REPORTABLE

IN THE SUPREME COURT OF INDIA
CIVIL APPELLATE/ORIGINAL JURISDICTION
CIVIL APPEAL NO. 1337/2003

M/s Southern Technologies Ltd. … Appellant(s)

versus

Joint Commnr. of Income Tax, Coimbatore … Respondent(s)

with

C.A.No. 154 /2010 @ SLP(C) No. 22176/2009

TRANSFERRED CASE NO. 5/2005 & 6/2005

JUDGMENT

S.H. KAPADIA, J.

Leave granted in the Special Leave Petition.

Introduction

An interesting question of law which arises for determination in these Civil Appeals filed by Non-banking Financial Companies ("NBFCs" for short) is:

> "Whether the Department is entitled to treat the "Provision for NPA", which in terms of RBI Directions 1998 is debited to the

P&L Account, as "income" under Section 2(24) of the Income Tax Act, 1961 ("IT Act" for short), while computing the profits and gains of the business under Sections 28 to 43D of the IT Act?"

Facts

For the sake of convenience, we may refer to the facts in the case of M/s. Southern Technologies Ltd. [Civil Appeal No. 1337 of 2003].

At the outset, it may be stated that categorization of assets into doubtful, sub-standard and loss is not in dispute.

The financial year of the Appellant is July to June and the P&L Account and the Balance Sheet are drawn as on 30th June. The P&L Account and Balance Sheet is for shareholders, Reserve Bank of India (RBI) and Registrar of Companies (ROC) under the Companies Act, 1956. However, for IT Act, a separate P&L Account is made out for the year ending 31st March and the Balance Sheet as on that date is prepared and submitted to the Assessing Officer(AO) for computing the Total Income under the IT Act, which is not for use of RBI or ROC.

For the accounting year ending 31.03.1998, Assessee debited Rs. 81,68,516/- as Provision against NPA in the P&L Account on three counts, viz., Hire-Purchase of Rs. 57,38,980/-, Bill Discounting of Rs. 12,79,500/-

and Loans and Advances of Rs. 31,84,701/-, in all, totalling Rs. 1,02,03,121/- from which AO allowed deduction of Rs. 20,34,605/- on account of Hire Purchase Finance Charges leaving a balance provision for NPA of Rs. 81,68,516/-.

Before the AO, Assessee claimed deduction in respect of Rs. 81,68,516/- under Section 36(1)(vii) being Provision for NPA in terms of RBI Directions 1998 on the ground that Assessee had to debit the said amount to P&L Account [in terms of Para 9(4) of the RBI Directions] reducing its Profits, contending it to be write off. In the alternative, Assessee submitted that consequent upon RBI Directions 1998 there has been diminution in the value of its assets for which Assessee was entitled to deduction under Section 37 as a trading loss. This led to matters going in appeal (s). To conclude, it may be stated that following the judgment of the Gujarat High Court in the case of **Vithaldas H. Dhanjibhai Bardanwala** v. **Commissioner of Income-Tax, Gujarat-V** 130 ITR 95, the ITAT held that since Assessee had debited the said sum of Rs. 81,68,516/- to the P&L Account it was entitled to claim deduction as a write off under Section 36(1)(vii) which view was not accepted by the High Court, hence, this batch of Civil Appeal (s) are filed by NBFCs.

Submissions

Appellant made "Provision for NPA" amounting to Rs. 81,68,516/- for the financial year ending 31st March, 1998. This was calculated as per Para 8 of the Prudential Norms 1998. Accordingly, the P & L Account was debited and corresponding amount was shown in the Balance Sheet. The Department sought to add back Rs. 81,68,516/- to the taxable income on the ground that the provision for bad and doubtful debt was not allowable under Section 36(1)(vii) of the IT Act. The appellant claimed that the "Provision for NPA", however, represented "loss" in the value of assets and was, therefore, allowable under Section 37(1) of the IT Act. This claim of the appellant was dismissed on the ground that the provisions of Section 36(1)(vii) of the IT Act could not be by-passed.

The basic submission of the appellant in the lead case before us was that an amount written off was allowable on the basis of "real income theory" as well as on the basis of Section 145 of the IT Act. In this connection, the appellant submitted that it was bound to follow the method of accounting prescribed by RBI in terms of Paras 8 and 9 of the Prudential Norms 1998. As per the said method of accounting, the "Provision for NPA" actually represented depreciation in the value of the assets and, consequently, it is deductible under Section 37(1) of the IT Act. In this connection, appellant placed reliance on the judgment of this Court in

Commissioner of Income-Tax v. **Woodward Governor India P. Ltd.**, 312 ITR 254. According to the appellant, applying "real income theory", the "Provision for NPA" which is debited to P&L Account in terms of the RBI Directions 1998 and shown accordingly in the Balance Sheet can never be treated as income under Section 2(24) of the IT Act and added back while computing profits and gains of business under Sections 28 to 43D of the IT Act.

In reply, the Department contended before us that the IT Act is a separate code by itself; that the taxable total income has to be computed strictly in terms of the provisions of the IT Act; that the Reserve Bank of India Act, 1934 ("RBI Act" for short) operates in the field of monetary and credit system and that the said RBI Act never intended to compute taxable income of NBFC for income tax purposes; and, hence, there was no inconsistency between the two Acts.

According to the Department, RBI has classified all assets on which there is either a default in payment of interest or in repayment of the principal sum for more than the specified period as NPA. According to the Department, NPA does not mean that the asset has gone bad. It still continues to be an asset in the books of the lender, i.e., NBFC under the head "Debtors/Loans and Advances". According to the Department, RBI as a regulator wants NBFCs who accept deposits from the public to provide for a possible loss. The RBI Directions 1998 insists that non-payment on Due Date alone is sufficient for creation of a "Provision for NPA" (hereinafter referred to as "provision"). In this connection, it was submitted that even if a borrower repays his entire loan liability subsequent to the closing of the Books on 31st March, say on 10th April, even then as per the RBI Directions 1998, a provision has to be created to cover a possible loss. According to the Department, even applying "real income theory" as propounded on behalf of the assessee(s), the said theory presupposes that not only income but even expenditure or loss incurred should be real. According to the Department, "Provision for NPA" is definitely not an expenditure nor a loss, it is only a provision against possible loss and, therefore, it is not open to the appellant(s) to claim deduction for such provision under Section 36(1)(vii) of the IT Act, as it stood at the material time. The only object behind RBI insisting on an NBFC to make "Provision for NPA" compulsorily is to enable NBFC to state its profits only after compulsorily creating a "Provision for NPA" because it is the net profit of NBFC which is the base to determine its capacity to accept deposits from the public. More the profit more they can accept deposits. According to the Department, vide RBI Directions 1998, RBI tries to bring out the Profit in the P&L Account after providing for NPA which profit will be the minimum profit that the company would make so that the real or true and correct profit earned by an NBFC shall not be anything lesser than what is disclosed. According to the Department, the said "Provision for NPA" is in substance a "Reserve", which has been named as a "Provision" in the RBI Directions 1998 to protect the depositors of NBFC. According to the Department, even under accounting concepts, a provision for possible diminution in value of an asset is a reserve. In this connection, the Department has given three illustrations – Depreciation Reserve, Reserve against Long Term Investments, and Reserve against bad and doubtful debts. According to the Department, as per accounting principles, reserves are normally adjusted against the assets and only a net figure is shown in the balance sheet. However, RBI, in the case of NBFC, has deviated from the above accounting concept by insisting that the provision for NPA shall not be netted against the assets and should be shown separately on the liability side of the balance sheet so as to inform its user about the quantum and quality of NPA, in a more transparent manner. To this extent, there is a deviation from Part I of Schedule VI to the Companies Act, 1956.

Coming to the scope of Section 145 of the IT Act, it was submitted by the Department that Section 145 occurs in Chapter IV of the IT Act which deals with computation of total income. It indicates how the taxable income should be arrived at vide Sections 14 to 59. It is not an assessment Section. Section 145 helps to arrive at taxable total income. It nowhere indicates that the net profit arrived at shall be by adopting the accounting standards of Institute of Chartered Accountants of India (ICAI). It is the 1998 Directions which *inter alia* states that NBFC shall not recognize any income from an asset classified as NPA on mercantile system of accounting and that such Income shall be recognized only on cash basis. In the case under appeal, the Assessing Officer, in his wisdom, has not considered Rs.20,34,605/- as "income" (being income accrued on mercantile system of accounting) and did not include the same in computing the total income.

