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IN THE HIGH COURT OF KARNATAKA, BENGALURU

DATED THIS THE 25TH DAY OF JUNE 2018

PRESENT

THE HON'BLE DR.JUSTICE VINEET KOTHARI

AND

THE HON'BLE MRS.JUSTICE S.SUJATHA

I.T.A. No.431/2017

BETWEEN :

1. THE PR. COMMISSIONER OF
INCOME-TAX CIT (A)
5TH FLOOR, BMTC BUILDING
80 FEET ROAD, KORAMANGALA
BENGALURU - 560095
2. THE DEPUTY COMMISSIONER OF
INCOME TAX, CIRCLE 1(1) (1),
2ND FLOOR, BMTC BUILDING,
80 FEET ROAD, KORAMANGALA
BENGALURU - 560095

...APPELLANTS

(BY SRI K.V.ARAVIND, ADV.)

AND :

M/s ACER INDIA PVT. LTD.,
EMBASSY HEIGHT'S, 6TH FLOOR,
No.13, MAGRATH ROAD
BENGALURU - 560025

...RESPONDENT

(BY SRI ANKUR PAI, ADV.)

THIS INCOME TAX APPEAL IS FILED UNDER SECTION 260-A OF INCOME TAX ACT 1961, ARISING OUT OF ORDER DATED 29.11.2016 PASSED IN IT(TP)A NO.1561/BANG/2014, FOR THE ASSESSMENT YEAR 2009-2010, PRAYING TO: I. FORMULATE THE SUBSTANTIAL QUESTIONS OF LAW STATED ABOVE. II. ALLOW THE APPEAL AND SET ASIDE THE ORDERS PASSED BY THE INCOME-TAX APPELLATE TRIBUNAL, BENGALURU IN IT(TP)A NO.1561/BANG/2014 DATED 29.11.2016 CONFIRMING THE ORDER OF THE APPELLATE COMMISSIONER AND CONFIRM THE ORDER PASSED BY THE DEPUTY COMMISSIONER OF INCOME TAX, CIRCLE-1(1)(1), BENGALURU.

THIS APPEAL COMING ON FOR ADMISSION, THIS DAY, **Dr. VINEET KOTHARI, J.**, DELIVERED THE FOLLOWING:

J U D G M E N T

Mr. K.V.Aravind, Adv. for Appellants – Revenue.
Mr. Ankur Pai, Adv. for Respondent – Assessee.

The Revenue has filed this appeal u/s 260-A of the Income Tax Act, 1961 ['Act' for short] raising purported substantial questions of law arising from the order of the Income Tax Appellate Tribunal ['Tribunal' for short] dated **29.11.2016** in **IT [TP] A.No. 1561/Bang/2014** for A.Y. 2009-10 in **Dy.Commissioner of Income Tax, Circle 1(1)(1), Bangalore –v- M/s Acer India Pvt. Ltd., Bangalore.**

2. Learned Tribunal following its own order for the preceding assessment year in the case of Respondent-Assessee itself, allowed the **provision of warranty** made by the Assessee for meeting the probable costs of repairs and maintenance of computers and other hardware supplied by the Respondent-Company to its customers. The Learned Tribunal also referred to and relied upon the decision of the Hon'ble Supreme Court in the case of **Rotork Controls India (P) Ltd., -v- Commissioner of Income-tax, Chennai (2009) 180 Taxman 422(SC)**. The relevant portion of the order of the Tribunal is quoted below for ready reference:

"4. We have heard the learned Departmental Representative as well as learned Authorised Representative and considered the relevant material on record. At the outset we note that this is a recurring issue for last several assessment years and has been decided in favour of the assessee by this Tribunal. This Tribunal in assessee's own case for A.Ys 2007-

08 & 2008-09 vide order dated 04.11.2015 in ITA Nos.1179 & 1180/Bang/2012 has held in paras 9 to 12 as under:

“9. We have also heard the learned Departmental Representative and considered the facts and materials on record including the decisions cited before us.

