

**(2008) 217 CTR 254 : (2010) 327 ITR 360**

**Gujarat High Court**

**Case No:** Income Tax Reference No. 45 of 1998

Voltamp Transformers  
Ltd.

APPELLANT

Vs

Commissioner of  
Income Tax

RESPONDENT

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**Date of Decision:** April 30, 2008

**Acts Referred:**

- Income Tax Act, 1961 - Section 145, 256(2)

**Citation:** (2008) 217 CTR 254 : (2010) 327 ITR 360

**Hon'ble Judges:** Z.K. Saiyed, J; D.A. Mehta, J

**Bench:** Division Bench

**Advocate:** Manish J. Shah, for the Appellant; B.B. Naik, for Respondent 1, for the Respondent

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### **Judgement**

D.A. Mehta, J.

The Income Tax Appellate Tribunal, Ahmedabad Bench "B" has referred the following questions u/s 256(2) of the Income Tax Act, 1961 (the Act), at the instance of the assessee:

Whether, the Hon'ble Tribunal has erred in law and on the facts and failed to appreciate the circumstances prevailing on the valuation date i.e. 30.6.1983 for the purpose of valuation of two transformers ordered by Punjab State Electricity Board having regard to the material on record and thereby erred in holding the manner in which the company valued the closing stock of two transformers, and that such market value is not justified ?

2. The Assessment Year is 1984-85, the relevant accounting period being year ended on 30th June, 1983. The assessee, a limited Company, is manufacturer of power transformers normally supplied to the State Electricity Boards and large companies. Punjab State Electricity Board (PSEB) placed an order for 12 transformers of 33/11 KV class. The assessee company manufactured one transformer and called upon PSEB to

take delivery after inspection. The delivery was taken in December, 1982 after some correspondence was exchanged between the parties. In the mean time two more units were manufactured by the assessee, but PSEB did not undertake inspection nor did respond to the request for accepting delivery of the two transformers. It appears that after exchange of correspondence between the parties PSEB cancelled the order placed with the assessee company. The assessee, therefore, moved the Indian Transformers Manufacturers Association for intervention in the matter and simultaneously filed writ petition before the High Court seeking direction to PSEB. During the pendency of the aforesaid proceedings as the accounting period ended on 30.6.1983 the assessee company finalised its accounts which were approved by the Board of Directors on 5.12.1983. While finalizing the accounts the assessee Company valued the two units of transformers lying with the assessee Company in stock by adopting the market value on the basis of one quotation received from one M/s. Manish Electricals at a sum of Rs. 4,99,999/-.

3. The Assessing Officer vide assessment order dated 28.12.1987 did not accept the value put on the closing stock by the assessee and adopted the figure of Rs. 16,40,000/- as against Rs. 5 lacs adopted by the assessee. Thus, the addition of Rs. 11,40,000/- came to be made by the Assessing Officer. The basis for the figure of Rs. 16,40,000/- adopted by the Assessing Officer is, according to the Assessing Officer, the sale price of the two transformers which were sold subsequently to PSEB at the tendered price.

4. The assessee carried the matter in Appeal before the Commissioner (Appeals) who, for the reasons stated in the order dated 7.11.1990, did not uphold the amount of addition though the Appellate Authority agreed in principle with the Assessing Officer, and issued the following directions:

The DC (IT) however, has taken the value at the market price i.e. Rs. 16,40,000/- i.e. the tender price at which the transformers were sold to PSEB. This is not correct. The closing stock value should have been taken at cost. In the course of appeal hearing the A.R. stated that the normal G.P. rate was 20% which could be deducted from the sale for arriving at the cost of transformers since no separate cost accounting was maintained in respect of the transformers. The G.P. rate should be verified and the gross profit should be deducted from the sale value of the transformers so as to find out the value of the transformers at cost. The difference between this value and the value shown could be added in place of Rs. 11,40,000/-. This is for verification of the DC (IT) after allowing an opportunity to the appellant of being heard, if found necessary. Needless to say that the closing stock adopted is taken as the opening stock of the next year.

