

(2012) 02 AP CK 0079

In the Andhra Pradesh High Court

Case No : Income Tax T.A. No. 10 of 2000

Sri Chakra Financial Services Limited (Formerly known as
Priyadarshini Leasing and Finances Limited, Hyderabad)

APPELLANT

Vs

The Commissioner of Income Tax, Central, Bangalore

RESPONDENT

Date of Decision : 07-02-2012

Acts Referred:

Income Tax Act, 1961 — Section 144, 145, 260A

Citation : (2013) 261 CTR 425 : (2013) 350 ITR 396

Hon'ble Judges : Sanjay Kumar, J; Madan B. Lokur, J

Bench : Division Bench

Advocate : A.V. Krishna Koundinya, for the Appellant; J.V. Prasad, for the Respondent

Final Decision : Dismissed

Judgement

Sri Justice Sanjay Kumar

1. The issue for consideration in this assessee's appeal u/s 260-A of the Income Tax Act, 1961 (hereinafter, "the Act") is as to the methodology of computation of the assessee's income from finance charges.

2. The assessee is a public limited company engaged in the business of leasing, hire purchase and finance. For the assessment year 1987-88, it admitted a loss of Rs. 7,09,738/-. The Assistant Commissioner of Income Tax, Central Circle-III, Hyderabad, however assessed the income of the assessee at Rs. 6,77,460/-. This assessment was based on disallowance of deductions and consequential additions in connection with finance charges, loss on revaluation of shares and notional interest on interest free loans given by the assessee.

3. Finance charges represent the interest component of the hire purchase monthly instalments paid by hirers to the assessee. The assessee had itself credited Rs. 12,33,700/- under this head in its profit and loss account. However, in its return of income the finance charges were reduced to Rs. 6,71,326/- on the

ground that the amount of Rs. 5,62,374/- did not accrue as income though credited as such in the profit and loss account during the assessment year. The Assessing Officer (AO) however did not accept this deduction and took into account the credited amount of Rs. 12,33,700/- while computing the income under this head. The AO also disallowed the deductions on the other two counts.

4. Dissatisfied with this assessment, the assessee filed an appeal before the Commissioner of Income Tax (Appeals) III, Andhra Pradesh, Hyderabad. By order dated 30.11.1990, the Commissioner accepted the stand of the assessee and allowed the appeal. Aggrieved, the Revenue carried the matter in appeal before the Income Tax Appellate Tribunal, Hyderabad Bench "A", Hyderabad, in I.T.A. No. 463/Hyd/91. The two issues raised before the Tribunal related to the finance charges and the loss on revaluation of its shares. By order dated 30.12.1998, the Tribunal allowed the Revenue's appeal and reversed the order passed by the Commissioner. Consequently, this appeal by the assessee.

5. Though the aspect of the alleged loss on revaluation of the shares held by the assessee was also sought to be raised, this Court, while admitting the appeal, framed only one substantial question of law:

We are of the view that the first question as to the methodology of computing the income representing receipts on account of finance charges and interest raises a substantial question of law to be decided in the appeal.

As regards the second question, i.e., loss claimed on account of re-valuation of shares, we do not find any arguable question of law and the reasoning given by the Tribunal is based on appreciation of facts.

The appeal is admitted as regards the first question indicated above.

6. The scope of this appeal is therefore limited to the methodology of computation of the assessee's income from finance charges earned through its hire purchase and leasing operations.

7. It is not in dispute that the assessee credited Rs. 12,33,700/- towards finance charges in its books of account. This figure was arrived at by adopting the "Indexing" or "Sum of Digits" (SOD) system of accounting. However, while offering income under this head in its return of income, the assessee followed the mercantile system of accounting and reduced the income on this count to Rs. 6,71,326/-. The orders of the authorities below reflect that the hire purchase agreements entered into by the assessee with its customers required finance charges to be paid at the rate of 15% per annum over a period of five years. The consolidated Equated Monthly Instalment (EMI) payable by the hirers was detailed in Schedule-II of the agreement and each composite instalment of the EMI contained two elements - part principal and part finance charges. The "principal component" constituted capital receipt while the amount collected towards "finance charges" was obviously a revenue receipt. In its books of account, the assessee used the SOD system of accounting and reflected more

receipts on the revenue account and less on the capital account from out of the EMIs received during the assessment year. While submitting its return of income, the assessee however adopted the mercantile system of accounting and showed lesser receipts on the revenue account.

