

**THE HON'BLE SRI JUSTICE DILIP B.BHOSALE
AND
THE HON'BLE SRI JUSTICE A.RAMALINGESWARA RAO**

- **I.T.T.A. Nos.252 & 291 of 2003, 76 & 77 of 2006 and 132 & 136 of 2004**

- **ORAL JUDGMENT:** (per the Hon'ble Sri Justice Dilip B.Bhosale)

The first four appeals, under Section 260A of the Income Tax Act, 1961 (for short 'the Act'), are preferred by the Revenue. Out of which, first two appeals are against the orders dated 30-07-2002 and 29-11-2002 in I.T.A.Nos.142/HYD/2002 and 141/HYD/2002 respectively and the remaining two are against the common order dated 26-03-2002 rendered by the Income Tax Appellate Tribunal in Income Tax Appeal bearing No.229/HYD/2000 and 273/HYD/2000. By these orders, the Tribunal allowed the Income Tax Appeals filed by the respondent-assessee against the orders of the Commissioner of Income Tax (Appeals) dated 10-12-2001, 14-12-2001 and 28-01-2000. Insofar as ITA No.273/Hyd/2000 is concerned, that was also disposed off by the order dated 28-01-2000 along with the assessee's appeal bearing ITA No.229/Hyd/2000. All these appeals pertain to the assessment years 1996-97 to 1999-2000.

2. Before the Commissioner of Income Tax (Appeals), the assessees had called in question the orders of Assessing Officer (for short 'the A.O.'), who, while completing the assessment for the relevant assessment years disallowed the deduction of the "lease equalization" charges from the lease rental income. The disallowed amounts by the CIT (Appeals) in these appeals are of Rs.48,56,224/-, Rs.44,18,245/- and Rs.13,16,123/-.

3. Since the questions raised and the assessee in all four appeals are common, for the sake of convenience we state the facts leading to I.T.T.A.No.252 of 2003 preferred by the Revenue, to the extent they are necessary, as follows: the assessee-Company had filed its return of income on 30.11.1998 declaring the income of Rs.58,65,660/-. The return was processed under Section 143 (1) (a) of the Act on 28.09.1999 without any adjustments. Then the assessee's case was selected for scrutiny by issue of a notice under Section 143(2) dated 28.09.1999. The notice was served on the assessee on 11.10.1999. Subsequently, notices under Section 142 (1) and 143 (2) were issued, in response to which, Chartered Accountant of the assessee appeared before the A.O. and furnished details called for. The assessment was then completed and the A.O. disallowed the lease equalization charges of Rs.48,56,224/- from the lease rental charges for the assessment year 1998-99.

3.1 During the assessment year 1998-99, the assessee had given certain assets on lease and shown gross lease rentals of Rs.1,14,91,395/-, as income in the profit and loss account. Out of this, a sum of Rs.48,56,224/- was claimed as deduction by way of "lease equalization charges" from the lease rental income. In the course of assessment proceedings, it was submitted on behalf of the assessee that the treatment in the accounts had been given as per the "Guidance Note" on accounting for leases, issued by the Institution of Chartered Accountants of India (for short 'the ICAI'). In this backdrop, the question that was considered by the Tribunal and CIT (Appeals) was whether the assessee could take recourse to the "Guidance Note" issued by the ICAI *qua* accounting for lease in determination of its income, and whether the deduction as

claimed by the assessee ought to be allowed.

4. The CIT (Appeals) disallowed the “lease equalization” charges from the lease rental income, whereas the Tribunal allowed and hence, the Revenue preferred the above four appeals raising five questions of law in the memorandum of appeals. At the stage of admitting the appeals no substantial question of law was framed. In view thereof, learned senior counsel for the Revenue, fairly submitted that only the following substantial question of law, in their appeals, arise for our consideration:

- (1) whether, on the facts and in the circumstances of the case, the Income Tax Appellate Tribunal was justified in allowing the assessee to deduct the lease equalization charges from the lease rental income, accepting its accounting policy based on the Guidance Note issued by ICAI for preparation of accounts and whether it would override the statutory provisions of the Act?

