
(2010) 07 MAD CK 0169

In the Madras High Court

Case No : Tax Case (Appeal) No's. 489 to 494 of 2010

Commissioner of Income Tax

APPELLANT

Vs

Luk India P. Ltd.

RESPONDENT

Date of Decision : 05-07-2010

Acts Referred:

Income Tax Act, 1961 — Section 115JB, 37

Citation : (2011) 239 CTR 440

Hon'ble Judges : M.M. Sundresh, J; F.M. Ibrahim Kalifulla, J

Bench : Division Bench

Advocate : K. Subramanian, for the Appellant; R. Venkatanarayan, for Subbaraya Aiyar Padmanabhan, for the Respondent

Final Decision : Dismissed

Judgement

F.M. Ibrahim Kalifulla, J.—The Revenue has come forward with these appeals raising the following substantial questions of law:

1. Whether on the facts and in the circumstances of the case, the Income Tax Appellate Tribunal was right in holding that the provision for warranty was an allowable deduction, even though the provision had not been made on any scientific basis ensuring a fair degree of accuracy, thereby resulting in huge deferment of revenue and tax liability thereon?

2. For Assessment Year 2003-04 and 2004-05:

Whether on the facts and in the circumstances of the case, the Income Tax Appellate Tribunal was right in holding that the provision made by the assessee should be allowed as a deduction for the purpose of 115JB on the I.T. Act, even though such provision has not been made on any scientific basis and huge excess provision had been made resulting in deferment of revenue?

2. The question concerns the provision for warranty claims made and it is allowable.

3. Mr. K. Subramanian, learned senior standing Counsel for the appellant, vehemently contended that no scientific method was adopted by the respondent/ assessee while making the provision for warranty claims and therefore, the Tribunal went wrong in allowing the said deduction. Learned standing Counsel however fairly brought to our notice a recent decision of the Hon''ble Supreme Court reported in (2009) Rotork Controls India (P) Ltd. Vs. Commissioner of Income Tax, Chennai, , wherein the Hon''ble Supreme Court dealt with this issue in depth and has laid down the principles while examining a claim for warranty provision by way of allowable deduction. Paragraph 14 of the said decision, where the principle has been laid down, reads as under:

14. In this case, we are concerned with product warranties. To give an example of product warranties, a company dealing in computers gives a 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 per cent. 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 recognised (accrued). In other words, it is not based on the matching concept. Under the matching concept, if revenue is recognised 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 fulfils accrual concept as well as the matching concept. For determining an appropriate historical trend, it is important that the company has a proper accounting system for capturing the 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 unutilised at the end of the period prescribed in the warranty. Therefore, the company should scrutinise 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, provision for warranty is rightly made by the appellant enterprise because it has incurred a present obligation as a result of past events. There is also an outflow of resources. A reliable estimate of the obligation was also possible. Therefore, the appellant has incurred a liability, on the facts and circumstances of this case, during the relevant assessment year which was entitled to deduction u/s 37 of the 1961 Act. Therefore, all the three conditions for recognising a liability for the purposes of provisioning stands satisfied in this case. It is important to note that there are four important aspects of provisioning. They are - 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. Keeping in mind all the four aspects, we are of the view that the High Court should not have interfered with the decision of the Tribunal in this case.

4. A perusal of the principles stated therein shows that while there could be three broad options available to a company while making a provision viz., (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 the turnover of the company based on past experience (historical trend), the Hon''ble Supreme Court while holding the first two options would not be appropriate, the third option would be more appropriate as that would fulfil the accrual concept as well as the matching concept. The Hon''ble Supreme Court appreciated the decision of the Company that while making a warranty provision based on past experience of the company, it held that there should be a warranty provisioning policy based on a scientific method and that if such provisions are made on experience and historical trend and if the working is robust, then the question of reversal in the subsequent two years, in the said case, may not arise significantly. The four important aspects of provisioning have also been highlighted by the Hon''ble Supreme Court and keeping those aspects in mind, when a case is analysed and the facts involved therein satisfied those principles, no interference should be made.

5. Keeping the above legal principles in mind, when we examine the order of the Tribunal impugned in these appeals and the questions of law raised before us, we find that the Tribunal has in effect applied the principles and has held that the assessee herein made a scientific approach while making a provision for warranty account for the relevant years and therefore, there was no scope to disallow the claim made by the assessee. The assessment years related to 1999-2000 to 2004-2005. Before the Tribunal, on behalf of the assessee, the provisions for warranty made in the books of accounts and the actual settlements of warranty

claims for the assessment years 1997-1998 to 2009-2010 were furnished and the same has been set out in paragraph 7. Similarly, the details of the year-wise sales and the percentage, at which the quantum of provision for warranty was worked out in each year by the assessee-company were also furnished. After referring to those figures furnished in the form of statements and after considering the stand of the Revenue as well as the assessee, the Tribunal has rendered its finding as under in paragraph 11.

11. It is seen from the chart reproduced in paragraph (8) above that the multiplying factor was 3.99 in AY 2002-03 and that it came down to 0.67 in 2007-08. Since the basis of computation is the average of the immediately preceding three year's actual settlements, the accumulated credit balance in the "Provision for Warranty Account" will become self-limiting, as can be seen from the chart in paragraph (8) above. For A.Y. 2007-08, the sale was more than three times the sale for AY 2002-03, whereas the provision for warranty was about one-half. Further, the genuineness of the figures of the actual settlements has not been doubted by the AO. In view of these facts, the method of computation adopted by the assessee cannot be said to be arbitrary and therefore, we see no reason to interfere with the conclusions reached by the CIT(A). His orders for AYs 1999-2000 to 2002-03 are, accordingly confirmed.

6. We also perused the statements, which have been extracted by the Tribunal in its order in paragraphs 7 and 8. In fact, on behalf of the assessee, a categorical stand was made that the assessee was making a reasonable estimate of the provision for warranty claims and that it was consistently adopting a method of taking the average of actual settlements of the immediately preceding three years while working out the provision based on the percentage of current year's sales.

7. Having regard to the figures furnished and the claim that a scientific approach was made while making a provision for warranty claim, which was based on the average of the previous years' warranty settlements, it cannot be held that there was any error, much less an illegal error committed by the Tribunal while passing the impugned order. In fact, a cursory glance of the figures set out in the statements in paragraphs 7 and 8 disclose that depending upon the trend of warranty settlements over a period of time corresponding to the sales figures, the percentage of provisions made was not inconsistent and as rightly held by the Tribunal, there was no arbitrary approach made by the assessee while making the provision for warranty claims. Therefore, looked at from any angle, we do not find any flaw in the order of the Tribunal in having decided to confirm the order of the Commissioner of Income Tax (Appeals) for the relevant years. We are, therefore, not inclined to entertain the appeals, as we do not find any question of law, much less substantial question of law arising in these appeals. These appeals fail and the same are dismissed. No costs. Consequently, M.P. Nos. 1 of 2010 (5 petitions) are also dismissed.