GN(A) 12 (Revised 2000)

Guidance Note on Accounting Treatment for Excise Duty

Foreword to the Third Edition

With the issuance of the (Revised) Accounting Standard 2, ‘Valuation of Inventories’, which came into effect in respect of accounting periods commencing on or after 1.4.1999, and became mandatory from that date, it became imperative to revise the erstwhile Guidance Note on Accounting Treatment for Excise Duty to bring it in line with the requirements of the Standard.

I am pleased that the Research Committee of the Institute has revised the Guidance Note, which will go a long way in adoption of sound accounting practices in respect of accounting for excise duty.

I am sure that this Edition of the Guidance Note will also be useful to the members in practice as well as in industry.

New Delhi
July 18, 2000

G. Sitharaman
President

Preface to the Third Edition

Subsequent to the issuance of the last Edition of the Guidance Note on Accounting for Excise Duty, the Institute has revised its Accounting Standard 2, 'Valuation of Inventories', which became mandatory for the accounting periods commencing on or after 1.4.1999. It, therefore, became necessary to withdraw the option of disclosing the excise duty liability, in respect of inventories of finished goods lying in bonded warehouse or in the factory in the notes to accounts, which was given in the last Edition of the Guidance Note. Accordingly, the Guidance Note has been revised recommending that the excise duty liability on the said inventories should be provided for in the financial statements. The Guidance Note also provides guidance with regard to estimation of the amount to be provided for the excise duty liability. Certain other modifications have also been made in the Guidance Note incorporating some of the recently decided cases laying down the nature of the excise duty as a manufacturing cost.

I am sure that the Guidance Note will be useful to the members in discharging their day-to-day duties.

New Delhi
July 20, 2000

Bhavna G. Doshi
Chairperson
Research Committee

Foreword to the Second Edition

I am pleased to note that the Research Committee of the Institute has revised its erstwhile Guidance Note on Accounting for Excise Duties and has brought out this Guidance Note on Accounting of Excise Duty with the objective of making the accounting practices with regard to accounting for excise duty more uniform and in harmony with the principles of inventory valuation. Though, the subject of accounting of excise duty has, so far, beset with certain controversies, yet, I hope, with the issuance of this Guidance Note, recommended practices which are broadly in accordance with the generally accepted accounting principles would be well established.

I am confident this Guidance Note will be immensely useful to members and others concerned.

New Delhi
October 10, 1988

K. G. Somani
President

Preface to the Second Edition

The Research Committee of the Institute had issued a Guidance Note on Accounting Treatment for Excise Duties in 1979. Subsequent to the issuance of that Guidance Note, the nature of excise duty has been further clarified by some Supreme Court decisions. Further, the principles to be followed for the valuation of inventories have been explained in the Accounting Standard (AS) 2 on 'Valuation of Inventories', issued by the Institute of Chartered Accountants of India. Pursuant to the aforesaid developments the Research Committee published an Exposure Draft on the subject in the November, 1985, issue of 'The Chartered Accountant'. It was, however, decided by the Council in June 1986 that no revision of the existing Guidance Note was called for at that time.

The Research Committee recently decided that the Guidance Note should now be revised with the view of bringing about more uniformity in the accounting treatment of excise duty. The Guidance Note was accordingly revised in the light of, inter alia, various comments received in response to the aforesaid Exposure Draft and approved by the Council. The revised Guidance Note discusses, at the outset, the normally accepted accounting principles of inventory valuation, followed by the nature of excise duty in the light of various Court decisions and the recommendations on the accounting of excise duty.

I am grateful to Shri P.N. Shah, former President of the Institute and a member of last Research Committee, for preparing the basic draft of the revised Guidance Note. I am also thankful to other members of the Research Committee, in extending their full co-operation in finalising the draft.

I hope this Guidance Note will go a long way in bringing about greater uniformity in the accounting practices in industry with regard to accounting treatment of excise duty.

New Delhi
September 16, 1988

A.H. Dalal
Chairman
Research Committee

Foreword to the First Edition

In certain industries Excise Duty levied by the Government constitutes a major out-flow of funds. Differing views were expressed about the accounting treatment for this expenditure. Some organisations took the view that this was a period cost and could therefore, be treated as an expenditure of the period in which the liability for excise duty was incurred. On the other hand a large number of organisations treated this as an element of cost for the purpose of inventory valuation or carried forward the amount paid in respect of goods cleared from bonded godown but not sold before the close of the accounting period as prepaid expense or deferred charge. In order to determine the correct procedure and to achieve uniformity in the accounting treatment for excise duty, some members sought guidance of the Research Committee on this subject.

