Retail method could be used for valuation when actual cost of product couldn't be ascertained

Summary – The Delhi ITAT in a recent case of VRB Foods (P.) Ltd., (the Assessee) held that Retail method could be used as a valuation technique when actual cost of product is not feasible to be ascertained

Facts

- The assessee company was engaged in the business of manufacturing and sale of processed food products. During the course of assessment proceedings, the Assessing Officer on the basis of report of the Statutory Auditor noted that auditor was unable to comment on the accuracy of the valuation of the inventories of finished goods. He further noted that net profit ratio for the year was 10.72 per cent compared to 15.19 per cent. Thus, the Assessing Officer invoked the provisions of section 145 and estimated the net profit at the rate of 15.19 per cent of previous year and made an addition.
- On appeal, the Commissioner (Appeals) based on his order in case of the assessee for assessment year 2011-12 confirmed the addition. He also upheld the applicability of section 145(3). He also rejected the certificate given by the auditor of the assessee.
- On second appeal:

Held

- The issue involved in this appeal is whether on the basis of qualification by the Auditor addition with respect to the gross profit can be made or not. It is necessary to go through the auditor's report issued under section 227(4A) of the Companies Act as required under companies auditor's report order, 2003 to ascertain the correctness of accounts is required to be examined.
- On perusal of the auditor's report, it was apparent that the company's inventory were valued at lower of cost or net reliable value and included all cost incurred in bringing the goods to their present location and conditions. There was no dispute about the valuation of raw material and packing material. The issue was with respect to the valuation of manufactured goods which were valued on the basis of retail method wherein, the assessee reduced the gross margin from the selling price of the goods to derive at the cost of goods produced. The auditor has stated that such method could be used when the actual cost of production was approximate. As the assessee is in the business of manufacturing and selling of processed foods like sauces, mayonnaise, spreads, dips, mustards, milk shake mixes, egg-less cake mixes, peanut butter and culinary powders. Therefore, it is apparent that in the nature of the business activities carried on by the assessee, it is not possible to keep the production cost of each and every finished products, therefore, in such type of industry certain cost were used on approximate basis and they were then spread over the goods produced. The another method which was called the retail method based on which from the selling price of the

goods the gross margin of the product was reduced which is obviously the actual cost of the goods produced by the assessee. In case if there is a net loss then such finished goods are valued at selling price as the cost price is higher than the sale price. The auditor had also stated that such method can be used as a valuation technique when the actual cost of the product is not feasible to be ascertained. According to the Accounting Standard where the techniques for measurement of cost is mentioned that technique for the measurement of cost of the inventories such as the standard cost method or retail method might be used for convenience if the results approximates the cost. It is stated that retail method is often used in retail industry where, large numbers of rapidly changing items with similar margins for which it is impracticable to use other costing methods. In such circumstances, the cost of the inventory is determined by reducing the sales value of the inventory by the appropriate percentage of the gross margin. An average percentage for each retail department is often used. Therefore, looking at the accounting standard for inventory valuation there is no any infirmity in the method of techniques of measurement of cost as well as cost formula used by the assessee. The assessee in fact has followed the accounting standard only. In view of this, provision of section 145(3) are incorrectly invoked by the Assessing Officer and confirmed by the Commissioner (Appeals) because the valuation method is correct and therefore, it does not impact the correctness or completeness of the account of the assessee. In fact it makes the accounts of the assessee complete and correct. Furthermore, the Assessing Officer has applied the past year's gross profit ratio in that year also the valuation of the inventory was on similar basis, therefore, if opinion of the Assessing Officer is accepted then it cannot be said that accounts of previous year were correct and complete. The method of valuation of inventory followed by the assessee was year-to-year same. Furthermore, the assessee had maintained complete quantitative details also. No defects had been pointed out by the Assessing Officer in the books of account other than what was stated by the Auditor. To invoke provisions of section 145(3) it is necessary that accounts of the assessee suffers from latent, patent and glaring errors. In the instant case, there is no any such finding by the Assessing Officer. Further, the assessee has given detailed reason for the down fall in the gross profit also. Further, the details of valuation of closing stock of the manufactured goods as per retail method were also filed before the lower authorities and no infirmity was found in the same. In view of this, there is no reason to sustain the orders passed by the lower authorities with respect to the invocation of provisions of section 145(3) and consequently, making the addition to the total income of assessee.