

CTR ENCYCLOPAEDIA ON INDIAN TAX LAWS

COMMISSIONER OF INCOME TAX vs. INDO NIPPON CHEMICAL CO. LTD.

HIGH COURT OF BOMBAY

S.H. Kapadia & J.N. Patel, JJ.

IT Appeal No. 191 of 2000

14th August, 2000

(2000) 68 CCH 0446 MumHC

(2000) 164 CTR 0078 : (2000) 245 ITR 0384 : (2000) 112 TAXMAN 0555

Legislation Referred to

Section 145(1) proviso

Case pertains to

Asst. Year 1989-90

Decision in favour of:

Assessee

Accounts—Valuation of stock—Modvat credit—Is related only to raw material consumed—The credit has a direct linkage with the consumption of the raw material—It is obtained on the date when the raw material is purchased and can be utilised at any stage thereafter—Assessee had shown closing stock of raw material net of Modvat credit—There was no understatement of profits—Whether one applies the net method or gross method gross profit remains the same—AO was wrong in calculating Modvat credit on the basis of purchase cost and erred in invoking proviso to s. 145(1)—Provisions of s. 145A which were made applicable w.e.f. 1st April, 1999, have no applicability in the year in question i.e., asst. yr. 1989-90

Held :

Reading the two methods given by the Institute of Chartered Accountants of India, it is clear that in both cases the Modvat credit is related only to the raw material consumed. Even a bare reading of r. 57A of Central Excise Rules shows that the Modvat scheme provides for instant credit of the input duty on the goods (raw material) used in the manufacture of final products. Therefore, it has to be related to the raw material consumed. The credit has a direct linkage with the consumption of the raw material. It is obtained on the date when the raw material is purchased. Hence, it is clear that whether one applies the net method or the gross method the gross profit remains the same. Therefore, there is no understatement of profits as found by the Department. This is on the basis that Modvat credit is relatable to the raw material consumed. The valuation of closing stock (inventory) has to be on the basis of purchase cost. If the purchase cost includes the element of Modvat credit then the closing stock should also include such element, otherwise the P&L a/c. will result in a distorted picture. The AO has calculated the Modvat credit not on the raw material consumed but on the basis of the purchase cost. This

calculation cannot be accepted. The reason is that the AO has failed to appreciate the principle laid down by the Supreme Court in *Chainrup Sampatram vs. CIT*, viz., that whatever is in purchase is also in the closing stock. If the Modvat credit is calculated in the above example on the entire raw material purchased then the element of the Modvat benefit in the closing stock of 40 is not taken into account. Therefore, the Department has taken a larger credit into account than what is debited to the P&L a/c. For example, if one debits the P&L a/c. with Rs. 10,000 then you cannot credit the said account with Rs. 11,000. This is where the distortion comes into the calculation made by the AO even while applying the gross method. It omits to take into account the Modvat element in the closing stock of the material. As stated above, under r. 57A, the credit is given to the assessee on purchase of the raw material (input) on goods used in manufacture of final products. The credit is taken at the stage of the receipt of the inputs. The same can be utilised at any stage thereafter. The credit can be availed of even before the consumption of the units. In the circumstances, it is clear that Modvat credit must be only for raw material consumed. It cannot be taken for the full amount. In the light of the above discussion, it is clear that the gross profit figure remains the same and, therefore, the AO erred in invoking the proviso to s. 145(1).—[Collector of Central Excise vs. Dai Ichi Karkaria Ltd.](#) (1999) 156 CTR (SC) 172 : (1999) 112 ELT 353 and [Chainrup Sampatram vs. CIT](#) (1953) 24 ITR 481 (SC) : TC.2R.124 applied; [CIT vs. British Paints India Ltd.](#) (1991) 91 CTR (SC) 108 : (1991) 188 ITR 44 (SC) : TC.2R.113 distinguished.

(Para 9)

Sec. 145A was introduced by the Finance (No. 2) Act, 1998. Originally, the Bill contemplated the proposed amendment to apply from 1st April, 1986, in relation to the asst. yr. 1986-87 and subsequent years. However, later on, when the said Bill was enacted into law, the provision was made applicable from 1st April, 1999, i.e., asst. yr. 1999-2000. This appeal is concerned with the asst. yr. 1989-90. In the circumstances, the Court is not inclined to go into the provisions of s. 145A and the subsequent guidance note issued by the Institute of Chartered Accountants of India which is based on s. 145A.

(Para 10)

Conclusion :

Modvat credit is related only to raw material consumed and there was no understatement of profits when the assessee showed its closing stock of raw material net of Modvat credit and, therefore, the AO was wrong in calculating Modvat credit on the basis of purchase cost and in applying proviso to s. 145(1).

