrespective of fact whether the sugar was free saleable or a levy sugar . However , during the year 1969-70 the company changed the method of valuation from market price to cost or market price whichever is lower which was opposed by the tax authorities on the plea that once the assesses has exercised its option to value the closing stock of sugar on market value it can not subsequently be allowed in any circumstances to change the method of

valuation . It was held by Hon'ble court that :

(i)The method of valuation of stock is part of the method of accounting followed by an assesses u/s 145(1) of the Income Tax Act .The above section before its amendment by finance Act 1995 provides as under:

"Income chargeable under the head profit and gains of business or profession or income from other sources shall be computed in accordance with the method of accounting regularly employed by the assessee"

This section leaves open to the assessee to adopt any system of accounting. The AO is obliged upon to adopt such system of accounting regularly followed by the assessees if profit can be deduced properly. Now since there is no prescribed method of valuation of stock under the Income Tax laws and rules framed thereunder, the ordinary principle of commercial accounting prevails according to which the valuation should be done on the basis of cost or market price whichever is less. The court overruled the plea of deptt. that once the assessee has exercised its option in respect of valuation of closing stock on the basis of market price it cannot subsequently be permitted to change the same.

CHANGE IN METHOD OF VALUATION SHOULD BE BOAFIDE PLEA OF DEPARTMENT FOR LOSS OF REVENUE REJECTED

Whenever the change in method of valuation takes place it always have some impact upon the valuation of closing stock . Whenever the change in valuation resulted into the overstatement of income the same is accepted by the revenue authorities but whenever the change resulted into understatement of income the same generally disputed by the revenue authorities on the plea that the change in method is not bonafide but has been effected with some ulterior purposes with the intention to reduce tax impact . It was held by the Kerala high court in the case FOREST INDUSTRIES TRAVANCORE LTD. Vs CIT (1964) 51ITR 329 that the assessees was entitled to change his method of valuation of stock in this manner even though the revenue may be affected adversely by such change . It is a concession given to the assessee based on the well recognised usage of the trade and the principle underlying that concession is in no way violated when the assessee change his method of valuation from cost to market value , when the latter is less then the cost price ,provided the change is bona fide and the new system is continued in subsequent years."

PLEA OF REVENUE DEPTT. TO REVALUE OPENING STOCK ACCORDING TO REVISED METHOD REJECTED :

In the case of change in method of valuation it is always the value of closing stock which has to be revalued as per the revised method leaving aside the value of opening stock intact . In no case the valuation of opening stock is changed in the books of accounts . The valuation of opening and closing stock under two different methods always have some impact upon the taxable income of the assessee. The revenue department sometimes take the plea that for ascertaining the correct taxable income of the assessees the opening stock should also be valued on the basis of new method of valuation on which the closing stock has been valued .In the case of CIT Vs MOPEDS INDIA LIMITED 173 ITR 347 AP the assessee company was initially valuing its closing stock on the basis of Total cost method which includes the proportionate overheads for administrative , selling and interest expenses in the closing stock . However ,in the assessment year under consideration the company changed its method of valuation from Total cost to work cost method in which the proportionate administrative overheads were not included . During the course of assessment proceeding the company pleaded that the new method of valuation is more scientific and was for bonafide purposes . During appeal to the commissioner (appeal), the commissioner was satisfied that the change of method by the company from Total cost to Work cost excluding the proportionate administrative overhead exp. was for bonafide purposes. After getting confirmation from the Assessing Officer regarding the valuation of closing stock as per the revised method, the Commissioner recorded the findings that the assessee did not change the method of valuation with some ulterior purpose or with the motive of reducing its tax liability. The Commissioner directed that the opening stock of relevant accounting year should also be valued on the Work cost basis and the difference should be added to profit . During appeal to the Tribunal by the assessee against the order of Commissioner Appeal for directing the revaluation of opening stock on Works Cost basis in the year of change of valuation method the Tribunal upheld the plea of assessee and held that the decision of Commissioner Appeal to revalue the opening stock was uncalled for .The Hon'ble court upheld the decision of the Tribunal not to revalue the opening stock in view of the fact that the changed method was for bonafide purposes and not effected with the motive of reducing the income for tax purposes .Similarly, in the case of RAM

LAXMAN SUGER MILLS Vs CIT [1967] 63 ITR 51 (ALLAHABAD) the court rejected the plea of the ITO to revalue the opening stock on the basis of closing stock when the method of valuation used was cost or market price whichever is less.

