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CHANGE IN THE METHOD OF VALUATION OF INVENTORIES

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INTRODUCTION

At the initiation of the business, it becomes really important to choose the valuation method for the inventories because further it helps in realizing the reasonable income of the assessee at the end of the accounting year. It is imperative to choose the method of valuation according to the Accounting Standards as well as the business practices, if not done so, there is an actual need to change the method of valuation to the recognized method of valuation and the changed method is accepted as bonafide and the assessee is allowed to use the new method in the future.

Further the discussion revolves around the change in the method of valuation of inventories from the facet of taxation and talks about the circumstances where the change is allowed by the IT authorities, in spite of the fact that the revenue department may incur losses in the accounting year due to the aforementioned change.

The further discussed literature revolves around the change in the method of valuation of inventories. The published data is the secondary data that deal with the acceptable method of change in valuation of the inventory.

The document is divided into different sections that deal with different legal cases that conclude the methods that are accepted or unaccepted by the IT authorities. It gives a detailed description of the features of the IT Act that provides a vivid insight to the legalities that need to consider. Considering different cases, it was mentioned that the "most preferred method of valuation" is the "cost price or the market price whichever is lower."

When the discussion elevates, it came into the picture that the assessee is allowed to change the method of valuation, but just once and the reason behind the change should be bonafide and not for tax saving. The literature as it revolves around the method of valuation, it focuses on the different methods that are allowed and the chosen method has to be followed without deviation to another method. As different cases take into consideration the plea of different department of the assessee, it provides not only a background knowledge for the courts and authorities to take decisions in the same kind of cases, but also acts as base and a great help to the assessee to act in a law binding manner.

OBJECTIVES

- To have the right method of valuation of inventories from the commencement of the business

- To have knowledge about the requirements so the reason for the change in method is not contradicted by the IT Authorities

- To consider all the conditions required in presenting the financial statements so that they reveal the true picture of the assessee.

SALIENT FEATURES OF SEC 145 OF IT ACT REGARDING METHOD OF ACCOUNTING

a. Section 145 of the IT Act, revolves around the accounting method that has to be regularly followed by the assessee to compute the income under different heads like "profits and gains of business or profession" or "income from other sources" on cash or mercantile basis.
b. There is a power vested in the Central Government to announce the AS that has to be followed by the assessee in the preparation of the financial statements. The wide notification no. 9949 [F.No.132/7/95TPL] dated on 25.1.1996 of accounting standards has been prescribed by the Central Government. The notified AS are:

- AS requires the assessee to disclose all the accounting policies that he has followed to prepare the financial statements.
- It also requires the assessee to give a detail about the extraordinary items and the effect of the change in the accounting policies.

c. Under section 145 (3), the AO is given the right to assess as per his judgment, if he is not satisfied with the authenticity of the accounts or the method (Sec 145 (1)) or the AS followed (Sec 145 (2))

WHETHER CHANGE IN METHOD OF VALUATION OF INVENTORIES IS ALLOWABLE

Under section 145 (2) and 145 (3) of the Income Tax, the provisions do not define the accounting policies that need to be followed while preparing financial statements in the case of the method of valuation of inventories, but demands the acknowledgement of the accounting policies used in the preparation of accounts. A special power is given to the AO under section 145 (3) of the IT Act, that he can reject the account, if he is not satisfied with the accounts presented under two conditions – if the accounts is not correct or the assesse have seemed to violate the method of prescribed accounting under Sec 145 (1) or the accounting standards under Sec 145 (2).

It is imperative to have knowledge about the requirement of AS I & II as per the Sec. 145 (2) of IT Act to understand the eligibility of changes in method of valuation.

a. Under AS I, para 3, it is important to disclose any change in the accounting policies that has had a substantial effect in the previous years. The impact needs to be disclosed in the financial statement of the year where the actual change in the accounting policy was materialized and had an effect.
b. Under para 4, the accounting policy that is chosen by the assese should show a true image of his business. Accounting policy is defined as the specific accounting principles and the method of applying those principles adopted by the assessee in preparation and presentation of financial statements.
c. Changes in accounting policies are allowed according to AS II only if – a different policy is required by the statute or it is believed that a new policy will help in an effective preparation of accounts.
d. It is necessary to disclose the substantial change in the financial statements of the year that is experienced due to the change in the accounting policies as per para 10 of AS II

Knowing about the Sec 145 and AS I & II, following conclusion is achieved-

- The change in the method of valuation of inventories is only brought into action if it is required by the statute.
- If the prevalent method was not bonafide and the proposed method of valuation is more recognized, is it allowed to change the method of valuation of inventories so as to have a better preparation of the financial accounts.

