REPORTABLE

IN THE SUPREME COURT OF INDIA

CIVIL APPELLATE JURISDICTION

CIVIL APPEAL NOS. 3506-3510 OF 2009
(Arising out of S.L.P.(C) Nos.14178-14182 of 2007)

M/s. Rotork Controls India (P) Ltd. … **Appellant (s)**

Versus

Commissioner of Income Tax, Chennai … **Respondent(s)**

WITH

Civil Appeal No. 3511 of 2009 – Arising out of S.L.P. (C) No.7490 of 2009
Civil Appeal No. 3512 of 2009 – Arising out of S.L.P. (C) No.5616 of 2009
Civil Appeal No. 3513 of 2009 – Arising out of S.L.P. (C) No. 12063 of 2009
(SLP(C) ………CC No.4633 of 2009)
Civil Appeal No. 3514 of 2009 – Arising out of S.L.P. (C) No.722 of 2009
Civil Appeal No. 3515 of 2009 – Arising out of S.L.P. (C) No.723 of 2009
Civil Appeal No. 3516 of 2009 – Arising out of S.L.P. (C) No.4776 of 2009
Civil Appeal No. 3517 of 2009 – Arising out of S.L.P. (C) No.3440 of 2009
Civil Appeal No. 3518 of 2009 – Arising out of S.L.P. (C) No.4182 of 2009
Civil Appeal No. 3519 of 2009 – Arising out of S.L.P. (C) No.4183 of 2009
Civil Appeal No. 3520 of 2009 – Arising out of S.L.P. (C) No.4184 of 2009
Civil Appeal No. 3521 of 2009 – Arising out of S.L.P. (C) No.8983 of 2009
Civil Appeal No. 3522 of 2009 – Arising out of S.L.P. (C) No.8982 of 2009
Civil Appeal No. 3523 of 2009 – Arising out of S.L.P. (C) No.8311 of 2009
Civil Appeal No. 3524 of 2009 – Arising out of S.L.P. (C) No. 12064 of 2009
(SLP(C) ………CC No.5279 of 2009)

J U D G M E N T

S. H. KAPADIA, J.

1. Delay condoned.

2. Leave granted.

FACTS IN THE LEAD MATTER

Civil Appeal Nos. of 2009 – Arising out of S.L.P.(C) Nos.14178-14182 of 2007 – M/s. Rotork Controls India (P) Ltd. v. Commissioner of Income Tax, Chennai.

3. In these civil appeals filed by the assessee we are concerned with the assessment years 1991-92, 1992-93, 1993-94 and 1994-95. For the sake of convenience we hereby refer to the facts concerning assessment year 1991-92.

4. Appellant-company sells Valve Actuators. Bulk of the sales is to BHEL. At the time of sale appellant (assessee) provides a Standard Warranty whereby in the event of any Beacon Rotork Actuator or part thereof becoming defective within 12 months from the date of commissioning or 18 months from the date of despatch whichever is earlier, the company undertakes to rectify or replace the defective part free of charge. This warranty is given under certain conditions stipulated in the warranty clause. For the assessment year 1991-92, the assessee made a provision for warranty at Rs.10,18,800/- at the rate of 1.5% of the turnover.