5. The remaining two appeals, bearing I.T.T.A.Nos.132 and 136 of 2004, preferred by the assessees, are against the orders passed by all the three authorities, disallowing the deduction of “lease equalization charges” from the gross lease receipts, holding that the assessee was in the wrong in employing the “Guidance Note” issued by ICAI for computing their income from lease rent. In these appeals, the following substantial question of law is raised for our consideration :

- (1) Whether on the facts and in the circumstances of the case, the Tribunal was justified in law in disallowing deduction of lease equalization charges from the gross lease receipts?

6. Counsel for the assessees, at the outset, invited our attention to the judgments of Delhi High Court in **Commissioner of**

Income Tax Vs. *Virtual Soft System Limited*^[1] and of Karnataka High Court in ***Prakash Leasing Limited Vs. Deputy Commissioner of Income Tax, Central Circle-III, Bangalore***^[2]

and contended that similar questions fell for consideration of these High Courts and based on the Guidance Note issued by ICAI held that the assessee is entitled for deduction of lease equalization charges from lease receipts. In short, it was contended that the questions raised in these appeals are squarely covered by those judgments. It was further submitted that the assessee is entitled to have its accounting policy taking recourse to the Guidance Note issued by ICAI, while accounting for lease transactions. It was further submitted that the Courts have accepted the recommendations issued by ICAI from time to time, with respect to the manner and mode of reflecting transactions in books of accounts, in number of judgments pronounced by High Courts as well as the Supreme Court. Lastly, he submitted that what is provided in the Guidance Note stands transacted into an accounting standard issued by the ICAI and approved under sub-section (2) of section 145 of the Act by the Central Government.

7. Mr.S.R.Ashok, learned Senior Counsel appearing for the Revenue, on the other hand, at the outset, invited our attention to Section 145 of the Act, in particular sub-section (2) thereof, and submitted that neither the accounting standards nor the Guidance Note issued by ICAI could be taken recourse to in the absence of a notification being issued by the Central Government as contemplated by sub-section (2). He submitted that Delhi High Court and Karnataka High Court did not consider the provisions contained in sub-section (2) of Section 145 of the Act in proper perspective, and without reference thereto considered whether the

Guidance Note could be the basis for accepting the accounting system followed by the assessee. He submitted that the taxable income of the assessee should be determined as per the Income Tax Act and not on the basis of the Guidance Note issued by ICAI. In other words, it was submitted that the assessee cannot take recourse to the Guidance Note issued by ICAI *qua* accounting for lease in determination of its income and, therefore, in that regard whether a particular deduction ought to be allowed or disallowed, one should only have to look to the provisions of the Income Tax Act.

8. The arguments advanced by learned counsel for the parties were centered around the judgment of Delhi High Court in **Virtual Soft Systems Limited** and of Karnataka High Court in **Prakash Leasing Limited** and also the provisions contained in sub-section (2) of Section 145 of the Income Tax Act. In view thereof, we would like to have a glance at both the judgments and the provisions of Section 145(2) of the Income Tax Act.

8.1 In **Virtual Soft Systems Limited** (supra), the following questions were framed:

- (1) Whether, on the facts and circumstances of the case, the Income-tax Appellate Tribunal erred in law and on the merits in allowing the deduction of the lease equalization charges from the lease rental income?
- (2) Whether the Guidance Note issued by the ICAI for presentation of accounts would override the statutory provisions of the Income-tax Act 1986?

