

Commissioner of Income-tax, Calcutta

Vs

British Paints India Ltd.

Civil Appeal Nos. 1918-19 of 1976

(Dr. T.K. Thommen, M.M. Punchhi JJ)

13.12.1990

JUDGMENT

THOMMEN J

1. These appeals by certificate arise from the judgment dated August 22, 1974 of the Calcutta High Court in I.T. R. No. 9 of 1970 (reported in 1976 (1) Cal LJ 102) concerning the assessment years 1963-64 and 1964-65, relevant to the accounting years ended 31-12-1962 and 31-12-1963.

Answering the question referred to it in the negative and against the Revenue, the High Court stated that the Income-tax Appellate Tribunal was not justified in rejecting the method of valuation of the goods in process and the finished products on the basis of the cost of raw material after excluding altogether the overhead expenditure. The Tribunal had by its Order dated 27-2-1969 upheld the findings of the Income-tax Officer, as confirmed by the Appellate Assistant Commissioner, that the assessee's goods in process and finished products were liable to be valued at 100 percent of the cost which included the overhead expenditure and not at 84.49 per cent. as claimed by the assessee.

2. The assessee is a limited liability company engaged in the business of manufacture and sale of paints. It contended before the authorities that it had been its consistent practice to value the goods in process and finished products exclusively at cost of raw materials and totally excluding overhead expenditure. The justification for this practice, according to the assessee, was that the goods being paints had limited storage life and, if not quickly disposed of, they were liable to lose their market value. This contention of the assessee was rejected by the Income-tax Officer observing that at no time had the assessee claimed any deduction on account of deterioration or damage to goods. The Officer held that there was no justification to recognise a practice, as claimed by the assessee, of valuing its stock otherwise than in accordance with the well-recognised principle of accounting which required the stock to be valued at either cost (raw material + expenditure) or market price, whichever was the lower. Recalculating the value of the opening and closing stocks by adding the overhead expenditure, the Officer made an addition of Rs. 1,04,417/- for the assessment year 1963-64 and allowed a deduction of Rs. 3,338/- for the assessment year 1964-65. These orders, as stated above, were confirmed by the Assistant Appellate Commissioner and by the Tribunal.

3. The Tribunal held that there was no evidence to show that the goods in stock deteriorated in value and there was no justification for excluding the overhead expenditure in valuing the stock. If it was in the interest of the business to value stock solely with reference to the cost of raw materials and without including the overhead expenditure, such valuation was not appropriate to the computation of income chargeable under the Income-tax Act. The High Court noticed that there was no evidence

of deterioration of the goods in stock. But after an exhaustive review of the case law on the question, the learned judges came to the conclusion that, having regard to the consistent practice of the assessee, the Tribunal was not justified in rejecting the assessee's method of valuation of its stock-in-trade.

4. The computation made by the Income-tax Officer in making the addition and deduction for the respective years was in exercise of his power under Section 145 of the Income-tax Act, 1961. This provision, in so far as it is material, reads:

"145. (1) Income chargeable under the head 'Profits 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:

Provided that in any case where the accounts are correct and complete to the satisfaction of the Assessing Officer but the method employed is such that, in the opinion of the Assessing Officer, the income cannot properly be deduced therefrom, then the computation shall be made upon such basis and in such manner as the Assessing Officer may determine:.....

The question to be determined by the Assessing Officer in exercise of his power under this provision is whether or not income can properly be deduced from the accounts maintained by the assessee, even if the accounts are correct and complete to the satisfaction of the Officer and the income has been computed in accordance with the method of accounting regularly employed by the assessee. What is to be determined by the Officer in exercise of his power is a question of fact, i.e., whether or not income chargeable under the Act can properly be deduced from the books of account, and he must decide the question with reference to the relevant material and in accordance with the correct principles. In the words of Viscount Haldane "it is plain that the question of what is or is not profit or gain must primarily be one of fact, and of fact to be ascertained by the tests applied in ordinary business" (*Sun Insurance Office v. Clark*, 1912 AC 443). Referring to Section 13 of the Income-tax Act, 1922, which corresponds to Section 145 of the Income-tax Act, 1961, this Court had stated in *Chhabildas Tribhuvan, das Shah v. Commr. of Income-tax, West Bengal* (1966) 59 ITR 733, 737:

"We may point out that we are not concerned with the correctness of the conclusion and we are only concerned with the question whether there is any material in support of the finding of the Appellate Tribunal. In cases involving the applicability of the proviso to Section 13, the question to be determined by the Income-tax Officer is a question of fact, namely, whether the income, profits and gains can or cannot be properly deduced from the method of accounting regularly adopted by the assessee. There is nothing special about this question of fact, and generally the only question of law that can possibly arise 'is whether there is any material for the finding... "

5. The facts are not in dispute. It is the assessee's case that the stock-in-trade has been valued at 84.49 per cent. representing the actual cost of the raw materials. The overhead charges representing 15.51 per cent. of the total cost have been admittedly excluded from the assessee's valuation of the stock. But by the very method of accounting which the assessee has adopted, it is possible for the Income-tax Officer to make the necessary additions or deductions so as to arrive at the correct value

of the stock for the purpose of determining the chargeable income. The correctness of the accounts maintained by the assessee is not in question; nor is the system adopted by the assessee, except insofar as the stock is valued without taking into account the production expenditure. The question, therefore, is whether or not the Assessing Officer is justified in holding that the stock-in trade of the assessee has necessarily to be valued, for the purpose of computing the income, at 100 per cent. of the cost, and not at 84.49 per cent, as the assessee has admittedly done.

6. It is contended on behalf of the assessee that for a number of years the Revenue did not question the method of accounting regularly employed by the assessee. It was during the assessment years in question that objection was raised -for the first time on the ground that overhead expenditure was not included in the value of the stock The Revenue has; however, not questioned' the correctness of the accounts. The Assessing Officer, according to counsel, has exceeded his jurisdiction by adding the overhead expenditure to the cost of raw material, especially because of the short durability of paint. The Officer has not appreciated that the method adopted by the assessee is a well recognised method among accountants of repute.

7. The assessee's counsel places much reliance upon the decision of the House of Lords in *Duple Motor Bodies Ltd. v. Inland Revenue Commissioners*, (1961) 1 WLR 739. That, was a case where the assessee carried on the business of building bodies for motor-coaches. At the end of each accounting period 'the assessee had in hand a number of un.finished bodies. In computing the value of work in progress for income-tax purposes the assessee adopted what is called the 'direct cost' method, on the basis of which only the direct cost of raw materials and labour expended on the work was taken into account. The Revenue sought to value the work in progress on an 'on-cost' basis. The direct cost method, as adopted by the assessee in that case, takes into account monies spent solely for the purpose of the manufacture of the particular goods, whilst the on-cost method treats, as an additional item of cost, proportions of various items of expenditure incurred in connection with the manufacture of those goods as well as of other goods. The two principal elements in 'direct cost', as adopted by the assessee in that case, are labour and raw-materials and that method is far more accurate in respect of the goods in progress which by their very nature have insignificant market value. On the other hand there is much uncertainty in the 'on-cost' method. The House of Lords held that particularly in view of the fact that the direct cost method had been applied consistently in the past and being more accurate as a method of computation, the assessing authority was not justified in discarding that method and adopting the 'on-cost' method, especially when great uncertainty was attached to it. The decision in that case turned on the peculiar facts concerning goods in progress which by their very nature, being unfinished goods, had limited market value and to value them otherwise than by the direct cost method was uncertain and inaccurate and did not give a true value of the goods for the purpose of computing the correct income.

8. In the present case, what the assessee contends for is neither the 'direct cost' method nor any other method which takes into account the actual or even part of the cost involved in the manufacture of the goods in process and finished products. What it contends for is valuation of the raw material without taking into account any portion of the cost of manufacture. No decision has been brought to our notice in support of such contention. The question of fact which the Assessing Officer must necessarily decide is whether or not the method of accounting followed by the assessee discloses the true income.