According to the Department, under the accounting concepts, a provision is a charge against a profit, whereas, a reserve is an appropriation of profit. According to the Department, the RBI Directions 1998 are not in conflict with the provisions of the IT Act, however, they constitute deviations to the presentation of the financial statements indicated in Part I of Schedule VI to the Companies Act, 1956. For example, under the 1998 Directions, Income from NPA under mercantile system of accounting is not recognized and to that extent it insists on NBFCs following the cash system of accounting. Thus, the P&L Account prepared by NBFC shall not recognise income from NPA but it shall create a provision by debit to the P&L Account on all NPAs. Similarly, under the said 1998 Directions, there is insistence on creation of a provision in respect of all NPAs summarily as against creation of a provision only when the debt is doubtful of recovery. These deviations are made mandatory with the paramount object of protecting the interest of the depositors, even though they are against accounting concepts. To the extent of these above mentioned specific deviations, the RBI Directions 1998 shall prevail over the provisions of the Companies Act (See Section 45Q of the RBI Act). Therefore, according to the Department, inconsistency in terms of Section 45Q of the RBI Act is only with respect to the Companies Act, 1956 so far as it relates to Income recognition and Presentation of assets and Presentation of Provision/ Reserve created against NPAs and not with the IT Act. According to the Department, if the argument that Section 45Q prevails over the IT Act is accepted, then various incomes like dividend income, agricultural income, profit on sale of depreciable assets, capital gains, etc. which items are all credited to P&L Account, but, which are exempted under the IT Act would become taxable income which is not the intention of Section 45Q of the IT Act. That, the said 1998 Directions cannot be taken as an excuse by the NBFC to compute lower taxable income under the IT Act.

In rejoinder, it has been submitted on behalf of the appellant(s) /assessee(s) that even if "Provision for NPA" is treated to be in the nature of a reserve still it will not convert a statutory debit in the P&L Account or a statutory charge in the said Account as "real income". It is contended that under Section 145 of the IT Act, NBFCs are bound to follow the method of accounting prescribed by RBI. Hence, a statutory debit or a statutory charge under RBI Directions 1998 issued under Section 45JA of the RBI Act cannot form part of the "real income" and, consequently, it cannot be subjected to tax under the IT Act. According to the appellant(s), the "real income theory" is concerned with determining whether a particular amount can be treated as taxable income based on commercial principles. According to the appellant(s), the statutory provision for NPA represents an amount forming part of the value of the asset that the assessee is entitled to, but not likely to receive. According to the appellant(s), they are in the business of lending of money, financing by way of hire purchase, leasing or bill discounting. According to the appellant(s), on default, interest as well as the principal remains unrealized and, thus, the "provision for NPA" provides for a diminution in the amounts realizable (assets) and, consequently, "provision for NPA" cannot be treated as "real income" and added back to the taxable income of NBFCs, as is sought to be done by the Department. According to the appellant(s), they have never asked for deduction under Section 36(1)(vii) of the IT Act. It is the case of the appellant(s) that if one applies "real income theory", "Provision for NPA" cannot be added back to the income of NBFCs, as is sought to be done by the Department. It is this "add back" which is impugned in the present case. According to the appellant(s), when RBI Act has specifically used the words "provision", "reserves", "assets", etc., it is not permissible to treat a "provision for NPA" mentioned in the 1998 Directions as a "reserve" for income tax proceedings.

According to the appellant(s), the RBI Directions 1998 provides for a mandatory method of accounting. It inter alia mandates Income recognition of NPA on cash basis and not on mercantile basis as required by Section 209(3) of the Companies Act. It lays down, vide para 8, the "provisioning requirements" which have got to be followed and the aggregate amount whereof has got to be debited to the P&L Account. According to appellant(s), para 8 of the 1998 Directions shows that the "Provision for NPA" takes into account diminution in value of the security charge, hence, it was, under Section 37 of the IT Act, entitled to deduction. According to the appellant(s), Section 45IA of the RBI Act defines "NOF". The Explanation (I) to the said Section defines "NOF" as the aggregate of paid-up equity capital and free reserves. According to the appellant(s), if "Provision for

NPA" is treated as reserve, it would increase the NOF of the company and, consequently, the higher the provision for NPAs, higher will be the net worth of the company which could never have been the intention or objective of the RBI Directions 1998. Further, according to the appellant(s), in view of a statutory reserve fund which has to be created by all NBFCs under Section 45IC, the "Provision for NPA" can never be treated as one more another type of reserve.

Coming to the accounting treatment, the appellant has given us the following chart to bring out the difference between "provision" and "reserve": ___

S.No.	Provision	Reserve
1.	Provision is a charge or debit to the P& L Account.	Reserve is an appropriation of profits.
2.	Provision is made against gross receipts in the P & L A/c irrespective of whether there is profit or loss. Provisions are a pretax charge to P & L account irrespective of whether the NBFC makes a net profit or not.	No reserve can be created in accounting year when there is a loss. Reserves are created out of post-tax profits, by way of appropriation, subject to there being adequate net profit.
3.	If NPA is Rs. 10 lakhs, then the accounting entry is: P&L A/c Dr. 10,00,000	If NPA is Rs. 10 lakhs, and there is a loss, no "Reserve can be created.

	To Prov. for NPA 10,00,000 If there is a loss, the debit of Rs. 10,00,000/- will increase the quantum of loss. This aggregate loss will be shown on the assets side as debit balance of P&L A/c.	
4.	Provision is based on a one-stage entry: P&L A/c Dr. To Prov. for Excise/ PF/ Gratuity/ etc.	Reserves are based on a two stage accounting process under the horizontal system. If the profits are Rs. 10 crores, the Board of Directors may transfer Rs. 8 crores to P&L Appropriation A/c for taxation, dividend and reserve. The balance will be transferred to credit balance of P&L A/c. The entries will be as follows:- **<u>Stage 1:</u>** P&L A/c Dr. 10.00 To P&L Appropriation A/c 8.00 To P& L A/c 2.00 **<u>Stage 2:</u>** P&L Appropriation A/c 8.00 To Prov. Taxation 4.00 To Prov. for Dividends 2.00 To Transfer to Reserve 2.00 Thus, if there are no profits, there

		can be no debit to the reserve. Under the vertical system, "profits available for appropriation" are post-tax profits. Appropriation to reserves can be made only when there is a surplus.
5.	Under Clause 7(1)(a) of Part – III of Schedule VI of Companies Act, 1956 – provision, inter alia, is to provide for depreciation, renewals or diminution in value of assets or to provide for any taxation.	Under Clause 7(1)(b) of Part – III of Schedule – VI of Companies Act, 1956 – reserve does not include any amount written off or retained by providing for depreciation, renewals, etc. or providing for any known liability. Under Part – I of Schedule – VI, 'reserve' can be made in respect of capital reserves, capital redemption, share premium, etc.
6.	Provision cannot be used to declare dividend, etc.	Reserves can be utilized to pay dividends/ bonus, unless there is a statutory bar.

Lastly, on the question of adding back to the taxable income, it has been submitted on behalf of the appellant(s) that the profits arrived as per the P&L Account under the Companies Act are after debiting several provisions under various accounting heads. There are several statutory liabilities like provision for excise duty, gratuity, provident fund, ESI, etc. The IT Act disallows several such provisions under Sections 40A(7), 43B, 40 and 40A. Such disallowances alone could be added back to the taxable income. The IT Act does not disallow a provision for NPA; that, unless the "provision for NPA" is specifically disallowed under the IT Act, the same cannot be added back and, hence, such a provision for NPA cannot be added back in computing the taxable income. According to the appellant, the purpose behind prescribing RBI Directions 1998 is to ensure that members of the public and shareholders of the company obtain a true picture of the financial health of the company. Its purpose is not to create a notional income. According to the appellant, in the present case, only a method of accounting has been prescribed by RBI. This accounting method cannot be used by the Department to assume existence of an income when such income does not really exist and, consequently, add back to the taxable income is not contemplated by the IT Act, nor is it contemplated under the "real income theory", however, if at all it has to be taken into account, it should be made allowable as a loss under Section 37(1) of the IT Act.

