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COMMISSIONER OF INCOME TAX, UDAIPUR

v

M/S. HINDUSTAN ZINC LTD.

MAY 18, 2007

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[S.H. KAPADIA AND B. SUDERSHAN REDDY, JJ.]

*Income Tax Act, 1961;*

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*Valuation of closing stock—Exporting of accumulated stock of zinc concentrate by assessee—a Government Company—Fixing of International Price lower than Weighted Average Cost/domestic price—Additions in income of the assessee for the accounting year during which such stock accumulated—Correctness of—Held: In the past assessee has been valuing the commodity in question at net realizable value at the domestic prices—International*

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*prices of the commodity were lower than the domestic prices—Under the circumstances, Auditor rightly observed in his report that had the net realizable value stood estimated in accordance with the past accounting policy, the profit of the Company would have been higher by certain amount—Besides, there is no anticipated loss but reduction in the prospective profit in the present case—Hence, Income Tax Appellate Tribunal erred in deleting the*

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*additions made in the assessment in terms of auditors' report.*

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**Respondent-assessee, a Government Company, was engaged in the business of production of zinc concentrate and utilizing the same captively. During the assessment year 1996-97, a huge quantity of zinc concentrate got accumulated and it was not possible for the assessee to consume the accumulated quantity. Since domestic consumption of the accumulated stock was not possible the assessee decided to explore the possibilities of exporting the accumulated stock. With the permission of the Government, the assessee decided to price "zinc concentrate" for the purpose of sale by adopting the London Metallic Exchange (LME) Price as on 31.3.1996 however, the LME price was lower than the Weighted Average Cost (WAC) by Rs. 27.08 crores.**

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**Auditors also made certain recommendations, accordingly, the Assessing Officer made in addition to the income of the assessee for the accounting year ending 31.3.1996. Aggrieved by the order of the A.O. the assessee-respondent preferred an appeal before the appellate authorities, which was**

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partly allowed by the authorities. The assessee preferred an appeal before the ITAT which was allowed by the tribunal by directing Revenue to delete the additions made to the income of the assessee. Aggrieved, the Revenue preferred an appeal before the High Court which was dismissed by the High Court. Hence this appeal.

Revenue contend that on the facts and circumstances of the case there was no reason for the assessee to change the method accounting; that in the financial year ending 31.3.1996 there were no export sales, therefore, there was no question of taking into account the factum of export sales in the next accounting year ending 31.3.97; that there was no allegation that the accumulated stock and zinc concentrate was a junk which had no market in India; that the Auditors' Report clearly indicated that if the accounting policy of the earlier years was to be followed then in that event the profits would have increased by Rs. 27.08 crores; that in view of the Auditors' Report, Department was right in add back to the income of the assessee and that while valuing the closing stock it was not open to the assessee to say that the net realizable value estimated on the basis of LME price resulted in a loss that it was lower than WAC and that there was reduction in value; and that even under the accounting principles though reduction in value was admissible, the same was possible only in the year in which the same took place and since in the present case there were no export sales in the financial year 1995-96, the assessee was not entitled to claim reduction in value on the basis of LME price.

On behalf of the assessee-respondent it was submitted that the accumulated stock had no market for sale in India; that the assessee was a Government company; that the accumulated stock of zinc concentrate had low metal content and it had high impurity level of silica and, therefore, it was not fit for captive consumption; that under the circumstances with the permission of the Government, the assessee had to segregate the quantity which was capable of captive consumption and the balance of the stock which was not capable of captive consumption and which had to be sold; that, there were no buyers in India for the accumulated stock; that the Auditors failed to recognize such segregation. In the circumstances, a new commodity came into existence during the financial year 1995-96 which had to be given a new accounting treatment; that, in accordance with the principles of prudential accounting the assessee did not carry forward the current assets in excess of the amount expected to be realized in the ordinary course of business and, therefore, the quantity identified for sale was valued at net realizable value

- A from exports on the basis of LME (London Mettalic Exchange) Price; that the assessee has, therefore, acted on the accepted accounting practice recognized by the Institute of Chartered Accountants in India by way of Accounting Standards; that LME price was the best estimate of the market value of the said commodity as on 31.3.96; that the Revenue has failed to take into account the principle of anticipated loses which valuing the closing stock;
- B and that it was open to the assessee to value the inventory in the present case at below cost.

