Orissa Cement Ltd. Vs. Inspecting Assistant

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Court : Income Tax Appellate Tribunal ITAT Delhi

Decided On : Aug-03-1992

Reported in : (1992)43ITD424(Delhi)

Judge : S Kapur, A Kalyanasundharam

Appellant : Orissa Cement Ltd.

Respondent : inspecting Assistant

Judgement :
1. to 35. [These paras are not reproduced here as they involve minor issues.] 36. The objection of the revenue is on the acceptance of the change in the method of valuation of the closing stock, by the CIT (Appeals). The revenue had raised its objection on the basis that, the Absorption Cost gave a true value of the stock on hand and the Direct Cost did not. The revenue had also objected to the observation of CIT (Appeals) that, the method adopted by the appellant company would not result in any loss to the revenue, because, the stock would be sold in the next year. The revenue had contested that, by accepting the method of valuation to direct cost, year after year, the stock would continuously valued at a lesser value. The Assessing Officer was of the opinion that, the change in the method of valuation of the closing stock had resulted in under-valuation of the stock by Rs. 2.21 Crores.

The facts in this regard are brought out below in brief. The assessee had been valuing its closing stock of finished goods and work-in-progress on 'lower of cost or realisable value' and its opening stock is brought forward on that basis. The term cost as was adopted by the company was 'total cost'. The appellant company retained its method of valuation on 'cost or realisable value', but, modified the term cost to mean 'direct cost'. In direct cost, the appellant company had considered the element of cost of raw-materials, stores and such other materials, that go into production of the various articles manufactured by it and included the element of variable cost of manufacture. The element of fixed cost such as on administration etc., were not considered as part of the cost, on the reasoning that, they are incurred in the normal course of running of the business and as such in no way contribute to the production of the articles. In support of its method of determination of the cost of the products, it had obtained the opinion of a Cost Accountant Shri R.J. Goel (copy of opinion placed at pages 523-535 of Volume 2 of paper book).

The opinion has considered the Standard Accounting Principles AS-2 issued by the Institute of Chartered Accountants of India. Sh. Goel examined the system of determination of cost with the standard prescribed by the Institute of Chartered Accountants. He observed that, the appellant had been treating the cost to mean - (a) the cost of raw-materials, all other incidental materials that go into production, and the cost of stores and (b) all of the expenses had been taken into account and based on the actual production, the allocation was made to the products. He by making reference to the standard as prescribed, observed that, the system of determination of cost hitherto adopted by the appellant was neither direct cost nor absorption cost. He had noted that, the 'direct cost' required to take into account all the cost of raw-materials, incidental materials and stores and the element of variable cost only. The 'absorption cost' required to take into account all the cost of raw-materials, incidental materials and stores, the element of variable cost and the element of fixed cost apportioned on normal levels of production. He therefore, concluded that, the method of determination of cost of products, both finished and semi-finished did not conform to the prescribed standard.

He accordingly proceeded to examine, which of the two methods of determination of cost, i.e., direct cost or absorption cost should be followed by the appellant company. He considered the fact of the company having several units and also several articles being produced in such units. He also noted that, the production of articles were never uniform in any of the units and fluctuated widely and therefore, he concluded that, fixing of normal production was a near impossibility. He also considered the fact that, the fluctuation in production was influenced by several factors internal and external, on which, it had no control. He also considered the fact that no two months was uniform. He observed that, absorption costing which required allocation of all fixed expenses, was a very cumbersome process and it involved arbitrariness and subjectiveness. The reason given was that, the allocation initially was to be made to each of the unit and then to the different cost centers of those units, which required fixation of normal levels of production. He also observed that, since no two months production was uniform, the absorption costing of one month (by taking any one month as giving standard or normal production) would be in variance with the absorption cost of another month, because, of the fluctuation in the production. He felt that, the allocation of the expenses, which involves certain amount of assumptions, the end result of cost would include assumed portions as well and since no two persons would agree to the basis of assumptions and its quantum, it would never project the cost of the product to its near accurate value.

He considered the proposition of direct cost method. He felt that, this method limited itself to the point of stages of actual production, which are identifiable and did not involve any arbitrariness. He felt that, the fixed expenses which do not vary with production or with the factors which influence the production, both internal and external, should be charged off to the profit and loss account. He accordingly concluded that, the appellant company should adopt direct cost method for valuing the finished and the semi-finished goods. He felt that, the element of direct cost should include (a) cost of raw-materials; (b) power & fuel; (c) cost of direct contract labour; (d) grinding media; and (e) packing materials. He also opined that, the labourers employed by the company on fixed monthly/daily wages in its plants for manufacturing Cement, Refractories and Cement products at Rajgangapur and Soda Ash & Ammonium Chloride in Sahupuri though traceable to any production process is in the nature of 'fixed costs' and accordingly concluded that, the same has to be excluded for computing the 'cost' under Direct Costing Method. He also stated that, the method as elucidated by him of the valuation of the inventory of finished goods and work-in-progress, would be satisfying the standards laid down by the Institute of Chartered Accountants of India.