Relevant Provisions

(a) Of RBI Act, 1934

Chapter IIIB - PROVISIONS RELATING TO NON-BANKING INSTITUTIONS RECEIVING DEPOSITS AND FINANCIAL INSTITUTIONS

Section 45I - Definitions

In this Chapter, unless the context otherwise requires,-

(a) **"business of a non-banking financial institution"** means carrying on the business of a financial institution referred to in clause (c) and includes business of a non-banking financial company referred to in clause (f);

(aa) **"company"** means a company as defined in section 3 of the Companies Act, 1956 (1 of 1956), and includes a foreign company within the meaning of section 591 of that Act;

(c) **"financial institution"** means any non-banking institution which carries on as its business or part of its business any of the following activities, namely:-

(i) the financing, whether by way of making loans or advances or othervise, of any activity other than its own;

(ii) the acquisition of shares, stock, bonds, debentures or securities issued by a Government or local authority or other marketable securities of a like nature;

(iii) letting or delivering of any goods to a hirer under a hire-purchase agreement as defined in clause (c) of section 2 of the Hire-Purchase Act, 1972 (26 of 1972);

(iv) the carrying on of any class of insurance business;

(v) managing, conducting or supervising, as foreman, agent or in any other capacity, of chits or kuries as defined in any law which is for the time being in force in any State, or any business, which is similar thereto;

(vi) collecting, for any purpose or under any scheme or arrangement by whatever name called, monies in lump sum or otherwise, by way of subscriptions or by sale of units, or other instruments or in any other manner and awarding prizes or gifts, whether in cash or king, or disbursing monies in any other way, to persons from whom monies are collected or to any other person,

but does not include any institution, which carries on as its principal business,-

(a) agricultural operations; or

(aa) industrial activity; or

Explanation.-For the purposes of this clause, "industrial activity" means any activity specified in sub-clauses (i) to (xviii) of clause (c) of section 2 of the Industrial Development Bank of India Act, 1964 (18 of 1964);

(b) the purchase, or sale of any goods (other than securities) or the providing of any services; or

(c) the purchase, construction or sale of immovable property, so, however, that no portion of the income of the institution is derived from the financing of purchases, constructions or sales of immovable property by other persons;

45-IA. Requirement of registration and net owned fund

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Explanations.-For the purposes of this section,-

(I) **"net owned fund"** means-

(a) the aggregate of the paid-up equity capital and free reserves as disclosed in the latest balance-sheet of the company after deducting there from-

(i) accumulated balance of loss; (ii) deferred revenue expenditure; and (iii) other intangible assets; and

(b) further reduced by the amounts representing-

(1) investments of such company in shares of- (i) its subsidiaries; (ii) companies in the same group; (iii) all other non-banking financial companies; and

(2) the book value of debentures, bonds, outstanding loans and advances (including hire-purchase and lease finance) made to, and deposits with,-

(i) subsidiaries of such company; and

(ii) companies in the same group,

to the extent such book value exceeds ten per cent, of (a) above.

45-IC. Reserve fund

(1) Every non-banking financial company shall create a reserve fund the transfer therein a sum not less than twenty per cent of its net profit every year as disclosed in the profit and loss account and before any dividend is declared.

(2) No appropriation of any sum from the reserve fund shall be made by the non-banking financial company except for the purpose as may be specified by the Bank from time to time and every such appropriation shall be reported to the Bank within twenty-one days from the date of such withdrawal:

Provided that the Bank may, in any particular case and for sufficient cause being shown, extend the period of twenty-one days by such further period as it thinks fit or condone any delay in making such report.

(3) Notwithstanding anything contained in sub-section (1), the Central Government may, on the recommendation of the Bank and having regard to the adequacy of the paid-up capital and reserves of a non-banking financial company in relation to its deposit liabilities, declare by order in writing that the provisions of sub-section (1) shall not be applicable to the non-

banking financial company for such period as may be specified in the order:

Provided that no such order shall be made unless the amount in the reserve fund under sub-section (1) together with the amount in the share premium account is not less than the paid-up capital of the non-banking financial company.

45JA. Power of Bank to determine policy and issue directions

(1) If the Bank is satisfied that, in the public interest or to regulate the financial system of the country to its advantage or to prevent the affairs of any non-banking financial company being conducted in manner detrimental to the interest of the depositors or in a manner prejudicial to the interest of the non-banking financial company, it is necessary or expedient so to do, it may determine the policy and give directions to all or any of the non-banking financial companies relating to income recognition, accounting standards, making of proper provision for bad and doubtful debts, capital adequacy based on risk weights for assets and credit conversion factors for off balance-sheet items and also relating to deployment of funds by a non-banking financial company or a class of non-banking financial companies or non-banking financial companies generally, as the case may be, and such non-banking financial companies shall be bound to follow the policy so determined and the direction so issued.

(2) Without prejudice to the generality of the powers vested under subsection (1), the Bank may give directions to non-banking financial companies generally or to a class of non banking financial companies or to any non-banking financial company in particular as to-

(a) the purpose for which advances or other fund based or non-fund based accommodation may not be made; and

(b) the maximum amount of advances of other financial accommodation or investment in shares and other securities which, having regard to the paid-up capital, reserves and deposits of the non-banking financial company and other relevant considerations, may be made by that non-banking financial company to any person or a company or to a group of companies.

45K - Power of Bank to collect information from non-banking institutions as to deposits and to give directions

(1) The Bank may at any time direct that every non-banking institution shall furnish to the Bank, in such form, at such intervals and within such time, such statements information or particulars relating to or connected with deposits received by the non-banking institution, as may be specified by the Bank by general or special order.

(2) Without prejudice to the generality of the power vested in the Bank under sub-section (1), the statements, information or particulars to be furnished under sub-section (1), may relate to all or any of the following matters, namely, the amount of the deposits, the purposes and periods for which, and the rates of interest and other terms and conditions on which, they are received.

(3) The Bank may, if it considers necessary in the public interest so to do, give directions to non-banking institutions either generally or to any non-banking institution or group of non-banking institutions in particular, in respect of any matters relating to or connected with the receipt of deposits, including the rates of interest payable on such deposits, and the periods for which deposits may be received.

(4) If any non-banking institution fails to comply with any direction given by the Bank under sub-section (3), the Bank may prohibit the acceptance of deposits by that non-banking institution.

[***]

(6) Every non-banking institution receiving deposits shall, if so required by the Bank and within such time as the Bank may specify, cause to be sent at the cost of the non-banking institution a copy of its annual balance-sheet arid profit and loss account or other annual accounts to every person from whom the non-banking institution holds, as on the last day of the year to which the accounts relate, deposits higher than such sum as may be specified by the Bank.

45Q - Chapter IIIB to override other laws

The provisions of this Chapter shall have effect notwithstanding anything inconsistent therewith contained in any other law for the time being in force or any instrument having effect by virtue of any such law.

(b) Of Notification No. DFC.119/DG(SPT)-98 dated 31st January, 1998 issued by RBI under Section 45JA

RBI, having considered it necessary in public interest and being satisfied that for the purpose of enabling the Bank to regulate the credit system, it was necessary to issue directions relating to Prudential Norms, gives to every Non-Banking Financial Company the following directions. The said directions are called as "NBFCs Prudential Norms (Reserve Bank) Directions, 1998":

Definitions

2. (1) For the purpose of these directions, unless the context otherwise requires :-

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(iv) **"doubtful asset"** means -
(a) a term loan, or
(b) a lease asset, or
(c) a hire purchase asset, or
(d) any other asset,
which remains a substandard asset for a period exceeding two years;

(xii) with effect from March 31, 2003, **'non-performing asset'** (referred to in these directions as "NPA") means:
(a) an asset, in respect of which, interest has remained overdue for a period of six months or more;
(b) a term loan inclusive of unpaid interest, when the instalment is overdue for a period of six months or more or on which interest amount remained overdue for a period of six months or more;
(c) a demand or call loan, which remained overdue for a period of six months or more from the date of demand or call or on which interest amount remained overdue for a period of six months or more;
(d) a bill which remains overdue for a period of six months or more;
(e) the interest in respect of a debt or the income on receivables under the head `other current assets' in the nature of short term loans/advances, which facility remained overdue for a period of six months or more;
(f) any dues on account of sale of assets or services rendered or reimbursement of expenses incurred, which remained overdue for a period of six months or more;
(g) the lease rental and hire purchase instalment, which has become overdue for a period of twelve months or more;
(h) in respect of loans, advances and other credit facilities (including bills purchased and discounted), the balance outstanding under the credit facilities (including accrued interest) made available to the same borrower/beneficiary when any of the above credit facilities becomes non-performing asset:

Provided that in the case of lease and hire purchase transactions, an NBFC may classify each such account on the basis of its record of recovery;

"non-performing asset" (referred to in these directions as "NPA") means :-

(a) an asset, in respect of which, interest has remained past due for six months;

(b) a term loan inclusive of unpaid interest, when the instalment is overdue for more than six months or on which interest amount remained past due for six months;

(ba) a demand or call loan, which remained overdue for six months from the date of demand or call or on which interest amount remained past due for a period of six months;

(c) a bill which remains overdue for six months;

(d) the interest in respect of a debt or the income on receivables under the head `other current assets' in the nature of short term loans/advances, which facility remained over due for a period of six months;

(e) any dues on account of sale of assets or services rendered or reimbursement of expenses incurred, which remained overdue for a period of six months;

(f) the lease rental and hire purchase instalment, which has become overdue for a period of more than twelve months;

(g) In respect of loans, advances and other credit facilities (including bills purchased and discounted), the balance outstanding under the credit facilities (including accrued interest) made available to the same borrower/beneficiary when any of the above credit facilities becomes non- performing asset :

Provided that in the case of lease and hire purchase transactions, an NBFC may classify each such account on the basis of its record of recovery;"

(xiii) **"owned fund"** means paid up equity capital, preference shares which are compulsorily convertible into equity, free reserves, balance in share premium account and capital reserves representing surplus arising out of sale proceeds of asset, excluding reserves created by revaluation of asset, as reduced by accumulated loss balance, book value of intangible assets and deferred revenue expenditure, if any;

(xv) **“standard asset”** means the asset in respect of which, no default in repayment of principal or payment of interest is perceived and which does not disclose any problem nor carry more than normal risk attached to the business;

(xvi) **“sub-standard assets”** means -
(a) an asset which has been classified as non-performing asset for a period of not exceeding two years;
(b) an asset where the terms of the agreement regarding interest and/or principal have been renegotiated or rescheduled after commencement of operations, until the expiry of one year of satisfactory performance under the renegotiated or rescheduled terms;

Income recognition
3. (1) The income recognition shall be based on recognised accounting principles.
(2) Income including interest/discount or any other charges on NPA shall be recognised only when it is actually realised. Any such income recognised before the asset became non-performing and remaining unrealised shall be reversed. (Effective from May 12, 1998)
(3) In respect of hire purchase assets, where instalments are overdue for more than 12 months, income shall be recognised only when hire charges are actually received. Any such income taken to the credit of profit and loss account before the asset became non-performing and remaining unrealised, shall be reversed.
(4) In respect of lease assets, where lease rentals are overdue for more than 12 months, the income shall be recognised only when lease rentals are actually received. The net lease rentals taken to the credit of profit and loss account before the asset became non-performing and remaining unrealised shall be reversed.

Explanation For the purpose of this paragraph, `net lease rentals' mean gross lease rentals as adjusted by the lease adjustment account debited/credited to the profit and loss account and as reduced by depreciation at the rate applicable under Schedule XIV of the Companies Act, 1956 (1 of 1956).

Accounting standards

5. Accounting Standards and Guidance Notes issued by the Institute of Chartered Accountants of India (referred to in these directions as "ICAI") shall be followed insofar as they are not inconsistent with any of these directions.

Provisioning requirements

8. Every NBFC shall, after taking into account the time lag between an account becoming non-performing, its recognition as such, the realisation of the security and the erosion over time in the value of security charged, <u>make provision against sub-standard assets, doubtful assets and loss assets</u> as provided hereunder :-

Loans, advances and other credit facilities
<u>including bills purchased and discounted</u>

(1) The provisioning requirement in respect of loans, advances and other credit facilities including bills purchased and discounted shall be as under :

(i) Loss Assets	<u>The entire asset shall be written off</u>. If the assets are permitted to remain in the books for any reason, 100% of the outstandings should be provided for;
(ii) Doubtful Assets	(a) <u>100% provision to the extent to which the advance is not covered by the realisable value of the security</u> to which the NBFC has a valid recourse shall be made. The realisable value is to be estimated on a realistic

	(b) In addition to item (a) above, depending upon the period for which the asset has remained doubtful, provision to the extent of 20% to 50% of the secured portion (i.e. estimated realisable value of the outstandings) shall be made on the following basis : -	11

Period for which the asset has been considered as doubtful	**% of provision**
Upto one year	20
One to three years	30
More than three years	50
iii) Sub-standard assets	A general provision of 10% of total outstandings shall be made.

Lease and hire purchase assets

(2) The provisioning requirements in respect of hire purchase and leased assets shall be as under:-

Hire purchase assets

(i) In respect of hire purchase assets, the total dues (overdue and future instalments taken together) as reduced by

(a) the finance charges not credited to the profit and loss account and carried forward as unmatured finance charges; and

(b) the depreciated value of the underlying asset, shall be provided for.

Explanation

For the purpose of this paragraph,

(1) the depreciated value of the asset shall be notionally computed as the original cost of the asset to be reduced by depreciation at the rate of twenty per cent per annum on a straight line method; and

(2) in the case of second hand asset, the original cost shall be the actual cost incurred for acquisition of such second hand asset…"

Additional provision for hire purchase and leased assets

(ii) In respect of hire purchase and leased assets, additional provision shall be made as under :

(a) Where any amounts of hire charges or lease rentals are overdue upto 12 months	Nil
Sub-standard assets:	
(b) where any amounts of hire charges or lease rentals are overdue for more than 12 months but upto 24 months	10 percent of the net book value
Doubtful assets:	
(c) where any amounts of hire charges or lease rentals are overdue for more than 24 months but upto 36 months	40 percent of the net book value
(d) where any amounts of hire charges or lease rentals are overdue for more than 36 months but upto 48 months	70 percent of the net book value
Loss assets	
(e) where any amounts of hire charges or lease rentals are overdue for more than 48 months	100 percent of the net book value

(iii) On expiry of a period of 12 months after the due date of the last instalment of hire purchase/leased asset, the entire net book value shall be fully provided for.

NOTES :

1. The amount of caution money/margin money or security deposits kept by the borrower with the NBFC in pursuance of the hire purchase agreement may be deducted against the provisions stipulated under clause (i) above, if not already taken into account while arriving at the equated monthly instalments under the agreement. The value of any other security available in pursuance to the hire purchase agreement may be deducted only against the provisions stipulated under clause (ii) above.
2. The amount of security deposits kept by the borrower with the NBFC in pursuance to the lease agreement together with the value of any other security available in pursuance to the lease agreement may be deducted only against the provisions stipulated under clause (ii) above.
3. It is clarified that income recognition on and provisioning against NPAs are two different aspects of prudential norms and provisions as per the norms are required to be made on NPAs on total outstanding balances including the depreciated book value of the leased asset under reference after adjusting the balance, if any, in the lease adjustment account. The fact that income on an NPA has not been recognised cannot be taken as reason for not making provision.
4. An asset which has been renegotiated or rescheduled as referred to in paragraph (2) (xvi) (b) of these directions shall be a sub-standard asset or continue to remain in the same category in which it was prior to its renegotiation or reschedulement as a doubtful asset or a loss asset as the case may be. Necessary provision is required to be made as applicable to such asset till it is upgraded.
5. The balance sheet for the year 1999-2000 to be prepared by the NBFC may be in accordance with the provisions contained in sub-paragraph (2) of paragraph 8.

6. All financial leases written on or after April 1, 2001 attract the provisioning requirements as applicable to hire purchase assets.

Disclosure in the balance sheet

9. (1) Every NBFC shall separately disclose in its balance sheet the provisions made as per paragraph 8 above without netting them from the income or against the value of assets.

(2) The provisions shall be distinctly indicated under separate heads of accounts as under :-

(i) provisions for bad and doubtful debts; and

(ii) provisions for depreciation in investments.

(3) Such provisions shall not be appropriated from the general provisions and loss reserves held, if any, by the NBFC.

(4) Such provisions for each year shall be debited to the profit and loss account. The excess of provisions, if any, held under the heads general provisions and loss reserves may be written back without making adjustment against them.

Schedule to the balance sheet

9BB. Every NBFC shall append to its balance sheet prescribed under the Companies Act, 1956, the particulars in the format as set out in the schedule annexed hereto.

