

inspecting Assistant Vs. Consolidated Pneumatic Tool Co.

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Court : Income Tax Appellate Tribunal ITAT Mumbai

Decided On : Oct-14-1985

Reported in : (1986)15ITD564(Mum.)

Judge : D Meenakshisundaram, Rajendra

Appellant : inspecting Assistant

Respondent : Consolidated Pneumatic Tool Co.

Judgement :

1. In these three appeals, the revenue objects to the decision of the Commissioner (Appeals) deleting the following amounts which were disallowed by the ITO on account of obsolete stocks written off by the assessee in the following three years : 2. These appeals arise out of the income-tax assessments of Consolidated Pneumatic Tool Co. (India) Ltd., the assessee herein, which manufactures mainly pneumatic tools and air and gas compressors.

We are concerned with the assessment year 1973-74 for which the previous year is a period of 15 months commencing from 1-10-1971 to 31-12-1972 and the two subsequent assessment years 1974-75 and 1975-76 for which the previous years ended on 31-12-1973 and 31-12-1974, respectively. There is no dispute that the facts in regard to the addition in question in each of these three years are identical. We find that the department had come up in appeal in the assessment year 1973-74 against the decision of the AAC, deleting the addition of Rs. 2,74,764 in IT Appeal No. 730 (Bom.) of 1977-78. The Tribunal by their order dated 17-5-1978,

examined this issue in detail in paragraphs 14 to 27 of their order and felt that this point had been decided by the AAC without a proper determination of the necessary facts. They, therefore, set aside the order of the AAC on this point and restored the matter to his file for fresh disposal in accordance with law and in the light of their earlier observations. The Tribunal also clarified that both the assessee and the department were free to bring to the notice of the AAC the appropriate material in support of their rival cases in accordance with law.

3. Pursuant to this decision of the Tribunal, the Commissioner (Appeals) again examined the decision in great detail in his order for 1973-74 which is a common order for all the three years, since the appeals for the two subsequent years also were pending before him on this point. In paragraph 2.5 of his appellate order the Commissioner (Appeals) held that the assessee has been following consistently the method of valuing the stocks at their cost or net realisable value ; that this method was consistently followed up to the assessment year 1972-73 and that even in the subsequent assessment years the method was continued except for what the assessee considered as obsolete stock.

The Commissioner (Appeals) accepted the assessee's submission that the reason for obsolescence could be design modification, quality improvement, discontinuation of products and models, cost reduction and the like. He pointed out that up to the assessment year 1972-73 the assessee had not made any attempt to identify such obsolete stock probably because there was only a steady growth in the turnover of the company and probably obsolete items lying in closing stock were not very substantial. Even so, the Commissioner (Appeals) found that the assessee had been making a reserve for obsolescence right from the assessment year 1968-69 with the exception of 1969-70 and that various amounts had been transferred to the reserve for inventory of obsolescence, though the amounts transferred to the reserve were always offered for taxation. The Commissioner (Appeals) noticed that there were as many as 30 models of air compressors and over 125 models of pneumatic tools manufactured by the assessee and that these compressors and pneumatic tools are tailor-made to meet the requirements of the consumers. The Commissioner (Appeals) pointed out that with the advance of technology, very substantial change in the models and designs and the

components and spare parts manufactured for one model may not be of any use to the products manufactured subsequently and that this was the reason for obsolescence. The Commissioner (Appeals) then examined the inventory of obsolescence stock produced before him and found that the assessee had issued stocks which had been discarded, but that such issue was of a very small quantity. He further found that even this method of keeping obsolete stock in the separately earmarked portion of the stores was subsequently discarded by the assessee and that the stocks which were declared as obsolete had been lumped with the other scrap except for the brass and bronze scraps, which were valuable scraps and kept in special earmarked scrap-bins.

4. The Commissioner (Appeals) next examined the question whether the value of the stock that had become obsolete and written off in the books of account could be considered as a loss incidental to the carrying on of the business and whether" the method followed by the assessee in this regard was a scientific and rational method which did not distort the profit figures of the assessee-company. The Commissioner (Appeals) held that the assessee was engaged in the manufacturing of several types of pneumatic tools and air compressors of various designs, as per the requirements of the consumers, that these designs and models did undergo frequent changes and that the components and spares which were manufactured in a year might have little or no value at all in the subsequent years. He was of the view that for the ascertainment of the true profit, it would be necessary for a businessman to determine the proper value of the stocks and that it was a wholesome practice to discard the obsolete stock after taking into consideration its scrap value. He further found that in the assessment years 1972-73 and 1973-74 the assessee had followed the method of retaining some value in respect of the obsolete stock, but that such method had been discarded as a policy because of the difficulties faced by the assessee in the matter of accounting. He pointed out that this method involved determination of the value of the items discarded, when later on called back either because of certain demands from consumers or because the assessee required it in the course of its customer service. The Commissioner (Appeals) found that from the assessment year 1975-76 the method followed by the assessee was to identify the stocks which were of little use or no use and thereafter write off their value in the books. The

