IN THE INCOME TAX APPELLATE TRIBUNAL
"B''BENCH: BANGALORE

BEFORE SHRI N.V. VASUDEVAN, VICE PRESIDENTAND
SHRI B.R. BASKARAN, ACCOUTANT MEMBER

ITA No.121/Bang/2020
AssessmentYear:2008-09

Deputy Commissioner of Income-tax Circle-7(1)(1) Bangalore	**Vs.**	M/s. Thermo King India Pvt. Ltd. Plot No.35, KIADB Industrial Area Bidadi Bangalore-562109 **PAN NO :AABCT2265L**
APPELLANT		**RESPONDENT**

Appellant by	**:**	Shri Muzaffar Hussain, D.R.
Respondent by	**:**	Shri Sharath Rao, A.R.

Date of Hearing	**:**	03.09.2020
Date of Pronouncement	**:**	04.09.2020

O R D E R

PER B.R. BASKARAN, ACCOUNTANT MEMBER:

The revenue has filed this appeal challenging the decision rendered by Ld. CIT(A) Mysore in respect of disallowance of interest expenditure made by the A.O. in assessment year 2008-09.

2. We heard the parties and perused the record. The assessee is engaged in the business of trading in Refrigeration units (including Freezers and Chillers). During the course of assessment proceeding, the A.O. noticed that the assessee has shown closing stock of inventory at Rs.12.02 crores. He also noticed that the assessee has claimed interest expenditure of Rs.1.71 crores on the loan taken from M/s.

Inger Soll Rand (I) Ltd. The A.O. noticed that the assessee did not have surplus funds equal to the inventory held by it. Accordingly, he took the view that the assessee has used the loan funds for purchasing the inventory. In view of the same, the A.O. took the view that the interest expenditure should have been considered by the assessee while valuing inventory as at the year end, i.e., the assessee should have capitalized part of interest expenses in the value of inventory. The A.O. has so taken the view by observing that the interest attributable to bring the inventory to its present location and condition should be included in the cost of inventory. Accordingly, he computed the interest attributable to the inventory by adopting prime lending rate of 12.75% determined by the State Bank of India and accordingly computed a sum of Rs.1,53,37,415/-, as the interest attributable to the inventory and disallowed the same.

3. The Ld. CIT(A) deleted the disallowance and hence the revenue has filed this appeal before us.

4. We notice that the Ld. CIT(A) has deleted disallowance with the following observations:

> *"5.8 Ground no. 13 and 14 pertains to disallowance of interest expenses of Rs.1,53,37,415/- by attributing it to inventory. In brief, during the assessment proceedings, it was observed by the Assessing Officer that the appellant had claimed interest expense amounting to Rs. 1,71,25,525/-. The Assessing Officer noted that the appellant did not have interest free funds for the purpose of stocking its inventory. Further, the Assessing Officer held that the appellant was not able to prove that non-interest bearing funds were utilized for the purpose of inventory and therefore, held that interest attributable in bringing inventory to its present location and condition should form part of cost of inventory. Accordingly, the Assessing Officer made an addition of Rs. 1,53,37,415/-, computed at a rate of 12.75 percent being the*

average prime lending rate of SBI as on 31 March 2008. During the appellate proceedings, the appellant has made detailed submission. At the outset, the appellant submits that issue relating to the attribution of interest accrued on loan to the cost of inventory has already been decided in favour of the appellant by the Commissioner of Income Tax (Appeals) - 7, Bangalore for the AY 2010-11, AY 2011-12 and AY 2012-13. The appellant also argues that it had borrowed loan for the purpose of working capital requirements. Section 36(1)(iii) of the Act, provides that amount of interest paid in respect of capital borrowed for the purpose of business and profession shall be allowed as deduction while computing the income from business or profession, with the only exception being where it is utilized for acquisition of a capital asset, which then has to be capitalized till the asset is put to use. In the present case, the loan is utilized for the purpose of working capital. The appellant also has relied on section 145A of the Act to contend that valuation of inventory needs to be done as per the method of accounting regularly employed by the assessee. The Appellant being a Company, is mandated to follow AS 2 issued by the ICAI for valuation of inventories. AS 2 provides for valuing the inventory at cost or net realizable value whichever is lower. It also defines the cost of inventory to comprise all costs of purchase, costs of conversion and ***other costs*** *incurred in bringing the inventories to their present location and condition. The following relevant para of the AS-2 is reproduced here under:*

