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INVENTORY WRITE OFF – PRE AND POST GST SCENARIO

Author : G. Natarajan

1.0 In the Cenvat Credit Rules, 2004 (CCR, 2004), sub rule (5B) to Rule 3 was inserted vide Notification 26/2007 CE NT Dt. 11.05.2007, which read as below.

(5B). If the value of any,

- (i) input, or
- (ii) capital goods before being put to use,

on which CENVAT Credit has been taken is written off fully or where any provision to write off fully has been made in the books of account, then the manufacturer shall pay an amount equivalent to the CENVAT credit taken in respect of the said input or capital goods :

Provided that if the said input or capital goods is subsequently used in the manufacture of final products, the manufacturer shall be entitled to take the credit of the amount equivalent to the CENVAT Credit paid earlier subject to the other provisions of these rules."

1.1 Vide Notification 16/2009 CE NT Dt. 07.07.2009 a new sub rule (5B) to Rule 3 was substituted which is reproduced below.

(5B) If the value of any,
(i) input, or
(ii) capital goods before being put to use,

on which CENVAT credit has been taken is written off fully or where any provision to write off fully has been made in the books of account, then the manufacturer or service provider, as the case may be, shall pay an amount equivalent to the CENVAT credit taken in respect of the said input or capital goods :

Provided that if the said input or capital goods is subsequently used in the manufacture of final products or the provision of taxable services, the manufacturer or output service provider, as the case may be, shall be entitled to take the credit of the amount equivalent to the CENVAT credit paid earlier subject to the other provisions of these rules."

1.2 Further the following amendment was carried out in Rule 3 (5B), vide Notification 3/2011 CE NT Dt. 01.03.2011.

In rule 3 of the said rules

(iv) in sub-rule (5B), for the words and letters “on which CENVAT credit has been taken is written off fully or where any provision to write off fully has been made in the books of account then”, the words and letters “on which CENVAT credit has been taken is written off fully or partially or where any provision to write off fully or partially has been made in the books of account then” shall be substituted with effect from the 1st day of March, 2011;

2.0 The following may be observed from the above provisions and amendments.

- (i) With effect from 11.05.2007, if the value of inputs or unused capital goods are either **written off fully** or a **provision is made in the books to write off fully**, then the entire credit availed on such inputs and unused capital goods has to be reversed. This was applicable only for manufacturers.
- (ii) Such credit can be re-availed, when such inputs or capital goods are subsequently used.
- (iii) The above provisions were extended to service providers also, with effect from 07.07.2009.
- (iv) With effect from 01.03.2011, the rule was amended, whereby even if part of the value is written off or a provision to write off has been made for part of a value, even then the entire credit availed thereon has to be reversed.

3.0 At this stage, let us try to understand the concept of writing off / creating provision to write off.

3.1 The inputs procured by a manufacturer / service provider forms part of their inventory. They are booked in the books of accounts at the value at which they are procured. If the inventory is not used in production / provision of service within a normal time, they become slow moving / non moving. The realisable value of inventory also would normally diminish over a period of time, but the books of accounts would show the same value for such inputs, at which they are procured. In order to arrive at the correct profit, the expected loss in value, on account of ageing inventory should also be recognised in the books of accounts, by way of creating a provision for such value reduction on an average basis. If any part of the inventory becomes completely obsolete and unusable, its full value has to be completely removed from the books of accounts / inventory value.

This is known as writing off the value of inventory fully. As the deterioration in the value of inventory would be happening over a period of time, writing off the entire value in the year in which the inventory becomes obsolete, would cause undue effect in the profit of the year in which the inventory becomes obsolete. Hence, as per the prudent accounting principles, every year, a provision is to be created in the books of accounts for slow moving and non moving inventory, to the extent of reduction in their value. For example for inventory aged between 3 to 6 months, 25 % of the value could be provided for and for inventory aged between 6 to 12 months, 50 % of the value could be provided for, etc.