5. Being aggrieved, the assessee preferred Second Appeal before the Tribunal. The Tribunal, after recording the aforesaid facts, observed as under:

After careful consideration of the submissions of both sides and the material available in the appeal record, we find no merit in the case of the assessee. No doubt, the assessee

company has been following right method of accounting for valuation of the closing stock but in view of the facts and circumstances of the case, the manner in which it valued the closing stock of the two transformers is not justified. The market value or cost value whichever is less is to be taken for valuation of the closing stock but in the present case, there is no reliable and convincing market price of the transformers. There is nothing in the appeal record to show that if the quotation was asked for in general from the open market. The two transformers were not out of date or damaged or otherwise not usable and so in that view of the matter, their value being run down to 1/3rd cannot be conceived of only because it has been tailor-made as per the specification and design given by the PSEB. Only one single quotation cannot be the indicator of the market value so far as the price of the transformer is concerned. In our considered view, the learned CIT (A) has rightly directed to determine the value of the transformers at cost price particularly when in view of the fact that at the relevant period the Writ Petition was still pending in the High Court and further that negotiations for sale of the transformers were still going on. There is no merit in the case of the assessee. The order of the learned CIT (A) is justified and so we uphold it.

6. The learned Advocate for the assessee applicant has assailed the impugned order of Tribunal dated 15.12.1995 by submitting that an option is available to every assessee to adopt cost or market value as the basis for valuing the closing stock of goods, the assessee had exercised the said option and adopted the market value as per the quotation received considering the fact that the transformers were tailor-made for PSEB as per the designs furnished by PSEB. That the Taxing Authorities and the Tribunal wrongly refused to accept the said valuation on extraneous considerations without dislodging the evidence in the form of quotation denoting the market price. That in absence of any other evidence, in absence of examining the party who had furnished the quotation, the Tribunal and the Taxing Authorities could not have substituted the market value by the cost. In support of the submissions made reliance was placed on the following four decisions:

- i. [Chainrup Sampatram Vs. Commissioner of Income Tax, West Bengal,](#)
- ii. [K. Mohamad Adam Sahib Vs. Commissioner of Income Tax, Madras,](#)
- iii. [Commissioner of Income Tax Delhi-II, N. D. Vs. Bharat Commerce and Industries Ltd.,](#)
- iv. [Sadhuram Gordhandas Vs. Commissioner of Income Tax,](#)

Lastly it was contended that the Authorities failed to consider the fact that closing stock valuation of the year under consideration would be reflected by the valuation of the opening stock of the immediately succeeding year, namely, the year of sale of transformers. That as a result the assessee had recovered a higher sale price and the assessee had been taxed on higher profits.

7. Mr. B.B. Naik, learned Standing Counsel for the respondent " Revenue submitted that the facts of the case were peculiar inasmuch as there was no open market for the goods manufactured by the assessee and, therefore, so called quotation of market value furnished by the assessee could not be accepted as reflecting the market price. That the Revenue Authorities and the Tribunal were, therefore, justified in substituting the said valuation by referring to the contracted value of transformers at which price subsequently PSEB had taken delivery of the transformers. It was further submitted that in the case of Commissioner of Income Tax v. British Paints India Ltd. reported in : [1991]188ITR44(SC) the Apex Court has laid down that u/s 145 of the Act the Assessing Officer had sufficient powers, not only that, but was duty bound to make computation of income in such manner so as to deduce correct profits and gains. That in a case where accounts are prepared without disclosing the real cost of the stock-in-trade the Assessing Officer was duty bound to determine the taxable income by substituting such cost so as to reflect the correct trading profits of the year. It was, therefore, urged by the learned Advocate that there was no reliable evidence in support of the market price adopted by the assessee which would permit the Authorities to substitute the same.

8. The facts are not in dispute. The Tribunal has categorically found that the assessee company has been following the right method of accounting for valuation of the closing stock. After recording such a finding the Tribunal has gone on to state that in view of the facts and circumstances of the case the manner in which the closing stock of two transformers is valued is not justified. The reason for this observation made by the Tribunal is that, according to the Tribunal, there is no reliable and convincing market price of the transformers. The Tribunal thereafter observed that there is no evidence to show that the transformers were outdated, damaged or otherwise not usable and, therefore, according to the Tribunal, the market value could not be almost 1/3 of the sale price realised subsequently, even if the transformers had been made as per the specifications and designs given by PSEB. The Tribunal, therefore, upheld the view of the Commissioner (Appeals) that the value of the closing stock has to be determined at cost price.

9. The question, therefore, which arises is " whether it is permissible to change the method of accounting under the guise of substituting the value of closing stock ? The answer has to be in negative. In the case of CIT v. British Paints India Limited (Supra), the Apex Court itself has stated that the Assessing Officer is entitled to disturb the value put on the closing stock wherein the cost price adopted was not reflecting all the expenses which would go to make up the cost. In other words, there is no departure from the basic principle that it is the option of the assessee to adopt a particular method of valuation of closing stock, namely, the cost or market price, whichever is lower, as per settled principles of commercial accounting.