9. It is a well recognised principle of commercial accounting to enter in the profit and loss account the value of the stock-intrade at the beginning and at the end of the accounting year at cost or market price, whichever is the lower. As stated by the Lord President in *Whimster & Co. v.*

Commissioners of Inland Revenue, (1917-26) 12 Tax Cas 813, 823:

..... In computing the balance of profits and gains for the purposes of Income-tax..... two general and fundamental 'Common places have always to be kept in mind. In the first place, the profits of any particular year or accounting period must be taken to consist of the difference between the receipts from the trade or business during such year or a accounting period and the expenditure laid out to earn those receipts. In the second place, the account of profit and loss to be made up for the purpose of ascertaining that difference must be framed consistently with the ordinary principles of commercial accounting, so far as applicable, and in conformity, with the rules of the Income-tax Act, or of that Act as modified by the provisions and schedules of the Acts regulating Excess Profits Duty, as the case may be. For example, the ordinary principles of commercial accounting require that in the profit and loss account of a merchant's or manufacturer's business the values of the stock-in-trade at the beginning and at the end of the period covered by the account should be entered at cost or market price, whichever is the lower; although there is nothing about this in the taxing statutes....

10. Where the market value has fallen before the date of valuation and at that date the market value of the article is less than its actual cost, the assessee is entitled to value the articles at market value and thus anticipate the loss which he will probably incur at the time of the sale of goods. Valuation of the stock-in-trade at cost or market value, whichever is the lower, is a matter entirely within the discretion of the assessee. But whichever method he adopts, it should disclose a true picture of his profits and gains. If, on the other hand, he adopts a system which does not disclose the true state of affairs for the determination of tax, even if it is ideally suited for other purposes of his business, such as the creation of a reserve, declaration of dividends, planning and the like, it is the duty of the Assessing Officer to adopt any such computation as he deems appropriate for proper determination of the true income of the assessee. This is not only a right but a duty that is placed on the Officer, in terms of the first proviso to Section 145 which concerns a correct and complete account, but which in the opinion of the Officer does not disclose a true and proper income.

11. The correct principle of accounting is to enter the stock in the books of accounts at cost unless the value is required to be reduced by reason of the fall of the market value of those goods below their original cost. Ordinarily, therefore, the goods should not be written down below the cost price except where there is an actual or anticipated loss. On the other hand, if the fall in the price is only such as it will reduce merely the prospective profit, there would be no justification to discard the initial valuation at cost. In *B.S.C. footwear v. Ridgway (Inspector of Taxes)*, (1971) 2 WLR 1313, Lord Pearson, criticising retailer's stock, observed:

"Then is the incorrectness of the stock valuations such as to be likely to distort the assessment' of the profits and gains for the year? The system produces a comparatively low valuation of the opening stock at the beginning of the year and a comparatively low valuation of the closing stock at the end of the year and therefore a comparatively low difference between them Then in a period of rising turnover and rising prices the difference is an element of profit, and by keeping down that difference the system diminishes the assessment of taxable profit for the year. Over a series of years there is a continuing deferment of tax liability. In my opinion, therefore, system does produce some distortion of the assessment of taxable profits for any particular year."

In that case, the House of Lords accepted the contention of the Inland Revenue that, although the assessee's system of stock valuation had been accepted for tax purposes for many years up to 1959, it was liable to be rejected for the relevant and subsequent years as the system adopted by the assessee was likely to produce stock valuations which were seriously and substantially incorrect, thereby causing distortion of the assessment of the profits and gains for the year.

12. It is not only the right but the duty of the Assessing Officer to consider whether or not the books disclose the true state of accounts and the correct income can be deduced therefrom. It is incorrect to say, as contended on behalf of the assessee, that the Officer is bound to accept the system of accounting regularly employed by the assessee the correctness of which had not been questioned in the past. There is no estoppel in these matters, and the Officer is not bound by the method followed in the earlier years.