8.2 The facts leading to the appeal before Delhi High Court were almost similar, in the sense the assessment of the assessee for the assessment year 1996-97 was set aside by the Commissioner directing the Assessing Officer to include the assessee's lease

rental income. For the assessment years 1997-98 to 2000-2001, the assessments were reopened by the Assessing Officer and he came to the conclusion that the taxable income of the assessee had to be determined in accordance with the Act and not on the basis of the Guidance Note, which only provided guidelines for preparation of financial statements for the purpose of accounting. The Assessing Officer accordingly disallowed the sum attributed to lease equalization charges, and, consequently, added to the assessee's income. The Commissioner (Appeals) confirmed the order of the Assessing Officer, whereas the Tribunal allowed the appeals of the assessee on merits. In this backdrop, the relevant observations made by Delhi High Court in **Virtual Soft Systems Limited (supra)** read thus:

"In this background what is required to be considered is whether the books of account could be rejected by the Assessing Officer merely for the reason that recourse to the guidance note was taken by the assessee. In this regard, we would be required to examine the provisions of Section 145 of the Income-tax Act. Section 145 of the Income-tax adverts to the method of accounting followed by an assessee. Sub-section (1) of Section 145 provides that income chargeable under the head "Profits and gains of business or profession" or "Income from other sources" shall be computed either on cash basis or on mercantile system, whichever method being regularly employed by the assessee. This provision is, however, subject to the Central Government notifying accounting standard in respect of any class of assessee or class of income. Sub-section (3) of Section 145 empowers the Assessing Officer to disregard the books of account submitted by the assessee only if he is not satisfied with the correctness or completeness of the accounts of the assessee or the method of accounting employed by the assessee or on account of accounting standards notified under sub-section (2), not being particularly followed by the assessee. In this particular case, the Assessing Officer has disregarded, in substance, the method of accounting followed by the assessee qua lease rentals without basing it on the grounds provided in Section 145 of the Income-tax Act. The fact that the assessee justified its method of accounting, by

taking recourse to the Guidance Note issued by the ICAI in that behalf, was disregarded, on what we would term as, a disjointed reading of the provisions of the said Guidance Note. Both the Assessing Officer as well as the Commissioner of Income-tax (Appeals) have adverted to paragraph 2 of the Guidance Note to come to what we consider an erroneous conclusion inasmuch as they have held that in determining as to whether deduction on account of the lease equalization charges ought to be allowed or not, what has to be borne in mind is ultimately the provisions of the Income-tax Act. In our view, such an observation in paragraph 2 of the Guidance Note is really saying the obvious. Therefore, even if this Guidance Note was silent on this aspect the provisions of the Income-tax Act would undoubtedly still apply. Thus, as to what is the impact of provision of paragraph 2 of the Guidance Note will be considered by us as we progress further with our judgment.

9.1. However, what is important at this stage is to first address ourselves to the aspect as to whether the Assessing Officer could have disregarded the method of accounting followed by the assessee in respect of lease rentals. In our view, the Assessing Officer could not have done so, as the method of accounting was based on a guideline commended for adoption by a professional body such as the ICAI. The Guidance Note reflects the best practices adopted by accountants the world over. The fact that, at the relevant point in time, it was not mandatory to adopt the methodology professed by the Guidance Note issued by the ICAI is irrelevant for the reason that, as long as there was a disclosure of the change in the Accounting Policy in the accounts, which had a backing of a professional body such as the ICAI, it could not be discarded by the Assessing Officer. This is specially so, since the ICAI is recognized as the body vested with the authority to recommend accounting standards for ultimate prescription by the Central Government in consultation by the National Advisory Committee of Accounting Standards, for presentation of financial statements. The provisions of Section 211(3c) of the Companies Act are quite clear on this aspect. As a matter of fact, the proviso to the said sub-section, quite clearly specifies that till such time the Central Government prescribes the accounting standards the accounting standards issued by the ICAI shall be deemed to be the relevant accounting standards. The relevant provision reads as follows:

“211.(3C) For the purposes of this section, the

expression 'accounting standards' means the standards of accounting, recommended by the Institute of Chartered Accountants of India constituted under the Chartered Accountants Act, 1949 (38 of 1949), as may be prescribed by the Central Government in consultation with the National Advisory Committee on Accounting Standards established under sub-section (1) of Section 201A:

Provided that the standards of accounting specified by the Institute of Chartered Accountants of India shall be deemed to be the accounting standards until the accounting standards are prescribed by the Central Government under this sub-section."