This provision was made by the assessee on account of warranty claims likely to arise on the sales effected by the appellant and to cover up that expenditure. It may be noted that since the provision made was for Rs.10,18,800/- which exceeded the actual expenditure, the appellant reversed Rs.5,00,246 as Reversal of Excess Provision. Consequently, the assessee claimed deduction in respect of the net provision of Rs.5,18,554/- which was disallowed by the A.O. on the ground that the liability was merely a contingent liability not allowable as a deduction under Section 37 of the Income-tax Act, 1961 ("the 1961 Act", for short). This decision was upheld by CIT (A). The matter was carried in appeal to the Tribunal by the appellant. It was held by the Tribunal that right from the assessment year 1983-84 the CIT (A) as well as the Tribunal had allowed the warranty claim(s) on the ground that Valve Actuators are sophisticated equipments; that in the course of manufacture and sale of Valve Actuators a reasonable warranty was given to the purchasers; that every item of sale was covered by the warranty scheme; that no purchaser was ready and willing to buy Valve Actuators without warranty and consequently every item sold had a corresponding obligation under the warranty clause(s) attached to such sales. This has been the view of the Department and the Tribunal right from assessment year 1983-84. In fact the Department allowed deduction on the above facts constituting normal trading practice. For example, during the assessment year 1983-84 the total sales during the year was Rs.1,45,36,599/- and in that year the appellant had earmarked 1% of the total sales towards the warranty claims which it would have to meet. This amount provided for was held to be reasonable having regard to the anticipated liability which was discharged in the subsequent year. From that year onwards it has been consistently held that looking to the nature of the business and the nature of the product manufactured and sold it was necessary for warranty clause to be attached to the sales effected by the appellant and that the warranty obligations constituted an integral part of the sales effected during the year. All throughout this period between assessment year 1983-84 and assessment year 1991-92, the Tribunal took the view that the provision made by the appellant was realistic. Applying the Rule of Consistency, the Tribunal held that the assessee on the facts and circumstances of the case was entitled to deduction under Section 37 of the 1961 Act in respect of provision for warranty amounting to Rs.5,18,554. At this stage one point needs to be emphasized. During the assessment year 1983-

84 to assessment year 1991-92 there was one instance when the Tribunal disallowed the warranty claim that was in the assessment year 1985-86. The reason was in that year the assessee had not adjusted the excess out of the provision to the expense of the immediate following year and as a result the Closing Balance of the Provision Account was found to be swelling up from year to year. In other words, during that year reversal was not effected. That is not the position during the assessment years 1991-92, 1992-93, 1993-94 and 1994-95. Accordingly, for the assessment year 1991-92, the appellant herein succeeded before the Tribunal. Aggrieved by the decision of the Tribunal, the Department carried the matter in appeal to the Madras High Court vide Tax Case Appeal No.163 of 2003 etc. Those appeals were for all the assessment years 1991-92, 1992-93, 1993-94 and 1994-95. By common judgment dated 5.2.07, the High Court held that the assessee was not entitled to deduction in respect of the provision made for warranty claims. It was held that no obligation was ever cast on the date of the sale and consequently there was no accrued liability. According to the impugned judgment, the liability had not crystalised on the date of the sale and, therefore, appellant was not entitled to deduction in respect of the provision made for warranty charges payable under

the terms of sale. According to the impugned judgment, warranty provision was made against the liability which had not crystalised against the appellant and consequently it was a provision made for an unascertained liability and, therefore, the appellant was not entitled to claim deduction under Section 37 of the 1961 Act. The case of the Department was accepted by the High Court, hence these civil appeals are filed by the assessee.

CONTENTIONS

5. On behalf of the Department Mr. V. Shekhar, learned senior counsel, submitted that provision for warranty is towards unforeseen liability, which is not certain nor it could be foreseen with precision in the relevant year, hence, claim of warranty as well as liability in respect thereof was contingent. Being contingent, deduction as expense(s) was not available. According to learned counsel, Section 37 of the 1961 Act does not refer to "making of provision" it only refers to "deduction permissible on account of actual expenditure incurred". In other words, according to learned counsel, Section 37 does not refer to anticipated claims. According to learned counsel, in this case the liability is contingent. The goods sold may be defective or they may not be defective and,