13. In *Commr. of Income-tax, Bombay v. Sarangpur Cotton Manufacturing Co. Ltd.*, (1938) 6 ITR 36 : (AIR 1938 PC 1), Lord Thankerton stated that Section 13 of the Income-tax Act, 1922 related to a method of accounting regularly employed by the assessee. The section postulated that such a method of accounting was the necessary basis of computation, unless in the opinion of the Income-tax Officer, the income, profits and gains could not properly be deduced from such method. But it could very well be that, "though the profit brought out in the accounts is not the true figure for income-tax purposes, the true figure can be accurately deduced therefrom..... But it was not correct view that the Income -tax Officer was ,prima facie entitled" to accept the profits mentioned in the accounts where there was a method, of accounting regularly employed by the assessee. "It is the duty of the Income-tax Officer, where there is such a method of accounting to consider whether income, profits and gains can properly be deduced therefrom, and to proceed according to his judgment on this question (p. 43).

14. In *Commr. of Income-tax, Madras v. A. Krishnaswami Mudaliar*, (1964) 53 ITR ,1 22, 128: (AIR 1964 SC 1843 at p. 1847), this Court, referring to the earlier decisions on the point, observed:

"Again as observed by this Court in *Commr. of Income-tax v. Mc-Milan and Co.*, (1958) 33 ITR 182: (AIR 1958 SC 207), the expression 'in the opinion of the Income-tax Officer' in the proviso to Section 13 of the Indian Income-tax Act, 1922, does not confer mere discretionary power in the context it imposes a statutory duty on the Income-tax Officer to examine in every case the method of accounting employed by the assessee and to see whether or not it has been regularly employed and to determine whether the income, profits and gains of the assessee could properly be deduced therefrom".

The Officer has to consider the material placed before him, and, if upon such consideration, he is of the opinion that correct profits and gains could not be deduced from the accounts, he would then be obliged to have recourse to the proviso to Section 145. (See the principle stated in *S. N. Namasivayam Chettiar v. Commr. of Income-tax, Madras*, (1960) 38 ITR 579, 588: (AIR 1960 SC 729. at p. 734)).

15. For the computation of the true profits of the year in the case of a trade adventure, each year being a self-contained unit, the value of the stock-in-trade at the beginning and at the end of the accounting year has to be taken into account. In *Commissioners of Inland Revenue v. Cock, Russell and Co. Ltd.* (1949) 29 Tax Cas 387, 392, Croom Johnson, J. stated:

"..... there is no word in the statutes or Rules which deals with this question of valuing, stock-in-trade. There is nothing in the relevant legislation which indicates that in computing the profits and gains of a commercial concern the stock-in-trade at the start of the accounting period should be taken in and that the amount of the stock-in-trade at the end of the period should also be taken in. It would be 'fantastic not to do it; it would be utterly impossible accurately to assess profits and gains merely on a statement of receipts and payments or on the basis of turnover. It has long been recognised that the right method of assessing profits and gains is to take into account the value of the stock-in-trade at the beginning and the value of the stock-in-trade at the end as two of the items in the computation. I need not cite authority for the general proposition, which is admitted at the Bar, that for the purposes of ascertaining profits and gains the ordinary principles of commercial accounting should be applied, so long as they do not conflict with any express provision of the relevant statutes."

Referring to these observations, Shah, J., as he then was, in *Commr. of Income-tax, Madras v. A. Krishnaswami Mudaliar*, (1964) 53 ITR 122, 132 : (AIR 1964 SC 1843 at p. 1849)says:

"We have already said that in England there is no provision which compels the tax officer to adopt in the computation of income the system of accounting regularly employed by the assessee. But whatever may be the system, whether it is cash or mercantile, as observed by Croom-Joanson, J. in a trading venture'it would be impossible accurately to assess the true profits without taking into account the value of the stock-in-trade at the beginning and at the end of the year

16. The Income-tax Act does not contain any specific provision for the valuation of stock. Income, profits and gains must, however, be computed in the manner provided by the Act. It is the duty of the Officer to determine the profits and gains of a commercial adventure according to the correct principle of accounting. In doing so, he might, depending on the nature of the business and its special character, allow certain adjustments, but his primary purpose and duty is to deduce the correct income, profits and gains, and. this he cannot do without taking into account the value of the stock-in-trade at the beginning and at the end of the year and by ascertaining the difference between them: See *P. M. Mohammed Meerakhan v. Commr. of Income-tax, Kerala*, (1 969) 73 ITR 735: (AIR 1969 SC 1053):

17. The object of stock valuation is the correct determination of the profit and loss resulting from a year's trading. It is the true result of the trading activity of that year that must b'e disclosed by the books.