9.1 While dealing with the issue in the order dated 30.01.2009 in ITA No.774/Bang/2010 it has been observed as under:

“5. We have heard the rival contentions and perused the material available on record. We are of the considered view that the assessee’s case clearly falls in line with the legal ratio set out by the various appellate decisions cited at Bar in so far as the provision for warranty stood crystallized as soon as the sale was made which a customer would like to be fulfilled within the warranty period and is at the cost of an assessee’s goodwill. Therefore, the residual amount purported to have been held by the Assessing Officer as an excess provision

cannot be considered as a contingent provision and not an ascertained liability. The warranty period continues beyond an year which fact was rightly considered by the learned CIT(A) confining to the various decisions such as IBM India Ltd., [supra] reported in 290 ITR (AT) 183. Similar view has been taken by other co-ordinate Benches of the Tribunal therefore requires no further deliberation. In the light of the above, we hold the view that the decision of the learned CIT(A) requires no further interference on the issue. The revenue's appeal stands dismissed."

10. Again in the order dated 25.02.2011 in ITA No.784/Bang/2010, it has been observed as under:

"11.2 The assessee creates provision for warranty based on the estimation of expenditure likely to be incurred on the past sales made on yearly basis at then prevailing market prices for spares and labour. For the relevant previous year, the assessee estimated the warranty liability at Rs.12,76,77,530/- and created a

provision only for Rs.12,16,75,204/- in the books of account by charging a provision of Rs.8,24,29,136/- to the debit in the P&L account and claimed it as ITA 22(Bang)/2011 Page 5 of 7 deduction. The assessee company had created the provision based on the estimation of warranty liability, which is based on failure rates of the past year data/experience and industry trends and not on adhoc basis. The assessee has not changed the method of computing the warranty provision and it has been followed consistently.

11.3 The decision of the Hon'ble Supreme Court in the case of Rotork Controls India Pvt. Ltd., 314 ITR 62 would be squarely applicable to the facts of the case. The Hon'ble Supreme Court has held that provision made on past experience is a scientific method and is the most appropriate method. The relevant extract of the decision is provided below:

'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 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).....**

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 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”.....

If warranty provisions are based on experience and historical trends(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’.

11. In the assessee’s own case in identical facts for the immediately preceding year, the Tribunal in ITA No.22/Bang/2011 assessment year 2006-07 vide order dated 16.03.2012 has decided the issue in favour of the assessee, following the orders of the Tribunal for earlier years namely, 2004-05 and 2005-06.

12. Following the above decisions for earlier years passed by the Co-ordinate Bench of Bangalore, we hold that the CIT(A) is not justified in upholding the disallowance of provision for warranty and accordingly dismiss the ground of appeal of the revenue on this issue.”

Following the earlier orders of this Tribunal in assessee’s own case, we do not find any error or illegality in the impugned order of CIT (Appeals) qua this issue.”

3. The Assessing Authority in the present case disallowed the entire amount of such provision of warranty of **Rs.20,00,38,020/-** [Rupees Twenty Crores Thirty Eight Thousand and Twenty only] by holding in para 5.4 of the impugned Assessment Order, Annexure-A **dated 16.03.2013** that the system of making of the provision for warranty by the Assessee-Company was not scientific and the reversal of the provision at the year end in view of the actual claims made by the customers was huge, varying from 23% to 100% and therefore, since the Assessee has not followed the scientific system of making a provision in this regard, the entire amount of provision deserves to be disallowed and the same was added back to the declared income of the Assessee. The relevant extract of the assessment order is also quoted below for ready reference:

“5.4. It is seen that year-after-year the assessee is making warranty reversals of