On the above advice of the Cost Accountant, the appellant company valued its inventory of finished and semi-finished goods. The objection of the revenue as raised in its ground are that, the absorption cost is preferable for it takes into account all of the expenses that has some relation to the production and would reflect the near true cost of the inventory.

The contention of Sh. Ganesan was that, the method of cost as adopted by the company is in conformity with the prescribed standards. The Bench, during the course of hearing requested the counsel for the appellant company, to address its arguments with reference to the ratio laid down by the Supreme Court in C1T v. British Paints India Ltd. [1991] 188 ITR 44 54 Taxman 449. The counsel submitted that, in the case before Supreme Court, the method adopted by that company was neither direct cost nor absorption cost, for, it did not include any element of variable cost. It was in those circumstances that, the Apex Court had held that, the Assessing Officer could disturb the valuation of the inventory to arrive at the true income of the company. He pleaded that, the assessee had adopted direct cost method for valuing its finished and semi-finished goods and the said method is in conformity with the prescribed standards of institute of Chartered Accountants of India. He further contended that, the revenue has no dispute on the fact that, the method adopted of direct cost was not a proper one or that, it was not in accordance with the prescribed method of valuation. He contended that, the revenue only has been insisting on adoption of absorption cost in preference to direct cost. He pleaded that, the facts of the assessee's case being different from the case of British Paints India Ltd. (supra), the ratio laid down would be inapplicable to it.

On the above-mentioned facts, submissions and after considering the materials that have been placed on our record, at pages 352-522, we are giving our conclusions. We would to begin with bring out the definition of the terms 'direct costing', 'absorption costing', 'Variable costs' and the Standard prescribed by the Institute of Chartered Accountants of India (AS 2), in regard to the valuation of inventories of finished and work-in-progress.

The term 'direct costing' has been defined as the method whereby the cost of inventories is determined so as to include the appropriate share of variable costs only, all fixed costs being charged against revenue in the period in which they are incurred'. The term Variable costs' has been defined as 'those costs of production which vary directly, or nearly directly, with the volume of production'. The term 'absorption costing' has been defined to mean 'the method whereby cost of inventories is determined so as to include appropriate share of both variable and fixed costs, the latter being allocated on the basis of normal level of production'.

In para 24 of this standard, it is stated that, inventories should be valued at lower of historical cost and net realisable value. In the discussion on Historical Cost as the basis of inventory valuation, there is reference to 'Cost of conversion'. This term 'Cost of conversion' has been defined to include direct labour, direct expenses and production overheads. It has been amplified that it could be segregated into fixed costs and variable costs. In paras 27 and 28 it deals specifically to the mode of valuation of the inventories. In para 27, it states that, 'the historical cost of manufactured inventories may be arrived at on the basis of either direct costing or absorption costing. Where absorption costing has been used, the allocation of fixed costs to inventories should be based on the normal level of production'. In para 28, it is stated, 'overheads other than production overheads should be included as part of the inventory cost only to the extent that they clearly relate to putting the inventories in their present location and condition'.

The appellant company has stated that it had adopted 'direct costing' method for valuing the inventory of finished goods and the semi-finished goods. While doing so, it had taken into consideration the cost of raw-materials consumed, cost of conversion such as power & fuel, direct labour (stated to be of contracted labour which is treated as variable costs), grinding material and the packing material. The appellant company had excluded from this cost, the wages paid to its employees, who have contributed to bringing of the inventory to its present location and condition. The argument advanced was that, since the production staff are paid either daily or weekly or monthly and not with reference to the quantity produced, the wages have to be classified as fixed costs. According to the assessee, only costs that are incurred with reference to the number of units produced, are variable costs and therefore, they alone could be considered when valuing the inventory under the direct costing method.

The common meaning of the term 'direct' is straight, immediate and of the term 'cost' to require to be laid out or suffered. Therefore, the ordinary meaning of the combined term 'direct cost' would be immediate requirement to be laid out or suffered. This term 'direct cost' is taken to mean the aggregate of all those items, which result in the production of goods, i.e., without which, the goods would not have reached its finished state. Eric Kohler in his Dictionary for Accountants has defined 'direct cost' as the cost of any good or service that contributes to and is readily ascribable to product or service output, any other cost incurred being regarded as fixed costs.