therefore, warranty provision was made only to earn goodwill and stay in business. According to learned counsel, warranty is only an assurance about the quality of the product sold. The obligation to satisfy the claim in the warranty clause would depend upon factors, namely, whether the product was used in the manner required or whether the buyer was responsible for causing defect. In the alternative, learned counsel submitted that whether the liability for which provision is made was based on any scientific study is required to be examined before allowing deduction under Section 37 of the 1961 Act. Lastly, learned counsel urged that the amount which is provided for or kept apart cannot be held to be expenditure, actually incurred and consequently deduction is not admissible. Learned counsel submitted that in each case one has to find out whether there is an element of certainty that the liability would occur. In each case one has to ascertain whether there is any scientific data or material produced by the assessee about the liability incurred in the past and in the absence of such a data assessee was not entitled to deduction for warranty provision in its books of accounts. According to learned counsel, merely because the assessee is maintaining its account on mercantile basis, it cannot claim that the provision made towards warranty is an accrued liability. According to learned counsel, accounting treatment will not decide whether the warranty claim is actual liability, accrued liability or contingent liability. Since in the relevant year there was no claim for replacement of the defective pieces, the assessee could not have claimed deduction by merely making an entry in its books of accounts or by making a mere provision in its books of accounts. In this connection, learned counsel placed reliance on the judgment of the Madras High Court in the case of **Commissioner of Income-tax, Madras v. Indian Metal and Metallurgical Corporation –** (1964) 51 ITR 240. Learned counsel also placed reliance on the judgments of the Supreme Court in the case of **Indian Molasses Co. (Private) Ltd. v. Commissioner of Income-tax , West Bengal –** (1959) 37 ITR 66 (SC) and **Shree Sajjan Mills Ltd. v. Commissioner of Income-tax, M.P., and Anr. –** (1985) 156 ITR 585 (SC).

6. Mr. S. Ganesh, learned senior counsel, appearing on behalf of the assessee, submitted that in this case the High Court had erred in not following the Rule of Consistency. In this connection, it was urged that right from assessment year 1983-84 upto assessment year 1991-92, the Tribunal had come to the conclusion that Valve

Actuators were sophisticated items; that, the appellant has been following scientific method of accounting which included the concept of "reversal"; that looking to the nature of business and the nature of the product the appellant was entitled under the Commercial Accounting Principles to create provisions for warranty and accordingly the appellant was entitled to deduction under Section 37 of the 1961 Act. According to learned counsel, for the assessment years in question, the Tribunal has accordingly followed its earlier view which has prevailed right from assessment year 1983-84 and it has, therefore, directed deletion of the disallowance of Rs.5,18,554/- for the assessment year 1991-92. While explaining the concept of "reversal", learned counsel pointed out that 1.5% of total sales of Rs.1 crore (amounting to Rs.1.50 lakhs) was taken by the appellant as a provision for warranty claims in its balance-sheet by debiting its profit and loss account and by crediting the provision for warranty claims in the balance-sheet. This is in the first year. In the second year Rs.1.50 lakhs which was the provision for first year was brought forward by way of Opening Balance of the Provision Account in the Ledger Account. If expenditure incurred in the second year was not Rs.1.50 lakhs but only Rs.1 lakh then such actual expenditure of Rs.1 lakh alone was debited to the Provision Account which, as stated above, had the Opening Balance of Rs.1.5 lakhs and accordingly in the second year Rs.50,000/- was taken to the credit of profit and loss account and offered for tax. In other words, in the year in which the provision made by the appellant exceeded actual expenditure by Rs.50,000/- the same was offered for tax as income. In other words, there was reversal to the extent of Rs.50,000/- in the second year. This is the example of reversal. According to learned counsel, the concept of "reversal" forms part of scientific method of accounting which is being followed by the assessee from the assessment year 1983-84 onwards right upto assessment year 1991-92, 1992-93, 1993-94 and 1994-95. While overruling the judgment of the Tribunal, the High Court has failed to notice this important aspect of reversal. According to learned counsel, if one applies the concept of "reversal" which has been applied in the present case, there is no escapement of income from assessment and the entire exercise would be revenue neutral. Learned counsel placed reliance on the judgment of the Privy Council in the case of **Commissioner of Inland Revenue v. Mitsubishi Motors New Zealand Ltd. -** (1996) 222 ITR 697 (PC). Learned counsel also placed reliance on the judgments of the Supreme Court in the case of **Bharat Earth Movers** **v.** **Commissioner of Income-tax –** (2000) 245 ITR 428 (SC) and **Metal Box Company of India Ltd.** **v.** **Their Workmen –** (1969) 73 ITR 53 (SC).