- *"6. The cost of inventories should comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition...*

- ***"Other costs***

  11. Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include overheads other than production overheads or the costs of designing products for specific customers in the cost of inventories.

  12.Interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition and are, therefore, usually not included in the cost of inventories.

Para 12 of the AS 2, excludes the borrowing cost from the scope of other cost. Similar exclusion has been provided in the Income Computation and Disclosure Standard (ICDS) recently notified by Central Government for the purpose of

> *valuation of inventory as per ICDS - II. Further the interest accrued on loan for meeting working capital needs are in the nature of administrative overheads same should be specifically excluded from the cost. Therefore, based on the above, the appellant submits that interest accrued on loan taken for the purpose of meeting working capital needs cannot be attributed to the cost of inventory. Further, the appellant also has placed reliance on the decision of the Hon'ble Bangalore tribunal in the case of JSR Constructions (P) Ltd [2016] 71 Taxmann.com 184, wherein it was held that "interest cost attributed to loans for financing the normal trading activity of the appellant is a period cost and to be charged to profit and loss account and such interest cannot go into the cost of inventories". The submissions of the appellant have been considered. The appellant is a trader and the inventory maintained by it is that of the items traded by it. The same do not represent work-in-progress of any manufacturing activity or any capital item/asset being constructed or acquired by the appellant for its own use. Interest cost attributed to loans taken for financing its normal trading activities is a period cost that has to be charged to profit and loss account. The reference drawn to AS 2 & ICDS II by the appellant makes it clear that generally interest and borrowing cost do not form part of cost of inventory. Further, the reliance placed on the jurisdictional ITAT in the case of JSR Constructions (P) Ltd is also well placed. Therefore, the appellant is justified in considering interest as a period cost and debiting the profit and loss account. Therefore, the Assessing Officer is directed to delete the addition of interest cost amounting to Rs. 1,53,37,415/-.Therefore, appeal on this ground is allowed. As the main ground no. 13 is adjudicated in the appellant's favor, ground no. 14 becomes academic in nature and as such, the same are not being adjudicated."*

Aggrieved by the order so passed by Ld CIT(A), the revenue has filed this appeal before us.

5. The Ld. D.R. supported the order passed by the A.O.

6. On the contrary, the Ld. A.R. supported the order passed by the Ld. CIT(A). In addition to the above, the Ld. A.R. submitted that the principle enunciated by the A.O. would be applicable only to capital assets, as per the proviso to section 36(1)(iii) of the Income Tax Act 1961 (hereinafter called as 'the Act). He submitted that the assessee has used borrowed funds in the normal business activities of trading in refrigeration items. Hence, the question of capitalising the interest expenditure does not arise. He also placed reliance on the decision rendered by coordinate bench of ITAT in the case of DCIT Vs. JSR Constructions Pvt. Ltd. (2016) 71 Taxmann.com 184 and submitted that the coordinate bench has, after considering Accounting Standard - 2 relating to valuation of inventories, has held that the question of including interest expenditure for current assets does not arise. The Ld. A.R. also submitted that the newly introduced ICDS though applicable in the subsequent year also supports the methodology adopted by the assessee.

7. Having heard the rival submissions, we find merit in the contentions of the Ld. A.R. For the sake of convenience, we extract below the decision rendered by the coordinate bench on an identical issue in the case of M/s. JSR Constructions Pvt. Ltd. (supra).