In favour of :

Assessee

Cases referred:

Berger Paints India Ltd. vs. Dy. CIT (1992) 42 ITD 546 (Cal)

Challapalli Sugars Ltd. vs. CIT 1974 CTR (SC) 309 : (1975) 98 ITR 167 (SC) : TC 29R.273

CIT vs. U.P. State Industrial Development Corporation (1997) 139 CTR (SC) 267: (1997) 225 ITR 703 (SC) : TC S39.353

S.H. Kelkar & Co. vs. Dy. CIT (1999) 49 TTJ (Bom) 262: (1993) 44 ITD 170 (Bom)

Counsel appeared:

R.V. Desai with J.P. Deodhar & P.S. Jetley i/b. T.C. Kaushik, for the Appellant : F.B. Andhyarujina with K. Shivram, K. Gopal & K. Parida, for the Respondent

S.H. KAPADIA, J.:

Judgment

The issue relating to whether the value of the closing stock of the inputs, work-in-progress and finished goods must necessarily include the element for which Modvat credit is available has been the matter of considerable litigation. This point arises for determination in this appeal. Correspondingly, the question which also arises for determination in this appeal is : whether the AO was justified in invoking the proviso to s. 145(1) of the IT Act, 1961, on the ground that the net method adopted by the assessee resulted in understatement of profits ?

2. In this appeal, we are concerned with the asst. yr. 1989-90. The AO made an addition of Rs. 43,15,657 on account of Modvat. The said addition was made on account of valuation of closing stock on the basis of Modvat credit availed of by the assessee during the year. In the assessee's P&L a/c., the opening and closing stock of raw material were shown net of Modvat credit. The purchases were shown net of Modvat credit. The assessee asserted that the method of accounting followed by it was in accordance with the guidance note of accounting treatment for Modvat issued by the Institute of Chartered Accountants of India (hereinafter referred to for the sake of brevity as the "ICAI"). The AO held that the above method of accounting (briefly known as the net method) resulted in understatement of profits. He, therefore, invoked the proviso(1) to s. 145 of the IT Act. In order to show that the above method resulted in understatement of profits, the AO has worked out such understatement on the basis of an assumed data given at p. 18 of the paper-book which shows that the gross profits worked out on the basis of net/exclusive method stood at Rs. 24,000, whereas gross profits worked out on the gross method (also known as inclusive method) worked out to Rs. 25,000. Therefore, he concluded that the method adopted by the assessee, viz., the net method, in which the cost of raw material are debited at net of Modvat resulted in understatement of profits to the above extent. Being aggrieved by the order of the AO, the assessee carried the matter in appeal. The appellate authority came to the conclusion that in the net method adopted by the assessee, Modvat credit which is available to the assessee has not been accounted for, although, in fact, it is availed of by way of deduction in the Central excise duty liability insofar as the credit related to the closing stock of the raw materials. Before the appellate authority, it was contended on behalf of the assessee that the Modvat credit availed of can be subsequently withdrawn and, therefore, the assessee did not account for the Modvat credit. It was argued that to the extent of the Modvat credit which was embedded in the closing stock, the credit was a contingent credit and, therefore, it cannot be taken into account while computing the income of the assessee. It was also argued that the addition on the basis of valuation of the closing stock without increasing the value of the opening stock, would give a distorted figure. It was contended that if the closing stock is valued inclusive of Modvat credit, the opening stock should have also been valued by the AO on the same basis so as to work out the net additions to be made to the profits of the relevant year. This last argument appealed to the appellate authority. Accordingly, the assessee succeeded. Being aggrieved, the Department carried the matter in appeal to the Tribunal. Following the decision of the Special Bench in the case of S.H. Kelkar & Co. vs. Dy. CIT (1999) 49 TTJ (Bom) 262: (1993) 44 ITD 170 (Bom), the appeal came to be dismissed. The addition was ordered to be deleted. Hence, this appeal under s. 260A of the IT Act.

3. Mr. Desai, learned senior counsel for the Department, contended that under the proviso to s. 145(1) of the IT Act, the AO was entitled to disregard the net method of accounting employed by the assessee as it resulted in understatement of profits. He contended that the object of Modvat credit under the excise law was to avoid the cascading effect. He contended that under