7. Learned counsel next submitted that assuming for the sake of argument that the liability for warranty claim is a contingent liability, the amount claimed by the appellant as deduction was still allowable if deduction claimed is equal to the warranty expenses actually incurred and the deductibility of such expenses viewed over a number of years is beyond doubt. In this connection, learned counsel urged that if having regard to surrounding circumstances of the appellant's business as a whole, a certain item of expenditure is bound to incur year after year in different degrees then the business liability has definitely arisen and such liability cannot be considered as contingent liability.

8. It was next urged that under Section 145 of the 1961 Act, as it stood prior to 1997, the income of the appellant had to be determined on the basis of method of accounting followed by the appellant year to year and that method could be departed from by the A.O. only if it was in a position to give a finding that the correct income was incapable of being determined on the basis of the

assessee's impugned method of accounting. As stated above, from assessment year 1983-84 the appellant, according to learned counsel, has been making provision for warranty claims consistently at the rate of 1.5% of its total sales turnover and from 1987 appellant has introduced in its accounts the concept of "reversal" of excess provision which has been accepted by the Department right upto assessment years in question. According to learned counsel, there is no finding in the order of the A.O. for the assessment years in question saying that the method of accounting of the appellant was incapable of income determination. In the circumstances, learned counsel submitted that the High Court had erred in reversing the decision of the Tribunal.

<u>Relevant Provisions of Law:</u>

9. We quote herinbelow relevant provisions of the Income-tax Act, 1961 as it stood at the material time:

> "**General**
>
> **37. (1)** Any expenditure (not being expenditure of the nature described in Section 30 to 36 [***] and not being in the nature of capital expenditure or personal expenses of the assessee), laid out or expended wholly and exclusively for the purposes of the business or profession shall be allowed in computing the income chargeable under the head "Profits and gains of business or profession".

Expenses or payments not deductible in certain circumstances

40A.(7)(a) Subject to the provisions of Clause (b), no deduction shall be allowed in respect of any provision (whether called as such or by any other name) made by the assessee for the payment of gratuity to his employees on their retirement or on termination of their employment for any reason

(b) Nothing in Clause (a) shall apply in relation to:

(i) any provision made by the assessee for the purpose of payment of a sum by way of any contribution towards an approved gratuity fund, or for the purpose of payment of any gratuity, that has become payable during the previous year;

(ii) any provision made by the assessee for the previous year relevant to any assessment year commencing on or after the 1st day of April, 1973, but before the 1st day of April, 1976, to the extent the amount of such provision does not exceed the admissible amount, if the following conditions are fulfilled, namely:

> (1) the provision is made in accordance with an actuarial valuation of the ascertainable liability of the assessee for payment of gratuity to his employees on their retirement or on termination of their employment for any reason;
>
> (2) the assessee creates an approved gratuity fund for the exclusive benefit of his employees under an irrevocable trust, the application for the approval of the fund having been made before the 1st day of January, 1976; and
>
> (3) a sum equal to at least fifty per cent of the admissible amount, or where any amount has been utilised out of such provision for the purpose of payment of any gratuity before the creation of the approved gratuity fund, a sum equal to at least fifty per cent of the admissible amount as reduced by the amount so utilised, is paid by the assessee by way of contribution to the approved gratuity fund before the 1st day of April, 1976, and the balance of the admissible amount or, as the case may be, the balance

of the admissible amount as reduced by the amount so utilised, is paid by the assessee by way of such contribution before the 1st day of April, 1977.

Explanation 1.-For the purposes of sub-clause (ii) of clause (b) of this sub-section, "admissible amount" means the amount of the provision made by the assessee for the payment of gratuity to his employees on their retirement or on termination of their employment for any reason, to the extent such amount does not exceed an amount calculated at the rate of eight and one-third per cent of the salary [as defined in clause (h) of rule 2 of Part A of the Fourth Schedule] of each employee entitled to the payment of such gratuity for each year of his service in respect of which such provision is made.