This definition indicates that, 'direct cost' is the same thing as 'factory cost' or 'prime cost' or 'cost of produced goods'. Direct Cost therefore, should include all those costs, which are directly related to the making of the product. Such costs are, direct raw-materials, direct incidental raw-materials, direct power & fuel, direct labour and direct overheads. The meaning of the above terms as stated in Eric Kohler's Dictionary for Accountants are reproduced hereunder. 'Direct Material' means material entering into and becoming a constituent element of a product. 'Direct Labour' means labour applied directly to a product. 'Direct Overhead' means factory, selling or other expense attributed to solely to a certain product, and thus constituting a direct cost. Under normal parlance, direct raw-material and direct labour are treated as variable with production volume. It is only the manufactured overhead, which include the element of both variable and fixed components.

The direct cost method and the absorption method, cannot therefore be any different so far as inclusion of the elements of direct materials, direct labour and direct overhead. The only additional element in absorption cost is the element of fixed component of production and other overheads. Therefore, the exclusion of that part of direct labour, which is fixed on monthly, weekly or daily, would result in the inventory being valued at a price, that would not even reflect the direct cost of manufactured goods. When cost of goods produced which excludes the element of direct labour, i.e., own employees, is related to the sale value of such goods, it would give distorted figure of profit. This could be amplified with an example. 10 kilograms of Cement is produced with raw-materials of 11 kilograms of a value Rs. 10,000.

The cost of labour contracted is Rs. 1,200, cost of own employees in the factory is Rs. 3,600, the cost of direct overhead is Rs. 2,400 and the cost of indirect overhead (also termed as production overhead) is Rs. 3,000. The cost of other overheads such as administration, etc., are not considered. The direct cost of 10 Kgs of Cement as it should be as per assessee would be as under :- Elements of cost Value as per Assessee Correct Value Rs. Rs. Rs. Rs. Raw-material 10,000 10,000 Direct Labour - Contracted 1,200 1,200 Direct Labour - own employees 3,600 3,600 4,800 Direct Overhead 2,400 2,400 Indirect Overhead 3,000 3,000 ----------- ---------- TOTAL DIRECT COST 13,600 17,200 ----------- ---------- Cost of 5 Kgs of Cement: 6,800 8,600 Sale value of 5 Kgs of Cement 15,000 15,000 Gross Profit 8,200 6,400 Less : Direct Labour - own Less : Indirect overhead 3,000 6,600 3,000 3,000--- Net Profit 1,600 3,400 In addition to the direct cost, the gross profit and the net profit figures are also calculated in the above-mentioned example, only to highlight the fallacy in the theory advocated by the assessee in regard its definition of the direct costing method of valuation of inventory.

In the method adopted by the assessee, the gross profit is higher, but, the net profit is lower, because, the element of direct labour (own employees) is charged off as revenue, though, it had contributed directly in the making of the finished product, viz., Cement. The assessee conveniently omits the definition of the term Variable costs', as defined above, which includes those costs of production, which vary directly or nearly directly with the volume of production. Direct labour, whether, of own employees or of contract labour are fundamentally treated as variable with the volume of production, which is why, in the definition of variable costs too, reference is made to the term 'nearly directly'. Therefore, we are of the opinion that, in the method of direct costing adopted by the assessee, the exclusion of the cost of its own employees does not reflect the element of direct cost of the goods produced and under process and requires to be modified with the element of own labour cost as well.

The choice of direct costing method or absorption costing method rests with the assessee, so long as the cost of inventory reflects to near approximation, its true value. The direct cost method of valuation of inventory was examined by the Madras High Court in CIT v. Carborandum Universal Ltd. [1984] 149 ITR 758 16 Taxman 25. In this case, the assessee had modified its valuation of inventory to direct costing from total cost basis, and the question was, whether, the change was bona ftde or not. The conclusion of the Court was, that, direct costing method is one of the recognised principles of valuation of inventory and upheld the change of method. We may observe that, in this case, the court considered the various elements of direct cost and found that, it included direct materials, direct labour (without any exclusion of own labour cost), which included overtime, holiday pay, fringe benefits, bonus, ESI, PF, etc., direct overhead and salary of supervisory staff.

They also examined the distinction with total cost, the other elements that make the total cost, such as office and administrative overhead, selling overhead etc. This ruling of the Madras High Court, supports the view adopted by us above that, direct labour of own employees cannot be excluded for arriving at the direct cost of goods. In this decision, the Court ruled that, the revenue could not question the direct cost method, because, it was found that, the change was bona fide and was followed thereafter consistently. We are accordingly of the view that, the revenue could not impose upon the assessee to follow the absorption costing method in preference to the direct costing method, except to the extent of the modification of the direct costing as observed by us earlier.

Since the assessee's method considered most of the elements of direct cost, the revenue could not reject the method under Section 145 of the Act. Therefore, the ratio laid down in the Supreme Court decision in British Paints India Ltd.'s case (supra), would not be applicable to the appellant company.