the excise law and in particular r. 57A, the credit accrued to the assessee when it purchased the raw material since the cost of raw material included the excise duty. However, he contended that the said credit was only on account and it could be availed of only at the time of clearance of the excisable final product. He, therefore, contended that the said credit cannot be utilised till the final product is manufactured. He contended that there was a vast difference between the accrual of credit and utilisation of credit. He urged that the meaning of modified value added tax (Modvat) itself indicates that the tax was levied at each stage in the production and distribution on the basis of the value added to the goods or services passing through that stage. He contended that the Modvat scheme laid down a procedure under which specified goods which are used in the manufacture of final products were eligible for credit of a specified duty on inputs. He contended that the scheme was to operate only when excise duty became payable on the final product. He contended that under the IT Act each year was a self-contained unit and under the IT Act, the profits could not be postponed to the next year. He contended that it was the duty of the AO to deduce the profits. He relied upon the judgment of the Supreme Court in the case of CIT vs. British Paints India Ltd. (1991) 91 CTR (SC) 108 : (1991) 188 ITR 44 (SC) : TC 2R.113 in which it has been laid down that if the system adopted by the assessee does not disclose the true and proper income, the AO was entitled to adopt appropriate computation to determine the true income. In the said judgment, it has been further laid down that in any system of accounting where profit of one year was likely to be shifted to another year, such method would be an incorrect method of computing the profits as each year was a self-contained unit and the taxes of a particular year being payable with reference to the income of that year, the method adopted by the assessee under which the profit of one year was likely to be shifted to another year, would result in understatement of profits of the year in question and, therefore, it was the duty of the AO to act under the proviso to s. 145(1). Mr. Desai further submitted that the judgment of the Supreme Court in the case of Collector of Central Excise vs. Dai Ichi Karkaria Ltd. (1999) 156 CTR (SC) 172 : 1999 (112) ELT 353 has no application to the facts of the case. He contended that the said judgment did not deal with the value of the closing stock. That the said judgment did not deal with the cost of the raw material. He contended that, in that matter, the Supreme Court was required to ascertain the cost of intermediate product. He contended that, in that judgment, the Supreme Court has not dealt with the meaning of the closing stock under the IT Act. He accordingly contended that the said judgment did not apply to the facts of this case. Mr. Desai further placed reliance on the working done by the AO at p. 18 of the paper book. On the basis of assumed data, he argued that the Department was right in applying the gross method. He contended that applying the gross method in which raw materials are debited at gross cost, the closing stock which included Modvat credit stood at Rs. 10,000 whereas when the cost of raw materials is debited net of Modvat, the figure became 9,000 and correspondingly the gross profit stood reduced. Mr. Desai also contended that although the ICAI has prescribed the net method, the same should not be followed as it resulted in understatement of profits. In this connection, Mr. Desai invited our attention to the alternatives given by the ICAI in the guidance note. He contended that the basic difference between the net and the gross method was that, in the net method, the rate per unit of the raw material did not include the element of Modvat credit whereas, in the gross method, the rate per unit included Modvat credit. He contended that under the above circumstances, the net method adopted by the assessee resulted in understatement of the profits. He contended that under the circumstances, the AO was right in applying the gross method. He, however, contended that even the illustrations given in the guidance note of the ICAI did not depict the correct picture. He contended that under the gross method accepted by the ICAI, the Modvat credit which is taken into account is only to the extent of the raw materials consumed whereas, according to the Department, the Modvat credit is relatable to the full purchase cost and not only to the extent of raw materials consumed which has resulted in understatement of profits. He, therefore, contended that the AO was right in rejecting the working of the gross method by the ICAI in the illustration given hereinafter. Mr. Desai accordingly contended that the judgment of the Tribunal in the case of S.H. Kelkar & Co. Ltd. vs. Dy. CIT (supra) and the judgment of the Tribunal in the case of Berger Paints India Ltd. vs. Dy. CIT (1992) 42 ITD 546 (Cal), were erroneous decisions. He accordingly contended that this appeal needs to be allowed.

4. Mr. F.B. Andhyarujina, learned counsel for the assessee, contended that where an assessee regularly employs a method of accounting, his income shall be computed in accordance with such method unless by that method the true profits cannot be arrived at. It was urged that the assessee has been regularly following a correct method of accounting in respect of Modvat credit of input duty against excise duty on finished products in accordance with the recommendations of the ICAI. Therefore, the AO erred in disregarding the net/exclusive method followed by the assessee. It was urged that under rr. 57A to 57J of the Central Excise Rules, a manufacturer gets an instant credit of the input duty on goods (raw material) used in the manufacture of the final product. It was contended that under r. 57A Modvat credit is taken at the stage of receipt of inputs and such credit can be utilised at any stage thereafter and, with the result, such credit can be availed of even before consumption of units even though such inputs (raw material) may remain in stock. In other words, as long as excise duty is paid on raw materials, the manufacturer can claim credit in respect thereof and effectively reduce the duty amount on finished products in advance. Therefore, credit entitlement arises on payment of input duty and not on consumption of inputs. Accordingly, it was urged that the input duty was nothing but an advance towards the excise duty on the finished products and, therefore, cannot form part of the cost of inputs. Therefore, input duty was nothing but an advance. It was urged that the assessee has correctly followed the net method. It was urged that according to the ICAI, the cost of raw materials could be debited net of Modvat or they could be debited at gross cost (inclusive method). It was urged that the illustrations given by the guidance note of the ICAI show that under both the methods the gross profit remains at Rs. 120. Hence, even if the gross method is correctly applied, then there would be no revenue effect because the profit would remain the same. It was, however, contended that the AO has not correctly applied the gross method and, therefore, in this matter, essentially, the point which arises for consideration is : whether the Modvat credit must be taken on the entire purchase cost or whether Modvat credit should be taken only in respect of the units consumed. It was urged that closing stock forms part of the purchases and, therefore, the element of Modvat benefit cannot be excluded therefrom. It was further contended that the valuation of inventory is not affected by Modvat credit. That the effect on the profit remains the same. It was contended that if the inventory is valued at gross rate then the purchases will also have to be recorded at the gross rate. In this connection, reliance was placed on the judgment of the Supreme Court in the case of CIT vs. British Paints India Ltd. (supra). It was contended that whatever component forms part of purchase should also form part of the closing stock and if duty paid is excluded from purchase, it cannot be included in the closing stock. It was urged that under the Modvat scheme, the assessee was entitled to claim set off in respect of the excise duty paid on inputs which would effectively reduce the amount payable by way of excise duty on finished products well in advance and, therefore, such advance cannot form part of the cost of inputs. According to the assessee, when the raw material is purchased, the assessee not only purchases the raw material, he also earns Modvat credit which would be an asset in the balance sheet. Therefore, in the balance-sheet, the entry would show as advance and, ultimately, when the excise duty is paid on the final product the entry of advance in the balance-sheet shall stand correspondingly reduced. It was contended that the method followed by the AO, therefore, contains an arithmetical fallacy and if the said fallacy is removed then, in that event, there is no question of understatement of profits, whether one follows the exclusive method or the inclusive method. Therefore, whichever method is applied the end result is the same. Hence, s. 145(1) read with the proviso has no application. Reliance was also placed by learned counsel on the judgment of the Supreme Court in the case of Collector of Central Excise vs. Dai Ichi Karkaria Ltd. (supra) in which, inter alia, it has been laid down that excise duty paid on raw material, if modvated, shall not be included in the cost of production of the excisable product. In other words, if the assessee pays purchase price of Rs. 100 for the input and gets back Rs. 10 by way of Modvat credit the input cost would be Rs. 90 which would be the cost of raw material. According to the learned counsel, the Supreme Court has accepted the guidance note of the ICAI in the said judgment. Under the circumstances, the assessee was entitled to follow either of the two methods. The assessee has been following the net method particularly in view of the judgment of the Supreme Court under which the Modvat credit taken on inputs is of the nature of set off available against payment of excise duty on final products. Under the net method, duty paid on