(c) Of Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances dated July 1, 2009

2. DEFINITIONS

2.1 **Non performing Assets**

2.1.1 An asset, including a leased asset, becomes non performing when it ceases to generate income for the bank.

2.1.2 A non performing asset (NPA) is a loan or an advance where;

i.interest and/ or instalment of principal remain overdue for a period of more than 90 days in respect of a term loan,

ii.the account remains 'out of order' as indicated at paragraph 2.2 below, in respect of an Overdraft/Cash Credit (OD/CC),

iii.the bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted,

iv. the instalment of principal or interest thereon remains overdue for two crop seasons for short duration crops,

v. the instalment of principal or interest thereon remains overdue for one crop season for long duration crops,

vi. the amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitisation transaction undertaken in terms of guidelines on securitisation dated February 1, 2006.

vii. in respect of derivative transactions, the overdue receivables representing positive mark-to-market value of a derivative contract, if these remain unpaid for a period of 90 days from the specified due date for payment.

3. <u>INCOME RECOGNITION</u>

3.1 Income Recognition Policy

3.1.1 The policy of income recognition has to be objective and based on the record of recovery. Internationally income from nonperforming assets (NPA) is not recognised on accrual basis but is booked as income only when it is actually received. Therefore, the banks should not charge and take to income account interest on any NPA.

4. ASSET CLASSIFICATION

4.1 Categories of NPAs

Banks are required to classify nonperforming assets further into the following three categories based on the period for which the asset has remained non-performing and the realisability of the dues:

i.Substandard Assets

ii.Doubtful Assets

iii.Loss Assets

4.1.1 Substandard Assets

With effect from 31 March 2005, a substandard asset would be one, which has remained NPA for a period less than or equal to 12 months. In such cases, the current net worth of the borrower/ guarantor or the current market value of the security charged is not enough to ensure recovery of the dues to the banks in full. In other words, such an asset will have well defined credit weaknesses that jeopardise the liquidation of the debt and are characterised by the distinct possibility that the banks will sustain some loss, if deficiencies are not corrected.

4.1.2. Doubtful Assets

With effect from March 31, 2005, an asset would be classified as doubtful if it has remained in the sub-standard category for a period of 12 months. A loan classified as doubtful has all the weaknesses inherent in assets that were classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, – on the basis of currently known facts, conditions and values – highly questionable and improbable.

4.1.3 Loss Assets

A loss asset is one where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly. In other words, such an asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted although there may be some salvage or recovery value.

5 PROVISIONING NORMS

5.1 **General**

5.1.1 The primary responsibility for making adequate provisions for any diminution in the value of loan assets, investment or other assets is that of the bank managements and the statutory auditors. The assessment made by the inspecting officer of the RBI is furnished to the bank to assist the bank management and the statutory auditors in taking a decision in regard to making adequate and necessary provisions in terms of prudential guidelines.

(d) Of Income Tax Act, 1961

Section 36 - Other deductions [as it stood at the material time]

(1) The deductions provided for in the following clauses shall be allowed in respect of the matters dealt with therein, in computing the income referred to in section 28 –

(vii) subject to the provisions of sub-section (2), the amount of any bad debt or part thereof which is written off as irrecoverable in the accounts of the assessee for the previous year:

Provided that in the case of an assessee to which clause (viia) applies, the amount of the deduction relating to any such debt or part thereof shall be limited to the amount by which such debt or part thereof exceeds the credit balance in the provision for bad and doubtful debts account made under that clause.

Explanation.- For the purposes of this clause, any bad debt or part thereof written off as irrecoverable in the accounts of the assessee shall not include any provision for bad and doubtful debts made in the accounts of the assessee.

(viia) in respect of any provision for bad and doubtful debts made by –

(a) a scheduled bank not being a bank incorporated by or under the laws of a country outside India or a non-scheduled bank, an amount not exceeding five per cent of the total income (computed before making any deduction under this clause and Chapter VIA) and an amount not exceeding ten per cent of the aggregate average advances made by the rural branches of such bank computed in the prescribed manner.

43D - Special provision in case of income of public financial institutions, public companies, etc.

Notwithstanding anything to the contrary contained in any other provision of this Act, -

(a) in the case of a public financial institution or a scheduled bank or a State financial corporation or a State industrial investment corporation, the income by way of interest in relation to such categories of bad or doubtful debts as may be prescribed[2] having regard to the guidelines issued by the Reserve Bank of India in relation to such debts;

(b) in the case of a public company, the income by way of interest in relation to such categories of bad or doubtful debts as may be prescribed having regard to the guidelines issued by the National Housing Bank in relation to such debts,

shall be chargeable to tax in the previous year in which it is credited by the public financial institution or the scheduled bank or the State financial corporation or the State industrial investment corporation or the public company to its profit and loss account for that year or, as the case may be, in which it is actually received by that institution or bank or corporation or company, whichever is earlier.

<u>Reasons for RBI Directions 1998</u>

On 31.01.1998, RBI Directions 1998 introduced a new regulatory framework involving prescription of Disclosure norms for NBFCs which are deposit taking to ensure that these NBFCs function on sound and healthy lines. Regulatory and supervisory attention was focussed on the deposit taking NBFCs so as to enable the RBI to discharge its responsibilities to protect the interest of the depositors. These NBFCs are subjected to prudential regulations on various aspects such as income recognition; asset classification and provisioning, etc.

The basis of every business is that anticipated losses must be taken into account but expected income need not be taken note of. This is the basis of the RBI Directive of 1998 as it is closer to reality of cash liquidity that prevents NBFC from collapse.

The RBI Directions 1998 deal with Presentation of NPA provision in the Balance Sheet of an NBFC. Before 1998, the Balance Sheet and P&L Account of an NBFC were required to be prepared in accordance with Parts I and II of Schedule VI as provided under Section 211 of the Companies Act, 1956 like any other company. Schedule VI Part I of the Companies Act, 1956 specifically provides that Provision for doubtful debts should be reduced from the gross amount of debtors and advances. NBFCs were following the same practice of disclosure in their audited financial statements as done by the Company. Therefore, vide Para 9(1) of 1998 Directions, NBFCs are now obliged to disclose in the Balance Sheet the Provision for NPAs without netting them from the income or value of the assets. As per sub-para 2 of Para 9, "the provisions shall be distinctly indicated under separate heads of accounts" on the Liability side of the balance sheet under the caption "current liabilities and provisions".

It needs to be emphasized that the said 1998 Directions are only Disclosure Norms. They have nothing to do with computation of Total Taxable Income under the IT Act or with the accounting treatment. The said 1998 Directions only lay down the manner of presentation of NPA provision in the balance sheet of an NBFC.

Analysis of Para 9 of RBI Directions 1998

Vide Para 9, RBI has mandated that every NBFC shall disclose in its Balance Sheet the Provision without netting them from the Income or from the value of the assets and that the provision shall be distinctly indicated under the separate heads of accounts as: - (i) provisions for bad and doubtful debts, and (ii) provisions for depreciation in investments in the Balance Sheet under "Current Liabilities and Provisions" and that such provision for each year shall be debited to P&L Account so that a true and correct figure of "Net Profit" gets reflected in the financial accounts of the company. The effect of such Disclosure is to increase the current liabilities by showing the provision against the possible Loss on assets classified as NPA. An NPA continues to be an Asset – "Debtors/ Loans and Advances" in the books of NBFC. For creating a provision the only yardstick is default in terms of the loan under RBI norms, a provision is mathematical calculation on time lines. The entire exercise mentioned in the RBI Directions 1998 is only in the context of Presentation of NPA provisions in the balance sheet of an NBFC and it has nothing to do with computation of taxable income or accounting concepts.

It is important to note that the net profit shown in the P&L Account is the basis for NBFC to accept deposits and declare dividends. Higher the profits higher is the NOF and higher is the increase in the public making deposits in NBFCs. Hence the object of the NBFC is disclosure and provisioning.

NBFCs have to accept the concept of "income" as evolved by RBI after deducting the Provision against NPA, however, as stated above, such treatment is confined to Presentation / Disclosure and has nothing to do with computation of taxable income under the IT Act.

