

Assessee can change method of ascertaining cost of closing stock to weighted average method

Summary – The High Court of Bombay in a recent case of Bajaj Auto Ltd., (the Assessee) held that where assessee-company changed method of valuation of its closing stock from 'lowest price during year' method to 'weighted average cost' method, as changed method accords with international standards and more scientific and same was followed regularly, such change was justified

Facts

- The assessee-company was a manufacturer of scooters, three wheelers and their parts. It had been valuing its closing stock of stores and work in progress on the basis of 'lowest purchase price during the year'. Whilst determining the closing stock of relevant year, though the stock was valued on the basis of 'cost or market value whichever is lower', the cost itself was considered on 'weighted average cost' basis. This change resulted in the inventory and profits being shown in relevant year lesser by Rs. 12,03,509.
- The Assessing Officer did not accept the change and made an addition of Rs. 12,03,509.
- On appeal, the Commissioner (Appeals) set aside the order of the Assessing Officer.
- On further appeal, the Tribunal set aside the order of the Commissioner (Appeals) and restored the order of the Assessing Officer and referred the case to the High Court.
- On reference before the High Court :

Held

- The issue that arises for determination is whether or not the assessee was entitled to employ the method of valuation proposed by the assessee insofar as the closing stock was concerned. The proviso to sub-section (1) of section 145 (then in force), which deals with 'method of accounting', empowers the Assessing Officer to change the basis or manner of accounting in the event the accounts are correct and complete to the satisfaction of the Income-tax Officer but the method employed is such that, in the opinion of the Assessing Officer, the income cannot be properly deduced therefrom. So also, under sub-section (2) of section 145, which was applicable at the relevant date, if the Income-tax Officer was not satisfied about the correctness or completeness of the accounts of the assessee; or where no method of accounting has been regularly employed by the assessee, the Officer was empowered to make an assessment in the manner provided under section 144. The assessee's case is that the Assessing Officer could not have rejected the method of accounting employed by the assessee without having found under the proviso to sub-section (1) of section 145 that income cannot be properly deduced from the method employed or without being satisfied under sub-section (2) that no method of accounting has been regularly employed by the assessee. It is submitted that it is for the assessee to employ any particular method of accounting

and the Assessing Officer is not empowered to reject the method employed except in cases covered by the proviso to sub-section (1) or sub-section (2) of section 145.

- It is important to note that what the assessee has changed in the present case is the method of ascertaining the cost for the purpose of stock valuation and not the method of accounting employed by the assessee for the purpose of stock valuation as such. The method, as before, continues to be 'cost or market value whichever is lower'. It is only for determining the cost for the purpose of this method that instead of 'lowest purchase price' during the year, the basis of 'weighted average cost' was adopted. This on the footing that the latter was a more scientific basis for accounting the closing stock. It is doubtful whether this change can be termed as a new method of accounting. This change amounts to a change in the method of accounting, the assessee was well within its rights to bring about such change. So long as the assessee adopts such change *bona fide* and proposes to employ the new method regularly, no fault can be found with the same.
- Whilst accepting or rejecting a new accounting method proposed by the assessee is, whether the new method is adopted *bona fide* and whether the assessee intends to make this new method his regular method of accounting. As for the *bona fides* of the adoption of this new method by the assessee in the present case, the assessee's case has been that the new method was adopted in the face of the Manufacturing and Other Companies (Auditor's Report) Order, 1975. The Order applies to every company, which is engaged *inter alia* in manufacturing, mining or processing. The order requires that in the case of manufacturing, mining or processing companies, the auditor's report on the accounts must include a statement whether the company is maintaining proper records to show full particulars including quantitative details and situation of fixed assets; whether these fixed assets have been specifically verified by the management; and whether the same have been properly dealt with in the books of account. The auditor must further certify his satisfaction that the valuation of the stocks is fair and proper and in accordance with the normally accepted accounting principles. It is the assessee's case that at the relevant time, methods of accounting for measurement of inventories ordinarily adopted by companies were based on accounting standards followed internationally. These required the historical cost of inventories to be accounted by using the First-in-First-out (FIFO) formula or the 'Weighted Average Cost' formula. The weighted average cost formula adopted by the assessee, thus, accorded with the international standards and was a more scientific formula or method than the earlier used 'lowest cost of purchase in the year' formula. In fact, both the Assessing Officer as well as the Commissioner (Appeals) came to an express finding that the formula adopted by the assessee was more scientific than the one which was adopted earlier. The adoption of the new method by the assessee is accordingly clearly *bona fide*.
- As for the requirement of regular employment of the method of accounting, it is pertinent to note that the Tribunal does not dispute that the new system of accounting was followed by the assessee in the subsequent assessment years as well. This clearly supports the assessee's case that the method was meant to be adopted as a regular method for the future. The Tribunal appears to have been swayed by the fact that by means of this new method of determining the cost, the assessee

was having the benefit of taking the cost of items remaining in the closing stock on the basis of the lowest purchase price during the year with further reduction in the cost by following the weighted average cost formula. The method of determining the cost of items remaining in the closing stock is a part of a system of valuation of closing stock and if this method is changed, it would automatically lead to a change in the valuation of the closing stock. This is inevitable for the first year of change. Whether the exercise carried by the assessee is *bona fide* and is a permanent arrangement which is to be followed year after year, and not what immediate benefit accrues to the assessee for the particular year in which the change is introduced.

- The foregoing discussion makes it clear that so long as the change made by the assessee in his method of accounting is *bona fide* and amounts to a permanent arrangement to be followed, the revenue has no cause to complain. The conclusion drawn by the Tribunal that the change in the method of valuation adopted by the assessee, namely, from 'lowest price during the year' to the 'weighted average cost' formula was not justified, is without any merit.