LEMBAGA HASIL DALAM NEGERI MALAYSIA
INLAND REVENUE BOARD

PUBLIC RULING

VALUATION OF STOCK IN TRADE AND WORK IN PROGRESS PART I

Translation from the original Bahasa Malaysia text.

PUBLIC RULING NO. 4/2006

DATE OF ISSUE: 31 MAY 2006

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DIRECTOR GENERAL'S PUBLIC RULING

A Public Ruling is issued for the purpose of providing guidance for the public and officers of the Inland Revenue Board. It sets out the interpretation of the Director General of Inland Revenue in respect of the particular tax law, and the policy and procedure that are to be applied.

A Public Ruling may be withdrawn, either wholly or in part, by notice of withdrawal or by publication of a new ruling which is inconsistent with it.

Director General of Inland Revenue,
Malaysia

1. The Public Ruling on valuation of stock in trade and work in progress will be dealt with in two (2) parts. Part I of this Ruling explains:

   i. the importance of valuation of stock in trade and work in progress for the purpose of ascertaining the adjusted income of a person from a business for the basis period for a year of assessment;

   ii. the bases of valuation of stock in trade and work in progress; and

   iii. the special rules to be applied when the person permanently ceased to carry on the business.

2. The valuation of stock in trade and work in progress relating to specific businesses including:

   - construction contracts,
   - property development,
   - banks and financial institutions,
   - professional and service establishments,
   - livestock, agricultural, forest products and mineral ores, and
   - computer software and spare parts,

   will be explained in detail in Part II of this Ruling to be issued subsequently.

3. The related provisions which have relevance to stock in trade are sections 2, 24 and 35 of the Income Tax Act 1967 (ITA).

4. For the purpose of this Ruling, the words used have the following meanings:

   4.1 "FIFO" (first-in, first-out) means the method which assumes that the stock in trade purchased first are sold first and the remaining stock in trade are from the most recent purchases.

   4.2 "Work in progress" means goods in the process of production which will eventually be put up for sale in the ordinary course of the business.

   4.3 "Weighted average cost" means the method which values the stock in trade at the weighted average cost of similar items available for sale at the beginning of the period and purchased or produced during the period divided by the number of units available for sale to obtain a weighted average unit cost. The stock in trade at the end of the accounting period is then valued at this average unit cost.

4.4 "LIFO" (last-in, first-out) means the method which assumes that the stock in trade purchased last are sold first and the remaining stock in trade are from the earliest purchases.

4.5 "Market value" in relation to any thing, means the price which that thing would fetch if sold in a transaction between independent persons dealing at arm's length.

4.6 "Person" includes a company, a co-operative society, a club, an association, a Hindu joint family, a trust, an estate under administration, an individual and a partnership.

4.7 "Adjusted income" of a person from a business source for a basis period for a year of assessment is the gross income from that business less all deductible expenses incurred in the production of that gross income under the general provisions and specific provisions of the ITA.

4.8 "Tax computation" means the appendices, working sheets, and other supporting documents forming the basis upon which an income tax return is made.

4.9 "Business" includes profession, vocation and trade and every manufacture, adventure or concern in the nature of trade, but excludes employment.

4.10 "Stock in trade"**,** in relation to a business, means property of any description, whether movable or immovable, being either -

(a) property such as is sold in the ordinary course of the business or would be so sold if it were mature or if its manufacture, preparation or construction were complete;
or

(b) materials such as are used in the manufacture, preparation or construction of any such property as is referred to in paragraph (a) above,

and includes any work in progress.

4.11 "Year of assessment" means a calendar year.

4.12 "Basis period" in relation to a person, a source of his and a year of assessment, means such basis period, if any, as is ascertained in accordance with section 21 or 21A of the ITA.

5. Importance of stock in trade valuation in calculating adjusted income from a business

5.1 Generally, the adjusted income from a business of a person for the basis period for a year of assessment is calculated as follows:

	RM
Gross income	XX
Less: Allowable expenses	(XX)
Adjusted income	XX

5.2 In ascertaining the adjusted income from a business of a person for the basis period for a year of assessment, the value of the stock in trade at the beginning and at the end of the period should be taken into account. The current accounting practice of taking into account the value of the stock in trade in the profit and loss account satisfies the requirements of subsection 35(2) of the ITA. The value of stock in trade at the beginning and at the end of the accounting period is taken into account as follows:

	RM	RM
Sales or turnover		1,000,000
Less: Opening stock in trade	200,000	
Purchases	300,000	
Cost of production from manufacturing account	50,000	
Less: Closing stock in trade	100,000	
Cost of goods sold		450,000
Gross profit		550,000
Less: Allowable expenses (under the provisions of the ITA)		180,000
Adjusted income		370,000

5.3 Where the value of the stock in trade is greater at the end of the basis period than it was at the beginning of that basis period, the total deduction under the provisions of the ITA shall be reduced by the amount of that excess, thus resulting in an increase in the adjusted income (see Example 1). If the value of the stock in trade at the beginning of the basis period exceeds the value of the stock in trade at the end of that basis period, the total deduction under the provisions of the ITA shall be increased by the amount of the excess, thus resulting in a decrease in the adjusted income (see Example 2). (Subsection 35(2) of the ITA).