8. To understand the difference in the two systems of accounting, it would suffice to extract the hypothetical example adopted by the Commissioner of Income Tax (Appeals):

6. To illustrate the difference in accounting of incomes as per the indexing method and the mercantile system, a hypothetical transaction involving hiring of machinery worth Rs. 100/- is taken, on which hire purchase finance charges recoverable in 5 years is Rs. 70/-. The following are the amounts of recovery shown in the books of account and in the computation of income as per the return filed.

Total value of machinery

Rs. 100/-

Finance charges

Rs. 70/-

Rs. 170/-

Year

As per books based on Indexing Method

As per income tax return based on Mercantile System

Principal

Finance charges

Total

Principal

Finance Charges

Total

1

7

27

34

20

14

34
2
15
19
34
20
14
34
3
22
12
34
20
14
34
4
26
8
34
20
14
34
5
30
4
34
20
14
34
100

70

170

100

70

170

9. Receipt of finance charges for the first and second years under the indexing system would thus be far higher than that reflected in the mercantile system of accounting. That is what has happened in the present case. The issue however is whether the income of the assessee under this head is to be assessed as per the entries in its own books of accounts or in accordance with the mercantile system of accountancy which it chose to adopt in its return of income.

10. The AO, upon a detailed analysis, found that the mercantile system of accounting could not be applied to hire purchase transactions for computing the interest chargeable on the principal loan amount as it would not reflect the true state of affairs. He found that the interest component would remain constant in the mercantile system despite the outstanding principal amount reducing each year. Consequently, the rate of interest for the later years would work out to be far higher than the rate stipulated in the agreement. He was therefore of the opinion that whatever portion of the EMI was treated as interest/finance charges by the assessee should be held to have accrued to the assessee during the assessment year and chargeable to tax.

11. The AO also pointed out the anomaly which would arise if deductions towards finance charges in the hands of the hirers were permitted on the basis of the indexing system of accounting while allowing the hiring company/financer to adopt the mercantile system of accounting in respect thereof. The AO opined that the assessee could not maintain one system of accounting for the purpose of carrying on its business and another system for tax purposes. As the assessee had itself maintained its books of accounts on the indexing system of accounting, the AO held that it was bound to adopt the same for the purpose of the assessment proceedings also.

12. In appeal, the Commissioner of Income Tax (Appeals) observed that no hypothetical or theoretical income based on mere book entries could be brought to tax. Dealing with the differential income arising out of the finance charges in the present case, the Commissioner opined that the same was neither actually received by the assessee nor did it accrue to it as per the mercantile system of accounting. The finance charges income arrived at in the books of account following the indexing system of accounting was held to be hypothetical income which did not materialize either by accrual or by actual receipt. The Commissioner therefore concluded that the income on account of finance charges should be assessed as returned by the assessee and not as per its books of account.

13. In the second appeal, the Tribunal followed the decision in Deputy Commissioner of Income Tax V/s. Nagarjuna Investment Trust Limited 1998 (62) TTJ (HYD) (SB) 33 = 65 ITD 17 (SB), wherein a Special Bench of the Tribunal at Hyderabad held that finance charges/interest in relation to hire purchase agreements recognized by the assessee on the basis of the method of accounting employed by it and reflected in its books of account has to be considered as the real income which accrued and which was liable for assessment. In consequence, the Tribunal accepted the Revenue's stand in so far as this aspect was concerned.

14. Sri A.V. Krishna Koundinya, learned counsel for the appellant/assessee, would contend that adoption of the mercantile system of accounting for assessment purposes was valid and correct as the same would show the real income that had accrued and arisen on account of finance charges. With regard to the practice of the assessee in resorting to the indexing or SOD system of accounting in its books of account, the learned counsel stated that the same was done so as to lift the financial standard of the assessee in the eyes of the public, though it did not legitimately receive that much interest.

15. Reliance was placed by the learned counsel on United Commercial Bank, Calcutta Vs. Commissioner of Income Tax, West Bengal-III, Calcutta, . Therein, the Supreme Court observed that what is taxable under the Act is the really accrued or arisen income and if on the basis of the method of accountancy regularly employed by the assessee, the real income is pointed out in the IT Return submitted by the assessee, it cannot be ignored by holding that in a balance sheet which is required to be statutorily maintained in a particular form, a different system of accounting is adopted. The Supreme Court held that for the purpose of income tax whichever method is adopted by the assessee, a true picture of the profits and gains, that is to say, the real income is to be disclosed and for determining the real income, the entries in a balance sheet required to be maintained in the statutory form, may not be decisive or conclusive.