inputs is debited to Modvat credit receivable account which is a separate account and as and when Modvat credit is actually utilised against payment of excise duty of the final products, an appropriate accounting entry is made to adjust the excise duty paid out of the Modvat credit receivable account to the account maintained for payment of excise duty on final product. Therefore, the purchase cost of the input is net of input duty. Therefore, the inputs consumed and the inventory of inputs are valued on the basis of purchase cost net of input duty. The debit balance in the Modvat credit receivable account is accordingly shown on the asset side of the balance sheet under the head "Advances". Accordingly, under the net method on payment of excise duty on the final product, the entry, viz., "advances", would stand proportionately reduced. Reliance was also placed on the judgment of the Supreme Court in the case of *Challapalli Sugars Ltd. vs. CIT* 1974 CTR (SC) 309 : (1975) 98 ITR 167 (SC) : TC 29R.273, in which it has been laid down that the meaning of the words "actual cost" should be as the common commercial man would understand. The Court accepted the accountancy rules for deciding the cost of fixed assets so as to include all expenditure necessary to bring such assets into existence. Learned counsel for the assessee also relied upon the judgment of the Supreme Court in the case of *Chainrup Sampatram vs. CIT* (1953) 24 ITR 481 (SC) : TC 2R.124 in which it has been laid down by the Supreme Court that profits do not arise out of valuation of closing stock. 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 such valuations do not constitute source of profits. The source of profits is business. The true purpose of crediting the value of the 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 cancelling out of the entries relating to the same stock from both sides of the account would leave only the transaction on which there is actual sale in the course of the year showing profit or loss realised on the year's trading. That is how the Supreme Court has discussed the principle of balancing. Reliance was also placed on the judgment of the Supreme Court in the case of *CIT vs. U.P. State Industrial Development Corporation* (1997) 139 CTR (SC) 267 : (1997) 225 ITR 703 (SC) : TC S39.3531.

5. Mr. Pardiwala, learned counsel for the assessee, in ITA No. 3 of 1999, has adopted the arguments mentioned hereinabove. He contended that by the above principle of balancing, there is no effect on the profit. That valuation of the closing stock is not a source of profit. That when the assessee purchases the raw material, he also acquires, instantly, the right to Modvat benefit under the excise law. That such right accrues to the assessee on the date of the purchase under rr. 57A to 57J of the Excise Rules. Therefore, to that extent, the assessee acquires an asset and, therefore, the assessee has made an entry in the balance-sheet as "advances". Ultimately, when the assessee pays the excise duty on the final product, the assessee uses the said asset to pay off the excise duty on the final product and, accordingly, it is the asset which is reduced to that extent. In ordinary course, on purchase of raw material, the entry would have been bank balance which is again an asset from which the excise duty would be paid on the final product. He contended that Modvat credit was like duty draw-back and, therefore, the purchase cost to that extent was reducible. He contended that, in the present matter, the basic question which arises for determination is : whether Modvat credit should be taken for the full amount irrespective of the units consumed. According to learned counsel, the Modvat credit must be restricted to the raw material consumed and if it is so restricted then whether one follows the net method or the gross method, there will be no effect on the profit. Accordingly, the valuation of inventory is not affected by Modvat credit. He contended that even in the gross method the Modvat credit availed account is a balance sheet item. It can only be with reference to units consumed and not with reference to the entire purchase of raw materials, otherwise it would amount to double addition because in the closing stock of the raw material, the Modvat credit element is already embedded. He contended that if the AO values the inventory of the assessee at gross then purchases will also have to be recorded at gross. In this connection, he relied upon the judgment of the Supreme Court in the case of *CIT vs. British Paints India Ltd.* (supra). He contended that even if there would have been no manufacture, the profit would have remained the same because the main dispute in the present case is as to what should be the Modvat credit which should be taken into account while applying the above alternative methods. In fact, he contended that the said question is not the