Considering the practical importance of the subject the Research Committee made a study of the various issues in depth and issued an exposure draft of the proposed guidance note in March, 1978. This draft was discussed with various members in industry as well as in the profession. Before giving a final shape to the guidance note a discussion paper containing detailed submissions and arguments was prepared and published by the Research Committee in December 1978. The Committee received representations from various members as well as from Chambers of Commerce and Industry, Government bodies and other professional organisations. The various issues relating to the subject were discussed with representatives of various organisations from time to time. After consideration of the above views the guidance note on the subject has now been finalised by the Research Committee and approved by the Council.

This guidance note is being published for the benefit of members. It is also proposed to publish this note in the October, 1979 issue of the Institute's Journal. I hope this Guidance Note will be useful to members of the profession in industry as well as in practice. The conclusions arrived at after detailed consideration of all aspects should go a long way in achieving uniformity in the matter of accounting treatment for excise duty and in disclosure of the policy followed by the concerned organisation.

On behalf of the Research Committee I would like to place on record the untiring efforts put in by Shri Y.H. Malegam F.C.A., in his capacity as Chairman of the Research Committee and later as Vice-President of the

Institute in drafting the exposure draft, discussion paper and the final guidance note, in discussion the various issues with our members and representatives of various organisations and in synthesising different view points on various issues relating to this complex subject. I would also like to acknowledge my debt of gratitude to the members of the Research Committee, representatives of various organisations and members of the Council and in particular Shri P. K. Mallik F.C.A., the President of the Institute, for extending their fullest co-operation in our efforts to finalise this guidance note.

New Delhi
16th September, 1979

P. N. Shah
Chairman
Research Committee

GN(A) 12 (Revised 2000)

Guidance Note on Accounting Treatment for Excise Duty

Introduction

1. The Institute of Chartered Accountants of India had issued a Guidance Note on Accounting Treatment for Excise Duties in 1979. In order to bring uniformity in the accounting treatment of excise duty and inventory valuation, the Guidance Note was revised in 1988. Keeping in view further developments, viz., issuance of the revised Accounting Standard (AS) 2, “Valuation of Inventories” (which has come into effect in respect of accounting periods commencing on or after 1.4.1999 and is mandatory in nature), it has been decided to revise this Guidance Note again. This revised Guidance Note is being issued in supersession of the earlier Guidance Note issued in 1988 and is effective in respect of accounting periods beginning on or after April 1, 1999.

2. This Guidance Note recommends accounting treatment for Excise Duty in respect of excisable goods produced or manufactured by an enterprise. A separate Guidance Note on Accounting Treatment for MODVAT sets out principles for accounting for MODVAT (now renamed as ‘CENVAT’).

3. At the outset, this Guidance Note briefly deals with normally accepted accounting principles for inventory valuation as prescribed in revised Accounting Standard (AS) 2, “Valuation of Inventories” issued by the Institute of Chartered Accountants of India, and nature of excise duty. For details, reference should be made to revised Accounting Standard (AS) 2 and Central Excise Act, Rules, Notifications and Circulars.

Normally Accepted Accounting Principles for Inventory Valuation

4. Normally accepted accounting principles with regard to the valuation of inventories (i.e., materials or supplies to be consumed in the production process or in the rendering of services, work-in-process and finished goods), as

prescribed in revised Accounting Standard (AS) 2, "Valuation of Inventories", are reproduced below:

> ***"5. Inventories should be valued at the lower of cost and net realisable value.***
>
> ***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.***
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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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> 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."

"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."

Nature of Excise Duty

5. Excise duty is a duty on manufacture or production of excisable goods in India. Section 3 of the Central Excise Act, 1944, deals with charge of Excise Duty. This Section provides that a duty of excise on excisable goods which are produced or manufactured in India shall be levied and collected in such manner as may be prescribed. This prescription is contained in the Central Excise Rules, 1944, which provide that excise duty shall be collected at the time of removal of goods from factory premises or from approved place of storage (Rule 49). Rate of duty and tariff valuation to be applied is the one in force on that date, i.e., the date of removal (Rule 9A) and not the date of manufacture. This difference in the point of time between taxable event, viz., manufacture and that of its collection has been examined and discussed in a number of judgements. For instance, the Supreme Court in the case of Wallace Flour Mills Co. Ltd. vs. CCE [1989 (44) ELT 598] summed up the legal position as under:

"It is well settled by the scheme of the Act as clarified by several decisions that even though the taxable event is the manufacture or production of an excisable article, the duty can be levied and collected at a later stage for administrative convenience. The Scheme of the said Act read with the relevant rules framed under the Act particularly Rule 9A of the said rules, reveals that the taxable event is the fact of manufacture or production of an excisable article, the payment of duty is related to the date of removal of such article from the factory."