16. In such a case, the Supreme Court held that it was open to the income tax Officer as well as the assessee to point out the true and proper income while submitting the return. Pertinent to note, the Supreme Court pointed out that the method of accounting adopted by the tax payer consistently and regularly cannot be discarded by the departmental authorities on the view that the assessee should have adopted a different method of keeping accounts or of valuation. The Court also pointed out that whether the income has really accrued or arisen to the assessee must be judged in the light of the reality of the situation.

17. As pointed out by the Supreme Court in Commissioner of income tax V/s. British Paints India Limited (1991) 188 ITR 44, even if the assessee adopted a regular system of accounting, the Assessing Officer is under a duty u/s 145 of the Act to consider whether the correct profits and gains could be deduced from the accounts so maintained. If not, he is obliged to adopt such method of computation as he deemed appropriate for proper determination of the true income of the assessee.

18. In the present case, as the assessee itself adopted two systems of accounting - one for its books of account and the other for assessment purposes, the AO had to examine as to which of the two systems reflected the real income of the assessee under the head of finance charges. Section 145 of the Act dealing with the method of accounting reads as under:

Section 145. Method of accounting.-(1) 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.

(2) 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.

(3) 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 noticed 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.

19. In *Sanjeev Woolen Mills Vs. Commissioner of Income Tax, Mumbai*, the Supreme Court observed that the choice of method of accounting regularly employed by the assessee lies with the assessee but the assessee would be required to show that he has followed the chosen method regularly. The Department is bound by the assessee's choice of method regularly employed unless by this method the true income or profit of accounts cannot be arrived at. The method of accounting cannot be substituted by the Assessing Officer merely because it is unsatisfactory. What is material for the purpose of Section 145 of the Act is that the method should be such that the real income, profit and gain can be properly deduced therefrom. If the method adopted does not afford a true picture of profits, it would be rejected, but such rejection should be based on cogent evidence and would be done with caution. The power can be exercised by the assessing authority to choose the basis and manner of computation of the income but he must exercise his discretion and judgment judicially and reasonably.

20. Despite this Court granting time, both sides were unable to produce a copy of the hire purchase agreement entered into by the assessee with its customers. As the full particulars are not before this Court, the observations in this regard of the authorities below assume importance.

21. While considering the issue as to what portion of the monthly instalment accrued as interest, the AO did not detail the bifurcation, if any, of the consolidated monthly equated instalment mentioned in Schedule II of the agreement. In appeal, the Commissioner also referred to this aspect but did not elucidate as to whether any apportionment of the instalment amount is detailed

in the said Schedule towards the principal and interest components.

22. However, the AO while dealing with this aspect observed that the most appropriate method of accounting in the case of hire purchase financing, which would give the correct picture of the components of principal and interest in the instalments paid by the hirer would be the index system of accounting. He further observed that this was followed by the assessee and all other hire purchase financiers. The inference that can be logically drawn from this exercise by the AO is that there was no apportionment in the assessee's hire purchase agreements.

23. In appeal, the Commissioner baldly stated that the finance charges computed by adopting the SOD system of accounting would be hypothetical income and such income did not in fact materialize either by accrual or by receipt. There is however no basis for this conclusion of the Commissioner. It was for the assessee to apportion the EMIs towards the principal and interest components and once such apportionment was voluntarily made by the assessee, it would constitute the "real income" of the assessee. There was nothing "hypothetical" about it as the same apportionment was, in fact, shown by the assessee in its books of account.

24. It may be noticed that unlike in *United Commercial Bank, Calcutta Vs. Commissioner of Income Tax, West Bengal-III, Calcutta*, the assessee in the present case was not statutorily compelled to adopt different systems of accounting. As pointed out by the assessee itself, adopting of dual systems was only for the purpose of building up its public image by boosting its financial strengths. As the practice of those involved in hire purchase and leasing transactions was to account for such income on the basis of the Indexing System of accounting and as such system was voluntarily adopted and followed by the assessee itself, there was no valid reason for it to resort to a different system of accounting only for tax assessment.