subject-matter of the appeal.

6. At the outset, it may be mentioned that in order to appreciate the method of working adopted by the assessee, certain accounting concepts are required to be kept in mind. They are also legal concepts. Modvat credit arises on purchase of raw material. It is attributable to purchase cost. It is, therefore, used to reduce the purchase cost. In the case of CIT vs. U.P. State Industrial Development Corporation (supra), the assessee was an underwriter. The assessee was entitled to receive commission and brokerage. The assessee offered 100 shares to the public for subscription. Only 50 thereof were subscribed. To the extent of the shares subscribed by the public, the assessee received brokerage/commission which was returned by the assessee as income. On this point, there was no dispute. However, on the remaining 50 shares the public did not subscribe. Therefore, the assessee had to purchase the balance 50 shares. The assessee received commission and brokerage for the said balance 50 shares. The AO treated the commission and brokerage in respect of the balance 50 shares as income whereas the assessee used the said receipt of brokerage and commission on the balance 50 shares to reduce the purchase cost. In other words, the consideration of the balance of 50 shares was reduced to the extent of commission and brokerage as the receipt was attributable directly to the purchase cost. This is only to show that in certain cases such receipts can be used to reduce the purchase cost. The Supreme Court has accepted this method. Therefore, the AO erred in that matter in treating the entire brokerage and commission on the balance 50 shares as income of the assessee, viz., CIT vs. U.P. State Industrial Development Corporation (supra). Similarly, it is a well settled principle of law that valuation of closing stock (inventory) has to be on the basis of purchase cost. If the purchases include an element of Modvat benefit then the closing stock should also correspondingly include the Modvat benefit [See the judgment of the Supreme Court in the case of Chainrup Sampatram vs. CIT (supra)].

7. Keeping the above principles in mind, we have to examine the facts of the present case and in particular the method of accounting. At the outset, it may be mentioned that, according to the assessee, whether one adopts the net method or the gross method, it would have no effect on the gross profit. The Department contends that the gross method alone should be applied whereas the assessee has adopted the net method. However, according to the assessee, even if the gross method is correctly applied the result would be the same as far as arriving at the gross profit. Therefore, we start with examination of the gross method which is as follows :

Assumed data [see p. 74 of Guidance Note of ICAI]

The illustrations are based on the following assumptions :

- (i) There are no opening stocks :
- (ii) 100 units of raw materials are purchased at Rs. 10 per unit, plus Rs. 2 for excise duty, aggregating to Rs. 12.
- (iii) 60 units of raw material are consumed in a process involving manufacture of a component. All the 60 units are sold in the year. The balance 40 units are manufactured and sold in the subsequent year.
- (iv) The manufactured components are sold at a price of Rs. 15 per unit (including excise duty Rs. 3 per unit).
- (v) Modvat credit is available on the raw material purchased and can be set off against the excise duty payable on the final product.
- (vi) Conversion costs are ignored.

Gross method as applied by the AO

	Unit	Rate	Amount		Unit	Rate	Amount
To purchase of raw materials	100	12	1,200	Sale	60	15	900
Less : Stock of material	40	12	480				
Raw material consumed	60		720				
	100	2	200				
			520				
Less : Modvat credit							
Excise duty	60	3	180				
Gross Profit			200				
			900				900

Gross method applied by the assessee

	Unit	Rate	Amount		Unit	Rate	Amount
To purchase of raw	100	12	1,200	Sale	60	15	900

materials

Less : 40 12 480
Stock of
material

Raw 60 720
material
consumed

60 2 120 600

Less :
Modvat
credit

Excise 60 3 180
duty

Gross 120
Profit

900

900

(Note : Underlining (here italicised) indicates the area of dispute between the assessee and the Department).