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significant amounts. As held by the order [supra] if the warranty estimates are done in a robust way there will not be any huge reversals of the provisions. **Even basing solely on this fact, one can conclude that the provisions are not being created in a technical or scientific manner.** However, the other aspects were also analyzed. It is observed that the ratio of actual claims to that of the provision created also widely varied between the years. **In fact the variation is about five times, the ratio ranging from about 23% to close to 100%.** The assessee is also not in a position to lay on record any specific method used to arrive at the estimate of defective pieces. In fact, in the first place there should have been a meticulous and sound method to arrive at the rate of defects. Only after that stage is crossed one can create the required provisions. As per the order [supra] that exercise does not get over there. Over the years the figures have to be relooked and changed to suit the changing rate of defects. Even this has not been done. In short it can be concluded that the provisions for warranty are

not created on a scientific basis. Therefore such provision should not be allowed.

5.5 After analyzing the facts as per the order of the Supreme Court i.e., - whether the working has been robust based on historical data, whether there is minimal reversals, whether the estimates are reduced as one approaches the end of the warranty period and whether any detail assessment of the warranty provisions had been done? It is seen that the predominant answer to all these questions in this case is "No".

5.6 To highlight again, from the details furnished by the assessee it is also seen that the provisions created as a percentage to the actual claims, over the years, has widely varied. For the AY 2006-07 the percentage was only about 23%, within the next year i.e., for the AY 2007-08 the figure has steeply gone up to 59% which subsequently went down to 49%. For the year under scrutiny i.e., AY 2009-10 the figure has almost touched 100%. It can be easily seen that there is huge fluctuation of figures.

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Given this fact, the assessee cannot claim that the estimates were made on a scientific basic. If that were actually the case, then such excessive variations between the years would not have been there.

5.7 Going by all the above I conclude that the method being followed by the assessee to create the provision is not scientific. As per the decision in the case of **Rotork Controls India [P] Ltd** such a claim should not be allowed. In other words, the provision of warranty amounting to Rs.200,038,020/- should be disallowed. **Accordingly, an amount of Rs.200,038,020/- towards provision for warranty is disallowed and brought to tax."**

4. The First Appellate Authority – CIT [Appeals], however, granted the desired relief to the Respondent-Assessee in view of the decision of the Hon'ble Supreme Court in **Rotork Controls India (P) Ltd.**, with the following observations:

“3.8 Respectfully following the decisions of the Hon'ble ITAT referred to above, since the appellant has been consistent in following the method for creating provision for warranty even for the assessment year 2009-10, I hold that the AO was not justified in disallowing the appellant's claim for deduction of Rs.20,00,38,020/- and delete the disallowance accordingly.”

5. The Second appeal filed by the Revenue before the Tribunal also failed. Hence, the present appeal before us by the Revenue.

6. The Learned Counsel for the Revenue **Mr.K.V.Aravind** submitted that the Assessing Authority had followed the decision of the Hon'ble Supreme Court and finding that the Respondent-Assessee company had not adopted the scientific basis for creating provision for warranty and therefore, the provision in this regard was rightly disallowed by the Assessing Authority.

7. On the other hand, the Learned Counsel for the Respondent-Assessee **Mr. Ankur Pai**, brought to our notice that the initial provision created after

ascertaining the actual amount spent out of such provision, taking into account the actual complaints received and repairs and maintenance undertaken by the Respondent-Assessee for customers, consistently a reasonable amount of provision was made by the Assessee by reversing the excess provision made in each year and the very trend of reducing percentage of provision for warrantees over sales going down from 3.36% in the A.Y.2004-05 to 1.87% in the current A.Y.2009-10, would show that no excess provision was created by the Assessee-Company to claim unnecessary deduction from the taxable profits of the Respondent-Company and since a consistent scientific method has been adopted by the Respondent-Assessee, the learned Assessing Authority could not have arrived at any such findings for alleged unscientific method adopted by the Assessee and therefore, disallowance of the entire claim of provision in this regard of **Rs. 20,00,38,020/-** [Rupees Twenty Crores Thirty Eight Thousand and

Twenty only] by the Assessing Authority is wholly unjustified. He even submitted before the Court that the Assessee-Company moved for rectification of the said order claiming the alternative relief of allowing the actual expenses incurred during the year, which were in excess of the provision to the extent of **Rs. 20,00,38,020/-** [Rupees Twenty Crores Thirty Eight Thousand and Twenty only] but even that was not allowed to the Assessee -Company by the Assessing Authority and thus the assessee was put to a disadvantage in both ways, which was quite illegal.