In this context, it would be important to note that Accounting Standard 1 pertaining to disclosure of accounting policies has already been notified by the ICAI as having attained mandatory status for periods commencing on or after April 1,1991. It is not the Assessing Officer's case that the accounting policy with regard to the lease rentals was not disclosed by the assessee. The Assessing Officer seems to have taken umbrage to the change in the accounting policy having been brought about only with effect from the assessment year 1996-97. In our view, as long as there was a disclosure of the factum of change in the accounting policy and its effect in the accounts no fault could be found with the change in the accounting policy merely on account of the fact that it was employed for the first time in the assessment year 1996-97. The change in the accounting policy, as noticed by us above, had the imprimatur of a duly recognized professional body, i.e., the ICAI. Therefore, notwithstanding the fact that the opinion of the ICAI was expressed in a Guidance Note which had not attained a mandatory status, would not, in our view, provide a basis to the Assessing Officer to disregard the books of accounts of the assessee and in effect method of accounting for leases followed by the assessee."

8.3 The Karnataka High Court, in **Prakash Leasing Limited (supra)** framed the following questions of law:

1. Whether in law the Tribunal was justified in confirming the disallowance made by the lower authorities on the claim of the appellant with regard to the lease equalization account to the extent of Rs.4,35,89,466/-?
2. Whether in law the Tribunal is justified in not appreciating that the appellant being a NBFC had followed the norms required by its regulatory authority namely RBI and hence the claim made by the appellant with regard to

the lease equalization account was perfectly in order?

3. Whether in law the Tribunal was justified in declining to accept the deduction claimed by the appellant which was in accordance with accounting standard which was consistently followed which declares the real income in the relevant year?
4. Whether in law the Tribunal was justified in concluding that Lease Equalization Reserve is an appropriation of profit and thus cannot be allowed as deduction?

8.4 Karnataka High Court considered several judgments including the judgment of Delhi High Court in **Virtual Soft Systems Limited** (supra) and in paragraph 12, observed thus:

“Admittedly, insofar as the lease equalization charges are concerned, it is not provided in the notified accounting standards by the Department. It is also not in dispute that in the Act what the lease equalization charges is not explained. In the absence of any specific provision in the Act dealing on the subject, when the accounting standard is now made the basis for maintaining the accounts for the purpose of income tax, even if the Central Government has not notified in the Official Gazette the accounting standards, certainly the accounting standards prescribed by the Institute of Chartered Accountants has to be followed. In fact, the Hon’ble Supreme Court in *Challapalli Sugars Limited Vs. CIT* (1975) 98 ITR 167 has put its seal of approval on adopting the accounting standards while interpreting Section 10(2) (vi), (via), (vib) and Section 10(5) of the Indian Income Tax Act 1922, while interpreting the expression ‘actual cost’. The Supreme Court held in (ITR page 173): “as the expression ‘actual cost’ has not been defined, it should, in, our opinion, be construed in the sense which no commercial man would misunderstand. For this purpose, it would be necessary to ascertain the connotation of the above expression in accordance with the normal rules of accountancy prevailing in commerce and industry. Therefore, it is judicially accepted that when determining whether there has in fact been accrual of liability or income, the accountancy standards prescribed by the ICAI would have to be followed and applied.” Therefore, the reasoning of the authorities though the claim of the assessee is based on such accounting standards of ICAI while deciding whether receipt of money is taxable or not it has to be decided in accordance with the provisions of law and not in accordance with the accounting practice has no substance as there is no

inconsistency between the said accounting practice and any provisions of the Act.”