Explanation 2.-For the removal of doubts, it is hereby declared that where any provision made by the assessee for the payment of gratuity to his employees on their retirement or on termination of their employment for any reason has been allowed as a deduction in computing the income of the assessee for any assessment year, any sum paid out of such provision by way of contribution towards an approved gratuity fund or by way of gratuity to any employee shall not be allowed as a deduction in computing the income of the assessee of the previous year in which the sum is so paid.”

FINDINGS:

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.

14. In this case the High Court has principally gone by the judgment of the Supreme Court in the case of **Shree Sajjan Mills (supra)**. That was the case of gratuity. For the assessment year 1974-75 the assessee-company sought to deduct a sum of Rs.18,37,727/- towards the amount of gratuity payable to its employees and worked out actuarially. No provision was made for Rs.18,37,727/-. The claim for deduction was made on the ground that the liability stood ascertained by actuarial valuation and, therefore, was deductible under Section 37 of the 1961 Act. The ITO allowed the deduction only in respect of the amounts actually paid by the assessee and the rest was disallowed on the ground of non-compliance with the provisions of Section 40A(7) of the 1961 Act. This view of the ITO was affirmed by CIT(A). The Tribunal held that for the earlier assessment year relating to 1973-74, actuarially ascertained liability for gratuity arising under Payment of Gratuity Act, 1972 was an allowable deduction. However, for the

assessment year in question, the Tribunal held that the increased liability claimed by the assessee for deduction was allowable on general principles of accounting. This view was taken by the Tribunal on the basis that the actuarially determined liability was not provided for in the assessee's books of account. In appeal by the Department, the High Court held that the assessee was not entitled to deduction without complying with the provisions of Section 40A(7) of the 1961 Act. This view of the High Court was affirmed by this Court. It was held that Section 40A(7) which stood inserted by Finance Act, 1975 w.e.f. 1.4.73 has been given an overriding effect over Section 28 as well as Section 37 of the 1961 Act. Consequently, the deduction allowable on general principles was ruled out as Section 40A(1) made it clear that Section 40A had effect notwithstanding anything contained in Sections 30 to 39 of the 1961 Act. In other words, as regards deduction in respect of gratuity, the assessee was required to comply with the provisions of Section 40A(7) after Finance Act, 1975. It is interesting to note that prior to 1.4.73 actual payment or provision for payment was eligible for deduction either under Section 28 or under Section 37 of the 1961 Act. This has been reiterated in **Shree Sajjan Mills (supra)**. The position got altered only after 1.4.73. Before that date, provision made in the P & L Account for the estimated present value of the contingent liability properly ascertained and discounted on an accrued basis could be deducted either under Section 28 or Section 37 of the 1961 Act. This has been explained in **Shree Sajjan Mills** **(supra)** at page 599. Section 40A(7) deals only with the case of gratuity. Even in the case of gratuity but for insertion of Section 40A(7), provision made in the P & L Account on the basis of present value of the contingent liability properly ascertained and discounted on an accrued basis was entitled to deduction either under Section 28 or under Section 37 of the said Act. This aspect, therefore, indicates that the present value of the contingent liability like the warranty expense, if properly ascertained and discounted on accrued basis, could be an item of deduction under Section 37 of the said Act. This aspect is not noticed in the impugned judgment. We may add a caveat. As stated above, the principle of estimation of the contingent liability is not the normal rule. As stated above, it would depend on the nature of business, the nature of sales, the nature of the product manufactured and sold and the scientific method of accounting being adopted by the assessee. It will also depend upon the historical trend. It would also depend upon the number of articles produced. As stated above, if it is a case of single item being produced then the principle of estimation of contingent liability on *pro rata* basis may not apply. However, in the present case, it is not so. In the present case, we have the situation of large number of items being produced. They are sophisticated goods. They are supported by the historical trend, namely, defects being detected in some of the items. The data also indicates that the warranty cost(s) is embedded in the sale price. The data also indicates that the warranty is attached to the sale price. In the circumstances, we hold that the principle laid down by this Court in the case of **Metal Box Company of India** **(supra)** will apply. In that case this Court held that contingent liabilities discounted and valued as out-of-necessity could be taken into account as trading expenses if these were capable of being valued. It was further held that an estimated liability even under a gratuity scheme even if it was a contingent liability if properly ascertainable and if its present value stood fairly discounted, was deductible from the gross profits while preparing the P & L Account. In view of this decision it became permissible for an assessee to provide, in his P & L Account, for the estimated liability under a gratuity scheme by ascertaining its present value on accrued basis and claiming it as an ascertained liability to be deducted in the computation of profit and gains of the previous year either under Section 28 or under Section 37 of the 1961 Act. However, the above principle would not apply after insertion of Section 40A(7) w.e.f. 1.4.73. It may be stated that the principles of commercial accounting, mentioned above, formed the basis of the judgment of this Court in the case of **Metal Box Company of India (supra)** and those principles are affirmed by the judgment of the Supreme Court in **Shree Sajjan Mills (supra)** upto 1.4.73. In this case we are concerned with warranty claims. In respect of warranty claims during the relevant assessment years in question there is no provision similar to Section 40A(7) of the 1961 Act. We may add that the above principle of commercial accounting in **Metal Box Company of India (supra)** also find place in the judgment of this Court in the case of **Madras Industrial Investment Corporation Ltd. v. Commissioner of Income-tax –** (1997) 225 ITR 802 (SC), in which the Court has explained the meaning of the word "expenditure" in Section 37 of the 1961 Act. In other words, the principle enunciated in **Metal Box Company of India (supra)** which has been reiterated in **Shree Sajjan Mills (supra)** (upto 1.4.73) which deals with making of provision on the basis of estimated present value of contingent liability holds good during the assessment years in question qua warranty claims.