Supreme Court in another case, viz., CCE vs. Vazir Sultan Tobacco Co. [1996 (83) ELT 3] held as under:

"We are of the opinion that Section 3 cannot be read as shifting the levy from the stage of manufacture or production of goods to the stage of removal. The levy is and remains upon the manufacture or production alone. Only the collection part of it is shifted to the stage of removal."

6. The levy of excise duty is not restricted only to excisable goods manufactured and intended for sale. It is also leviable on excisable goods manufactured or produced in a factory for internal consumption. Such intermediate products may be used in manufacture of final products or for repairs within the factory or for use as capital goods within the factory. Excisable goods so used for captive consumption may be eligible for exemption under specific notifications issued from time to time. Finished excisable goods cleared from the place of removal may also be eligible for whole or partial duty exemption in terms of notifications issued from time to time. Such exemption, subject to specified limits, if any, may relate to a manufacturer, e.g., a small-scale industrial unit. Exemption may be goods specific, e.g., handicrafts are currently wholly exempt from duty. The exemption may also be end-use specific, e.g., goods for use by defence services. Excisable goods can be removed for export out of India either wholly without payment of duty or under bond or on payment of duty under claim for rebate of duty paid.

7. Excisable goods, after completion of their manufacturing process, are required to be kept in a storeroom or other identified place of storage in a factory till the time of their clearance. Each such storeroom or storage place is required to be declared to the Excise Authorities and approved by them. Such storeroom or storage place is generally referred to as a Bonded Storeroom. Dutiable goods are also allowed, subject to approval of Excise Authorities, to be removed without payment of duty, to a Bonded Warehouse outside factory. In such cases, excise duty is collected at the time of clearance of goods from such Bonded Warehouses.

8. Amount of excise duty forming part of the sale price of the goods is required to be indicated separately in all documents relating to assessment of duty, e.g., excise invoice used for clearance of excisable goods (Section 12A). It is, however, open to a manufacturer to recover excise duty separately or not to make a separate recovery but charge a consolidated sale price inclusive of excise duty. The incidence of excise duty is deemed to be passed on to the buyer, unless contrary is proved by the payer of excise duty (Section 12B).

Excise Duty as an Element of Cost

9. In considering the appropriate treatment of excise duty for the purpose of determination of cost for inventory valuation, it is necessary to consider whether excise duty should be considered differently from other expenses.

10. Admittedly, excise duty is an indirect tax but it cannot, for that reason alone, be treated differently from other expenses. Excise duty arises as a consequence of manufacture of excisable goods irrespective of the manner of use/disposal of goods thereafter, e.g., sale, destruction and captive consumption. It does not cease to be a levy merely because the same may be remitted by appropriate authority in case of destruction or exempted in case goods are used for further manufacture of excisable goods in the factory. Tax (other than a tax on income or sale) payable by a manufacturer is as much a cost of manufacture as any other expenditure incurred by him and it does not cease to be an expenditure merely because it is an exaction or a levy or because it is unavoidable. In fact, in a wider context, any expenditure is an imposition which a manufacturer would like to minimise.

11. Excise duty contributes to the value of the product. A "duty paid" product has a higher value than a product on which duty remains to be paid and no sale or further utilisation of excisable goods can take place unless the duty is paid. It is, therefore, a necessary expense which must be incurred if the goods are to be put in the location and condition in which they can be sold or further used in the manufacturing process.

12. Excise duty cannot, therefore, be treated differently from other expenses for the purpose of determination of cost for inventory valuation. To do so would be contrary to the basic objective of carrying forward the cost related to inventories until these are sold or consumed.

13. As stated in para 6 above, liability to excise duty arises even on excisable goods manufactured and used in further manufacturing process. In such a case, excise duty paid (if the same is not exempted) on the intermediary product becomes a manufacturing expense. Excise duty paid on such intermediary products must, therefore, be included in the valuation of work-in-process or finished goods manufactured by the subsequent processing of such products.