25. In *Nagarjuna Investment Trust Limited 1998 (62) TTJ (HYD) (SB) 33 = 65 ITD 17 (SB)*, the hire purchase agreement did not give the apportionment or bifurcation of each equated monthly instalment between the principal and interest components. The Special Bench of the Tribunal was of the opinion that where the debtor/hirer paid an instalment without specifying or earmarking any amounts towards the principal or interest, the creditor is entitled to appropriate the amount of instalment first towards the payment of interest and the balance amount towards the principal. The Tribunal found that was what had been precisely done by the hiring company in that case on the basis of SOD method in its books of account.

26. Reliance in this regard was placed on the Judgment of the Supreme Court in *Meghraj and Others Vs. Mst. Bayabai and Others*, wherein it was held that the normal rule in the case of a debt due with interest is that any payment made by the debtor is in the first instant to be applied towards the satisfaction of the

interest and thereafter to the principal. The Tribunal found that the indexing method/SOD method takes into account the reducing principal amount in each EMI and give a realistic, constant and uniform rate of interest which is the real rate of interest implicit in the hire purchase agreement.

27. The Tribunal therefore concluded that the finance charges income/interest income in relation to hire-purchase agreements recognized on the basis of SOD method by the assessee in its books of account represented the real income accrued to the assessee in the relevant previous year and which, having been apportioned from the amount of equated monthly instalment, also represented the income received/receivable in the relevant accounting year as per the terms of the respective hire-purchase agreements.

28. Sri Krishna Kaundinya, learned counsel, sought to draw a distinction between the above decision and the case on hand by placing reliance on Ashok Leyland Finance Limited V/s. Assistant Commissioner of Income Tax (1979) 59 TTJ (Mad) 736. Therein, a Division Bench of the Madras High Court was dealing with a case which was somewhat similar on facts to the present one. The appellant company before the Madras High Court was also engaged in the business of hire-purchase and lease financing. Its annual accounts were maintained in so far as finance charges were concerned on the reducing balance method (indexing method). However, the mercantile system of accounting was employed for the return of income as in the present case.

29. Faced with a situation where two systems were adopted for accounting for the income, the Madras High Court held that the right to receive an amount under a contract accrues or arises depending upon the terms of the particular contract. In other words, income has to be computed even under the accrual system of accounting only on the basis of accrual as provided for in the agreements evidencing the transactions. In short, there can be no accrual of income de hors the terms and conditions of the agreement. Viewed in this light, the Madras High Court held that the technique of accounting followed by the assessee (Reducing balance method or the SOD method) in its books of account for recording the transactions cannot determine the accrual of income.

30. The Court held that accrual would depend on the terms and conditions of the contract between the parties, but not at the whims of either party. Upon perusing sample copies of the agreements, the Madras High Court held that it was not open to the assessee to adopt the SOD method or the reducing balance method when the agreement was to the contrary.

31. Examination of the above judgment reflects that the case before the Madras High Court differed from the present one on crucial factual aspects. The Madras High Court found on facts that the terms of the agreement in that case did not permit adoption of the Indexing System of accounting and therefore, use of the said system in the books of accounts was held to be contrary to the terms of the contract itself.

32. In the present case, however, there is no indication of the assessee's hire purchase agreements reflecting bifurcation of the EMIs into principal and interest components. In the absence thereof, the common and accepted usage of the Indexing system of accounting in the hire purchase trade must be held to be valid as otherwise the rate of interest under the mercantile system in so far as the later EMIs are concerned would be far higher and contrary to the rate prescribed in the assessee's agreements. Further, as the assessee had itself employed this system of accounting in its books of account, applying the law laid down in *Sanjeev Woolen Mills Vs. Commissioner of Income Tax, Mumbai*, the Department was bound to accept the same for the assessment proceedings.

33. Viewed thus, we are of the opinion that the law laid down by the Special Bench of the Income Tax Appellate Tribunal at Hyderabad in *Nagarjuna Investment Trust Limited 1998 (62) TTJ (HYD) (SB) 33 = 65 ITD 17 (SB)* was correct. In the event the hire purchase or leasing agreement did not give the apportionment or bifurcation of the EMIs between the principal and interest components, the interest income in relation to such agreements, recognized on the basis of SOD system of accounting by the assessee in its books of account, represents the "real income" accrued to the assessee. Reliance placed by the Tribunal on this judgment while allowing the Revenue's appeal in the present case was therefore justified. The substantial question of law is accordingly answered upholding the Revenue's computation of the assessee's income from finance charges and in favour of the Revenue and against the assessee. In consequence, the ITTA is dismissed, but in the circumstances, without any order as to costs.