Allowing the appeal, the Court

- C HELD: 1.1. The narrow controversy involved in the present case is whether the assessee was right in writing down the inventory (zinc concentrate) below the cost price by estimating its net realizable value at London Mettalic Exchange Price and not by estimating its net realizable value at the domestic price. [Para 10] [309-A, B]

- D 1.2. There is no dispute in the present case that as on 31.3.96, the international prices of zinc concentrates were lower than the domestic price thereof. Further, in the past the assessee has been valuing zinc concentrates at net realizable value at the domestic prices. It is for this reason that Auditors in their Report have categorically stated that if the net realizable value stood estimated in accordance with the past accounting policy (at domestic prices)
- E the profits of the company would have been higher by Rs. 27.08 crores. This Report of the Auditors is not erroneous as sought to be urged on behalf of the assessee. [Para 10] [309-B, C]

- F 1.3. It is not the case of anticipated loss, it is the case of reduction in the prospective profits. Hence, the ITAT had erred in deleting the additions made in the assessment. [Paras 10 and 11] [309-D, E]

*Chainrup Sampatram v. Commissioner of Income Tax, West Bengal, (1953) 24 ITR 481 SC and Commissioner of Income-Tax v. British Paints India Ltd., (1991) 188 ITR 44 SC, relied on.*

- G CIVIL APPELLATE JURISDICTION : Civil Appeal No. 1179 of 2007.

From the Final Judgment and Order dated 14.11.2005 of the High Court of Judicature for Rajasthan at Jodhpur, in D.B. Income Tax Appeal No. 25 of 2003.

- H P.P. Malhotra, ASG., K.K. Senthivelan, Chetan Chawla and B.V. Balaram

Das for the Appellant. A

K. Sampath, Lakshmi Iyengar R.K. Raghavan, S. Krishnan and Rani Chhabra for the Respondent.

The Judgment of the Court was delivered by

**KAPADIA, J. 1.** A Short question which arises for determination in this civil appeal is : Whether ITAT was justified in Law, on the facts and circumstances of this case, in holding that the method adopted by the assessee for valuation of closing stock of "zinc concentrate" at the international rate, was in order, particularly when there was no export during the financial year ending 31.3.96 and particularly when in the past the assessee has been valuing the closing stock of zinc concentrate for captive consumption at the weighted average cost. The facts giving rise to this civil appeal briefly are as follows. B  
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2. At the relevant time respondent-assessee was a Government Company. In this civil appeal we are concerned with the assessment year 1996-97. Assessee was engaged in the business of producing zinc concentrate which was utilized by the assessee captively. During the assessment year 1996-97, zinc concentrate got accumulated to the extent of 84000 metric tones (approximately). It was not possible to consume the said quantity as the accumulated stocks contained low metal content and high impurity level of silica. Further, no other plant in India had the ability of producing zinc concentrate in a viable manner. Since domestic consumption of the accumulated stock was not possible the assessee decided to explore the possibilities of exporting the accumulated stock. Further in 1991, on account of economic reforms, globalization came to India. Therefore, the assessee-company took the decision in consultation with the Government to export the accumulated quantity of zinc concentrate. With the permission of the Government, the assessee decided to price "zinc concentrate" for the purpose of sale by adopting what is called as the London Metallic Exchange Price (for short, 'LME price) as on 31.3.1996 the LME price was lower than the weighted Average Cost (for Short, 'WAC' by Rs. 27.08 crores. However, the A.O. took the view that during the financial year 1995-96 there was no export sale of zinc concentrate; that in the Auditors' Report there was a categorical observation that the decrease in the value of inventory by Rs. 27.08 crores was not in accordance with the accounting policy of the company and if the inventory would have been valued at the domestic price then the company's profit would have been higher than by Rs. 27.08 crores. According to the A.O., in D  
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- A** view of the above Auditors' Report, an addition was inquired to be made to the income of assessee for the accounting year ending 31.3.96. According to the assessee-respondent, the allegation made by the A.O. that there was no export sale during the said year was not relevant as the goods were lying in stock and they were supposed to be sold out in the succeeding years.
- B** According to the assessee, the goods were actually exported out of India in subsequent years.