9. We would now like to consider the provisions of Section 145 of the Act. Section 145 deals with method of accounting. This provision was substituted by the Finance Act, 1995 w.e.f.1-4-1997. In the present case, we are concerned with the assessment years 1997-1998 to 2000-2001. Sub-section (1) of Section 145 states that income chargeable under the head “Profits and gains of business or profession” or “Income from other sources” shall, subject to the provisions of sub-section (2), be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee. Sub-section (2) provides that the Central Government may notify in the Official Gazette from time to time “accounting standards” to be followed by any class of assessee or in respect of any class of income. Sub-section (3) of Section 145 of the Act provides where the Assessing Officer is not satisfied about the correctness or completeness of the accounts of the assessee, or where the method of accounting provided in sub-section (1), or accounting standards as notified under sub-section (2), have not been regularly followed by the assessee, the Assessing Officer may make an assessment in the manner provided in Section 144 of the Act.

10. On the basis of the provisions contained in Section 145 of the Act, it was submitted on behalf of the Revenue that the taxable income of the assessee should be determined as per the Act and that the “Guidance Note” issued by ICAI cannot be the basis for such determination. It was further submitted that the Guidance Note or the accounting standards prescribed by ICAI cannot be taken recourse to or taken into account unless the Central Government

notify such accounting standards in the Official Gazette to be followed by any class of assesses or in respect of any class of income. Then, it was submitted that the word “may” in sub-section (2) should be read as “shall” having regard to the scheme of Section 145 of the Act. In other words, it was submitted that under any circumstances, the accounting standards or Guidance Note issued by ICAI cannot be taken recourse to while accounting for lease transactions unless the accounting standard is notified in the Official Gazette by the Central Government.

11. In the present case, at the relevant time, the accounting standard employed by the assessee was not notified though it was subsequently notified by the Central Government. We would, therefore, like to examine the question on the premise that at the relevant time the accounting standards employed by the assessee in the present case was not notified by the Central Government.

12. The ICAI’s publication on the subject indicates that the “Guidance Note” on accounting leases was issued by it, for the first time, in 1988, which was then revised in 1995. On 1-4-2001, the ICAI did publish Accounting Standard 19 in respect of leases. It is not in dispute that the said Accounting Standard 19 is applicable in respect of assets leased during accounting periods commencing on or after April 1, 2001. The assessment years, which are under consideration, in these appeals are prior to 1-4-2001. We are not entering into the details as to how the accounting standards work or applied in respect of lease income since the question that falls for our consideration is whether the assessee in these appeals were obliged to employ or to take recourse to Guidance Note issued by ICAI on accounting for leases even though the accounting standard was not notified by the Central Government in the Official Gazette

as contemplated by sub-section (2) of Section 145 of the Act. It is not in dispute that the Guidance Note reflects the best practices adopted by the Accountants in India. Further, it cannot be disputed that ICAI is the authority to recommend accounting standards for ultimate prescription by the Central Government in consultation by the National Advisory Committee of Accounting Standards, for presentation of financial statements. In support, as observed by the Delhi High Court in **Virtual Soft Systems Limited**, the provisions of Section 211(3C) of the Companies Act are quite clear. The proviso to this Section clearly specifies that till such time the Central Government prescribes the accounting standards issued by the ICAI shall be deemed to be the relevant accounting standards. It is not in dispute that the Accounting Standard 19 prescribed on 1-4-2001 in respect of leases and the accounting standard incorporated in the Guidance Note is one and the same. Therefore, notwithstanding the fact that the opinion of the ICAI was expressed in a Guidance Note which had not attained a mandatory status, would not, in our view provide a basis to the Assessing Officer to disregard the books of accounts of the assessee and in effect method of accounting for leases followed by the assessee as observed by the Delhi High Court in **Virtual Soft Systems Limited** (supra). In this connection, we would like to make a reference to the judgment of the Supreme Court in **CIT Vs. Bilahari Investment (P) Ltd.**^[3] wherein it was observed that every assessee is entitled to arrange its affairs and follow the method of accounting, which the Department has earlier accepted. It is only in those cases where the Department records a finding that the method adopted by the assessee results in distortion of profits that Department can insist on substitution of the existing method. Therefore, certainly the method adopted by the assessee in maintaining its accounts for the