Scope of the Finance Act No. 2 of 2001 w.e.f. 1.4.1989 insofar as Section 36(1)(vii) is concerned

Prior to 1.4.1989, the law, as it then stood, took the view that even in cases in which the assessee (s) makes only a provision in its accounts for bad debts and interest thereon and even though the amount is not actually written off by debiting the P&L Account of the assessee and crediting the amount to the account of the debtor, assessee was still entitled to deduction under Section 36(1)(vii). [See **Commissioner of Income Tax v. Jwala Prasad Tewari** 24 ITR 537 and **Vithaldas H. Dhanjibhai Bardanwala** (supra)] Such state of law prevailed upto and including assessment year 1988-89. However, by insertion (w.e.f. 1.4.1989) of a new Explanation in Section 36(1)(vii), it has been clarified that any bad debt written off as irrecoverable in the account of the assessee will not include any provision for bad and doubtful debt made in the accounts of the assessee. The said amendment indicates that before 1.4.1989, even a provision could be treated as a write off. However, after 1.4.1989, a distinct dichotomy is brought in by way of the said Explanation to Section 36(1)(vii). Consequently, after 1.4.1989, a mere provision for bad debt would not be entitled to deduction under Section 36(1)(vii). To understand the above dichotomy, one must understand "how to write off". If an assessee debits an amount of doubtful debt to the P&L Account and credits the asset account like sundry debtor's Account, it would constitute a write off of an actual debt. However, if an assessee debits "provision for doubtful debt" to the P&L Account and makes a corresponding credit to the "current liabilities and provisions" on the Liabilities side of the balance sheet, then it would constitute a provision for doubtful debt. In the latter case, assessee would not be entitled to deduction after 1.4.1989.

We have examined the P&L Account of First Leasing Company of India Limited for the year ending 31st March, 2003. On examination of Schedule J to the P&L Account which refers to operating expenses, we find two distinct heads of expenditure, namely, "Provision for Non-performing Assets" and "Bad Debts/ Advances Written Off". It is for the appellant (s) to explain the difference between the two to the assessing officer. Which of the two items will constitute expenditure under the IT Act has to be decided according to the IT Act. In the present case, we are not concerned with taxability under the IT Act or the accounting treatment. We are essentially concerned with presentation of financial statements by NBFCs under the 1998 Directions. The point to be noted is that even according to the assessee "Bad debts/ Advances Written Off" is a distinct head of expenditure vis-à-vis "Provision for Bad Debt". One more aspect needs to be highlighted. It is true that under Part I of Schedule VI to the Companies Act, 1956 an amount could be first included in the list of sundry debtors/ loans and then deducted from the list as "provision for doubtful debts". However, these are matters of Presentation of Provisions for doubtful debts even under the Companies Act and have nothing to do with taxability under the IT Act.

One more aspect needs to be mentioned. Section 36(1)(vii) is subject to sub-section (2) of Section 36. The condition incorporated in Section 36 of the IT Act, which was not there in Section 10(2)(xi) of the 1922 Act, is that the amount of debt should have been taken into account in computing the income of the assessee in the previous year. Under the IT Act, the emphasis is not on the assessee being the creditor but taking into account of the debt in computing the business income. [See Section 36(2)] In **Commissioner of Income-tax, A.P. v. T. Veerabhadra Rao K. Koteswara Rao & Co.** reported in 155 ITR 152 at 157, it was found that the debt was taken into account in the income of the assessee for the assessment year 1963-64 when the interest accruing thereon was taxed in the hands of the assessee. The said interest was taxed as income as it represented accretion accruing during the earlier year on the moneys owed to the assessee by the debtor. It was held that transaction constituted the debt which was taken into account in computing the income of the assesee of the previous years.

Deviations between RBI Directions 1998 and Companies Act

Broadly, there are three deviations:

(i) in the matter of presentation of financial statements under Schedule VI of the Companies Act;

(ii) in not recognising the "income" under the mercantile system of accounting and its insistence to follow cash system with respect to assets classified as NPA as per its Norms;

(iii) in creating a provision for all NPAs summarily as against creating a provision only when the debt is doubtful of recovery under the norms of the Accounting Standards issued by the Institute of Chartered Accountants of India.

These deviations prevail over certain provisions of the Companies Act, 1956 to protect the Depositors in the context of Income Recognition and Presentation of the Assets and Provisions created against them.

Thus, the P&L Account prepared by NBFC in terms of RBI Directions 1998 does not recognize "income from NPA" and, therefore, directs a Provision to be made in that regard and hence an "add back". It is important to note that "add back" is there only in the case of provisions.

As stated above, the Companies Act allows an NBFC to adjust a Provision for possible diminution in the value of asset or provision for doubtful debts against the assets and only the Net Figure is allowed to be shown in the Balance Sheet, as a matter of disclosure. However, the said RBI Directions 1998 mandates all NBFCs to show the said provisions separately on the Liability Side of Balance Sheet, i.e., under the Head "current liabilities and provisions". The purpose of the said deviation is to inform the user of the Balance Sheet the particulars concerning quantum and quality of the diminution in the value of investment and particulars of doubtful and sub-standard assets. Similarly, the 1998 Directions does not recognize the "income" under the mercantile system and it insists that NBFCs should follow cash system in regard to such incomes.

Before concluding on this point, we need to emphasise that the 1998 Directions has nothing to do with the accounting treatment or taxability of "income" under the IT Act. The two, viz., IT Act and the 1998 Directions operate in different fields. As stated above, under the mercantile system of accounting, interest / hire charges income accrues with time. In such cases, interest is charged and debited to the account of the borrower as "income" is recognized under accrual system. However, it is not so recognized under the 1998 Directions and, therefore, in the matter of its Presentation under the said Directions, there would be an add back but not under the IT Act necessarily. It is important to note that collectibility is different from accrual. Hence, in each case, the assessee has to prove, as has happened in this case with regard to the sum of Rs. 20,34,605/-, that interest is not recognized or taken into account due to uncertainty in collection of the income. It is for the assessing officer to accept the claim of the assessee under the IT Act or not to accept it in which case there will be add back even under real income theory as explained hereinbelow.

Scope and applicability of RBI Directions 1998

RBI Directions 1998 have been issued under Section 45JA of RBI Act. Under that Section, power is given to RBI to enact a regulatory framework involving prescription of prudential norms for NBFCs which are deposit taking to ensure that NBFCs function on sound and healthy lines. The primary object of the said 1998 Directions is prudence, transparency and disclosure. Section 45JA comes under Chapter IIIB which deals with provisions relating to Financial Institutions, and to non-banking Institutions receiving deposits from the public. The said 1998 Directions touch various aspects such as income recognition; asset classification; provisioning, etc. As stated above, basis of the 1998 Directions is that anticipated losses must be taken into account but expected income need not be taken note of. Therefore, these Directions ensure cash liquidity for NBFCs which are now required to state true and correct profits, without projecting inflated profits. Therefore, in our view, RBI Directions 1998 deal only with presentation of NPA provisions in the Balance Sheet of an NBFC. It has nothing to do with the computation or taxability of the provisions for NPA under the IT Act.

Prior to RBI Directions 1998, Advances were stated net of provisions for NPAs / bad and doubtful debts. They were shown at net figure (Advances less Provisions for NPAs) and the amount of provision for NPA was shown in the notes to the accounts only. Such presentation of NPA Provision warranted disclosure. Therefore, Para 9(1) of RBI Directions 1998 stipulates that every NBFC shall separately disclose in its Balance Sheet the provision for NPAs without netting them from the income or against the value of assets. That, the provision for NPA should be shown separately on the "Liabilities side" of the Balance Sheet under the head "Current Liabilities and Provisions" and not as a deduction from "Sundry Debtors/ Advances". Therefore, RBI has taken a position as a matter of disclosure, with which we agree, that if an NBFC deducts a provision for NPA from "sundry debtors/ loans and advances", it would amount to netting from the value of assets which would constitute breach of Para 9 of RBI Directions 1998. Consequently, NPA provisions should be presented on the "Liabilities side" of the Balance Sheet under the head "Current Liabilities and Provisions" as a Disclosure Norm and not as accounting or computation of income norm under the IT Act. At this stage, we may clarify that the entire thrust of RBI Directions 1998 is on presentation of NPA provision in the Balance Sheet of an NBFC. Presentation/ disclosure is different from computation/ taxability of the provision for NPA. The nature of expenditure under the IT Act cannot be conclusively determined by the manner in which accounts are presented in terms of 1998 Directions. There are cases where on facts courts have taken the view that the so-called provision is in effect a write off. Therefore, in our view, RBI Directions 1998, though deviate from accounting practice as provided in the Companies Act, do not override the provisions of the IT Act. Some companies, for example, treat write offs or expenses or liabilities as contingent liabilities. For example, there are companies which do not recognize mark-to-market loss on its derivative contracts either by creating reserve as suggested by ICAI or by charging the same to the P&L Account in terms of Accounting Standards. Consequently, their profits and reserves and surplus of the year are projected on the higher side. Consequently, such losses are not accounted in the books, at the highest, they are merely disclosed as contingent liability in the Notes to Accounts. The point which we would like to make is whether such losses are contingent or actual cannot be decided only on the basis of presentation. Such presentation will not bind the authority under the IT Act. Ultimately, the nature of transaction has to be examined. In each case, the authority has to examine the nature of expense/ loss. Such examination and finding thereon will not depend upon presentation of expense/ loss in the financial statements of the NBFC in terms of the 1998 Directions. Therefore, in our view, the RBI Directions 1998 and the IT Act operate in different fields.