15. Before concluding, we may refer to the judgment of this Court in the case of **<u>Indian Molasses Co.</u> (supra)**. In that case the facts were as follows:

> "One John Bruce Richard Harvey was the managing director of the assessee company in 1948. He had by then served the company for 13 years, and was due to retire at the age of 55 years on September 20, 1955. There was, it appears, an agreement by which the company was under an obligation to provide a pension to Harvey after his retirement. On September 16, 1948, the company executed a trust deed in favour of three trustees to whom the company paid a sum of Pound 8,208-19-0 (Rs. 1,09,643) and further undertook to pay annually Rs. 4,364 (Pound 326.14 sh.) for six consecutive years, and the trustees agreed to execute a declaration of trust. The trustees undertook to hold the said sums upon trust to spend the same in taking out a deferred annuity policy with the Norwich Union Life Insurance Society in the name of the trustees but on the life of Harvey under which Pound 720 per annum were payable to Harvey for life from the date of his superannuation. It was also provided in the deed that notwithstanding the main clause the trustees would, if so desired by the assessee company, take out instead a deferred longest life policy, with the said insurance company in their names, but in favour of Harvey and Mrs. Harvey for an annuity of Pound 558-1-0 per annum payable during their joint lives from the date of Harvey's superannuation and during the lifetime of the survivor, provided further that if Harvey died before he attained the age of 55 years the annuity payable to Mrs. Harvey would be Pound 611-12-0 during her life. It was further provided that should Harvey die before attaining the age of 55 years, the trustees would stand possessed of the capital value of the deferred annuity policy, upon trust to purchase therewith an annuity for Mrs. Harvey with the above insurance company or other insurance company of repute. The other conditions of the deed of trust need not be considered, because they do not bear upon the controversy.
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> In furtherance of these presents, the trustees took out a policy on January 12, 1949. In addition to conditions usual in such policies, it provided for the following benefits :

Amount per annum of deferred annuity.	Pound 563-5-8 p.a. if both Mr. and Mrs. Harvey be living on September 20, 1955. Pound 720-0-0 p.a. if Mrs. Harvey should die before September 20,

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1955, leaving Harvey surviving her.
Pound 645-0-0   p.a. if Harvey
should die before September 20,
1955, leaving Mrs. Harvey surviving
him.
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There was a special provision which must be reproduced :

"Provided the contract is in force and unreduced, the grantees (i.e., the trustees) shall be entitled to surrender the annuity on the option anniversary (i.e., September 20, 1955), for the capital sum of Pound 10,169 subject to written notice of the intention to surrender being received by the directors of the society within the thirty day preceding the option anniversary."