..... the profits are the profits realised in the course of the year. What seems an exception is recognised where a trader purchased and still holds goods or stocks which have fallen in value. No loss has been realised. Loss may not occur. Nevertheless, at the close of the year he is permitted to treat these goods or stocks as of their market value". (*Whimster & Co. v. Commissioners of Inland Revenue*, (1926) 12 Tax Cas 813, 827).

As stated by Patanjali Sastri, C.J., in *Chainrup Sampatram v. Commr. of Income-tax, West Bengal*, (1953) 24 ITR 481, 485-486 (AIR 1953 SC 519 at p. 520):

"..... It is wrong to assume that the valuation of the closing stock at market rate has, for its object, the bringing into charge any appreciation in the value of such stock. The true purpose of crediting the value of unsold stock is to balance the cost of those goods entered on the other side of the account at the time of their purchase, so that the cancelling out of the entries relating to the same stock from both sides of the account would leave only the transactions on which there have been actual sales in the course of the year showing the profit or loss actually realised on the year's trading..."

In the words of Singleton L.J. in *Patrick (Inspector of Taxes) v. Broadstone Mills Ltd.*, (1954) 25 ITR 377, 395:

".....(1) One cannot arrive at the profits of the year without taking into account the value of the stock one has at the beginning of, and at the end of, the accounting year. (2) The figures for stock are just as important as any other figures. Values may have to be estimated when market price is taken, but any departure from accuracy is reflected in the trading account. (3) Stock should be taken either at cost price or at market price, whichever is the lower....."

18. Lord Herschell in *Russell v. Town and County Bank*, (1888) 13 App Cas 418, 424: 4 TLR 500, observes:

"The 'profit of a trade or business was the surplus by which the receipts exceeded the expenditure necessary for the purpose of earning those receipts..."

19. What is the profit of a trade or business is a question of fact and it must be ascertained, as all facts must be ascertained, with reference to the relevant evidence, and not on doctrines or theories: "no assumption need be made unless the facts cannot be ascertained, and then only to the extent to which they cannot be ascertained. There is no room for theories as to flow of costs (*Minister of National Revenue v. Anaconda American Brass Ltd.*, (1956) AC 85 : (1956) ITR 84, 99).

20. Section 145 of the Income-tax Act, 1961 confers sufficient power upon the Officer - nay it imposes a duty upon him -to make such computation in such manner as he determines for deducing the correct profits and gains. This means that where accounts are prepared without disclosing the real cost of the stock-in-trade, albeit on sound expert advice in the interest of efficient administration of the company, it is the duty of the Income-tax Officer to determine the taxable income by making such computation as he thinks fit.

21. Any system of accounting which excludes, for the valuation of the stock-in-trade, all costs other than the cost of raw material for the goods in process and finished products is likely to result in a distorted picture of the true state of the business for the purpose of computing the chargeable income. Such a system may produce a comparatively lower valuation of the opening stock and the closing stock, thus showing a comparatively low difference between the two. In a period of rising turnover and rising prices, the system adopted by the assessee, as found by the Tribunal, is apt to diminish the assessment of the taxable profit of a year. The profit of one year is likely to be shifted to another year which is an incorrect method of computing profits and gains for the purpose of assessment. Each year being a self-contained unit, and the taxes of a particular year being payable with reference to the income of that year, as computed in terms of the Act, the method adopted by the assessee has been found to be such that income cannot properly be deduced therefrom. It is,

therefore, not only the right but the duty of the Assessing Officer to act in exercise of his statutory power, as he has done in the instant case, for determining what, in his opinion, is the correct taxable income.

22. The Tribunal's order, affirming that .of the Assessing officer. was based on findings of fact made on cogent evidence and in accordance with correct principles. The High Court was clearly wrong in interfering with those findings.

23. Accordingly, we set aside the judgment of the High Court and allow the appeals of the Revenue with costs throughout.

Appeals allowed.

</html