

## **Ramswarup Bengalimal vs Commissioner Of Income-Tax, U.P. & ... on 28 September, 1953**

### **Equivalent citations: [1954]25ITR17(ALL)**

#### **JUDGMENT**

MALIK, C.J. - The question referred to this Court for its decision in compliance with an order under Section 66(2) of the Indian Income-tax Act is :-

"Whether on the facts and in the circumstances of this case, the assessee was entitled to value his closing stock at market rate ?"

The assessee is a firm mainly carrying on wholesale cloth business. The accounts produced showed a total turnover of Rs. 12,81,375. The receipts showed a balance of Rs. 9,263 in favour of the assessee. After deducting certain expenses the assessee, however, worked out a net loss of Rs. 13,915. In preparing the profit and loss account the assessee had valued his closing stock at the market rate at Rs. 1,64,191. The cost price of the said stock was, however, Rs. 2,27,913. The Income-tax Officer was of the opinion that the assessee should have valued his closing stock at the cost price as he had been doing in previous years and he added back the difference between Rs. 2,27,913 and Rs. 1,64,191, i.e., Rs. 63,722. The Appellate Assistant Commissioner and the Tribunal agreed with the decision of the Income-tax Officer.

The assessee had pleaded that his usual method of accounting was that at the end of the year, for the purpose of the preparation of his profit and loss account, he used to value the closing stock either at cost price or at market price, whichever was lower, and that he had followed the same practice in the year in question. He further pleaded that by reason of the textile control restrictions, which came into force in June, 1943, there was an appreciable fall in the market price and he could not expect any relaxation of the controls and the rise in prices, so as to recover what he had paid for the stock.

The Appellate Tribunal held - and it is also stated in the statement of the case - that the assessee had failed to prove that he had always valued the closing stock at the lower of the two prices, the cost price and the market price. It is stated in the statement of the case that the method followed in preparing the profit and loss account by the assessee was that he valued his stock at cost price and in the year in question there had been a departure from the method of valuation followed in the previous years.

We may mention that though the assessee may not have succeeded in proving his case that he had valued his closing stock at the lower of the two figures - the cost price and the market price - the Department has not established that in any year the assessee had valued his stock at cost price though the market price might have been lower. The burden of proving that there has been a change in the method of accounting was on the Department and, in the absence of any evidence that the assessee had in any year valued his stock at cost price, even though the market price might have

been lower, it cannot be said that the method of accounting followed by the assessee was to value his stock at cost price even though the market price have been less.

We are asked to answer the question, whether the assessee was entitled to value the closing stock at market rate, when in the previous years he had been valuing it at cost price.

In *Whimster & Co. v. Commissioner of Inland Revenue* it was laid down that in preparing profits and gains for the purposes of income-tax two principles must be kept in mind : In the first place, the profits of any particular year of accounting must be taken to consist of the difference between the receipts from the trade or business during such accounting period and the expenditure laid out to earn those receipts. In the second place, the account of profit and loss to be made up for the purpose of ascertaining that difference must be framed consistently with the ordinary principles of commercial accounting, so far as applicable, and in conformity with the rules of the Income-tax Act, or of that Act as modified by the provisions and schedules of the Acts regulating excess profits duty, as the case may be.

No correct picture of the profit and loss account can be had unless the opening and the closing stocks are also taken into account. Two principles have not become well settled : (1) that the assessee is entitled to value the closing stock either at cost price or market value whichever is lower and (2) that the value of closing stock must be the value of opening stock in the succeeding year, that is, an assessee cannot close his accounts and value his stock at a particular figure and the next morning on the first day of the next year he cannot value it at a different figure. In *Halsburys Laws of England*, Hailsham Edition, volume 17, page 124, paragraph 232 is as follows :-

"It is to be observed that the allowance by the Inland Revenue authorities of a writing down of stock when market value is lower than cost is in effect the allowance of a reserve for a future unrealised loss, and as such is an exception to the general rule that precautionary reserves are not allowable."