8. Now the main point which arises for determination is : what should be Modvat credit ? A comparison of the above two charts shows that the assessee purchased 100 units at the rate of Rs. 12 for Rs. 1,200. They are the 100 units of the raw material. Out of 100 units the assessee sold 60 at the rate of Rs. 15 for Rs. 900. The assumed data shows that the cost of the raw material has been taken at Rs. 12 which includes Rs. 2 per unit as excise duty on which the assessee got Modvat credit. On the other hand, in the cost of finished goods, the element of excise duty is Rs. 3 per unit. Having sold 60 units, the balance 40 units constitute closing stock. It is well settled that whatever is in purchase should also be in the closing stock. In order to arrive at the raw materials consumed the above chart shows deduction of the closing stock from the purchase. Therefore, out of 100 units the closing stock has been deducted which gives us the exact amount of raw materials consumed which is $60 \times 12 = \text{Rs. } 720$. Upto this stage, there is no dispute. Similarly, there is no dispute between the two charts as regards excise duty paid on sale of 60 units of finished goods. The only area of conflict arises because of the item in the above two charts under the caption "Less : Modvat credit".

Now, in the above illustration, the account is debited when 100 units were purchased at Rs. 1,200. The AO has assumed that all 100 units were consumed in the same year. Therefore, the AO has calculated the Modvat credit on 100 whereas the assessee has calculated the Modvat credit on 60. If Modvat credit is calculated on 100 in the above chart then the gross profit is worked out at Rs. 200 whereas if Modvat credit is taken on 60 units then the gross profit is worked out at Rs. 120. Therefore, according to the AO, there is understatement of profits to the extent of Rs. 80 in the above two workings. But here lies the fallacy. As stated above, what is in purchase must come in the value of the closing stock. In the calculations made by the AO, the

Modvat element in the closing stock of 40 is not taken into the calculations. Hence, the balancing principle is violated whereas in the assessee's calculation it is taken into account. In fact, in the Department's calculation, there is double addition. The matter can be examined from another angle. The AO has proceeded on the footing that the entire raw material of 100 units are bought and consumed in the same year as stated above. However, the AO in his working discounts the element of Modvat benefit from the value of inventory which distorts the account. But, let us assume that the working of the AO is correct. Then, the value of the inventory/closing stock (at 40) would still contain the Modvat element and if the closing stock is the opening stock of the next year, then in the next year, in any event, the profits would be evened out. Therefore, in any case, proviso to s. 145(1) cannot apply. On this point, we may clarify that the judgment of the Supreme Court in the case of British Paints India Ltd. (supra) does not deal with Modvat credit.

9. At this stage, we may also examine the net method followed by the assessee. The assumed data remains the same. The only difference between the net method and the gross method is that in the net method the rate does not include the excise duty element and correspondingly Modvat benefit, whereas in the gross method the rate includes the element of Modvat benefit. In other words, in the net method the closing stock/inventory is valued at net of input duty, i.e., the input duty paid on the raw materials does not form part of the cost of the inventory/closing stock, whereas in the gross method the raw materials are valued on the gross basis. The assessee has contended that the Modvat scheme under rr. 57A to 57J provides for instant credit on purchase of the raw material by the assessee. They contend that Modvat credit is taken at the stage of the receipt of the raw materials and the same could be utilised at any stage thereafter. In other words, the credit can be availed of even before consumption of inputs. Therefore, according to the assessee, on the purchase of the raw material, the assessee does not only buy the raw material but he also buys a benefit in the form of Modvat credit to the extent of Rs. 2 in the above example. Therefore, the assessee buys the raw material as also the Modvat benefit. Therefore, the cost of Rs. 12 consists of two components, viz., price of the raw material and Modvat benefit. When the assessee purchases the raw material at Rs. 12 in the above example, the said rate includes excise duty of Rs. 2 and, accordingly, the assessee earns the Modvat credit to that extent. Therefore, an asset is created in favour of the assessee. Now the assessee has bought 100 units of raw material. Therefore, on his purchasing 100 units of raw material, the assessee creates an asset to the extent of the Modvat credit of Rs. 200 which is shown in the balance sheet as advance. On manufacture of the final product, the assessee pays the excise duty at the rate of Rs. 3 per unit. In the above assumed data, the assessee has sold 60 units of finished goods. He sells it at the rate of Rs. 15 per unit which includes Rs. 3 as excise duty. Therefore, $60 \times 3 = \text{Rs. } 180$ which is the liability towards excise duty on finished goods. As stated hereinabove, on the purchase of the raw material, an asset is created of Rs. 200, i.e., 100 units of raw material purchased by paying Rs. 2 as excise duty is equal to Rs. 200. Therefore, finally, when the excise duty of Rs. 180 becomes payable on the finished product, the amount of Rs. 180 will be reduced from Rs. 200 which is an asset in the balance sheet. It is shown as advance in the balance sheet and, to that extent, the asset would stand reduced to Rs. 20 when the excise duty on the finished goods is paid. In short, on the purchase of raw material, an asset of Rs. 200 is created and out of the said asset of Rs. 200 the assessee pays excise duty on the finished product of Rs. 180. Therefore, the assessee pays excise duty out of its assets. This, in short, is the net method. Reading the two methods given by the ICAI, it is clear that in both cases the Modvat credit is related only to the raw material consumed. Even a bare reading of r. 57A shows that the Modvat scheme provides for instant credit of the input duty on the goods (raw material) used in the manufacture of final products. Therefore, it has to be related to the raw material consumed. Hence, even in the net method the gross profit on the above data is Rs. 120. Therefore, the basic controversy in this case is : whether Modvat credit is relatable only to the raw material consumed or whether it is relatable to the entire purchase (cost of 100 units). In the case of Collector of Central Excise vs. Dai Ichi Karkaria Ltd. (supra) the facts were as follows. The matter arose under the Central Excise Act. In that case, the manufacturer purchased raw material which he used to manufacture an intermediate product. He then used the intermediate product in the manufacture of a final product (captive