Example 1

Star Enterprise Sdn Bhd trades in stationery. For the year ended 31 December 2006, the information relating to the business is as follows:

	RM
Sales	850,000
Purchases	225,000
Opening stock in trade	100,000
Closing stock in trade	180,000
Allowable expenses (under the provisions of the ITA)	250,000

The gross profit and adjusted income from the business for the year of assessment 2006 is computed as follows:

	RM	*RM*
Sales		*850,000*
Less: Opening stock in trade	*100,000*	
Purchases	*225,000*	
	325,000	
Less: Closing stock in trade	*180,000*	
Cost of goods sold		*145,000*
Gross profit		*705,000*
Less: Allowable expenses (under the provisions of the ITA)		*250,000*
Adjusted income from the business		*455,000*

In this case the value of the stock in trade at the end of the basis period (RM180,000) is greater than the value of the stock in trade at the beginning of that basis period (RM100,000), the total deduction under the provisions of the ITA is reduced by the amount of the excess.

Example 2

Using the facts in Example 1, if the opening stock in trade and closing stock in trade at 31 December 2006 are valued at RM180,000 and RM100,000 respectively, the gross profit and adjusted income from the business for the year of assessment 2006 would be as follows:

	RM	*RM*
Sales		*850,000*
Less: Opening stock in trade	*180,000*	
Purchases	*225,000*	
	405,000	
Less: Closing stock in trade	*100,000*	
Cost of sales		*305,000*
Gross profit		*545,000*
Less:Allowable expenses (under the provisions of the ITA)		*250,000*
Adjusted income from the business		*295,000*

In this case, the value of the stock in trade at the beginning of the basis period (RM180,000) exceeds the value of the stock in trade at the end of that basis period (RM100,000), the total deduction under the provisions of the ITA is increased by the amount of the excess.

6. Value of stock in trade at the beginning of the basis period

Paragraph 35(3)(b) of the ITA provides that the value of the stock in trade at the beginning of the basis period, unless it is a commencement of business case, must always be the same as the value of the stock in trade at the end of the immediately preceding basis period.

7. Approach

The value of the stock in trade should be determined item by item. However, if it is inappropriate or impractical to do so (especially where individual items are small in size but large in number), the stock in trade should be grouped according to type or nature. The value of the stock in trade should then be determined according to clearly identifiable groups or batches of homogenous or related items.

8. Bases of valuation of stock in trade

Subsection 35(3) of the ITA deals with the bases of valuation of stock in trade which are acceptable for income tax purposes. In the actual accounts prepared by the taxpayer, however, stock in trade may be valued on a basis which is not acceptable for income tax purposes. Where this occurs, an adjustment must be made in the computation to bring the valuation of stock in trade in line with the requirements of the ITA. If the stock in trade has been valued on some basis other than that set out in subsection 35(3) of the ITA, the taxpayer must make the appropriate adjustment so that the adjusted income is correctly computed.

9. Market value or total cost

Paragraph 35(3)(a) of the ITA provides the statutory basis of stock in trade valuation as follows:

9.1 The value of any particular item of the stock in trade at the end of the basis period should be the market value at that time or a person may elect to value the stock in trade at the total cost of acquiring that item and bringing it to its condition and location. The election of valuing at total cost will apply only in the case where the items are physically tangible (such as textiles, books, stationery and sundry goods).

9.2 In the case of stock in trade consisting of immovable properties, stocks, shares or marketable securities, the value of the stock in trade at the end of the basis period should be the **lower** of the cost price or the market value at that time.

10. Total cost or historical cost

10.1 In the case of a manufacturing business, the total cost or the historical cost should include:

- the direct cost of material and labour used in the manufacture of the finished products,
- a proportion of production overhead costs that relate to the manufacture of the finished products, and
- any other cost of putting the stock in trade in its present location and condition.

10.2 In the case of a retail business, total cost should include the cost of acquiring the stock in trade and the cost of bringing it to its location and condition (such as custom duties, transportation costs and packaging costs).

10.3 The cost of keeping the asset in its condition should not be added to its original cost. For example, if a trader keeps perishable stock in trade for some time, he may have to incur expenditure on keeping it in good condition that is on refrigeration. The refrigeration cost must not be included as an element in the expenditure on maintaining it in good condition as such cost is considered as having been spent on upkeeping the stock in trade.

10.4 The total cost method adopted for accounting purposes should use the FIFO (first-in, first-out) or the weighted average cost formula.

10.5 Other costing methods such as LIFO (last-in, first-out) are not acceptable for income tax purposes.

11. Work in progress

11.1 Work in progress should be valued either at cost or market value.

11.2 The cost of work in progress should include not only the direct cost incurred in manufacturing the product but also the cost of production overheads such as factory office expenses.

