

IN THE HIGH COURT OF JUDICATURE AT MADRAS

DATED: 03.09.2018

CORAM:

THE HONOURABLE MR.JUSTICE T.S. SIVAGNANAM
&
THE HONOURABLE MRS.JUSTICE V. BHAVANI SUBBAROYAN

T.C.A.No.1003 of 2008

M/s.Grundfos Pumpas India Limited,
118, Old Mahabalipuram Road,
Thoraipakkam, Chennai. .. Appellant/Respondent

Vs

The Deputy Commissioner of Income Tax,
Company Circle II (2), Chennai. ..Respondent/Appellant

* * *

Prayer:- Tax appeal has filed under Section 260A of the Income Tax Act, against the order of the Income Tax Appellate Tribunal, [A] Bench, Chennai, dated 23.01.2008 in the ITA No.939/Mds/2007 for the Assessment Year 2003-2004.

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For Appellant : Mr.Vikram Vijayaraghavan

For Respondent : Mr.Karthick Renganathan
Standing Counsel

JUDGMENT

This appeal is directed against the order of the Income Tax Appellate Tribunal, [A] Bench, Chennai, in ITA No.939 of 2007, dated 23.01.2008, for the assessment year 2003-2004.

2. This appeal has been admitted vide order dated 19.08.2008 on the following the substantial questions of law :

- (i) Whether, on the facts and in the circumstances of the case, the Tribunal was right in law in holding that the appellant is not entitled to deduction in respect of provision for warranty?
- (ii) Whether, on the facts and in the circumstances of the case, the Tribunal failed to appreciate that the provision was made on a scientific basis on the basis of actual warranty cost incurred in the year and the outstanding warranty risk and not an adhoc estimate?□

3. The facts, which are necessary for the disposal of this appeal are as hereunder :

- (i) The Assessee is engaged in the business of manufacturing, assembling and marketing of pumps and components. For the Assessment Year 2002-2003 (year under consideration), it filed its return of income on 28.11.2003 admitting an income of Rs.1,51,35,912/- after setting off an unabsorbed

depreciation of earlier years amounting to Rs.49,79,526/-. The case was selected for scrutiny under Sections 143(2) and 142(1) of the Income Tax Act, 1961 (hereinafter referred to as "the Act"). The assessment was completed under Section 143(3) of the Act vide order dated 30.01.2006 determining the total income of Rs.1,73,66,446/-. While completing the assessment, the Assessing Officer disallowed, among others, the provision of warranty amounting to Rs.18,01,443/-.

(ii) The Assessee filed an appeal before the Commissioner of Income Tax (Appeals) [in short, "the CIT(A)"]. The appellate authority vide order dated 02.02.2007 allowed the appeal and set aside the order of the Assessing Officer thereby allowing the provision for warranty.

(iii) The Revenue preferred an appeal before the Income Tax Appellate Tribunal (in short "the Tribunal"), which was allowed by the impugned order dated 23.01.2008, as against which, the Assessee is before this Court by way of this appeal.

4. Heard Mr.Vikram Vijayaraghavan, learned counsel appearing for the appellant/assessee and Mr.Karthick Renganathan, learned Counsel appearing for the Revenue.

5. Before we examine the substantial questions of law, which have been framed for consideration, we need to observe that the impugned order passed by the Tribunal is bereft of particulars; outcome of non-application of mind; and no reasons have been assigned, as it is a non-speaking order. This would be sufficient for us to set aside the order and remand the matter for fresh consideration. However, we refrain from doing so, keeping in mind that the Assessment Year was 2003-2004 and the Tribunal passed the impugned order on 23.01.2008 and after about ten years we are taking up this appeal for disposal. Thus, we proceed to decide the substantial questions of law framed for consideration.

6. The Tribunal allowed the case of the Revenue on the ground that the Assessee did not submit any details regarding the incurrence of the liability and therefore, held that it is squarely covered by the decision of the Division Bench of this Court in the case of CIT V. Rotork Controls India Limited, 293 ITR 311 (Mad.). The said decision of the Division Bench relied on by the Tribunal has been reversed by the Hon'ble Apex Court in Rotork Controls India (P) Ltd. V. CIT, (2009) 314 ITR 0062, and it is a good ground to set aside the impugned order of the Tribunal.

7. Nevertheless, the Court will consider as to whether there is any error in the order passed by the first appellate authority. In other words, whether the Assessing Officer committed an error in disallowing the warranty claim.

8. As mentioned earlier, the case of the Assessee was taken up for scrutiny, which culminated in the assessment order dated 30.01.2006. We find from the assessment order that the assessee was asked to justify the claim of provision for warranty, for which, it had given a detailed reply dated 25.11.2005 contending that the provision is an ascertained liability, as it was based on scientific method and on past experience and not an adhoc provision. Further, the Assessee contended that they do assembly of pumps and give warranty of eighteen months from the date of dispatch. A warranty letter is issued along with sale invoices and the Assessee has got an obligation to replace/repair the products sold free of cost during the warranty period. Thus, the Assessee contended that as the actual expenses cannot be ascertained, the provision was made on a scientific basis. The Assessee relied upon the decisions in Sheratan Apparels V. ACIT, 256 ITR 20 (Bom.), Shree Sajjan Mills Ltd., 156 ITR 585 (SC) and Mysore Lamp Works Ltd. 185 ITR 96.

