

**IN THE INCOME TAX APPELLATE TRIBUNAL
COCHIN BENCH, COCHIN**

**Before Shri Waseem Ahmed, Accountant Member &
Shri Soundararajan K, Judicial Member**

ITA No.189/Coch/2023 : Asst.Year 2017-2018

Sri.Arunkumar Puthige Prop : Sree Vinayaka Enterprises Onden Road, Kannur – 670 001. PAN :AOTPP7763E.	v.	The Income Tax Officer Ward 1 & TPS Kannur.
(Appellant)		(Respondent)

Appellant by : Sri.Arunraj S, Advocate
Respondent by :Smt.Girly Albert, Sr.DR

Date of Hearing : 25.09.2024	Date of Pronouncement : 30.09.2024
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ORDER

Per Bench :

This is an appeal filed by the assessee challenging the order of the NFAC/CIT(A) dated 27.10.2022 in respect of the assessment year 2017-2018.

2. Brief facts of the case are that the assessee filed return of income declaring total income of Rs.8,71,560 and thereafter the case was selected for scrutiny and the AO determined the income at Rs.9,74,740 by making addition under the head underreporting of closing stock. The AO added the value added tax along with the value shown in the closing stock and thereby estimated the additional income of Rs.1,02,910. As against the said order, the assessee filed an appeal before the CIT(A) and contended that the method

adopted by the assessee by not including the value added tax in the value of the closing stock is correct since the assessee had adopted the practice of showing the value of the opening and closing stocks at cost price and even assuming that the method is incorrect, the AO ought to have added the value added tax in respect of the opening stock also and therefore, there is no escapement of any income as alleged by the AO. The Id.CIT(A) had dismissed the appeal by relying on the findings of the AO, and therefore, the present appeal has been filed before this Tribunal. The assessee in the present appeal had raised the following grounds:-

“1. The learned Assessing Officer erred under circumstances and facts of the case and in law in making an addition of Rs. 1,02,910/- being incorrect application of section 145A which required disclosure as per Income Computation and Disclosure Standards II Valuation of Inventories (ICDS-II). He should have appreciated the fact that Income Computation and Disclosure Standards I Valuation of Inventories prevails over the provisions of Section 145A of the Income Tax Act, 1961. Even before the applicability of ICDS, under the provisions of Section 145A (pre-amendment), purchases, sales and inventory were required to be valued by including therein the amount of any tax, duty, cess or fee by whatever name called actually paid or incurred by the assessee. Therefore, it was necessary to comply with the provisions of Section 145A of the Income Tax Act to make adjustments as given in the said section and no additions were contemplated in any of the previous assessment years.

2. The learned Assessing Officer had erred in making additions only to a chosen limb - being closing adjustments of closing stock without considering the overall valuation impact. The basic principle of the valuation of unsold stock at the close of the accounting period is a necessary part of the process of determining the trading results of that period and it cannot be regarded as source of profits as determined by the AO.

3. Para -22 read with Para -4 of the ICDS-II - Valuation of inventory states that the value of the inventory as on the beginning of the previous year shall be

A. the cost of inventory available, if any, on the day of the commencement of the business when the business has commenced during the previous year; and

B. the value of the inventory as on the close of the immediately preceding previous year, in any other case.

The above Para as notified by the government also prescribes that the opening stock also needs to be adjusted for the VAT as done for the closing stock, which was not considered

4. Para-5 of the ICDS-II states that the costs of purchase shall consist of purchase price including duties and taxes, freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates and other similar items shall be deducted in determining the costs of purchase.

5. Para -2 of ICDS-IV - Revenue Recognition defines that "Revenue" is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of a person from the sale of goods, from the rendering of services, or from the use by others of the person's resources yielding interest, royalties or dividends. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration

6. On plain reading of Para 3, 4 and 5 above your good self can conclude that the fact of making addition on account of undervaluation of closing stock without making any corresponding adjustment to opening stock, purchases and sales there of being the inclusive method of valuation of inventories is illogical and unjustified and on such adjustments of VAT the tax effect is neutral in general and shall not have any impact on the Revenue statement for any financial year.