**C** 3. Aggrieved by the order of the A.O. the assessee-respondent preferred an appeal before CIT (A) which was partly allowed. The assessee further carried the matter in appeal before the ITAT which deleted the additions made to the income of the assessee.

**D** 4. Aggrieved by the decision of the ITAT, Department preferred an appeal before the Division Bench of the High Court which was of the opinion that no substantial question of law as suggested by the Department arose for consideration. Hence this civil appeal.

**E** 5. Mr. P.P. Malhotra, Additional Solicitor General, appearing on behalf of the Department submitted that on the facts and circumstances of the case there was no reason for the assessee to change the method of accounting. It was urged that in the financial year ending 31.3.96 there were no export sales and, therefore, there was no question of taking into account the factum of export sales in the next accounting year ending 31.3.97. Learned counsel submitted that in the present case there was no allegation that the accumulated stock and zinc concentrate was a junk which had no market in India. Learned counsel urged that the Auditors' Report in the present case clearly indicated that if the accounting policy of the earlier years was to be followed then in that event the profits would have increased by Rs. 27.08 crores. Learned counsel urged that in view of the said Auditors' Report the Department was right in add back to the income of the assessee for the financial year ending 31.3.96.

**G** 6. Mr. K. Sampath, learned advocate appearing on behalf of the assessee-respondent, on the other hand submitted that the accumulated stock had no market for sale in India. He urged that the assessee was a Government Company; that the accumulated stock of zinc concentrate had low metal content and it had high impurity level of silica and, therefore, it was not fit for captive consumption. Learned advocate submitted that under the above circumstances with the permission of the Government, the assessee had to segregate the quantity which was capable of captive consumption and the

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balance of the stock which was not capable of captive consumption and which had to be sold. however, there were no buyers in India for the accumulated stock. Learned advocate urged that the portion of the stock which had to be sold constituted a new commodity. Learned advocate submitted that the Auditors failed to recognize such segregation. In the circumstances, according to the assessee, a new commodity came into existence during the financial year 1995-96 which had to be given a new accounting treatment. In this connection, learned advocate for the assessee placed reliance on the letter dated 10.8.98 in which the assessee had stated that the international rate showed a declining trend in the prices of zinc concentrate and, therefore, it became necessary to write down the inventory to the net realizable value. That, in accordance with the principles of prudential accounting the assessee did not carry forward the current assets in excess of the amount expected to be realized in the ordinary course of business and, therefore, the quantity identified for sale was valued at net realizable value from exports on the basis of LME price. Learned advocate urged that the assessee has, therefore, acted on the accepted accounting practice recognized by the Institute of Chartered Accountants In India by way of Accounting Standards. This letter has been noted in the Assessment Order (at Page 47 of the S.L.P. paper book). In this connection learned counsel placed reliance on the authorities mentioned hereinbelow. It was further urged that LME price was the best estimate of the market value of the said commodity on 31.3.96. Learned advocate also relied upon the circular of the Board of Direct Taxes which stated that the Department was not entitled to deviate from the Accounting Standards. According to learned advocate for the assessee, the Department has failed to take into account the principle of anticipated losses while valuing the closing stock. Learned advocate submitted that it was open to the assessee to value the inventory in the present case at Below Cost.

