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* **IN THE HIGH COURT OF DELHI AT NEW DELHI**

Date of decision: 19.11.2012

+ ITA 39/2012
+ ITA 40/2012
+ ITA 41/2012
+ ITA 42/2012
+ ITA 43/2012

CIT

..... Appellant

Through Mr. Rohit Madan, Adv.

versus

BECTON DICKINSON INDIA PVT LTD

..... Respondent

Through Mr. Piyush Singh and Ms. Ayushi Pareek,
Advs.

CORAM:

MR. JUSTICE S. RAVINDRA BHAT

MR. JUSTICE R.V. EASWAR

S. RAVINDRA BHAT, J: (OPEN COURT)

The revenue claims to be aggrieved by the common order dated 12.11.2010 of the Tribunal in several appeal filed by the revenue for various assessment years 2001-02, 2002-03, 2004-05 and 2005-06.

2. The assessee's appeals for assessment years 2004-05 and 2002-03 were also considered by the ITAT by the said common order.

3. The revenue urges following substantial question of law before this Court i.e. *whether the Tribunal fell into error in treating the provision for warranty as*

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provision for diminution in the value of assets and thus to be added to the 'book profit' under Explanation 1(i) to Section 115JB of the Income Tax Act, 1961?

4. The facts of the case are that the assessee which is engaged in the business of manufacture and trading of medical consumable devices and diagnostic equipment for use by the health care professionals, medical research institutions, industry and general public etc. had claimed provision for warranty service. It had contended that this provision was based on adoption of scientific analysis. The assessee provided for 4% of the total sale value of its products as "provision for warranty". The assessee supplied details of the warranty provision made and claimed by it as deduction from its computation of the 'book profit'. The warranty provision was created in the year of sale and the claim was based on scientific and reasonable basis. The assessing officer, for all the years under consideration uniformly disallowed the claim and added back the amount. The assessee succeeded in some cases, before the appellate Commissioner. The revenue carried the matter in appeal to the ITAT contending that the amount had to be added back by virtue of Explanation 1(i) to Section 115JB. The Tribunal after discussing the rival contentions and also analyzing the order of the CIT(Appeals) held as follows :

"8. We have heard both sides and gone through the record and relevant provisions of Explanation (1) to Section 115JB(2) which is relied upon in support of the addition to the book profit rates as under :-

"Explanation (1) for the purpose of this section, "book profit" means the net profit as shown in the profit and loss account for the relevant previous year prepared under sub-section (2), as increased by"

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... ..

(c) *the amount or amounts set aside to provisions made for meeting liabilities, other than ascertained liabilities; or*

(i) *the amount or amounts set aside as provision for diminution in the value of any asset."*

9. *The assessee in this case as is clear from the impugned orders has made the provision @ 4% of the sale value, as the provision for liabilities in respect of after sales warranty offered to the customers. The assessee has also supplied detailed working of the warranty provisions made. The warranty provision was created in the year of sale which according to the assessee is clearly based on some scientific and reasonable basis and now we will examine whether the same can be disallowed as an amount or amount set aside as provision for diminution in the value of an asset which can alone be the subject matter of increase to the book profit in terms of clause (i) of the aforesaid Explanation (1). In our opinion, the provision made for warranty claims in respect of sales which are affected and cannot be treated as a provision for diminution in the value of asset. Even in terms of clause (c) of the aforesaid Explanation (1) which we have extracted above, it cannot be said that the amount or provisions for meeting liabilities other than ascertained liabilities, the Hon'ble Supreme Court in Rotork Controls India P. Ltd. Vs. CIT 314 ITR 62 was concerned with an identical issue wherein identical provisions for warranty were made. The apex court after elaborately dealing with the issue has held that the assessee was entitled to deduction for provision of warranty claims. In the case before us what the AO is trying is to make an addition to the book profit u/s 115JB of the Act. In our view, the plain reading of the provisions of clause (c) or (i) of Explanation (1) of sub-section (2) of Section 115(J) does not justify the action of the department."*

