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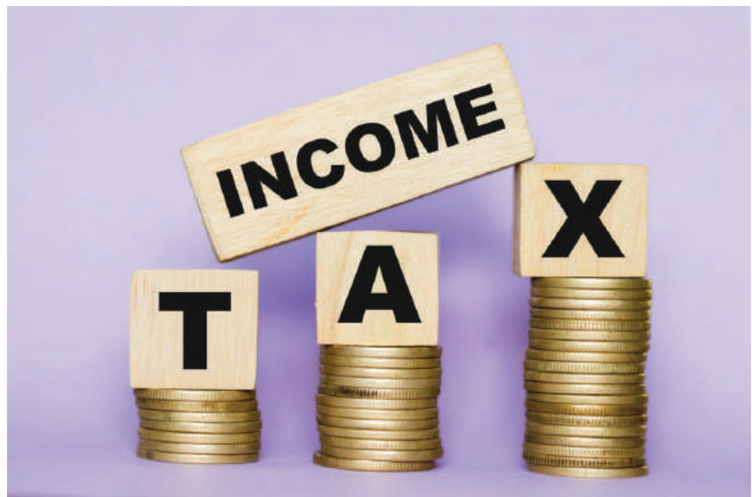
When Rising Gold Prices Create Paper Profits

Why inventory valuation rules can inflate taxable income without increasing real earnings

Rising gold prices should, in theory, be a windfall for the jewellery trade. Instead, for many jewellers, the recent surge in prices has created an uncomfortable paradox — soaring reported profits without a corresponding increase in cash flows. Across the industry, concerns are mounting that tax liabilities are rising not because of improved trading margins, but because of the manner in which inventory is required to be valued for tax purposes. What appears on paper as profit often feels very different on the shop floor.

One would have thought that the increase in the gold prices was manna for the gold industry. But Murphy's Law seems to have kicked in with the proverbial, "What can go wrong, shall go wrong", much to the chagrin of the industry. The celebrations seem to be short lived as the tax man will come knocking on the door of the jeweller with a new proposition; that of how to calculate profitability of the past year. And sadly, it seems, he isn't quite warming to the explanations made for determining the profitability of the jeweller. And herein lies the gloom.



This article is written as a policy commentary on the impact of statutory inventory valuation rules on the bullion and jewellery trade. It does not seek to state the settled legal position but highlights the economic and cash-flow consequences of the present framework and suggests areas for reform.

Diving right into the issue, the problem at hand seems to be the exponential increase in the gold prices and its accounting treatment. Let's lay out an example to better understand this as may be seen below.

XYZ Jewellers has 100kgs of opening stock, (read: inventory) valued at Rs. 4500/g, or Rs. 45.00 crores. The total sales done over the year are of 75kgs at an average

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gold rate of Rs. 10750/g, thus the total sales were of Rs. 80,62,50,000/-. The total purchases made in the fiscal year were of 75kgs at an average gold rate of Rs. 9137.50/g, or Rs. 68,53,12,500/-.

The question at hand is, "What is the value of the closing stock?" And this is where the difference of opinion between the jeweller and the taxman, thus the confusion starts.

XYZ Jewellers would argue that, to determine the year's gross profit, a trading account should be made in which the year's purchases should be deducted from the same quantity of sales to establish the gross profit. The logic being that the quantity of gold sold has been completely hedged through constant and continual purchases from time-to-time, thereby ensuring no loss to the jeweller. Thus, the total sales of Rs. 80,62,50,000 minus the total purchases of the financial year of Rs. 68,53,12,500, which equal Rs. 12,09,37,500/, is what the Gross Profit for the year should be. Therefore, the closing stock would remain at 100kgs valued at Rs. 4500/g, which would be a total of Rs. 45.00 crores. This is also known as the LIFO, (Last-In-First-Out), basis of valuation of inventory.

At this juncture, it is important to distinguish between accounting standards followed for financial reporting and statutory computation rules under the Income-tax Act. While a business may adopt a particular method of inventory valuation for commercial accounting, taxable income is computed subject to Section 145 of the Income-tax Act, 1961, read with the Income Computation and Disclosure Standards (ICDS), which may override book treatment for tax purposes.

After the introduction of ICDS II, (Income Computation and Disclosure Standards II), in terms of Section 145 of the Income-tax Act, 1961, there are only two methods of accounting for valuation of inventories viz., FIFO, (First-in-First-out), basis and the WAC, (Weighted Average Cost), basis, that are recognised by the taxman.