earlier period is an important factor, which the authorities have to keep in mind at the time of framing the assessment orders. It is well settled that in determining whether there has in fact been accrual of liability or income, the accountancy standards prescribed by the ICAI would have to be followed and applied. [See *Challapalli Sugars Ltd., Vs. CIT (1975) 98 ITR 167*]. In this judgment, the Supreme Court has put its seal of approval on adopting the accounting standards while interpreting Section 10(2)(vi), (via),(vib) and Section 10(5) of the Indian Income Tax Act, 1922, and the expression “actual cost”. Thus, even if at the relevant time, it was not mandatory to adopt the methodology prescribed by the Guidance Note or for that matter the accounting standard as it was not notified by the Central Government in the Official Gazette, in our opinion, it is not relevant for the reason that, as long as there was a disclosure of the Accounting Policy in the accounts, which had a backing of a professional body, such as ICAI, it could not be discarded by the Assessing Officer.

13. Lastly, we would like to consider the submission that the word ‘may’ employed in sub-section(2) of Section 145 of the Act should be read as ‘shall’. Sub-section(2) provides that the Central Government “may” notify in the official gazette from time to time accounting standards to be followed by any class of assesseees or in respect of any class of income. The question, therefore, is whether in the absence of such notification, being issued by the Central Government, the accounting standards or the Guidance Note, prescribing the accounting standards, issued by ICAI could be adopted as a method for accounting. It is judicially accepted that in determining whether there has in fact been accrual of liability or income, the accountancy standards prescribed by the ICAI would have to be followed and applied. In other words, the accounting

standards prescribed by the ICAI has received recognition in several decisions of the High Courts and the Supreme Court. We have also made reference to the provisions of Section 211 (3c) of the Companies Act, 1956. Proviso to this Section clearly specifies that till such time Central Government prescribes, the accounting standards issued by ICAI shall be deemed to be the relevant accounting standards. Keeping that in view, it would not be possible to read the word 'may' employed in sub-section(2) of Section 145 of the Act as 'shall'. It is well settled that the word 'may' normally indicate that the provision is not mandatory. It is also true that the word 'may' can also be used in the sense 'shall' or 'must' by the Legislature. The intent of the Legislature, however, will have to be gathered from the scheme of the relevant provision, Chapter or the relevant Statute and also judicial pronouncements dealing with the relevant provision. Having regard to the provisions contained in Section 145 of the Act, we are of the opinion that the word 'may' used in sub-section(2) thereof cannot be read as 'shall'. Merely because, the Central Government has not notified in the official gazette "accounting standards" to be followed by any class of assessee or in respect of any class of income, it cannot be stated that the "accounting standards" prescribed by ICAI or the accounting standards reflected in the "Guidance Note" cannot be adopted as an accounting method by an assessee. Thus, this submission also deserves to be rejected.

14. Therefore, in our opinion, notwithstanding the fact that the opinion of the ICAI was expressed in the Guidance Note, which had not attained a mandatory status, would not, in our view, be a ground to discard the books of accounts of the assessee or method of accounting for lease followed by the assessee and disallowing the assessee to deduct the lease equalization charges from the lease

rental income.

15. Thus, substantial questions of law framed by us are answered in favour of the assessee and against the Revenue. The first four(4) appeals filed by the Revenue are accordingly dismissed and the remaining two(2) appeals filed by the assessee are allowed with no order as to costs.

16. Miscellaneous petitions pending in the appeals, if any, also stand disposed of.

Dilip B.Bhosale, J

A.Ramalingeswara Rao, J

5th February, 2015.
Kdl/Tsnr

Note : L.R. copy to be marked : YES / NO

[\[1\]](#) (2012) 205 Taxman 257 (Delhi)

[\[2\]](#) (2012) 208 Taxman 464 (Karnataka)

[\[3\]](#) [2008] 299 ITR 1