5. Counsel for the revenue reiterates the submission made before the ITAT as well as grounds urged on its behalf in the appeal. We have considered the submissions. In *Rotork Controls India P. Ltd. Vs. CIT* (2009) 314 ITR 62, the

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Supreme Court had occasion to consider the deductibility of a liability such as provision for warranty. The context of course was deductibility claimed under Section 37(1) of the Act. In that connection the Court pertinently observed as follows :

"Liability is defined as a present obligation arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

12. *A past event that leads to a present obligation is called as an obligating event. The obligating event is an event that creates an obligation which results in an outflow of resources. It is only those obligations arising from past events existing independently of the future conduct of the business of the enterprise that is recognized as provision. For a liability to qualify for recognition there must be not only present obligation but also the probability of an outflow of resources to settle that obligation. Where there are a number of obligations (e.g. product warranties or similar contracts) the probability that an outflow will be required in settlement, is determined by considering the said obligations as a whole. In this connection, it may be noted that in the case of a manufacture and sale of one single item the provision for warranty could constitute a contingent liability not entitled to deduction under Section 37 of the said Act. However, when there is manufacture and sale of an army of items running into thousands of units of sophisticated goods, the past event of defects being detected in some of such items leads to a present obligation which results in an enterprise having no alternative to settling that obligation. In the present case, the appellant has been manufacturing and selling Valve Actuators. They are in the business from assessment years 1983- 84 onwards. Valve Actuators are sophisticated goods. Over the years appellant has been manufacturing Valve Actuators in large numbers. The statistical data indicates that every year some of these manufactured Actuators are found to be defective. The statistical data over the years also indicates that being sophisticated item no customer is prepared to buy Valve Actuator without a warranty. Therefore,*

(11)

warranty became integral part of the sale price of the Valve Actuator(s). In other words, warranty stood attached to the sale price of the product. These aspects are important. As stated above, obligations arising from past events have to be recognized as provisions. These past events are known as obligating events. In the present case, therefore, warranty provision needs to be recognized because the appellant is an enterprise having a present obligation as a result of past events resulting in an outflow of resources. Lastly, a reliable estimate can be made of the amount of the obligation. In short, all three conditions for recognition of a provision are satisfied in this case.

13. In this case we are concerned with Product Warranties. To give an example of Product Warranties, a company dealing in computers gives warranty for a period of 36 months from the date of supply. The said company considers following options : (a) account for warranty expense in the year in which it is incurred; (b) it makes a provision for warranty only when the customer makes a claim; and (c) it provides for warranty at 2% of turnover of the company based on past experience (historical trend). The first option is unsustainable since it would tantamount to accounting for warranty expenses on cash basis, which is prohibited both under the Companies Act as well as by the Accounting Standards which require accrual concept to be followed. In the present case, the Department is insisting on the first option which, as stated above, is erroneous as it rules out the accrual concept. The second option is also inappropriate since it does not reflect the expected warranty costs in respect of revenue already recognized (accrued). In other words, it is not based on matching concept. Under the matching concept, if revenue is recognized the cost incurred to earn that revenue including warranty costs has to be fully provided for. When Valve Actuators are sold and the warranty costs are an integral part of that sale price then the appellant has to provide for such warranty costs in its account for the relevant year, otherwise the matching concept fails. In such a case the second option is also inappropriate. Under the circumstances, the third option is most appropriate because it fulfills accrual concept as well as the matching concept. For determining an appropriate historical trend, it is important that the

