

## **ADD TO SUBTRACT!**

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Way back in 1987, the Apex Court had emphatically laid down the method of valuation for the goods manufactured on job work basis, in the landmark Ujagar Prints case. Till date, the ratio laid down in the said case, has remained to be a colossal Modern Art! Everyone, be it the Revenue, the trade or the learned Consultants, has tried to interpret the ratio, based on their own understanding, and we are also no less!

“Waste and scrap” is a thorough misnomer under Central Excise! As in common parlance, they mean pint-worthy, in Excise, they are mint-worthy! That too, the “waste and scrap” emerging at the hands of the job workers, had always been a hot cake for the Revenue! Insistence of return of such scrap by the job workers to the principal, duty liability on such scrap, disposal of such scrap by the job workers themselves, the duty liability in such cases, etc. have been the feedstock for bulk of the cases, registered by the department. This article addresses an interesting and intriguing impact of the valuation of the “waste & scrap”, emerging at the hands of the job workers.

In many cases, considering the logistics involved in returning the scrap by the job workers, such job workers are allowed to dispose off the scrap, by themselves. They are also allowed to retain the sale proceeds and this fact is taken into account while fixing their labour / conversion charges. It is often disputed that, such realization from the sale of waste and scrap by the job worker, shall constitute an additional consideration at the hands of the job workers and the same shall also be considered as part of his labour / conversion charges. The issue is no longer *res integra*. It has been held by the Hon'ble Tribunal in the case of **Jay Engineering Works Limited Vs CCE – 1997 (93) ELT 492**, that such scrap realization clearly has a bearing on the job charges and is an additional consideration for the job worker and has to be reckoned towards the assessable value. This decision was also affirmed by Hon'ble Apex Court, as reported in **2000 (115) ELT A 77**. The same view has been held by the Hon'ble Tribunal once again, in the case of **General Engineering Works Vs CCE – 2001 (135) ELT 1149**, wherein, it is observed that such scrap realization retained by the job worker would have the effect of depressing the job charges and hence includible in the assessable value.

If the issue is so simple, why this article?

We are afraid that, in all the above cases, an important factor to the said issue has not at all been brought before these fora.

While there can be no grouse about the reasoning that such scrap realization has to be added to the labour / conversion charges, at the same time, such scrap realization has to be deducted from the value of raw materials, so as to arrive at the real / intrinsic landed cost of raw materials. In effect, such scrap realization which are to be added to the conversion charges as an additional consideration, are to be deducted from the raw material cost, at the first place! Sounds interesting and intriguing? Lets delve a bit deep!

Kind reference is drawn to the Indian Accounting Standard 2, relating to valuation of inventories, which is recognized and adopted by the Institute of Chartered

Accountants of India. The following portion of the said Standard is relevant, which reads as:

*22. In computing the cost of purchase of raw materials consumed and the cost of conversion, the value of by-products and / or waste is deducted.*

From the above, it may be observed that the scrap realization would have the effect of reducing the value of raw materials consumed. When the requirement in the instant case is to arrive at the "landed cost of the raw materials", such landed cost, in intrinsic terms, shall be computed with reference to the purchase price of such raw materials and the freight incurred for bringing it to the job workers' premises **minus** the realisation of scrap, if any, arising during the course of processing of such raw materials.

Reference can also be made to the Cost Accounting Standard – CAS 4, issued by the Institute of Cost and Works Accountants of India, relating to valuation of captively consumed goods. The said standard has also been adopted by the CBEC, vide its Circular No.692/8/2003 Dated 13.02.2003. In para 5.12 of the standard, it is observed:

*"5.12 Treatment of scrap and waste.*

*The production process may generate scrap or waste. Realised or realizable value of scrap or waste shall be credited to cost of production...The scrap value for the scrap produced during a period calculated at the rate as explained above may be deducted to find out the cost of production".*

In the Appendix I (Statement of cost of production) of the said Standard also, under S.No. 12, it is stated that the recoveries from scrap shall be reduced to arrive at the cost of production.

The above standards deal with determination of value of inventories (which includes raw materials, work in progress and finished goods) and determination of cost of production. The crux of the Standards, which have been reproduced above, are to the effect that, while determining the "cost" of the inventory, be it raw materials or work in progress or finished goods, any realisation from the sale of waste and scrap has to be deducted. These provisions are framed on the basis of the common logic that, if a raw material is purchased for Rs.1,000 and the waste emerging during the course of such raw materials is sold for Rs.50, the actual cost of raw materials would only be Rs.950.

In view of the foregoing, it may be observed that the proper course for the job workers would be to reduce such realisation from the value of raw materials to arrive at the "landed cost of the raw materials" and then to add the same to the conversion charges received by him. This would only lead to a simple arithmetic equation, whereby, an absolute revenue-neutral situation emerges! (Rs.100 – Rs.10 + Rs.10, is nothing but Rs.100).

The above view can also be supported from the ratio of the decision of the Hon'ble Apex Court in the case of **CCE Vs Dai Ichi Karkaria Limited – 1999 (112) ELT 353 SC**, wherein, it has been held by the Hon'ble Apex Court that, while determining the cost of production, the duties paid on raw materials, which is allowed as Modvat

credit should not be included. The following observations of the Hon'ble Apex Court in this case are worth of reproduction:

**24.**We think it is appropriate that the cost of the excisable product for the purposes of assessment of excise duty under Section 4(1)(b) of the Act read with Rule 6 of the Valuation Rules should be reckoned as it would be reckoned by a man of commerce. We think that such realism must inform the meaning that the Courts give to words of a commercial nature, like cost, which are not defined in the statutes which use them. A man of commerce would, in our view, look at the matter thus : "I paid Rs. 100/- to the seller of the raw material as the price thereof. The seller of the raw material had paid Rs. 10/- as the excise duty thereon. Consequent upon purchasing the raw material and by virtue of the Modvat scheme, I have become entitled to the credit of Rs. 10/- with the excise authorities and can utilise this credit when I pay excise duty on my finished product. The real cost of the raw material (exclusive of freight, insurance and the like) to me is, therefore, Rs. 90/-. In reckoning the cost of the final product I would include Rs. 90/- on this account." This, in real terms, is the cost of the raw material (exclusive of freight, insurance and the like) and it is this, in our view, which should properly be included in computing the cost of the excisable product.

In the above case, it has been held by the Hon'ble Apex Court that, while determining the cost of raw materials, the duties paid thereon, which has been received back by the assessee by way of Modvat credit, shall be excluded from the cost of such raw materials. The above reasoning of the Hon'ble Apex Court is squarely applicable to the instant case also. Thus, in the instant case also, the scrap realisation, which has come back to the job workers, shall be excluded from the value of such raw material cost.

The department cannot be choosy and demand the inclusion of the scrap realisation in the conversion charges and refuse to reduce it from the cost of raw materials.

Unfortunately, the above pleas have not at all been taken in the case laws mentioned above and hence the said decisions cannot be considered to have said the last word on the said issue!

Before parting....

What happens in situations where the scrap is returned to the principal and the principal has sold it? As the job workers has not pocketed such realization there is no need to include it in the conversion charges. But, in such cases, whether such scrap realization would be allowed to get deducted from the cost of raw materials, to arrive at the "landed cost of the raw material?" Why not?