consumption). The raw material and the intermediate product were liable to excise duty. At this stage, it may be mentioned that when an intermediate product is used for captive consumption for the next stage of production such intermediate product is nothing but the raw material. The assessable value of the intermediate product was determined on the basis of its cost. In determining the assessable value of the said product, the cost of the raw material was taken into account. According to the assessee, in that matter, since the manufacturer got Modvat credit for the amount of excise duty paid on the raw material, the amount of such excise duty cannot be said to form a part of the cost incurred by the manufacturer in procuring the raw materials. This view was accepted by the Tribunal. Ultimately, the matter came before the apex Court. The apex Court dismissed the appeal. The apex Court held that excise duty paid on raw material, if modvated shall not be included in determining the cost of production of the excisable product. The Supreme Court held that when the word "cost" is not defined in the statute, it should be interpreted as it would be by a man of commerce. The Supreme Court gave an illustration in the said judgment, viz., that if an assessee paid the purchase price of Rs. 100 for the input (raw material) and got back Rs. 10 by way of Modvat credit, the assessee would reckon the input cost at Rs. 90 and not at Rs. 100. In other words, Rs. 90 was the real cost of the raw material. In support of the above conclusion, the Supreme Court has placed reliance on the same guidance note of the ICAI which is also the subject-matter of the consideration in this appeal under the IT Act. The Supreme Court has accepted the net method. The Supreme Court, in the said judgment has considered the net and the gross methods in the context of Modvat credit and has, ultimately, concluded that since a manufacturer-assessee obtains credit for the excise duty paid on raw material to be used by him in the product of final product immediately and since, according to the Supreme Court, there is no provision in the rules for reversal of the credit by the Department except in cases of illegality or irregularity, it has been held that the credit was indefeasible. It was further held that there is no provision under the excise rules which stipulates that Modvat credit can be taken only on the final product. In fact, the Supreme Court, has categorically held that credit is taken under the rules when the raw materials are purchased. Hence, the ratio of the judgment clearly shows that Modvat credit is relatable to the raw material consumed. The credit has a direct linkage with the consumption of the raw material. It is obtained on the date when the raw material is purchased. In the said judgment of the Supreme Court in Collector of Central Excise vs. Dai Ichi Karkaria Ltd.'s case (supra), the apex Court has computed the real cost of the raw material at Rs. 90 and not Rs. 100. The above judgment of the Supreme Court applies to the facts of this case. Hence, it is clear that whether one applies the net method as discussed above or the gross method as calculated by the assessee in the above chart/working, the gross profit remains at Rs. 120. Therefore, there is no understatement of profits as found by the Department. This is on the basis that Modvat credit is relatable to the raw material consumed. Our conclusion is further supported by the following judgment of the Supreme Court on the principle of valuation of closing stock. As stated above, the valuation of closing stock (inventory) has to be on the basis of purchase cost. If the purchase cost includes the element of Modvat credit then the closing stock should also include such element, otherwise the P&L a/c. will result in a distorted picture. In the case of Chainrup Sampatram vs. CIT (supra), the Supreme Court has discussed the above principle of balancing. It has laid down, firstly, that profits do not arise out of valuation of closing stock. Secondly, that valuation of unsold stock at the close of the accounting period is a necessary part of the process of determining the trading results and it cannot be regarded as source of such profits. 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 the cancelling out of the entries relating to the same stock from both sides of the account would leave only the transaction 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. In short, this is the principle of balancing. The Supreme Court has further laid down that as the entry for stock which appears in a trading account is merely to cancel the charge for the goods purchased and which have not been sold, it should necessarily represent the cost of the goods. Therefore, as stated hereinabove, whatever is in purchase should be in the closing stock. In the case of CIT vs. British Paints India Ltd. (supra), the facts were as follows : The assessee-company was engaged in the manufacture and sale of paints. As a consistent practice, the assessee valued its goods-in-process and finished goods exclusively at