3. Having heard the learned Counsels for the parties, we are of the clear opinion that no substantial question of law arises in the present appeal filed by the Revenue. We are satisfied that the Respondent-Assessee company has consistently followed the similar practice with regard to making provision of warranty given to the customers for providing them free repairs and

maintenance for the computers and hardware supplied to them, which in their ordinary course of business, the Respondent-Company gave such warrantees. The excess provision created by the Company itself has been reversed by the respondent-Company and only the provision to the extent of making an adequate provision for meeting such possible expenses for repairs and maintenance has been debited by the Assessee-Company in its books of accounts over the period of six years, the details of which are given by the Assessing Authority itself in the assessment order.

9. We are absolutely at a loss to understand how the Assessing Authority has found the said consistent practice of the Assessee-Company to be unscientific and untenable and then proceeded to disallow the entire claim of provision made by the Assessee-Company in this regard. Neither allowing the provision made for warrantees nor the actual expenses

incurred by the company to be deducted from the profits of the company during the year is absolutely arbitrary and unscientific on the part of Assessing Authority, to say the least. There was absolutely no basis for the Assessing Authority to make both the disallowances of provision for warranty as well as actual expenses at the same time in the hands of the Respondent-Assessee. In view of the comparison of actual expenses and provisions made for warranty, the details of which are given in the Assessment Order itself, we do not find any abnormal fluctuation or excess provision made by the Assessee-Company on this account.

10. We express our concern and dissatisfaction at the manner in which the Assessing Authority in the present case has very casually disallowed the said claim in the hands of the Respondent-Assessee. Moreover, when the Higher Appellate Authorities have corrected

the said approach of the Assessing Authority by the First Appellate Authority allowing the appeal of the Assessee and the Tribunal dismissing the appeal of the Revenue, we are all the more pained to see that the Revenue still felt dissatisfied and has brought up the matter before this Court under Section 260-A of the Act without actually any substantial question of law arising in the matter. This reflects the irresponsible manner in which the Revenue Department becomes a frivolous litigant in constitutional courts, by dragging such case, wasting public time and money.

11. As is well settled, the appeal under Section 260-A of the Act lies before this Court only on substantial questions of law. The final fact findings of the Tribunal under the Act are binding on this Court and cannot be disturbed unless they are found to be perverse on the basis of established material on record.

We do not find any such case of Revenue in the present appeal.

12. Moreover, we are satisfied that the practice of making a provision for warranty in the present case has been found to be consistent, scientific and regular by the two Appellate Authorities below in consonance with the judgment of the Hon'ble Supreme Court in the case of **Rotork Controls India (P) Ltd.** (supra). The Hon'ble Supreme Court in the aforesaid case, discussed in detail how the accounting entries for product warranty are to be made by the Assessee. We quote below the relevant portion of the judgment for ready reference:

*“10. What is a provision? 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.

11. 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, 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 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, 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 under Section 37 of the 1961 Act. Therefore, all the three conditions for recognizing 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 to have interfered with the decision of the Tribunal in this case.”

13. We are, therefore, satisfied that both the Appellate Authorities below were justified in returning the proper findings of facts on the relevant material

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before them and have rightly found that the provisions of warranty made by the Respondent-Assessee Company was on the basis of the scientific and consistent method and therefore, the present appeal of the Revenue does not give rise to any substantial question of law and the same deserves to be dismissed and is accordingly dismissed. No costs.

**Sd/-
JUDGE**

**Sd/-
JUDGE**

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