RECOGNISED METHOD OF VALUATION

As per the judgment by the Supreme Court in case of CIT vs. British Paints India Ltd. 188 ITR 44, the valuation of the closing stock is based on the value of the cost price or market price whichever is less.
It is also allowed for the assessee to value his foreign market goods at nil when there is no demand and the assessee is not obligated to reveal his efforts of selling his goods in the market before valuing at nil. (K. Mohammed Adam Sahib vs. CIT [1965]56 ITR 360)
AS II of the ICAI deals in the valuation of inventories and as per this standard, the inventories are valued at the "historical cost" (an aggregate of the purchase cost, conversion cost and other costs that are responsible for the inventory level) or the "net realizable value" (estimated SP – completion cost – cost of sales), whichever is less.

CHANGE SHOULD BE BONAFIDE AND REGULARLY FOLLOWED THEREAFTER

The case of CIT vs. Corporation Bank 174 ITR 616 (Karnataka), accepted the plea and allowed the party to change the method of valuation of the securities from a cost basis to cost or market price, whichever is lower as the change was bonafide, but also told them to follow the new method of valuation for all the coming years. This change is only made to the valuation of the closing stock and not to the opening stock. This will affect the revenue earned but it is slowly worn off in the coming years when the same valuation method is practiced.

PLEA OF DEPT. FOR OPPOSING THE ADOPTION OF CHANGED METHOD OF VALUATION REJECTED

When the method of valuation is changed, the new method has to be followed by the assessee for all the coming years and to change the method again becomes difficult. Due to this reason, the revenue department opposes to the change in the method. It was seen in the case of Triveni Engg. Works Ltd. vs. CIT 167 ITR 742, Allahabad, where the plea was opposed by the tax authorities to change the method of valuation from market price to market price or cost price, whichever is less. In this it was concluded by the Hon'ble Court that according to Sec 145 (1), the profits and gains of business and income from other sources should be calculated using the method that has been followed regularly by the assessee.
An assessee should select a method that reveals the true income of the assessee and as no prescribed method exists for valuation of stock as per the laws and rules, the method of cost price or market price whichever is lower must be adopted by the assessee. Therefore the plea was overruled that once market price is chosen as a method is cannot be changed further.

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

Due to the change in the method of valuation, there are changes of either an increase in income or a decrease in income. The increase in income is usually avoided by the authorities, but a reduction gives rise to doubt of purposeful tax reduction. This was held in the case of Forest Industries Travancore Ltd. vs. CIT (1964) 51ITR 329, if the market price is less than the cost price, the change is bonafide and the new method is brought to application.

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

In this change of method, only the closing stock is revalued and opening stock remains unchanged. This affects the income, but if the purpose of the change in the method is bonafide and not for ulterior purposes, it is accepted and only the closing stock is valued.

In the case of CIT vs. Mopeds India Ltd. 173 ITR 347, the assessee changed the method of valuation from total cost to work cost method and requested to use the new method for the valuation of opening stock as well but this plea was rejected by the Tribunal and the Honorable Court followed the same and dint allow to revalue the opening stock as per the new method as the change was bonafide and not for some ulterior purposes.

CASUAL DEPARTURE IN STOCK VALUATION NOT ALLOWED

In the case of Sri Ram Bearing Ltd. vs. CIT 1991 &579, the assessee company followed many methods that were not recognized and rational and hence this was not appreciated, it was clearly noticed by the Tribunal that same methods of valuation were only used in the year 1972-73 and 1977-78 and then again dropped. This was regarded as a casual departure in stock valuation and hence was rejected. Therefore, it is necessary that when the method of valuation is changed, the new method is followed and continued for all the coming years and it is not appreciated to change the method of valuation.

IMPROPER METHOD OF VALUATION NOT ALLOWED

A proper method of valuation needs to be used that reveals the true income of the company in the most realistic and logical manner. A method is said to be improper if all costs are not recorded properly, including the cost of raw material. This doesn't reveal the true income and leads to shifting of income from one year to the other.

In the case of CIT vs. British Paints India Ltd. and K.G Khosla and Company Pvt. Ltd. vs. CIT 99ITR 574, it was concluded that all the costs need to be disclosed and the assessee cannot hide any costs in valuation of the inventory.

CONCLUSION

After a detailed study of all the topics related to the change in the method of valuation of inventories, it can be easily concluded that it is a very important decision whether to change the method or not as it has an adverse effect on the profit of the assessee. The decision regarding the method should be well discussed and correctly taken because the new method has to be followed for all the years so that it may not lead to any tax implications in the near future. It is should also be kept in mind that the reason for the change in the method of valuation of inventories is bonafide and not for ulterior purposes to reduce the tax impact on the income.