10. The Taxing Authority is entitled to disturb such valuation by modifying the cost or the market value whichever is adopted by the assessee by reflecting the correct cost or nearest market value on the basis of facts and evidence on record after recording a clear

cut finding that the value adopted by the assessee does not reflect either correct cost or correct market price. However, once the assessee has chosen one of the two, the Authority cannot discard the same and impose other one. To wit, in a case where the assessee has opted to adopt the cost as the basis for valuing the closing stock the Taxing Authority can substitute the same by bringing cogent and material evidence on record to show that such cost does not reflect all the components of cost of the goods forming part of closing stock. Similarly, in a case where the assessee has adopted the market price for the purpose of valuing the closing stock it is open to the Authorities to disturb the same by bringing cogent and reliable evidence on record to establish that the market price is not what has been shown by the assessee, but is something else.

11. In the facts of the present case the Authorities have approached the issue, to say the least, in a confused manner. After discarding the market value adopted by the assessee the Authorities have, more particularly, the Commissioner (Appeals) and the Tribunal, proceeded to adopt cost price as the value of the closing stock. There is no basis, there is no evidence to discard the market value shown by the assessee merely because such a value is 1/3rd of the sale price. The sale price would not indicate in any manner that the market price shown by the assessee was not the market price as on 30.6.1983 i.e. last day of the accounting period merely because subsequently higher sale price has been realised. The Tribunal has also failed to appreciate that even the Commissioner (Appeals) had after disturbing the valuation put on the closing stock directed the Assessing Officer to adopt the same valuation of the opening stock of the next year. The Tribunal was duty bound, in the circumstances, to ascertain whether disturbing of the valuation put on the closing stock during the year under consideration would have any real effect when the same valuation would be reflected by opening stock of the immediately next accounting period.

12. In the circumstances one may fruitfully reproduce what the Apex Court has stated in the case of Chainrup Sampatram (supra) as to what is the purpose of valuing the closing stock:

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. As pointed out in paragraph 8 of the Report of the Committee on Financial Risks attaching to the holding of Trading Stocks, 1919. "As 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 sold, it 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 which actually have been sold at the incorrect figure..... From this rigid doctrine one exception is very generally recognised on

prudential grounds and is now fully sanctioned by custom, viz. the adoption of market value at the date of making up accounts, if that value is less than cost. It is of course an anticipation of the loss that may be made on those goods in the following year, and may even have the effect, if prices rise again, of attributing to the following year's results a greater amount of profit than the difference between the actual sale price and the actual cost price of the goods in question" (extracted in paragraph 281 of the Report of the Committee on the Taxation of Trading Profits presented to British Parliament in April 1951). While anticipated loss is thus 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 profit before its actual realisation. This is the theory underlying the rule that the closing stock is to be valued at cost or market price whichever is the lower, and it is now generally accepted as an established rule of commercial practice and accountancy. As profits for Income Tax purpose are to be computed in conformity with the ordinary principles of commercial accounting unless of course, such principles have been superseded or modified by legislative enactments, unrealised profits in the shape of appreciated value of goods remaining unsold at the end of an accounting year and carried over to the following year's account in a business that is continuing are not brought into the charge as a matter of practice, though, as already stated, loss due to a fall in price below cost is allowed even if such loss has not been actually realised....

Again, it is misconception to think that any profit "arises out of the valuation of the closing stock" and the situs of its arising or accrual is where the valuation is made. As already stated, valuation of unsold stock at the close of an accounting period is a necessary part of the process of determining the trading results of that period, and can in no sense be regarded as the "source" of such profits.

13. If the Tribunal had borne the aforesaid principles in mind while determining the controversy before it the Tribunal would not have committed an error in law which the Tribunal has committed. The purpose of valuation of the closing stock is not for working out any profit on the basis of such valuation as stated by the Apex Court. The valuation of unsold stock at the close of accounting period is a necessary requirement of commercial accounting, a part and parcel of determining the trading profits of the accounting period by ensuring that the expenses which have actually been incurred in the production of goods which remained unsold at the end of the year, are squared off to reflect the correct trading profits of the goods which have been sold during the year.

14. In the aforesaid set of facts and circumstances of the case the approach of the Tribunal in disturbing the valuation of the closing stock as on 30.6.1983 in relation to the two transformers cannot be sustained. The question referred for the opinion of this Court is accordingly answered in the affirmative i.e. in favour of the assessee and against the Revenue.

15. Reference stands disposed of accordingly with no order as to costs.