In *Inland Revenue Commissioners v. Cock, Russell and Co. Limited* it was held that in valuing stock-in-trade for the purpose of ascertaining the profits of the business for revenue purposes it proper to consider each item of stock separately and to take it at cost, or value it at market value, whichever is the lower. *Clauson, L.J.*, in *B.G. Utting & Co. Ltd. v. Hughes* (H.M. Inspector of Taxes) said :-

"The normal method of dealing with this item would be to make it up by calculating cost or market value, whichever is the lower, of the various assets represented."

In *Spicer and Peglers Practical Auditing*, Sixth Edition, page 170, the basis of valuation of stock is laid down as follows :-

"Stock should be valued at cost or market price, whichever is lower at the date of the balance sheet."

In this connection, the term market value means either the replacement value or the selling value, whichever is the lower.....

In no case should the value be higher than cost, even though the market value has risen, as these would result in taking profit before the sale is effected and the profit earned. On the other hand, a fall in the market value, due to a fluctuation in the price, need not be considered if the value has since risen. A permanent fall in value, however, must be taken into account.

Stock is a floating asset, and as such must be brought into account at its realisable value, when that value is lower than cost."

There is for this has been given by Courts Trotter, Chief Justice, in Commissioner of Income-tax, Madras v. Chengalvaraya Chetty to enable a trader more evenly to distribute his loss. The learned Chief Justice observed :-

"I should add that the accepted rule is that the assessee in crediting the closing stock figure is to take either the cost price or the market value whichever be the less -a provision obviously intended to be in favour of the trader and enables him more even the to distribute his loss."

The learned Chief Justice, Rajamannar, C.J., in Commissioner of Income-tax and Excess Profits Tax, Madras v. Messrs. Chari and Ram, Madura has said :-

"The accepted basis of valuation of stock is cost or market value whichever is lower, at the date to which the accounts for a period are made up."

As regards the reason for the rule the learned Chief Justice has observed as follows :-

"If one can speculate on the rational of the rule, which allows as assessee to adopt the market value when it is lower than the cost, it appears to be this : If one were to imagine a sale taking place on the closing day of the entire stock, it is reasonable to expect that the articles of which the market value is lower would not fetch anything more than at those rates, and therefore loss would be certain. But there would be no assurance that there would be a market of the entire stock of articles of which the market value is higher and therefore it would be hazardous to assume that the entire stock could be sold at the prevailing market rate and necessarily bring in a profit."

Whatever may be the reason for the rule is now well settled that while the Income-tax Department is not entitled to anticipate profits and compute such anticipated profit as income the trader has been given a concession, not by any statute but by the general practice of accountancy, to value has closing stock at cost or market value whichever is lower, so that he may be able to spread out his loss.

In the case before us on behalf of the Commissioner of Income-tax reliance is placed on the fact that the assessee has not claimed that he made a change in the method of account in and his plea that he had always been valuing the stock at market price or cost price which ever was lower has not been found to be true. On behalf of the Commissioner of Income-tax reliance is also placed on the fact that the assessee had always been valuing his stock at cost price and, it is said, that he is bound by the method of accounting regularly followed by him and as he has not even alleged that he had made a change in the method of accounting here is no reason to give him any relief.

Section 13 of the Indian Income-tax Act makes it clear that the Income-tax authorities are bound to accept the method of accounting regularly employed by the assessee for computation of his income unless the method employed by him is such that in the opinion of the Income-tax Officer the income, profits and gains cannot properly be deduced therefrom. In the case the Income-tax Officer has been given the right to make the computation on such basis and in such manners he may determine. Section 13 of the Income-tax Act is as follows :-

"Method of accounting. - Income, profits and gains shall be computed, or the purposes of Section 10 and 12, in accordance with the method of accounting regularly employed by the assessee :

Provided that, if no method of accounting has been regularly employed, or if the method employed is such that, in the opinion of the Income-tax Officer, the income, profits and gains cannot properly be deduced therefrom, then the computation shall be made upon such basis and in such manner as the Income-tax Officer may determine."