Further that the inclusive method of valuation of inventories is in compliance with Section 145A of the Income Tax Act and Income Computation and Disclosure Standards II Valuation of Inventories

7. The learned Commissioner of Income Tax (Appeal) in the following cases within the same jurisdiction have concluded that the appellant applied Inclusive method of valuation of inventories in compliance with Section 145A of the Income Tax

Act as well as Income Computation and Disclosure Standards II 'Valuation of Inventories' and made the adjustment of VAT therein. The overall impact of the adjustments made on the appellant income is nil. Therefore, the addition made of on account of incorrect application of ICDS-II cannot be sustained and the appeal is allowed on these grounds of appeal. We have mentioned the said facts during our appeal proceedings which too was not considered:

Sl. No.	Case title	Order No.	Exhibit No.
1.	Thuruthel Drug Lines v. ITO Ward4 Kannur	ITBA/NFAC/S/250/2022-23/1046492229(1)dated 27.10.2022	Exhibit-1
2.	Jayvi Pharma v. ITO Ward 1 & TPS Kannur	ITBA/NFAC/S/250/2021-22/1038152631(1)dated 27.12.2021	Exhibit-2
3.	Shankarsv.ITO Ward-1 & TPS Kannur	ITBA/NFAC/S/250/2022-23/1049590978(1)dated 09.02.2023	Exzhibit-3
4.	Harisree Steel Centre v. ITO Ward-1 & TPS Kannur	ITBA/NFAC/S/250/2022-23/1043894088(1)dated 18.07.2022	Exhibit-4
5.	Top Optics v. ITO Ward-1 & TPS Kannur	ITBA/NFAC/S/250/2022-23/1049253470(1)dated 30.01.202\32	Exhibit-5
6.	Abdulla Nellery v. ITO Ward-2 Kannur	ITBA/NFAC/S/250/2022-23/1042797733(1)dated 21.04.2022	Exhibit-6

8. Upon above and other reasons that may be adduced at the time of hearing, the Hon'ble Tribunal of the Income Tax, Additional bench, cochin may be pleased to set aside the order of CIT (Appeals)-NFAC dated 23.01.2024 upholding the assessment and allow this appeal.”

4. The assessee in the grounds of appeal relied on the orders of the CIT(A) in respect of other six assesseees, in which the Id.CIT(A) had accepted the method adopted by the assessee and deleted the addition made by the AO by including the value added tax in the value of closing stock. The assessee had also filed copies of the orders passed by the

ld.CIT(A) as exhibit – 1 to 6 along with the appeal and prayed to allow the assessee's appeal also.

5. The learned DR relied on the order of the ld.CIT(A) and prayed to dismiss the appeal.

6. We have heard the rival parties and perused the material available on record. In the assessment order, we have seen that the AO in his order had stated that the closing stock value should be after adding the value added tax rate and on that basis the AO had alleged that the closing stock is under-assessed due to the incorrect application of ICDS-2 in the return of income filed and therefore the addition was made to the returned income.

7. In this case the assessee is accounting purchase and sale and inventory at cost excluding Value Added Tax (VAT) as the method of accounting regularly followed for more than a decade. The input State-Level Value Added Tax (VAT) paid on purchases cannot be included in the cost of purchases where the tax paid on inputs is available for set-off against the tax payable on sales or is refundable, it is in the nature of taxes recoverable from taxing authorities. The Accounting Standard (AS) 2 "Valuation of Inventories" issued by the Institute of Chartered Accountants of India (ICAI) deals with "cost of inventories" and "cost of purchases". As per para 6 and 7 of the said AS-2, the cost of purchases cannot include duties and taxes which are subsequently recoverable from the taxing authorities. Hence the input tax which is refundable, should

not be included in the cost of purchases. The Input State-Level VAT, to the extent it is refundable, will not form part of the cost of the inventory. The inventory of inputs is to be valued at the net of the input tax which is refundable. The Assessee prepared their accounts in compliance with the AS-2 "Valuation of Inventories" issued by the Institute of Chartered Accountants of India.

8. According to the Guidance Note on Tax Audit under Section 44AB of the Income Tax Act, 1961 issued by the Institute of Chartered Accountants of India, section 145A provides that the valuation of purchase and sale of goods and inventory for the purpose of computation of income from business or profession shall be made on the basis of the method of accounting regularly employed by the assessee but this shall be subject to certain adjustments. Therefore, it is not necessary to change the method of valuation of purchase, sale and inventory regularly employed in the books of account. The adjustments provided in this section can be made while computing the income for the purpose of preparing the return of income.

9. Section 145A of the Income Tax Act has been substituted by the Finance Act, 2018 with retrospective effect from AY 2017-18. Section 145A of the Act reads as follows:

Method of accounting in certain cases.

145A. For the purpose of determining the income chargeable under the head "Profits and gains of business or profession", -

(i) the valuation of inventory shall be made at lower of actual cost or net realisable value computed in accordance with the income computation and disclosure standards notified under sub-section (2) of section 145;

(i) the valuation of purchase and sale of goods or services and of inventory shall be adjusted to include the amount of any tax, duty, cess or fee (by whatever name called) actually paid or incurred by the assessee to bring the goods or services to the place of its location and condition as on the date of valuation;

Explanation 1 to section 145A clarifies that for the purposes of this section, the expression. "Any tax, duty, cess or fee (by whatever name called) under any law for the time being in force", shall include all such payment notwithstanding any right arising as a consequence to such payment;

Clause (ii) of Section 145A specifically states that the valuation of purchase and sale of goods or services and of inventory shall be adjusted to include the amount of any tax, duty, cess or fee (by whatever name called) actually paid or incurred by the assessee to bring the goods or services to the place of its location and condition as on the date of valuation.