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company has a proper accounting system for capturing relationship between the nature of the sales, the warranty provisions made and the actual expenses incurred against it subsequently. Thus, the decision on the warranty provision should be based on past experience of the company. A detailed assessment of the warranty provisioning policy is required particularly if the experience suggests that warranty provisions are generally reversed if they remained unutilized at the end of the period prescribed in the warranty. Therefore, the company should scrutinize the historical trend of warranty provisions made and the actual expenses incurred against it. On this basis a sensible estimate should be made. The warranty provision for the products should be based on the estimate at year end of future warranty expenses. Such estimates need reassessment every year. As one reaches close to the end of the warranty period, the probability that the warranty expenses will be incurred is considerably reduced and that should be reflected in the estimation amount. Whether this should be done through a pro rata reversal or otherwise would require assessment of historical trend. If warranty provisions are based on experience and historical trend(s) and if the working is robust then the question of reversal in the subsequent two years, in the above example, may not arise in a significant way. In our view, on the facts and circumstances of this case.....”

6. In the facts of the present case too this Court is of the opinion that the reasoning adopted by the Tribunal cannot be found fault with. The considerations which weighed with the Supreme Court in *Rotork Controls India P. Ltd.* (supra) in concluding such warranty provisions were not contingent liabilities would apply with greater force to negate the claim by the revenue that such provisions are made for diminution in the value of any asset, so as to be covered by Explanation 1(i) to Section 115 JB of the Act. In these circumstances, the Court is satisfied that no substantial question of law arises for consideration.

7. In addition to the above question for warranty services, the revenue urges that the setting aside of the disallowance in respect of "slow moving finished goods" made by the Tribunal is not justified. The assessee had sought to justify this provision contending that it amounted to foolproof identified products which are slow moving or non-productive and had disclosed all details. In addition it is contended that the assessee is dealing with sophisticated medical consumables which are used by the large public and if an inventory is not moving for sufficiently long period, it is considered to be non-productive or non-useable. The assessee had identified through SAP computer programme which took into consideration each and every item of slow moving finished goods lying at the end of each year and contained information in that regard.

8. The Tribunal's reasoning as far as this item i.e. provision for slow moving goods are concerned are as follows :

"5. We have gone through the records including the details of slow moving stock as on 31.3.2001 and similar stocks in the other years and do not find any infirmity in the order of the CIT(A). The assessee has been consistently following the method of accounting over a period of time. The assessee is in the business of pharmaceutical products where strict supervision of the quality has to be ensured and these products are mostly surgical needles and medical consumable and if such fast moving items are not sold for a considerably lengthy period. It can be safely said that they have lost their consumable acceptability over a period of time, may be due to advent of new products. After all, as long as the assessee acted in a bona fide manner and has appreciated the business realities in which he is placed, the same should be accepted. The assessee has a foolproof method of identification of slow moving or dead stock and has put the realizable value for the purpose of valuing the same. In fact, the principle of valuation is the cost or the market value whichever is lower. The market value here

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become obsolete or slow moving it naturally has a lower market value which the assessee has recognized. The assessee has properly identified such stock and has also followed in accordance with commercially accepted accounting principles of valuation. In our view, the CIT(A) was correct in law and on facts to have deleted the addition made by the AO which was based not taking into consideration the hard realities of assessee's business. The addition in our view, is properly deleted and we decline to interfere."

9. This Court is of the opinion that the concurrent findings as to the scientific and reasonable method adopted by the assessee in the facts of this case have been recorded after the facts were gone into in detail by the appropriate authorities. The Court does not find any reasons to disturb the said findings. On this ground too the revenue's claim has to fail.

10. The view of the Tribunal also finds support in a judgment of this Court reported as *CIT vs. Hotline Teletube & Components Ltd.* (2008) 12 DTR 311 where the Court had relied upon the judgment of the Supreme Court in *CIT Vs. Hindustan Zinc Ltd.* (2007) 291 ITR 391.

11. For the above reasons all questions of law sought to be urged are answered against the revenue and in favour of the assessee.

The appeals are therefore dismissed.


S. RAVINDRA BHAT, J


R.V.EASWAR, J

NOVEMBER 19, 2012

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