The question still remains as to what is the nature of "Provision for NPA" in terms of RBI Directions 1998. In our view, provision for NPA in terms of RBI Directions 1998 does not constitute expense on the basis of which deduction could be claimed by NBFC under Section 36(1)(vii). Provision for NPAs is an expense for Presentation under 1998 Directions and in that sense it is notional. For claiming deduction under the IT Act, one has to go by the facts of the case (including the nature of transaction), as stated above. One must keep in mind another aspect. Reduction in NPA takes place in two ways, namely, by recoveries and by write off. However, by making a provision for NPA, there will be no reduction in NPA. Similarly, a write off is also of two types, namely, a regular write off and a prudential write off. [See Advances Accounts by Shukla, Grewal, Gupta, Chapter 26, Page 26.50] If one keeps these concepts in mind, it is very clear that RBI Directions 1998 are merely prudential norms. They can also be called as disclosure norms or norms regarding presentation of NPA Provisions in the Balance Sheet. They do not touch upon the nature of expense to be decided by the AO in the assessment proceedings.

<u>Theory of "Real Income"</u>

An interesting argument was advanced before us to say that a provision for NPA, under commercial accounting, is not an "income" hence the same cannot be added back as is sought to be done by the Department. In this connection, reliance was placed on "Real Income Theory".

We find no merit in the above contention. In the case of **Poona Electric Supply Co. Ltd.** v. **Commissioner of Income-Tax, Bombay City I,** 57 ITR 521 at page 530, this is what the Supreme Court had to say:

> "Income Tax is a tax on the "real income", i.e., the profits arrived at on commercial principles subject to the provisions of the Income Tax Act. The real profit can be ascertained only by making the permissible deductions under the provisions of the Income Tax Act. There is a clear distinction between the real profits and statutory profits. The latter are statutorily fixed for a specified purpose".

To the same effect is the judgment of the Bombay High Court in the case of **Commissioner of Wealth-Tax, Bombay** v. **Bombay Suburban Electric Supply Ltd.** 103 ITR 384 at page 391, where it was observed as under:

> "Income Tax is a tax on the real income, i.e., profits arrived at on commercial principles subject to the provisions of the Income Tax Act, 1961. The real profits can be ascertained only by making the permissible deductions".

The point to be noted is that the IT Act is a tax on "real income", i.e., the profits arrived at on commercial principles subject to the provisions of the IT Act. Therefore, if by Explanation to Section 36(1)(vii) a provision for doubtful debt is kept out of the ambit of the bad debt which is written off then, one has to take into account the said Explanation in computation of total income under the IT Act failing which one cannot ascertain the real profits. This is where the concept of "add back" comes in. In our view, a provision for NPA debited to P&L Account under the 1998 Directions is only a notional expense and, therefore, there would be add back to that extent in the computation of total income under the IT Act.

One of the contentions raised on behalf of NBFC before us was that in this case there is no scope for "add back" of the Provision against NPA to the taxable income of the assessee. We find no merit in this contention. Under the IT Act, the charge is on Profits and Gains, not on gross receipts (which, however, has Profits embedded in it). Therefore, subject to the requirements of the IT Act, profits to be assessed under the IT Act have got to be Real Profits which have to be computed on ordinary principles of commercial accounting. In other words, profits have got to be computed after deducting Losses/ Expenses incurred for business, even though such losses/ expenses may not be admissible under Sections 30 to 43D of the IT

Act, unless such Losses/ Expenses are expressly or by necessary implication disallowed by the Act. Therefore, even applying the theory of Real Income, a debit which is expressly disallowed by Explanation to Section 36(1)(vii), if claimed, has got to be added back to the total income of the assessee because the said Act seeks to tax the "real income" which is income computed according to ordinary commercial principles but subject to the provisions of the IT Act. Under Section 36(1)(vii) read with the Explanation, a "write off" is a condition for allowance. If "real profit" is to be computed one needs to take into account the concept of "write off" in contradistinction to the "provision for doubtful debt".

Applicability of Section 145

At the outset, we may state that in essence RBI Directions 1998 are Prudential/ Provisioning Norms issued by RBI under Chapter IIIB of the RBI Act, 1934. These Norms deal essentially with Income Recognition. They force the NBFCs to disclose the amount of NPA in their financial accounts. They force the NBFCs to reflect "true and correct" profits. By virtue of Section 45Q, an overriding effect is given to the Directions 1998 vis-à-vis "income recognition" principles in the Companies Act, 1956.

These Directions constitute a code by itself. However, these Directions 1998 and the IT Act operate in different areas. These Directions 1998 have nothing to do with computation of taxable income. These Directions cannot overrule the "permissible deductions" or "their exclusion" under the IT Act. The inconsistency between these Directions and Companies Act is only in the matter of Income Recognition and presentation of Financial Statements. The Accounting Policies adopted by an NBFC cannot determine the taxable income. It is well settled that the Accounting Policies followed by a company can be changed unless the AO comes to the conclusion that such change would result in understatement of profits. However, here is the case where the AO has to follow the RBI Directions 1998 in view of Section 45Q of the RBI Act. Hence, as far as Income Recognition is concerned, Section 145 of the IT Act has no role to play in the present dispute.

Analysis of Section 36(1)(viia)

Section 36(1)(vii) provides for a deduction in the computation of taxable profits for the debt established to be a bad debt.

Section 36(1)(viia) provides for a deduction in respect of any provision for bad and doubtful debt made by a Scheduled Bank or Non-Scheduled Bank in relation to advances made by its rural branches, of a sum not exceeding a specified percentage of the aggregate average advances by such branches. Having regard to the increasing social commitment, Section 36(1)(viia) has been amended to provide that in respect of provision for bad and doubtful debt made by a scheduled bank or a non-scheduled bank, an amount not exceeding a specified per cent of the total income or a specified per cent of the aggregate average advances made by rural branches, whichever is higher, shall be allowed as deduction in computing the taxable profits.

Even Section 36(1)(vii) has been amended to provide that in the case of a bank to which Section 36(1)(viia) applies, the amount of bad and doubtful debt shall be debited to the provision for bad and doubtful debt account and that the deduction shall be limited to the amount by which such debt exceeds the credit balance in the provision for bad and doubtful debt account.

The point to be highlighted is that in case of banks, by way of incentive, a provision for bad and doubtful debt is given the benefit of deduction, however, subject to the ceiling prescribed as stated above. Lastly, the provision for NPA created by a scheduled bank is added back and only thereafter deduction is made permissible under Section 36(1)(viia) as claimed.

Whether provision on NPA is allowable under Section 37(1)?

As stated above, Section 36(1)(vii) after 1.4.1989 draws a distinction between write off and provision for doubtful debt. The IT Act deals only with doubtful debt. It is for the assessee to establish that the provision is made as the loan is irrecoverable. However, in view of Explanation which keeps such a provision outside the scope of "written off" bad debt, Section 37 cannot come in. If an item falls under Sections 30 to 36, but is excluded by an Explanation to Section 36(1)(vii) then Section 37 cannot come in. Section 37 applies only to items which do not fall in Sections 30 to 36. If a provision for doubtful debt is expressly excluded from Section 36(1)(vii) then such a provision cannot claim deduction under Section 37 of the IT Act even on the basis of "real income theory" as explained above.

Analysis of Section 43D

It is similar to Section 43B.

The reason for enacting this Section is that interest from bad and doubtful debts in the case of bank and financial institutions is difficult to recover; taxing such income on accrual basis reduces the liquidity of the bank without generation of income.