10. We have seen that the Assessing Officer completed the assessment by making an addition of Value Added Tax only on the closing stock without increasing the valuation of purchase and sale and opening stock of goods with corresponding VAT and therefore the same is not in accordance with the provisions of Sec 145A of the Act.

11. Further the preamble of ICDS (i) "Valuation of Inventories" states -

"This Income Computation and Disclosure Standard is applicable for computation of income chargeable under the head "Profits and gains of Business or profession" or" income from other sources" and not for the purpose of maintenance of books of accounts.

In the case of conflict between the provisions of Income Tax Act, 1961 ('the Act)' and this Income Computation and Disclosure Standard, the provisions of the Act shall prevail to that extent".

12. It may be noted that under the provisions of para 7 of the Revised AS 2"Valuation of Inventories" issued by ICAI, duties and taxes that are subsequently recoverable from the taxing authorities are excluded while arriving at the cost of purchase. ICDS II differs from Revised AS 2, in this respect. The ICDS prescribes an "inclusive method" while the Accounting Standards prescribe an "exclusive method".

13. As per ICDS II on Valuation of Inventories, the inventory shall be valued at cost or net realisable value whichever is lower. The valuation of purchase or sale of goods or services and of inventory shall be adjusted to include the amount of any trading account is intended to cancel the charge for the goods bought which have remained unsold which should represent the cost of the goods",

14. The learned Assessing Officer by adding Value Added Tax only on closing Stock, makes the closing stock a source of profit, which is totally against the principles laid down in the judgment of Honourable Supreme Court in the case of Chainup Sampairam vs. CIT, reported in 24 ITR 48.

15. We also gave our attention to Notes on Clauses in the Finance (No. 2) Bill, 1998, when section 145A of the Act was being inserted with effect from April 1,1999. It has been stated in the Notes on Clauses as follows (1998) 231 ITR (St.)175, 201): "It is proposed that while computing the value of the inventory as on the first and the last day of the previous year, the computation according to the method of accounting regularly employed by the assessee shall be adjusted to include the amount of any tax, duty, cess or fees paid or liability incurred for the same under any law in force. This amendment is proposed as the valuation of inventory after this adjustment will present the correct value."

16. We have also considered the decision of the Privy Council in the case of CIT v. Ahmedabad New Cotton Mills Co. Ltd.,

AIR 1930 PC 56, where the effect of altering the method of valuation was considered. While discussing this issue, the Privy Council opined as under(page56):

"If the method of altering both valuations is not adopted it is perfectly plain that the profit which is brought forward is not the real one. It may be more or it may be less, but it has no relation to the true profit if the stock is valued on one basis when it goes out without considering the value of the stock when it comes in. When, therefore, there is undervaluation at one end, the effect is to cause both a smaller debit in respect of the stock introduced into the next account and a larger sum for profits realised by the sale, change in market values being immediately reflected in the price obtained for the goods that are sold; in these circumstances to contend that there should be undervaluation at one end and not at the other is to raise an argument which their Lordships cannot accept."

17. The finding of the Privy Council was that whenever there is a change in the valuation at one end (that is on March 31, 2017, as in the present case) then there must necessarily be a corresponding change at the other end (that is on April 1, 2018, as in the present case) otherwise the true profit would not be reflected.

18. In the present case before us the learned Assessing Officer has made an addition of Rs.1,02,910 being the Value Added Tax (VAT) component on Closing Inventory to returned income. It is a well-settled principle of law that the valuation

of closing stock has to be on the basis of the purchase cost. If the purchases include an element of VAT benefit, then the closing stock should also correspondingly include the VAT benefit.

19. As per Para 22 of the ICDS 1I value of opening inventory shall be the value of inventory as on the close of the immediately preceding previous year. The above para is not the transitional provision and needs to be applied every year. Thus, to comply with para 22 for the Asst year 2017-18, the opening inventory shall be computed by applying the provisions of Section 145A which is nothing but the inclusive method. In order to comply with the provisions of Section 145A, the inventory as on 31.3.2016, necessary adjustments as required in the said section is also to be made.

20. We also rely on the judgment of Honourable High Court of Delhi in the case of CIT vs Mahavir Alluminium Ltd. reported in 297 ITR:77 in which it has been held that paragraph 23.13 of the guidance note (Guidance Note on Tax Audit under Section 44AB of the Income Tax Act, 1961 issued by ICAI) itself makes it clear that whenever any adjustment is made in the valuation of inventory, this will affect both the opening as well as the closing stock. It is also to be noted that if any adjustment is required to be made by a statute, (as for example section 145A of the Act), effect to the same should be given irrespective of any consequences on the computation of income for tax purposes.