Provision for Unpaid Excise Duty

14. Since the point of time at which duty is collected is not necessarily the point of time at which the liability to pay the duty arises, situations will often arise when duty remains to be collected on goods which have been manufactured. The most common of these situations arises when the goods are stored under bond, i.e., in a Bonded Store Room, and the duty is paid when the goods are removed from such Bonded Store Room.

15. Divergent views exist as to whether provision should be made in the accounts for the liability in respect of goods which are not cleared or which are lying in bond at the balance sheet date.

16. The arguments in favour of the creation of liability are briefly summarised under:

(a) the liability for excise duty arises at the point of time at which the manufacture is completed and it is only its collection which is deferred; and

(b) failure to provide for the liability will result in the balance sheet not showing a true and fair view of the state of affairs of the enterprise.

17. The arguments against the creation of the liability, briefly summarised, are as under:

(a) though the liability for excise duty arises at the point of time at which the manufacture is completed, it gets quantified only when goods are cleared from the factory or the bonded warehouse;

(b) the actual liability for excise duty may get modified by the time the goods are cleared from the factory or bonded warehouse;

(c) where goods are damaged or destroyed before clearance, excise duty may be waived by the competent authority and therefore the duty may never be paid; and

(d) failure to provide for the liability does not affect the profits or losses.

18. Since the liability for excise duty arises when the manufacture of the goods is completed, it is necessary to create a provision for liability of unpaid excise duty on stocks lying in the factory or bonded warehouse. It is true that the recovery of the duty is deferred till the goods are removed from the factory or the bonded warehouse and the exact quantification will, therefore, be at the time of removal and that estimate of duty made on balance sheet date may change on account of subsequent events, e.g., change in the rate of duty and exports under bond. But, this is true of many other items also, e.g., provision for gratuity and this cannot be an argument for not making a provision for existing liability on estimated basis.

19. The estimate of such liability can be made at the rates in force on the balance sheet date. For this purpose, other factors affecting liability should also be considered, e.g., exemptions being availed by the enterprise, pattern of sales – export, domestic etc. Thus, if a small-scale undertaking is availing the benefit of exemption allowed in a particular financial year and declares that it wishes to avail such exemption during next financial year also, excise duty liability should be calculated after taking into consideration the availability of exemption under the relevant notification. Similarly, if an enterprise is captively consuming all its production of a specific product and has been availing of exemption from payment of duty on that product, no provision for excise duty may be required in respect of non-duty paid stock of that product lying in factory or bonded warehouse. An auditor must, however, apply appropriate audit tests while verifying statements and declarations made by an enterprise in this regard.

Auditor's Responsibility

20. The auditor has a responsibility to express his opinion whether the financial statements on which he reports give a true and fair view of the operating results and state of affairs of the entity. In the case of companies, under MAOCARO, 1988, the auditor has to express an opinion whether the valuation of inventories is fair and proper in accordance with normally accepted accounting principles and is on the same basis as in the earlier years. If there is any change in the basis of valuation, the effect of such change, if material, is to be reported.

21. As explained in this Guidance Note, the liability for excise duty arises at the point of time at which the manufacture is completed. The excise duty paid or provided on finished goods should, therefore, be included in inventory valuation. Similarly, excise duty paid on purchases (other than those subsequently recoverable by the enterprise from the taxing authorities) as well as intermediary products used for manufacture should also be included in the valuation of work-in-progress or finished goods.

22. If the method of accounting for excise duty is not in accordance with the principles explained in this Guidance Note, the auditor should qualify his report. In the case of a company, reference to this qualification should also be made in the auditor's report under section 227(4A) of the Companies Act, 1956.

23. Summary of Recommendations

(i) Excise duty should be considered as a manufacturing expense and like other manufacturing expenses be considered as an element of cost for inventory valuation.

(ii) Where excise duty is paid on excisable goods and such goods are subsequently utilised in the manufacturing process, the duty paid on such goods, if the same is not recoverable from taxing authorities, becomes a manufacturing cost and must be included in the valuation of work-in-progress or finished goods arising from the subsequent processing of such goods.

(iii) Where the liability for excise duty has been incurred but its collection is deferred, provision for the unpaid liability should be made.

(iv) Excise duty cannot be treated as a period cost.

(v) If the method of accounting for excise duty is not in accordance with the principles explained in this Guidance Note, the auditor should qualify his report.