> **"The question is not how much gold was sold, but how the unsold gold is being valued – and that single choice can dramatically alter taxable profits."**

The ICDS framework, including ICDS II, has been the subject matter of constitutional challenge before various High Courts. In P. A. Jose v. Union of India (Kerala High Court, judgment dated 20 May 2024), the Court examined the application of ICDS II in the context of opening stock valuation and reiterated the settled principle that opening and closing stock must be valued using the same methodology. The Court held that ICDS II could not be applied in a manner that artificially re-values opening stock for Assessment Year 2017-18, though it did not strike down ICDS II in its entirety.

The implication of this judicial position is that, while FIFO and WAC remain the prescribed methods under ICDS II, their application must conform to the principle of consistency and real income. To better understand the problems this has created, one would have to delve into greater detail on the accounting process itself and see how using WAC and FIFO would impact, not only the jeweller, but also the taxman.

Weighted Average Cost (WAC) Method

Thus, if the WAC method is used to determine the closing stock and profitability, one would need to use the opening inventory valuation along with the current year's purchases to ascertain the cost of goods, which is, therefore, 100kgs @ 4500/g, valued at Rs. 45.00 crores plus 75kgs @ 9137.50/g, valued at Rs. 68,53,12,500/-, thus the total 175kgs would have been purchased for Rs. 113,53,12,500/- at an average gold rate of Rs. 6487.50/g. To calculate the profitability for the year, one would merely subtract the sale amount from the same quantity, which was purchased, thus, 75kgs sold @ 10750/- for Rs. 80,62,50,000 minus the average cost of 75kgs @ 6487.5/g, which is Rs. 48,65,62,500/-, thus the profitability for the year would be Rs. 31,96,87,500/-. The closing stock, therefore, would be 100kgs @ 6487.5/g, which is Rs. 64,87,50,000/-. As you may see, the gross profit is nearly triple of what the earlier method, used by the jeweller, (LIFO), suggests.

FIFO Method

This also means that under the FIFO method used to determine the closing stock and profitability one would need to use the opening inventory valuation as the cost of the sales. To calculate the profitability for

the year, one would merely subtract the sale amount from the same quantity, which was the value of the opening inventory, thus, 75kgs sold @ 10750/- for Rs. 80,62,50,000 minus the value of opening inventory of 75kgs @ 4500/g, which is Rs. 33,75,00,000/-, thus the profitability for the year would be Rs. 46,87,50,000/-. The closing stock, therefore, would be 25kgs @ 4500/g. and 75kgs @ 9137.5/g, aggregating to Rs. 79,78,12,500/- . As you may see, the gross profit is nearly four times of what the earlier method, used by the jeweller, (LIFO), suggests.

The jeweller would argue that both methods, FIFO and WAC, of determining the gross profit would be biased, as it includes profit on unsold goods. (Fortunately for the jeweller, the taxman would recognize WAC method, where there is a less burden of tax on the jeweller compared to the FIFO method). The taxman would give a rebuttal dismissing this, as he would insist that the determination of profit is always based on all the goods, not merely through a trading account of a specific period of time. Sadly, neither the jeweller, nor the taxman, is incorrect in their disposition, but the proverbial axe would fall on the neck of the jeweller, and he would have no option but to liquidate inventory to meet the tax bill. Surely, this could not be what was been envisaged by the founding fathers of tax policies for the nation — to liquidate existing inventory to pay tax on a notional profit?

The Supreme Court has consistently held that valuation of closing stock is only a mechanism to arrive at real profits and not an independent source of taxable income. In Chainrup Sampatram v. CIT (1953) 24 ITR 481 (SC), the Court held that unrealised appreciation in the value of stock-in-trade cannot be treated as income. This principle has been reiterated in subsequent decisions, including CIT v. British Paints India Ltd. (1991) 188 ITR 44 (SC).

It is the author's humble opinion that this is an incorrect method of evaluating the profitability for the year. This method inflates the profitability by incorrectly using the value of the opening inventory valuation. What should be considered by the tax man is that since the opening and the closing inventory are the same quantity, thus remain unsold, would it not be prudent to use the trading account to determine the profitability for the year?

The Case of Falling Gold Prices:

To further this point, let us then consider what would happen in the year of falling gold prices. For the sake of argument, let us presume, albeit for just this moment, that the gold prices crash (something that may be argued against, but cannot be ruled out completely).

Moving forward from the previous example, since the closing stock was valued @ 6487.50/g, XYZ Jewellers now has 100kgs of opening stock valued at Rs. 64,87,50,000/-. The total sales done over the year are of 75kgs at an average gold rate of Rs. 6325/g, thus the total sales are of Rs. 47,43,75,000/-. The total purchases made in the fiscal year were of 75kgs at an average gold rate of Rs. 5376.50/g, or Rs. 40,32,37,500/-.