9. The Assessing Officer, while considering the stand taken by the Assessee, held that the Assessee has made only a provision for warranty based on the past practice and experience and it is only a contingent liability, the contingency being that the product sold by the Assessee undergoes repairs during warranty period. Further, the Assessing Officer observed that it is not that all the products

sold became repairable and the Assessee has to incur expenditure and there is nothing wrong on the part of the Assessee to debit the actual expenditure incurred every year on warranties given as revenue expenditure and claim the same as a deduction. Further, the Assessing Officer held that the provision made by the Assessee is an expenditure, which would be incurred on the happening of an event and as such, the same cannot be treated as business expenditure within the ambit and scope of Section 37 of the Act. The provision for warranty cannot be considered as an "expenditure" at all and the expenditure has to be an actually existing liability and the expenditure which is deductible for income tax purposes, but merely putting aside the money which may become expenditure on the happening of an event is not an expenditure. So far as the decisions relied on by the assessee, they support the case of the Assessee, but those decisions did not attain finality and accordingly, rejected the plea of the Assessee with regard to the provision for warranty.

10. The Assessee preferred an appeal contending that the Assessing Officer erred in not allowing the provision for warranty, in spite of the same having been made based on a scientific basis. The appellate authority, after considering the submissions made by the Assessee as well as the detailed note submitted by the Assessee, held that the provision has been made by the Assessee on a scientific basis and it is an ascertained liability. Examining the nature of business done by the Assessee, the CIT(A) pointed out that the Assessee is engaged in the business of manufacturing, assembling and marketing of pumps and components and they have explained the basis for working the said provision for warranty, which is based on past experience and not on adhoc basis. Further, the CIT(A) pointed out that the said amount is based on turnover of the last three years and it is based on the provision for expenses on repairs during the warranty period as contemplated in the sale agreements. Keeping in view the above factual position, the CIT(A) accepted the case of the Assessee and the additions made by the Assessing Officer was deleted.

11. As mentioned earlier, the Tribunal failed to examine the factual issue and made a factually incorrect statement that the details were not submitted. We need not labour much to decide the substantial questions of law as framed for consideration in this appeal, since the said questions have been settled by the Hon'ble Supreme Court in Rotork Controls India (P) Limited (cited supra). The Hon'ble Supreme Court explained as to what is a provision on the following lines :

□ 10. This is the question which needs to be answered. A provision is a liability which can be measured only by using a substantial degree of estimation. A provision is recognized when : (a) an enterprise has a present obligation as a result of a past event ; (b) it is probable that an outflow of resources will be required to settle the obligation ; and (c) a reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision can be recognized.□

12. Nextly, the Hon'ble Supreme Court went on to examine as to what are the types of product warranties, a company would give and held that there were three options, namely, □(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 per cent of turnover of the company based on past experience (historical trend)□. Among these three options, it was held that 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. To be precise, the Assessing Officer has opted to follow the first option, which has been held to be unsustainable. Therefore, the finding of the Assessing Officer has to be necessarily set aside.

13. The Hon'ble Supreme Court pointed out that the second option is also inappropriate as it is not based on matching concept and held that the third option must be the most appropriate, because it fulfills the accrual concept as well as matching concept. The observation of the Supreme Court in this regard is as follows :

□13. 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.□

14. Further, the Hon'ble Supreme Court pointed out the four important aspects of provisioning namely, provisioning which relates to present obligation, it arises out of obligating events, it involves outflow of resources and lastly, it involves reliable estimation of obligation.

15. Learned counsel for the Assessee filed a paper book containing the movement in provision for warranty and note on allowability of provision for warranty with annexures, which were placed before the Assessing Officer, CIT(A) as well as the Tribunal. The relevant details, which are contained in the movement in provision for warranty were culled out in the form of a separate sheet from which, we find that the exposure to warranty risk has been done on a scientific basis. The assessee has been able to produce the details from the year 2001 onwards. Thus, the CIT(A) was perfectly correct in coming to the conclusion that the Assessee has explained the basis for working of the provision for warranty based on past experience and it is not on adhoc basis and moreover, it is based on the turnover of the last three years and based on provision for expenses on repairs during the warranty period as contemplated in the sale agreements.

16. For all the aforesaid reasons, we are of the considered view that the Tribunal has erroneously reversed the order passed by the CIT(A) that too without assigning any reasons and without considering the materials, which are available on record. Accordingly, the Assessee is entitled to succeed in this appeal.

17. In the result, the appeal is allowed. The order passed by the Tribunal is set aside and the order of the CIT(A) is restored. The substantial questions of law are answered in favour of the Assessee and against the Revenue. No costs.

(T.S.S., J.) (V.B.S., J.)

03.09.2018

Index : Yes / No

Internet : Yes

To

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