With a view to improve their viability, the IT Act has been amended by inserting Section 43D to provide that such interest shall be charged to tax only in the year of receipt or the year in which it is credited to the P&L Account, whichever is earlier.

Before concluding, we may state that none of the judgments cited on behalf of the appellant(s) are relevant as they do not touch upon the concept of NPA. In our view, the issues which arise for determination in this case did not arise in the cases cited by the appellant(s).

Challenge to the constitutional validity of Sections 36(1)(viia) and 43D of the IT Act

According to NBFCs, there is no reason why a Provision for NPA of an NBFC be treated differently from a provision for NPAs of banks, SFCs, HFCs, etc. According to NBFCs, the Disclosure Norms for NBFCs are designed to bring NBFCs in line with banks, SFCs, HFCs, etc. That, if NPAs are similar to Doubtful Debts, then permitting deductions only in the case of Provisions for doubtful debts of banks, cooperative financial corporations, etc. will violate Article 14 of the Constitution. In this connection, it was submitted that when banks, financial institutions and NBFCs are all subject to RBI norms in the matter of Income Recognition, denial of deduction only to NBFCs in respect of Provisions which they make against their NPAs and not including NBFCs in Sections 43D and 36(1)(viia) would be wholly discriminatory and violative of Article 14.

According to NBFCs, levying a tax on the Provision for NPA would amount to an unreasonable restriction on the right of the NBFCs to carry on business under Article 19(1)(g) of the Constitution. For example, in the case of First Leasing Company, who made the Provision for NPA of Rs. 15.77 crores, the taxable income stands increased by the said sum even when it does not represent real or notional income. Accordingly, the taxable income of the Company stands raised by a fictitious amount. This, according to the Company, would constitute an unreasonable restriction on the fundamental rights of the Company to carry on business under Article 19(1)(g).

We find no merit in the above contentions. In the context of Article 14, the test to be applied is that of “rational/ intelligible differentia” having nexus with the object sought to be achieved. Risk is one of the main concerns which RBI has to address when it comes to NBFCs. NBFCs accept deposits from the Public for which transparency is the key, hence, we have the RBI Directions/ Norms. On the other hand, as far as banking goes, the weightage, one must place on, is on “liquidity”. These two concepts, namely, “risk” and “liquidity” bring out the basic difference between NBFCs and Banks. Take the case of the scope of impugned Section 43D. As stated above, an asset is rated as NPA when over a period of time it ceases to get converted to cash or generate income and becomes difficult to recover.

Therefore, Parliament realized that taxing such "income" on accrual basis without actual recovery would create liquidity crunch, hence, Section 43D came to be enacted. So also, as stated above, Section 36(1)(viia) provides for a deduction not only in respect of "written off" bad debt but in case of banks it extends the allowance also to any Provision for bad and doubtful debts made by banks which incentive is not given to NBFCs. Banks face a huge demand from the industry particularly in an emerging market economy and at times the credit offtake is so huge that banks face liquidity crunch. Thus, the line of business operations of NBFCs and banks are quite different. It is for this reason, apart from social commitments which banks undertake, that allowances of the nature mentioned in Sections 36(1)(viia) and 43D are often restricted to banks and not to NBFCs. Lastly, as stated above, even in the case of banks the Provision for NPA has to be added back and only after such add back that deduction under Section 36(1)(viia) can be claimed by the banks. Therefore, even in the case of banks, there is an element of add back, however, by way of special provision banks are allowed to claim deduction under Section 36(1)(viia). One more aspect needs to be mentioned, apart from the fact that NBFCs and Banks are two different entities, under Section 36(1)(viia) the banks are allowed deductions subject to a ceiling or a limit and if the contentions of NBFCs are to be accepted that NBFCs should also be included in Section 36(1)(viia), then, we will be undertaking judicial legislation which is not allowed, hence, in our view, we hold that neither Section 36(1)(viia) nor Section 43D violates Article 14. We further hold that the test of "intelligible differentia" stands complied with and hence we reject the challenge.

As regards challenge to the validity of Sections 43D and 36(1)(viia) as violative of Article 19, we find that RBI Directions 1998 govern the business of NBFCs. To protect the investors, RBI has prescribed norms for provisioning and disclosure. These norms have nothing to do with computation of taxable income under the IT Act. These Directions 1998 do not apply to banks. Ultimately, the challenge is to the validity of a taxing enactment. In such cases, we must give some latitude to the law makers in enacting laws which impose reasonable restrictions under Article 19(6). This we say so for two reasons. Firstly, the impugned allowance under Section 36(1)(viia) cannot be extended to NBFCs which are vulnerable to economic and financial uncertainties. Secondly, the RBI Directions 1998 are only Disclosure Norms. They require NBFCs to make a Provision for possible loss to be made and disclosed to the public. Such debits are only notional for purposes of disclosure, hence, they cannot be made an excuse for claiming deduction under the IT Act, hence, "add back". Since RBI

Direction 1998 is not applicable to Banks, there is no question of extending the benefit of deduction to NBFCs under Section 36(1)(viia) or under Section 43D. Keeping in mind an important role assigned to banks in our market economy, we are of the view that the restriction, if any placed on NBFC by not giving them the benefit of deduction, satisfies the principle of "reasonable justification".

Before concluding, we may cite the following judgments of this Court in the context of the constitutional validity of Sections 36(1)(viia) and 43D of the IT Act.

In the case of **R.K. Garg v. Union of India (1981) 4 SCC 675** this Court held that every legislation, particularly in economic matters, is essentially empiric and it is based on experimentation. There may be possibilities of abuse but on that account alone it cannot be struck down as invalid. These can be set right by the legislature by passing amendments. The Court must, therefore, adjudge the constitutionality of such legislation by the generality of its provisions. Laws relating to economic activities should be viewed with greater latitude than laws touching civil rights such as freedom of speech, religion, etc. Moreover, there is a presumption in favour of the constitutionality of a statute and the burden is upon him who attacks it to show that there has been a clear transgression of the constitutional principles. The legislature understands and correctly appreciates the needs of its own people, its laws are directed to problems made manifest by experience and its discrimination is based on adequate grounds. There may be cases where the legislation can be condemned as arbitrary or irrational, hence, violative of Article 14. But the test in every case would be whether the provisions of the Act are arbitrary and irrational having regard to all the facts and circumstances of the case. Immorality, by itself, cannot be a constitutional challenge as morality is essentially a subjective value. The terms "reasonable, just and fair" derive their significance from the existing social conditions.

In the case of **Bhavesh D. Parish v. Union of India,** (2000) 5 SCC 471, this Court laid down that while considering the scope of economic legislation as well as tax legislation, the courts must bear in mind that unless the provision is manifestly unjust or glaringly unconstitutional, the courts must show judicial restraint in interfering with its applicability. Merely because a statute comes up for examination and some arguable point is raised, the legislative will should not be put under a cloud. It is now well settled that there is always a presumption in favour of the constitutional validity of any legislation unless the same is set aside for breach of the provisions of the Constitution. The system of checks and balances has to be utilised in a balanced manner with the primary objective of accelerating economic growth rather than suspending its growth by doubting its constitutional efficacy at the threshold itself.

In the case of **State of Madras v. V.G. Row** 1952 SCR 597**,** this Court observed as follows:

> "It is important in this context to bear in mind that the test of reasonableness, wherever prescribed, should be applied to each individual statute impugned, and no abstract standard, or general pattern of reasonableness can be laid down as applicable to all cases. The nature of the right alleged to have been infringed, the underlying purpose of the restrictions imposed, the extent and urgency of the evil sought to be remedied thereby, the disproportion of the imposition, the prevailing conditions at the time, should all enter into the judicial verdict."

In the case of **Barclays Mercantile Business Finance Ltd. v. Mawson (Inspector of Taxes)**, 2005 (1) All ER 97, the House of Lords observed that "a tax is generally imposed by reference to economic activities or transactions which exist in the real world". When an economic activity is to be valued, it is open to the law makers to take into account various factors like public investments, disclosure and transparency in the matter of maintenance of accounts, reflection of true and correct profits, etc. This is precisely what is done by RBI Directions 1998.

Conclusion

For the afore-stated reasons, we find no merit in the Civil Appeals filed by the NBFCs, so also in the Transferred Cases, and, accordingly, the same are dismissed with no order as to costs.

………………………..J.
(S. H. Kapadia)

………………………..J.
(Aftab Alam)

New Delhi;
January 11, 2010