Two other clauses of the Second Schedule of the policy may also be quoted :

"(III) If both the nominees shall die whilst the contract remains in force and unreduced and before the option anniversary the said funds and property of the society shall be liable to make repayment to the grantees of a sum equal to a return to all the premiums which shall have been paid under this contract without interest after proof thereof and subject as hereinbefore provided.

(IV) The grantees shall before the option anniversary and after it has acquired a surrender value be entitled to surrender the contract for a cash payment equal to return of all the premiums (at the yearly rate) which have been paid less the first year's premium or five per cent of the capital sum specified in the special provision of the First Schedule whichever shall be the lesser sum, provided that if the deferred annuity has been reduced an equivalent reduction in the guaranteed surrender value as calculated above will be made."

The assessee company paid the initial sum and the yearly premia for some years before Harvey died. In the assessment years 1949-50, 1950- 51, 1951-52 and 1952-53, it claimed a deduction of these sums from its profits or gains under section 10(2) (xv) of the Indian Income-tax Act (hereinafter called the Act), which provides :

"Such profits or gains shall be computed after making the following allowances, namely :-

any expenditure (not being in the nature of capital expenditure or personal expenses of the assessee) laid out or expended wholly and exclusively for the purposes of such business, profession or vocation."

This claim was disallowed by the Department and the Appellate Tribunal. The Tribunal held that it was not necessary to decide if the expenditure was wholly or exclusively for the purposes of the company's business, and if so,

> whether it was of a capital nature, because in the Tribunal's opinion there was no expenditure at all. The reason why the Tribunal held this way may be stated in its own words :
>
> "Clauses (I) and (II) do not contain any provision having a material bearing upon clause (III). Therefore, if it happens that both Mr. and Mrs. Harvey die before 20th September, 1955, all the payments till then made through the trustees to the Insurance Society will come back to the trustees and, as there is not the slightest trace of any indication anywhere that the trustees should have any beneficial interest in these moneys there would be a resultant trust in favour of the company in respect of the moneys thus far paid out. In other words, what has been done amounts to a provision for a contingency which may never arise. Such a provision can hardly be treated as payment to an employee whether of remuneration or pension or gratuity, and cannot be a proper deduction against the incomings of the business of the company for the purpose of computing its taxable profits. In short, there has been no expenditure by the company yet; there has been only an allocation of a part of its funds for an expenditure which may (or may not) have to be incurred in future."

16. The question which arose for determination was : whether during the assessment years 1949-50, 1950-51, 1951-52 and 1952-53 the assessee-company was entitled to claim deduction of the yearly premium from its profits under Section 10(2)(xv) of the Income-tax Act, 1922. It was held that the provision in the policy for surrendering annuity and the provision in policy for return of premium was not entitled to deduction as the payment made to the trustees by the assessee-company was towards a contingent liability or towards a liability depending on a contingency, namely, the life of a human-being. It was held that putting aside of money which may become expenditure on the happening of an event is not an expenditure under Section 10(2)(xv) of the 1922 Act. It was held

on facts that the money was placed in the hands of trustees and/or the insurance company to purchase annuities, if required, but to be returned if the annuities were not purchased. Therefore, it was a case of setting apart of the money and consequently the assessee was not entitled to deduction under the said section.