21. From the above, it is clear that the learned Assessing Officer made the addition of Value Added Tax on closing stock only, not in compliance with the provisions of Section 145A of the Income Tax Act, 1961.

22. As per para 23 of the Guidance Note on Tax Audit under section 44AB of the Income-tax Act, 1961 issued by the ICAI (Paras 23.7 to 23.24) deal with deviations from the method of valuation prescribed under section 145A and the effect thereof on the profit or loss to be reported under clause 14(b) of Form 3CD. These sub-paras explain the adjustments to be made to comply with the provisions of section 145A and the procedure for the adjustments to be carried out in case of both, trading and manufacturing concerns.

23. As per para 6.4 of the Technical Guide on Income Computation and Disclosure Standards issued by the ICAI, if an exclusive method is followed for the purpose of valuation of inventory as per Accounting Standard the tax payer would be required to prepare the memorandum account to demonstrate that vis a vis inclusive method, it is tax neutral. This will be in compliance with section 145A and ICDS.

24. As per paragraph 23.13 to 23.15 of the Guidance Note on Tax Audit U/s 44AB of the Income Tax Act, 1961 issued by the Institute of Chartered Accountants of India, New Delhi the valuation of inventories are explained in detail. The above-referred Honourable High Court has accepted the view of ICAI.

In this case the assessee had prepared the valuation of inventories based on the ICAI guidance note.

25. As per para 23 of the Guidance Note on Tax Audit under section 44AB of the Income-tax Act, 1961 issued by the ICAI (Paras 23.7 to 23.24) deal with deviations from the method of valuation prescribed under section 145A and the effect thereof on the profit or loss to be reported under clause 14(b) of Form 3CD. These sub-paras explain the adjustments to be made to comply with the provisions of section 145A and the procedure for the adjustments to be carried out in case of both, trading and manufacturing concerns. The illustrations given in the said Guidance Note show that the overall impact of the adjustments made to comply with the provisions of section 145A on the income of the assessee is nil. Accordingly, if an exclusive method is followed for the purpose of valuation of inventory as per AS, the taxpayer would be required to prepare the memorandum account to demonstrate that vis a vis inclusive method, it is tax neutral. This will be in compliance with section 145A and ICDS.

26. We therefore of the view that the grounds of appeal on the issue of addition on account of undervaluation of closing stock without making any corresponding adjustment to opening stock is to be accepted.

27. Upon perusal of the facts of case, it is observed that the assessee applied Inclusive method of valuation of inventories in compliance with Section 145A of the Income Tax Act as well

as Income Computation and Disclosure Standards II 'Valuation of Inventories' and made the adjustment of VAT therein. The overall impact of the adjustments made on the appellant income is NIL. Therefore, the addition made of Rs.1,02,910 on account of incorrect application of ICDS-II cannot be sustained and the appeal is allowed on these grounds.

28. In view of the above said facts that the closing stock value should be at the cost price and rightly the assessee had followed the said system and therefore there is no mistake on the part of the assessee and infact they have followed sec.145A of the Act. Further, the AO as well as the Id.CIT(A) had committed a mistake that when the authorities are intended to add the VAT amount along with the value of the closing stock, then the same method should be followed in respect of the opening stock which was shown on cost basis. Therefore, two different methods could not be adopted for the opening stock and the closing stock. If the AO decided to add VAT to the closing stock value, then necessarily he has to add VAT amount in the opening stock value also and in that circumstances the net effect will be neutral and no under-valuation would arise. In such circumstances, we accept the method followed by the assessee by following sec.145A of the Act and thereby hold that the method adopted by the AO in taking the closing stock value after adding the VAT amount is not correct and liable to be set aside. We are also entirely in agreement with the submission of the assessee that the other

orders passed by the ld.CIT(A) in respect of other six dealers are also in accordance with the view taken by us.

29. In coming to the above conclusion, we also relied on the judgment of the Hon'ble Supreme Court reported in (2003) 261 ITR 275 in the case of CIT v. Indo Nippon Chemicals Co. Ltd., wherein the Hon'ble Supreme Court has held that adopting gross method for purchases and net method for unconsumed stock at the year end is not permissible.

30. In the result, the appeal by the assessee is allowed.

Order pronounced on this 30th day of September, 2024.

Sd/-
(Waseem Ahmed)
ACCOUNTANT MEMBER

Sd/-
(Soundararajan K)
JUDICIAL MEMBER

Cochin ; Dated : 30th September, 2024.
Devadas G*

Copy to :S

1. The Appellant.
2. The Respondent.
3. The CIT Concerned.
4. The DR, ITAT, Cochin.
5. Guard File.

Asst.Registrar/ITAT, Cochin