***"20.** We have perused the record and heard the rival contentions. There is no dispute that work-in-progress shown by the assessee was a part of its current assets. Such work-in-progress and inventory did not represent any capital item or capital asset being constructed or acquired by the assessee for its own use. Assessee was doing road work based on contracts awarded to it. Interest cost attributed to loans taken for financing its normal trading activity is, in our opinion, a period cost that has to be charged to* *profit & loss account. Such interest cannot go into the cost of inventories. Accounting Standards AS-2 which deals with valuation of inventories states as under:—*

> *"Cost of Inventories*
>
> *6. The cost of inventories should comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to Valuation of Inventories to their present location and condition.*
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> *Costs of Purchase*
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> *7. The costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase.*
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> *Costs of Conversion*
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> *8. The costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings and the cost of factory management and administration. Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and indirect labour.*
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> *9. The allocation of fixed production overheads for the purpose of their inclusion in the costs of conversion is based on the normal capacity of the production facilities. Normal capacity is the production expected to be achieved on an average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates normal capacity. The amount of fixed production overheads allocated to each unit of production is not increased as a consequence of low production or idle plant. Unallocated overheads are recognised as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed production overheads allocated to each unit of production is decreased so that inventories are not measured above cost. Variable production overheads are assigned to each unit of production on the basis of the actual use of the production facilities.*

> *10. A production process may result in more than one product being produced simultaneously. This is the case, for example, when joint products are produced or when there is a main product and a by-product. When the costs of conversion of each product are not separately identifiable, they are allocated between the products on a rational and consistent basis. The allocation may be based, for example, on the relative sales value of each product either at the stage in the production process when the products become separately identifiable, or at the completion of production. Most by-products as well as scrap or waste materials, by their nature, are immaterial. When this is the case, they are often measured at net realisable value and this value is deducted from the cost of the main product. As a result, the carrying amount of the main product is not materially different from its cost.*
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> *Other Costs*
>
> *11. Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include overheads other than production overheads or the costs of designing products for specific customers in the cost of inventories.*
>
> *12. Interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition and are, therefore, usually not included in the cost of inventories."*

21. *It is clear from clause 12 of the Accounting Standards 2 that normal interest and borrowing costs cannot form part of cost of inventory. When an assessee is following method of valuation of inventory which is in accordance with the Accounting Standards prescribed by ICAI, in our opinion, Revenue cannot step into the shoes of assessee and foist on it a different method, unless there is a clear statutory edict allowing a departure from such accepted standards. We cannot say that assessee had understated its work-in-progress or inventory by not charging interest relating to working capital loan to its valuation. Assessee was well justified in considering interest as a period cost and debiting in its profit & loss account. We do not find any merit in the additions made by the AO. As such, these additions are deleted and ground No.5 is allowed."*

8. There is no dispute with regard to the fact that the inventories held by the assessee are current assets and hence the requirement of capitalising the interest does not arise, as per the proviso to section 36(1)(iii) of the Act mandates capitalization of interest only in respect of capital assets purchased out of borrowed funds. We also notice that the method of valuation adopted by the assessee also

gets support from Accounting Standard – 2 issued by ICAI. The Ld. A.R. also submitted that the newly introduced ICDS though applicable in the subsequent year also supports the methodology adopted by the assessee. Under these set of facts and in view of the fact that the decision rendered by the Ld. CIT(A) is in consonance with the decision rendered by the coordinate bench in the case of JSR Constructions (supra), we do not find any infirmity in the decision rendered by Ld. CIT(A) on this issue. Accordingly, we uphold the same.

9. In the result, the appeal filed by the revenue is dismissed.

Order pronounced in the open court on 4th Sept, 2020

Sd/-	**Sd/-**
(N.V. Vasudevan)	**(B.R. Baskaran)**
Vice President	**Accountant Member**

Bangalore,
Dated 4th Sept, 2020.
VG/SPS

Copy to:

1. The Applicant
2. The Respondent
3. The CIT
4. The CIT(A)
5. The DR, ITAT, Bangalore.
6. Guard file

By order

Asst. Registrar, ITAT, Bangalore.