11.3 If there is no market for uncompleted goods which can be sold as raw material of another manufacturer, the uncompleted goods should be valued at cost.

12. Consistency

12.1 Any acceptable method used in the valuation of stock in trade or work in progress should be applied consistently. If there is a valid reason for a change (for example, to give a more accurate valuation of stock in trade at cost or market value), details of the change should be appropriately documented and disclosed in the statement of accounts and/or the tax computation.

12.2 If there is a change in the valuation of the opening stock in trade or work in progress because of a change in the company's accounting policy in a financial year, the effect of the change on the profits of the company should be reflected in the tax computation for that year.

Example 3

Syarikat ABC Sdn Bhd closes its accounts on 31 December each year. In 2006 the company decides to change the valuation of its stock in trade from cost to market value. The opening stock in trade in 2006 which was originally valued at cost is also changed to market value. The following values are extracted from the final accounts of the company:

	Cost (RM)	**Market value (RM)**
Opening stock in trade	10,000	12,000
Closing stock in trade	-	14,000

The effect of the change of opening stock in trade values of RM2,000 (RM12,000 - RM10,000) should be taxed that is, added to net profit to arrive at the adjusted income from that business. If the figures for the opening stock in trade were reversed, the difference should be allowed.

13. Stock in trade withdrawn for own use

Where any stock in trade of the business is withdrawn for the person's own use without any considerations being given for the stock in trade, the market value of the stock in trade withdrawn from the business is taken as part of the gross income from the business.

Example 4

Ali, the sole proprietor of Batik Cantik Enterprise, trades in batik. The accounts of his business are closed on 31 December each year. On 25 June 2006, he withdrew 2 pieces of batik valued at RM1,000 from his stock in trade without making any payment for the batik withdrawn. The batik pieces were given to his friend as a wedding gift.

The market value of the batik of RM1,000 is taken as part of the gross income from his business for the year of assessment 2006 pursuant to paragraph 24(2)(a) of the ITA.

14. **Valuation of stock in trade on cessation of business**

14.1 Where a business ceases, special circumstances arise for which subsection 35(5) of the ITA provides special rules to be applied as stated in the following paragraphs.

14.2 Where a person permanently ceases to carry on the business and at or about the time he ceases in the business he sells his stock in trade or transfers his stock in trade for valuable consideration to another person who will use the stock in trade in a business of his and can deduct the cost of that stock in trade as purchases in calculating the adjusted income from his business, the price paid for the stock in trade or the value of the consideration is to be taken as the value of the stock in trade at the cessation of the business. The person buying the stock in trade must bring the stock in trade into his business at the same price or value.

Example 5

Syarikat A Sdn Bhd ceases its furniture retail business on 31 July 2006. On 10 August 2006 it sold all its remaining stock in trade to Syarikat C Sdn Bhd for RM80,000 although the original cost of the stock in trade was RM120,000.

In the accounts of Syarikat A Sdn Bhd for the period ending on 31 July 2006, Syarikat A Sdn. Bhd. should value its stock in trade at RM80,000.

Example 6

Syarikat B Restoran Sdn Bhd ceases its business on 30 September 2006. On 10 October 2006, it transfers all its remaining stock in trade valued at RM50,000 to Syarikat C Restoran Sdn Bhd in settlement of a debt of RM60,000.

As the value of the consideration received is RM60,000, Syarikat B Restoran Sdn Bhd should value its stock in trade at RM60,000 as at 30 September 2006.

14.3 If on cessation of trading the stock in trade is not sold, the market value of the stock in trade at the date of cessation of the business is to be the value of the stock in trade for income tax purposes.

14.4 If the stock in trade is sold or transferred for a consideration in cash or its equivalent, together with other assets of the business for cash or valuable consideration, the total consideration should be apportioned between the stock in trade and the other assets in such manner that is just and reasonable and the appropriate value taken for the stock in trade.

Example 7

Syarikat D Sdn Bhd carries on a business of dealing in used cars. It operates in an open parking lot situated on leased land. A building erected by the company in one corner of the lot is used as an office. As business is slack, the company decides to cease operations. At the end of the accounting period ending on 31 August 2006, the company decides to sell all its assets, including the stock in trade, for RM700,000.

The sum of RM700,000 should be apportioned between all the assets disposed of, such as the stock in trade, building and office equipment. Any method of apportionment is acceptable provided that it is just and reasonable.

15. **Stock in trade obsolescence**

A provision for obsolescence of stock in trade is not allowable. An actual write-off of stock in trade which is charged to the profit and loss account is allowable as it is realised. It is required that an adjustment be made to the opening stock in trade in the following year.

16. **Diminution in value of shares as stock in trade**

Where a person deals in shares and the shares are part of his stock in trade, any diminution in the value of shares to reflect market value is allowable. The diminution in value of the shares should be based on market value and cost of the particular shares. Any accretion in the value of the shares in the event that the provision for the dimunition in the value of shares is no longer required is taxable.

17. **Effective date**

This Ruling is effective for the year of assessment 2006 and subsequent years of assessment.

Director General
of Inland Revenue