Is this the end of NRV for closing stock?

By Joon Chong

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The Supreme Court of Appeal (SCA) has for the second time in *CSARS v Atlas Copco South Africa (Pty) Ltd*, confirmed that the net realisable value (NRV) method is not a suitable method to value closing stock for income tax purposes.

The SCA referred with approval to its earlier decision of *CSARS v Volkswagen South Africa (Pty) Ltd* and held that the NRV method is forward looking, taking into account estimated costs which would still need to be incurred before the stock is sold. The Income Tax Act 58 of 1962 (Act), and calculation of taxable income, is backward looking. The reduction from the cost price of the closing stock should only be allowed in two circumstances:

i. when an event that caused the value of the trading stock to diminish occurred in the tax year; and

ii. when the taxpayer knows with reasonable certainty that an event occurring in the following tax year will cause the value of trading stock to diminish.

The taxpayer purchased stock from its Swedish parent company in the form of machinery and equipment (including spare parts and consumables) for use in the mining and related industries in South Africa. The taxpayer received a finance and accounting manual from its parent company which was followed by all companies in the group. The manual prescribed that closing stock should be written down by 50% if unsold in the last 12 months, and 100% if unsold in 24 months.

The SCA held that the taxpayer had not presented reliable evidence that the time-based NRV policy resulted in a diminution of value. In other words, the taxpayer did not show that there was a clear link between the length of time stock was unsold and a corresponding diminution in value of such stock by reason of "damage, deterioration, change of fashion [or] decrease in market value." The SCA held that the evidence showed that the policy adopted was arbitrary. The taxpayer also did not take into account the actual selling prices of items in the tax year when items were sold below cost price. The taxpayer had argued that there were about 200,000 items which needed to be considered, and it would have been impractical for the taxpayer to verify the actual selling price for each item.

There are many examples where financial reporting requirements have differed significantly from the requirements of the Act. The valuation of closing stock is one of these. The NRV method is a common method to value closing stock as it is the method used by companies preparing their financial statements using International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS).

What should taxpayers do for historic years where they have valued closing stock using NRV?

The SCA accepted that sampling was a well-recognised method of dealing with high volume trading stock. Taxpayers could prepare a file with supporting documents of a sample of items for each category and condition of stock demonstrating that the closing stock value using NRV would have been similar to the closing stock value determined using the valuation approach in the SCA decisions. The file should document the events occurring in the tax year, or the events which would occur in the following tax year, that would have resulted in the diminished value of closing stock. Where possible, actual selling prices of stock should be used to support the reduction in value of closing stock in earlier years. Where actual selling prices do not support the reduction in value calculated using NRV, material differences should be explained as more an exception rather than the rule.

The draft Taxation Laws Amendment Bill 2019 proposes an amendment to require any diminution in value to be determined on an item-by-item basis. The sampling of items for each category and condition of stock should meet this item-by-item basis. The item-by-item basis should not be interpreted to require, for example, an analysis of each of the 5 million widgets that are in the warehouse as this would lead to an uncommercial outcome.

Taxpayers should prepare the file for the tax years which have not prescribed and where closing stock could possibly not be valued correctly in those years. (Generally, income tax assessments prescribe three years after the date of the original assessments.)

What can be done for current and future tax years?

As a matter of principle, the NRV method cannot be accepted on its own. IAS 2.6 states that NRV is the estimated selling price in the ordinary course of business, less the estimated cost of completion and the estimated costs necessary to make the sale.

It is possible to justify, using the NRV method, which add back future costs of selling but not costs which would be incurred with reasonable certainty in the next tax year. There could be many instances of industry trends or customer preferences, where additional costs would need to be incurred by the taxpayer in the next tax year to sell the stock. The additional costs which would need to be incurred could be the event occurring in the next tax year causing the reduction in value of trading stock. (For example, without incurring additional marketing costs or massive discounts, the stock would not be sold.) This exercise is a factual analysis and should be appropriately documented by the taxpayer.

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