As regards the assessee's right to change the method, learned counsel for the Commissioner of Income-tax has urged that though the assessee may have the right to change the method of accounting adopted by him, one method of accounting can be replaced only by another regular method of accounting. In *Ramkumar Kedarnath v. Commissioner of Income-tax, Bombay*, Beaumont, C.J., said :-

"Although I think it is open to an assessee to change the regular basis on which he keeps accounts, still if he seeks to do that he must satisfy the Commissioner on proper evidence that he has in fact changed the regular basis of accounting. I do not think here he did in fact change the regular basis of accounting except for this particular half year; and if the company had been reinstated again and had continued the agency agreement as before, there is nothing to show that the basis on which the accounts had been kept in the past would not have been continued in future."

On behalf of the Commissioner of Income-tax it is, therefore, urged that unless it is established that the assessee has now adopted a regular method of accounting of valuing his stock at market price or cost price, whichever is less, he should not be allowed to value the closing stock at the market price which was lower in the accounting year in question. Reliance is placed on the observations of their Lordships of Judicial Committee in *Commissioner of Income-tax, Bombay Presidency v.*

Ahmedabad New Cotton Mills Company Limited that "The one thing that is essential is that there should be a definite method of valuation adopted which should be carried through from year to year, so that in case of any deviation from strict market value in the entry of the stock at the close of one year it will be rectified by the accounts in the next year."

We were at one time inclined to the view that the words "method of accounting" in this section do not relate to the question of the valuation of the closing stock but mean whether the assessee had been keeping his account on cash basis or on mercantile basis or had followed the hybrid system of accounting, that is, partly mercantile and partly cash. In view, however, of the observations made by their Lordships of the Judicial Committee in Commissioner of Income-tax, Bombay presidency v. Ahmedabad New Cotton Mills Company Limited, referred to above, and commissioner of Income-tax, Bombay v. Sarangpur Cotton Manufacturing Co. Ltd., Ahmedabad, we must hold that how the closing stock was to be valued must also be deemed to be part of the method of accounting.

We have already said that it has been found that the assessee had all along been valuing his stock at cost price. It has not been shown on behalf of the Department that, in any year, the market price was less than the cost price. It cannot, therefore, be said that the assessee was following the method of valuing his stock at cost price even though the market price or cost price whichever was less and, in the absence of a proof or finding that the assessee had been regularly valuing his stock at cost price, even though the market price might have been less or, in the absence of evidence that, in any year, the market price was less than the cost price, it cannot be said that he has made a change in the method of accounting. No doubt, the assessee, has not substantiated his plea that he had always been valuing his stock at cost price or market price, whichever was less, but the Income-tax Officer was entitled to add back the sum of Rs. 63,722 to the income shown by the assessee only if he could arrive at a definite finding that there had been a change in the regular method of accounting employed by the assessee and the burden of proving that there had been such a change was clearly on the Department. In the statement of the case, the Tribunal has said that, on the record, there was no evidence produced by the assessee to prove that he had valued his opening and closing stocks in earlier years at cost simply because, in all those years the cost price was lower than the market price. Learned counsel for the Department had, however, to admit that the only fact known was that the assessee had always valued his stock at cost price but there was nothing on the record from which it could be deduced that, in those years, the market price was less. In the circumstances, it does not appear to be possible to draw an inference that the assessee had adopted the regular method of valuing his stock at cost price even if the market price was lower and, consequently, in valuing his stocks in the accounting year in question at the lower market price, it cannot be said that the assessee was changing the regular method of accounting employed by him in the past. It cannot, therefore, be held that the assessee was not entitled to value his closing stock at market rate. This is our answer to the question referred to us for decision.

We do not think that this is a case in which the assessee should get his costs as the plea taken by him that he had always been valuing his stock at cost or market price, whichever was lower, had been rejected by the tribunal and no reference was asked for specifically on that point.

Reference answered accordingly.