CASUAL DEPARTURE IN STOCK VALUATION NOT ALLOWED

Once a particular method of valuation is chosen the same should be followed in the near future on consistent basis . The frequent change in the method of valuation may attract the risk of its non approval by the income tax authorities as well as by the appelate authorities as held in the case of SRI RAM BEARING LTD .Vs CIT (Cal) 1991 &579 the assessee company used different method of valuation of closing stock and none of them were recognised method of valuation . In one particular year the assessee valued the finished goods at listed selling price less expense to the extent of 26%. Subsequently it adopted a new method of valuation by valuing the finished goods at listed selling price less 30% to 32%on account of selling expense and a further reduction of 20%on account of unrealised profits .The new method of valuation was not accepted by the ITO and the same position was upheld by tribunal . It was held by the Hon'ble court that it might be appropriate to calculate cost of finished goods by reducing from the sale price selling expresses and estimated margin of profit but it had been found by the Tribunal that even this changed method of valuation was not adopted by the assessees on consistent basis . The new method was followed only during the Assessment year 1972-73 to 1977-78 and in later years the new method was again discontinued .The court held that this was nothing but a casual departure in the method of stock valuation and it had been rightly rejected by the tribunal.

IMPROPER METHOD OF VALUATION NOT ALLOWED

The method of valuation of closing stock should be proper one by exercise of which income of the assessee can be deduced correctly. Any basis of valuation of closing stock which does not take into its account all the related cost and expenses incurred in presenting the goods to its present position and location in addition to the cost of raw material shall not be a proper method of valuation of stock . The adoption of such improper method shall result into suppression of taxable income of the assessee as will as shifting of income of one accounting year to another accounting year .It was held by the Supreme Court in the case of CIT Vs BRITISH PAINTS INDIA LTD. that any method of valuation which is apt for diminishing the taxable profit by shifting the profit to next year by excluding in the valuation of stock in trade or work in process and finished goods, all costs other then the cost of raw material is bound to be dismissed by ITO notwithstanding the fact that such method was accepted in the past by the tax authorities . Thus while valuing the closing stock all the related expenses of production and other incidental expenses and overheads expenses incurred should be added upon in addition to the cost of raw material for deducing the correct taxable income .Similarly ,in the case of K.G.KHOSLA AND COMPANY PVT.LTD Vs CIT 99 ITR 574, the assessee valued its closing stock during the year ended 31stdec. 1959 including in the invoice price the cost of import duty and other expenses but subsequently in the year ended 31st Dec. 1960 it valued its closing stock without the addition of custom duty and other incidental expenses which was not allowed by the Tribunal and subsequently by the Court and the valuation of closing stock was increased with the proportionate cost of custom duty and other incidental expenses . The Court held that the meaning of cost given in valuation of closing stock was improper as the expenses of custom duty and other incidental expenses by their nature were attributable to cost which were not included. The ICAI has issued The Accounting Standard 2 upon valuation of inventories which should be adopted by the assessee for arriving at proper basis of valuation.

CONCLUSION :-

It is apparent from the above discussion that the process of change in method of valuation is a very critical not only from the point of view of preparation and presentation of accounts as per the generally accepted accounting policies but by the very impact of change upon the profit of the assessee which in most of the cases become the bone of contention specifically in the case of reduction in the assessable income of the assesses in the year of change .Thus ,before taking any decision of change in the method of valuation of stock the decision should be carefully weighed in view of complicated tax implications carefully evaluating the changed method of valuation under the principle of bonafide , continuity and not with some ulterior purposes with the motive of reducing the taxable income . Once the method of valuation has been changed it must be followed on consistent basis in the near future to avoid the risk of rejection of method by the tax authorities. ■