3.2 As and when such provision is created, Profit and Loss account is debited and the "Provision for Loss in value of Inventory" account is credited. To that extent the profit of that year would get reduced. This will be done every year, based on the age of the inventory and policy of the organisation. In the year in which any inventory becomes obsolete and unusable, the book value of such inventory would be debited to the Provision for Loss in value of Inventory account and credited to the Inventory account. Only at this point, the inventory value would be reduced in the books of accounts and this is known as "writing off". Till then the inventory would be reflected in the books of accounts at its original value reduced by the accumulated balance in the Provision for Loss in value of Inventory.

3.3 It may be observed from the above that creating a provision is futuristic, to absorb the reduction in value of inventory over a period of time and when any inventory becomes completely obsolete, it is permanently removed / written off from the value of inventory. In other words, the loss on account of obsolete inventory is debited to the profit and loss account, not in the year in which it becomes obsolete but over a period of time, by creating provisions. All the above are governed by the mandatory Indian Accounting Standards issued by the Institute of Chartered Accountants of India.

3.4 The difference between creating a provision and writing off the value can thus be explained.

4.0 It may be observed, originally, Rule 3 (5B) of CCR, 2004 was applicable, only when either the entire value of an inventory is written off fully or a provision to write off has been made for the full value. For example, if provision is made for reducing 25 % of the value for the inventory aged between 3 to 6 months; if provision is made for reducing 50 % of the value for the inventory aged between 6 to 12 months; and if provision is made for reducing 100 % of the value for the inventory aged over 12 months, the liability for reversal of credit would arise, only when provision is made for reducing 100 % of the value.

Sometimes, certain inventory in respect of which any provision is created or not, may suddenly become obsolete, lost or destroyed, in which the case, the entire value of such inventory would be written off / removed from the value of inventory, in which case also the liability to reverse the credit would arise.

4.1 Subsequently, the rule has been amended whereby the entire credit needs to be reversed even if a provision is made to write off only part of the value or the value is written off partially on permanent basis. In the above example, the credit has to be reversed immediately when a provision is made to reduce 25 % of the value inventory.

5.0 If we compare the above provisions, with the requirement under GST law, it may be noted that as per Section 17 (5) of the CGST Act, 2017,

Notwithstanding anything contained in sub-section (1) of section 16 and sub-section (1) of section 18, input tax credit shall not be available in respect of the following, namely :–

(h) goods lost, stolen, destroyed, written off or disposed of by way of gift or free samples.

5.1 A careful reading of the above would reveal that credit would be inadmissible, only when the value is "written off". It may also be observed that the credit need not be reversed, when a provision is made to write of the inventory value, either partially or fully. The liability to forego the credit would arise, only when the value of inventory is fully written off / completely removed from the books of accounts, by way of reduction in inventory value, which would be done, only when the inventory becomes completely obsolete. It may also be observed that there is no provision to take the credit back, when such inputs are used subsequently, as the value of inputs would be fully written off, only when they could not be used subsequently.

6.0 Hence, it can be concluded, when a provision to write off the value of inventory is made, by debiting the Profit and Loss account and crediting the Provision for Loss in value of Inventory, either for part of the value of the inventory or for full value of the inventory is made, there is no liability to forego the credit already availed. Credit would be liable to be repaid / reversed, only when the entire value of any inventory is completely removed / written off from the books of accounts, by way of reduction in inventory value. In other words, when provisions are created to absorb the reduction in the value of the inventory, based on the ageing policy, the credit need not be reversed / repaid. Only when the value of any inventory is completely written off from the books, which would be done only when the inventory becomes completely obsolete, there would be a requirement for reversal / repayment of the credit availed.

Tail piece : Under the provisions of CCR, 2004, assesses would have reversed the entire credit, when any provision to write off the value, either fully or partially is made. As per the provisions of Rule 3 (5B) they are entitled to take the credit back, when such inputs are subsequently used. But there is no express provision under the GST law, either by way of transitional provision or as a regular provision to avail such credit, which was reversed originally under Rule 3 (5B) of CCR, 2004 when a provision was made, if such goods are used subsequently after 01.07.2017 But, the entitlement to such credit is protected under Section 174 of the CGST Act, 2017 and hence cannot be denied legally. But, in the absence of any provision for the same either in TRAN 1 or in GSTR 2, how such credit could be availed?