17. At this stage, we once again reiterate that a liability is a present obligation arising from past events, the settlement of which is expected to result in an outflow of resources and in respect of which a reliable estimate is possible of the amount of obligation. As stated above, the case of **Indian Molasses Co.** **(supra)** is different from the present case. As stated above, in the present case we are concerned with an army of items of sophisticated (specialiased) goods manufactured and sold by the assessee whereas the case of **Indian Molasses Co.** **(supra)** was restricted to an individual retiree. On the other hand, the case of **Metal Box Company of India** **(supra)** pertained to an army of employees who were due to retire in future. In that case the company had estimated its liability under two gratuity schemes and the amount of liability was deducted from the gross receipts in the profit and loss account. The company had worked out its estimated liability

on actuarial valuation. It had made provision for such liability spread over to a number of years. In such a case it was held by this Court that the provision made by the assessee-company for meeting the liability incurred by it under the gratuity scheme would be entitled to deduction out of the gross receipts for the accounting year during which the provision is made for the liability. The same principle is laid down in the judgment of this Court in the case of **Bharat Earth Movers** **(supra)**. In that case the assessee company had formulated leave encashment scheme. It was held, following the judgment in **Metal Box Company of India** **(supra),** that the provision made by the assessee for meeting the liability incurred under leave encashment scheme proportionate with the entitlement earned by the employees, was entitled to deduction out of gross receipts for the accounting year during which the provision is made for that liability. The principle which emerges from these decisions is that if the historical trend indicates that large number of sophisticated goods were being manufactured in the past and in the past if the facts established show that defects existed in some of the items manufactured and sold then the provision made for warranty in respect of the army of such sophisticated goods would be entitled to deduction from the gross receipts under Section 37 of the 1961 Act. It would all depend on the data systematically maintained by the assessee. It may be noted that in all the impugned judgments before us the assessee(s) has succeeded except in the case of **Civil Appeal Nos. of 2009 – Arising out of S.L.P.(C) Nos.14178-14182 of 2007 – M/s. Rotork Controls India (P) Ltd. v. Commissioner of Income Tax, Chennai**, in which the Madras High Court has overruled the decision of the Tribunal allowing deduction under Section 37 of the 1961 Act. However, the High Court has failed to notice the "reversal" which constituted part of the data systematically maintained by the assessee over last decade.

18. For the above reasons, we set aside the impugned judgment of the Madras High Court dated 5.2.07 and accordingly the civil appeals stand allowed in favour of the assessee with no order as to costs.

Civil Appeal No. of 2009 – Arising out of S.L.P. (C) No.7490 of 2009
Civil Appeal No. of 2009 – Arising out of S.L.P. (C) No.5616 of 2009
Civil Appeal No. of 2009 – Arising out of S.L.P. (C) No. of 2009 (SLP(C) ....CC No.4633 of 2009)
Civil Appeal No. of 2009 – Arising out of S.L.P. (C) No.722 of 2009
Civil Appeal No. of 2009 – Arising out of S.L.P. (C) No.723 of 2009
Civil Appeal No. of 2009 – Arising out of S.L.P. (C) No.4776 of 2009
Civil Appeal No. of 2009 – Arising out of S.L.P. (C) No.3440 of 2009
Civil Appeal No. of 2009 – Arising out of S.L.P. (C) No.4182 of 2009
Civil Appeal No. of 2009 – Arising out of S.L.P. (C) No.4183 of 2009
Civil Appeal No. of 2009 – Arising out of S.L.P. (C) No.4184 of 2009

Civil Appeal No. of 2009 – Arising out of S.L.P. (C) No.8983 of 2009
Civil Appeal No. of 2009 – Arising out of S.L.P. (C) No.8982 of 2009
Civil Appeal No. of 2009 – Arising out of S.L.P. (C) No.8311 of 2009
Civil Appeal No. of 2009 – Arising out of S.L.P. (C) No. of 2009 (SLP(C) ....CC No.5279 of 2009)

19. For the reasons given hereinabove in Civil Appeal Nos. of 2009 – Arising out of S.L.P.(C) Nos.14178-14182 of 2007 – M/s. Rotork Controls India (P) Ltd. v. Commissioner of Income Tax, Chennai, the civil appeals filed by the Department stand dismissed with no order as to costs.

................................J.
(S.H. KAPADIA)

................................J.
(AFTAB ALAM)

New Delhi;
May 12, 2009.