Commissioner (Appeals) held that no serious exception can be taken to this procedure though the assessee has not made any attempt of finding out the scrap value of such stock, because once the scrap value is determined, the stock that has been considered as obsolete, will have to be kept separately and when the same has been sold the scrap value will have to be adjusted from the sale proceeds. He pointed out that this would involve avoidable labour and also maintenance of list of obsolete stock. The Commissioner (Appeals) was of the opinion that there cannot be any serious objection to an assessee changing the method of valuation of closing stock, if such change in the method is a bona fide change and has been followed consistently thereafter, and that in the present case it is even doubtful whether there has been a change in the method of valuation of closing stock. According to the Commissioner (Appeals), what the assessee has been doing was to identify the stocks which have no value or little value and thereafter deduct its value, while valuing the closing stocks. The principle behind such valuation is that the stock that has been discarded as obsolete, has a little scrap value and it is not possible to ascertain what such stock would fetch if sold in the open market. The method of accounting for the sale proceeds as and when the stocks are sold, could compensate any possible distortion in the matter of reporting any profits and in this view, the Commissioner was of the opinion that the amounts written off by the assessee in the stock accounts in every year under consideration was in order. He further held that the non-retention of any value in respect of this discarded stock in the assessment year 1975-76 and onwards was purely dictated by the exigencies of accounting and was not likely to distort the profit figures in the long turn. He, therefore, upheld this claim of the assessee.

5. The Commissioner (Appeals) then examined the further question whether it was proper for the assessee to write off as obsolete stocks on the basis of inventory as on the 30th day of September of each year and especially when the previous year of the assessee ended on 31-12-1972. It was pointed out by the assessee that the exercise of inventorising the obsolete stock out of several hundred items, is a time consuming job and that this exercise has to be gone through well before the close of the accounting year and that the assessee, for this purpose, starts inventorising obsolete items of stock in the month of September, but that the write off is actually made at the end of the accounting year. The Commissioner (Appeals) accepted

this explanation offered by the assessee as satisfactory. He further held that even assuming that items listed as obsolete are out of the list prepared as at the end of September, that procedure left no room for mischief. The Commissioner (Appeals) pointed out that at best it might not have taken into consideration a few items which had become obsolete after this inventory was prepared and this by itself was not sufficient to condemn the method followed by the assessee. In this view of the matter, he accepted this claim of the assessee also. Consequently, the Commissioner (Appeals) deleted the additions in all the three years under appeal.

6. The revenue feels aggrieved by these orders and has again come up in appeal to the Tribunal.

7. We have heard Shri D.A. Kamat, the learned departmental representative, and Shri S.E. Dastur, the learned counsel for the assessee, and carefully considered their submissions. In our view the decision of the Commissioner (Appeals) is right and does not call for any interference at our hands. We are unable to agree with the revenue that the Commissioner (Appeals) had not examined the case in the light of the directions given by the Tribunal in the earlier order dated 17-5-1978. Apart from making a general submission, the revenue was unable to pin-point in what respect or aspect the Commissioner (Appeals) failed to follow the directions given by the Tribunal. On the contrary, a perusal of the entire order of the Commissioner (Appeals) from paragraph 2 to paragraph 2.6 would show that the Commissioner (Appeals) had applied his mind to every aspect of the case that has been pointed out by the Tribunal while remanding the case for the assessment year 1973-74. We have not burdened this order with the submissions urged on behalf of the assessee before the Commissioner (Appeals) which are set out in great detail in sub-paragraphs 2.1 to 2.4 of the Appellate order of the Commissioner (Appeals). A perusal of these four sub-paragraphs would establish that the preparation of the inventories of obsolete stocks, in these years, was not done in an arbitrary and whimsical manner by the assessee, but in a fair and reasonable way having regard to the development of technology, either on account of design change or for one or more reasons like quality, improvement, discontinuation of products and models and cost reduction and the like. In sub-paragraph 2.1 the Commissioner (Appeals) has referred to two specific instances