the cost of raw materials totally excluding overhead expenditure. The AO held for the asst. yrs. 1963-64 and 1964-65 that there was no justification to value the stock otherwise than in accordance with the well-recognised principles of accounting which required the stock to be valued at cost (viz., raw material plus expenditure) or market price whichever was lower. He, therefore, calculated the value of the opening and closing stocks by adding overhead expenditure. The first appellate authority confirmed that order. The Tribunal held that there was no evidence to show from the side of the assessee that the goods in stock deteriorated in value and, therefore, there was no justification for excluding overhead expenditure in valuing the stock and if it was in the interest of the business to value the stock solely with reference to cost of the raw material and without including the overhead expenditure, such valuation was not appropriate to compute the income chargeable under the IT Act. Accordingly, the Tribunal dismissed the appeal. However, the High Court, on a reference, reversed the decision of the Tribunal in view of the consistent practice followed by the assessee of excluding the overhead expenditure in valuing the stock. The Department took the matter in appeal to the Supreme Court. The Supreme Court held that even if the assessee had adopted a regular system of accounting, it was the duty of the AO under s. 145 of the Act to consider whether the correct profits could be deduced from the accounts so maintained. If the AO was of the opinion that the correct profits could not be deduced from the account, he was obliged to invoke the proviso to s. 145 of the Act. The Supreme Court further laid down that any system of accounting which excluded for the valuation of stock-in-trade all costs other than the cost of raw materials for the goods-in-process and finished goods, was likely to result in a distorted picture of the true state of the business. Such a system might produce comparatively a lower valuation of the opening stock and the closing stock. In a period of rising turnover and rising prices such a system may diminish the assessee of taxable profits of a year and the profit of one year is likely to be shifted to another year which would be an incorrect method of computing the profits because each year was a self-contained unit. Accordingly, the Supreme Court held, applying the principle of balancing, that if the inventory is valued at gross then the purchases shall also have to be recorded at gross. Only then, the balancing of the entries could effectively take place. However, this judgment has been relied upon by the Department in support of their contention that by taking the Modvat credit as relatable only to raw materials consumed the assessee is likely to shift the profits of one year to another year which practice has been deprecated by the Supreme Court in the above judgment. We do not find any merit in the said contention. In the above chart of the gross method applied by the Department, the AO has calculated the Modvat credit not on the raw material consumed but on the basis of the purchase cost of 100 units. This calculation cannot be accepted. The reason is that the AO has failed to appreciate the principle laid down by the Supreme Court in *Chainrup Sampatram vs. CIT* case (supra), viz., that whatever is in purchase is also in the closing stock. If the Modvat credit is calculated in the above example on the entire raw material purchased (i.e., on 100 and not 60) then the element of the Modvat benefit in the closing stock of 40 is not taken into account. Therefore, the Department has taken a larger credit into account than what is debited to the P&L a/c. For example, if one debits the P&L a/c. with Rs. 10,000 then you cannot credit the said account with Rs. 11,000. This is where the distortion comes into the calculation made by the AO even while applying the gross method. It omits to take into account the Modvat element in the closing stock of the material (viz., 40). As stated above, under r. 57A, the credit is given to the assessee on purchase of the raw material (input) on goods used in manufacture of final products. The credit is taken at the stage of the receipt of the inputs. The same can be utilised at any stage thereafter. The credit can be availed of even before the consumption of the units. As held by the Supreme Court in the case of *Collector of Central Excise vs. Dai Ichi Karkaria Ltd.* (supra), such credit is indefeasible. We make it clear that our judgment in the present case is based on the judgment of the Supreme Court in the case of *Collector of Central Excise vs. Dai Ichi Karkaria Ltd* (supra). In the circumstances, we make it clear that Modvat credit must be only for raw material consumed. It cannot be taken for the full amount. In the light of the above discussion, it is clear that the gross profit figure remains the same and, therefore, the AO erred in invoking the proviso to s. 145(1) of the IT Act.

10. Before concluding, we may mention that, in rejoinder, learned counsel for the Department

has brought to our attention s. 145A of the IT Act. He has also invited our attention to the subsequent guidance note issued by the ICAI on tax audit under s. 44AB of the IT Act. It was contended that even the ICAI has subsequently declared that the net/exclusive method adopted by various assessees should be applied with adjustments on account of any tax, duty, cess or fee actually paid or incurred on inputs which should be added to the cost of the inputs if not so added in the books of account. He contended that in the subsequent guidance note, the ICAI once again discussed the above two methods and, in the circumstances, it was urged that the net method followed by the assessee was wrong because the assessee has followed the net method without making any adjustments as required under s. 145A. In this connection, we may point out that s. 145A was introduced by the Finance (No. 2) Bill, 1998. Originally, the Bill contemplated the proposed amendment to apply from 1st April, 1986, in relation to the asst. yr. 1986-87 and subsequent years. However, later on, when the said Bill was enacted into law, the provision was made applicable from 1st April, 1999, i.e., asst. yr. 1999-2000. In this appeal we are concerned with the asst. yr. 1989-90. In the circumstances, we are not inclined to go into the provisions of s. 145A. We are also not examining, therefore, the subsequent guidance note issued by the ICAI which is based on s. 145A. The legislature clearly intended, therefore, that the computation made by assessees prior to the asst. yr. 1999-2000 should not be disturbed and, therefore, the legislature has brought the said s. 145A into force only from 1st April, 1999.

11. Accordingly, the appeal is dismissed with no order as to costs.

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