7. In rejoinder Mr. P.P. Malhotra, learned ASG appearing on behalf of the Department Urged that the Auditors' Report is the basis of the Assessment Order. It was pointed out that while valuing the closing stock it was not open to the assessee to say that the net realizable value estimated on the basis of LME price resulted in a loss; that it was lower than WAC and that there was reduction in value. Learned counsel submitted that even under the accounting principles though reduction in value was admissible, the same was possible only in the year in which the same took place and since in the present case there were no export sales in the financial year 1995-96, the assessee was not entitled to claim reduction in value on the basis of LME price.

A 8. In the Case of *Chainrup Sampatram v. Commissioner of Income Tax, West Bengal*, (1953) 24 ITR 481 SC, it has been held by this Court that valuation of unsold stock at the close of the accounting period was a necessary part of the process of determining the trading results of that period. It cannot be regarded as a source of profits. Profits can be correctly ascertained only after bringing into the trading account the closing stock wherever it may exist. It was further held that the true purpose of crediting the value of unsold stock is to balance the cost of the goods entered on the other side of the account at the time of their purchase so that on cancelling out of the entries relating to the same stock from both sides of the account would leave only the transactions in which actual sales in the course of the year have taken place and thereby showing the profit or loss actually realized on the years trading. The entry for stock which appears in a trading account is merely intended to cancel the charge for the goods purchased which have not been should necessarily represent the cost of the goods. If it is more or less than the cost, then the effect is to state the profit on the goods actually sold. From the doctrine there is one exception, namely, the adoption of market value at the date of making up of accounts, if that value is less than the cost. This is in anticipation of the loss that may be made on the goods in the following year. While anticipated loss is taken into account, anticipated profit in the shape of appreciated value of the closing stock is not brought into the account as no prudent trader would care to show increased profits before actual realization. This theory that the closing stock is to be valued at cost or market price whichever is the lower, is now generally accepted as an established rule of commercial practices and accountancy.

9. To the same effect is the judgment of this Court in the case of *Commissioner of Income Tax v. British Paints India Ltd.* (1991) 188 ITR 44 SC. In the said judgment it has been held that is a well-recognized principle of commercial accounting to enter in the profit and loss account the value of the Stock-in-trade at the beginning and at the end of the accounting year at cost or market price, whichever is the lower. where the market value has fallen before the date of valuation and where the market value of the article on that date is less than its actual cost, the assessee is entitled to value the articles at market value and thus anticipate the loss which he may incur at the time of the sale of the goods. It was further held that the correct principle of accounting is to enter the stock in the books of account at cost unless the value is required to be reduced by reason of the fall in the market value of the goods below the 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 would reduce merely the prospective profit, there would be no justification to discard the initial valuation at cost. A

10. The narrow controversy involved in the present case is whether the assessee was right in writing down the inventory (zinc concentrate) below the cost price by estimating its net realizable value at LME price and not by estimating its net realizable value at the domestic price. There is no dispute in the present case that as on 31.3.96 the international prices of zinc concentrates were lower than the domestic prices thereof. Further, in the past the assessee has been valuing zinc concentrates at net realizable value at the domestic prices. It is for this reason that Auditors in their Report have categorically stated that if the net realizable value stood estimated in accordance with the past accounting policy (at domestic prices) the profits of the company would have been higher by Rs. 27.08 crores. This Report of the Auditors is not erroneous as it sought to be urged on behalf of the assessee. There is no rectification of the said Report. In the case of *British Paints* (Supra) it has held by this out that if the fall in the price has the effect of merely reducing the prospective profits (which appears to be the case if one looks at the Auditors' Report) there would be no justification to discard the valuation at Cost. Therefore, in our view, the present case is not the case of anticipated loss, it is the case of reduction in the prospective profits. B C D

11. For the aforesaid reasons, we are of the view that the ITAT had erred in deleting the additions made in the assessment. Accordingly, the appeal is allowed and the impugned judgment of the High Court is set aside with no order as to costs. E

S.K.S.

Appeal allowed.