Using the taxman's logic, the inventory valuation as per WAC would be arrived at by adding the opening stock of 100kgs valued at Rs. 64,87,50,000/- with the average cost of the purchases of 75 kgs, valued at Rs. 40,32,37,500/-, thus arriving at an average cost of 175kgs @ 6011.36/g, or Rs. 105,19,87,500/-. The total sales for 75kgs were made at an average gold rate of Rs. 6325/g, or Rs. 47,43,75,000, thus the gross profit would be determined by deducting the average value of inventory arrived at, which is 75kgs @ 6011.36/g or Rs. 45,08,52,000/-. The gross profit, therefore, would be Rs. 2,35,23,500/- only. The closing stock valuation would be 100kgs @ 6011.36/g, or Rs. 60,11,36,000/-.

Using the FIFO method, continued from the opening stock valuation for 100kgs @ 7978.125/g, the gross profit would be determined by using the opening inventory as the cost of goods sold. That is, the total sales of 75kgs @ Rs. 6325/g, or Rs. 47,43,75,000/-, minus the opening inventory of the year of 75 kgs @ Rs. 7978.125/g, or Rs. 59,83,59,375/-, which would result in a gross loss of Rs. 12,39,84,375/-. The closing stock would then be valued for 25kgs @ 7978.125/g and 75kgs @ 5376.50/g, aggregating to Rs. 60,26,90,625/- for 100kgs @ 6026.906/g.

> "Valuation of closing stock is a method of computing real profits, not an independent source of taxable income."

When tax liabilities exceed actual cash profits, businesses are forced to liquidate inventory – a result that cannot be described as prudent tax policy.

On the other hand, using the trading account, i.e. LIFO method, continued from the opening stock valuation for 100kgs @ 4500/g (as preferred by the jeweller), the gross profit would be determined using the cost of the goods sold and purchased during the year. That is, the total sales of 75kgs @ Rs. 6325/g, or Rs. 47,43,75,000/-, minus the total purchases of the year of 75 kgs @ Rs. 5376.50/g, or Rs. 40,32,37,500/-, which would result in a gross profit of Rs. 7,11,37,500/-. The closing stock would continue to be valued for 100kgs @ 4500/g, or Rs. 45.00 crores.

If one were to stand back and take a good look at these examples, one may feel compelled to agree that the gold industry profitability determination cannot and should not happen with any other method except that of the trading account, or LIFO basis.

While all the accounting and tax experts worldwide acknowledge that in inflationary situations, LIFO is the appropriate method to best reflect "true" profits and the taxes thereof, of any business enterprise. Surprisingly, AS -12, (Accounting Standards- 12), issued by the ICAI, (The Institute of Chartered Accountants of India), along with IFRS, (International Financial Reporting Standards), do not approve of LIFO. Equally queer is the fact that though the above AS do not approve of LIFO, US GAAP permits LIFO as an acceptable accounting process.

This conclusion is advanced as a matter of tax policy and economic prudence, and not as a statement of the current legal mandate under ICDS II.

Recent media reports suggest increased scrutiny by the Income-tax Department of inventory valuation practices adopted by jewellers, particularly in cases where LIFO-like methodologies were followed in periods of sharp price increases. Notices reportedly focus on the mismatch between book profits and taxable profits under ICDS II. While no sector-specific circular has yet been issued, the heightened attention underscores the urgency of addressing valuation-driven distortions before they translate into prolonged litigation and business stress.

It is therefore imperative that suitable legislative or administrative solutions be considered. These may include permitting bullion and jewellery traders to opt for LIFO, FIFO, or WAC subject to consistency and disclosure, introducing transitional relief during periods of extreme price volatility, or mandating lock-in periods for inventory valuation methods to prevent opportunistic switching. Such measures would align tax outcomes more closely with commercial reality while safeguarding revenue interests.

As may be seen, under the FIFO method in the subsequent year, the accounting statements will reflect huge losses when the prices show a declining trend, which would attract its own woes vis-à-vis pressures from public and private sector lenders. The same will not be true if LIFO method is followed. It may yield lesser tax revenues; but would yield moderate revenues year-after-year and, most importantly, it would reflect the correct nature of profitability of the enterprise year on year.

I shall close with a quote which serves as a prudent advice from Ms. Diane Garnick for the purpose of accounting which seems extremely relevant in this particular case. She advised: "***Accounting does not make corporate earnings or balance sheets more volatile. Accounting just increases the transparency of volatility in earnings.***"

Contributed by
Ajay Mehra
Managing Director
Mehrasons Jewellers