by way of illustration. They are the cases of receiver strips used in compressors of the value of Rs. 12,754 which totally became obsolete due to alteration of design. Similarly 740 items of perforated stocks of the value of Rs. 11,322, which were used as a component in the filter element, were found to become obsolete due to alteration of filter element frame from wool to fibre glass wool and that consequently the perforated screen used in the wool frame became no longer usable and had to be discarded. There is no material placed by the revenue that these are incorrect. The Commissioner (Appeals) has also referred to the four broad classifications of obsolete stocks into castings, bar materials, blanks and finished parts, adopted by the assessee while preparing these inventories of obsolete stocks in the first two years and the basis on which they were valued as obsolete stocks. The Commissioner (Appeals) had also discussed the reasons as to why the assessee discarded this method of valuation of obsolete stocks in 1975-76 by taking the total value of the obsolete stocks as nil. The Commissioner (Appeals) has also taken note of the percentage of the obsolete stocks written off in each of these years, of the total cost inventory and the cost of sales.

The department has been unable to point out anything wrong in this approach of the assessee in arriving at the value of the obsolete stocks or suggest any other better or appropriate and scientific method of valuation of such obsolete stocks. It is not the case of the revenue that the inventories of obsolete stocks prepared by the assessee in these three years are neither correct nor represent the true state of affairs, nor has the department placed any material which would show that the findings reached by the Commissioner (Appeals) are not based on any material, but on mere surmises and conjectures.

8. We are also unable to accept the contention of the revenue that the Commissioner (Appeals) has not applied his mind to the last aspect stated by the Tribunal in paragraph 26 of their order, namely, whether the entire claim of loss was allowable in the assessment year 1973-74 as it may pertain to stock which had become obsolete in the earlier years. This argument of the revenue overlooks the fact that the Commissioner (Appeals) had relied upon two decisions of the Madras High Court in the case of K. Mohammad Adam Sahib v. CIT [1965J 56 ITR 360 and in India Motor Parts & Accessories (P.) Ltd. v. CIT [1966] 60 ITR 531.

Apart from these decisions, the following decisions relied upon by the learned counsel for the assessee, Shri Dastur, also support the assessee's case.

9. The first decision is of *Indo-Commercial Bank Ltd. v. CIT* [1962] 44 ITR 22 (Mad.). In this case it was held that the method an assessee adopted for valuing his closing stock was a 'method of accounting', within the meaning of Section 13 of the Indian Income-tax Act, 1922, and that at any rate it was an integral part of the mercantile system of accounting. It was also held that, on the facts, as the change in the basis of valuing the securities at the close of the year was made by the assessee bona fide and that basis was continued thereafter, the requirements of Section 13 were satisfied, that, the assessee had the option of adopting the well known system of valuing the closing stock at the market price and that the assessee had regularly thereafter adopted that system. The department was not, therefore, entitled to reject that system adopted by the assessee. Their Lordships further held that the change in the method of valuation was detrimental to the revenue was not a relevant factor in deciding whether the assessee had the right to change the basis of valuation, and that in deciding whether the changed method of valuation of closing stock attracted the proviso to Section 13, it was not a correct approach to see whether the losses of previous years would also enter into the claim made by the assessee for the accounting year. Their Lordships pointed out that an actual loss sustained by the sale of securities below the cost price could not be disallowed on such a ground, and that a notional or anticipatory loss resulting from a valuation of the closing stock, which an assessee was permitted to take into account in ascertaining his trading profits, stood on no different footing. According to their Lordships, it was a concession given to the assessee based on the well recognised usage of the trade, and the principle underlying that concession was in no way violated when the assessee changed his method of valuation from cost to market value, if the latter was less than the cost price. Their Lordships pointed out that if the revised basis of valuation was continued thereafter the profits and loss thereafter would be correctly computed. Their Lordships of the Madras High Court followed the decision of the Bombay High Court in *Sarupchand v. CIT* [1936] 4 ITR 420. This decision of the Madras High Court completely answers the contentions of the revenue in the present case. We may further point out that this decision of the Madras High Court was followed by

the Kerala High Court in the case of Forest Industries Travancore Ltd. v. CIT [1964] 51 ITR 329 and also in CIT v. Carborandum Universal Ltd. [1984] 149 ITR 759 (Mad.). No material has been placed before us by the revenue to show that the method of valuing the obsolete stocks and writing them off in its accounts, followed by the assessee in these three years, was not bonafide and that this method had not been followed by the assessee in the subsequent assessment years. We, therefore, respectfully follow the decisions quoted above and hold that the Commissioner "(Appeals) was right in accepting the assessee's contentions and in deleting the additions made by the 1TO on account of obsolete stocks written off by the assessee in its books.

Accordingly, we confirm the orders of the Commissioner (Appeals) in all the three years and dismiss the appeals.

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