

IN THE SUPREME COURT OF INDIA
 CIVIL APPELLATE JURISDICTION
CIVIL APPEAL No. 2206 OF 2009
 (arising out of S.L.P.(C) No. 593 of 2008)

Commissioner of Income Tax, Delhi ... Appellant (s)

versus

M/s Woodward Governor India P. Ltd. ... Respondent(s)

with

CIVIL APPEAL No. 2214 OF 2009
 (arising out of S.L.P.(C) No. 7632 of 2008)

Commissioner of Income Tax, Delhi ... Appellant (s)

versus

M/s Honda Siel Power Products Ltd. ... Respondent(s)

with

Civil Appeal No. 2212 /09 @ SLP (C) No. 4708/08
 Civil Appeal No. 2207/09 @ SLP (C) No. 18967/08
 Civil Appeal No. 2213/09 @ SLP (C) No. 6911/08
 Civil Appeal No. 2226 /09 @ SLP (C) No. 6321/09
 Civil Appeal No. 2215/09 @ SLP (C) No. 24601/08
 Civil Appeal No. 2210/09 @ SLP (C) No. 2159/09
 Civil Appeal No. 2235/09 @ SLP (C) No. 25893/08
 Civil Appeal No. 2208/09 @ SLP (C) No. 1300/09
 Civil Appeal No. 2209/09 @ SLP (C) No. 1297/09
 Civil Appeal No. 2211/09 @ SLP (C) No. 850/09
 Civil Appeal No. 2216/09 @ SLP (C) No. 4752/09
 Civil Appeal No. 2217/09 @ SLP (C) No. 8924/08
 Civil Appeal No. 2218/09 @ SLP (C) No. 9819/08
 Civil Appeal No. 2219/09 @ SLP (C) No. 14194/08
 Civil Appeal No. 2220/09 @ SLP (C) No. 14199/08
 Civil Appeal No. 2221/09 @ SLP (C) No. 16124/08
 Civil Appeal No. 2222/09 @ SLP (C) No. 2155/09
 Civil Appeal No. 2223/09 @ SLP (C) No. 16086/08
 Civil Appeal No. 2224/09 @ SLP (C) No. 899/09
 Civil Appeal No. 2225/09 @ SLP (C) No. 5013/09
 Civil Appeal No. 2227/09 @ SLP (C) No. 11516/08

Civil Appeal No.2228/09 @ SLP (C) No. 11534/08
Civil Appeal No. 2229/09 @ SLP (C) No. 11530/08
Civil Appeal No. 2230/09 @ SLP (C) No. 11517/08
Civil Appeal No. 2231/09 @ SLP (C) No. 11524/08
Civil Appeal No. 2232/09 @ SLP (C) No. 11535/08
Civil Appeal No.2233/09 @ SLP (C) No. 11518/08
Civil Appeal No. 223409 @ SLP (C) No. 11523/08
Civil Appeal No. 2237/09 @ SLP (C) No. 8718 /09 (CC No. 2868/09)
Civil Appeal No. 2236/09 @ SLP (C) No. 8717/09 (CC No. 3007/09)
Civil Appeal No. 2238/09 @ SLP (C) No. 8719 /09 (CC No. 1999/09)

J U D G M E N T

S.H. KAPADIA, J.

Delay condoned.

2. Leave granted.

3. In this batch of civil appeals, the following question arises for determination:

- (i) Whether, on the facts and circumstances of the case and in law, the additional liability arising on account of fluctuation in the rate of exchange in respect of loans taken for revenue purposes could be allowed as deduction under Section 37(1) in the year of fluctuation in the rate of exchange or whether the same could only be allowed in the year of repayment of such loans?**
- (ii) Whether the assessee is entitled to adjust the actual cost of imported assets acquired in foreign currency on account of fluctuation in the rate of exchange at each balance sheet date, pending actual payment of the varied liability?**

4. At the outset, for the sake of convenience, we may state that in this batch of civil appeals broadly we have before us two categories. In the first category, we are concerned with exchange differences arising in foreign currency transaction on

revenue items. In such category, we are concerned with the assessee(s) incurring loss on revenue account. In that category, we are concerned with the provisions of Sections 28, 29, 37(1) and 145 of the Income-tax Act, 1961 (“1961 Act”). In the second category of cases, we are concerned with exchange differences arising on repayment of liabilities incurred for the purpose of acquiring fixed assets. In other words, in the second category of cases, we are concerned with the assessee(s) incurring liabilities on capital account. In such cases, we are required to consider the provisions of Section 43(1), 43A (both, before and after Amendment *vide* Finance Act, 2002).

Facts in M/s Woodward Governor India P. Ltd.
[Civil Appeal arising out of SLP(C) No. 593/08]
– REVENUE ACCOUNT CASE:

5. The assessee filed its Return of Income on 28.1.1998 for the assessment year 1998-99 on a total income of Rs. 1,10,28,190.00. That return was processed under Section 143(1)(a) on 23.3.1999. On 16.8.1999 a notice under Section 143(2) was issued to the assessee stating that in the course of assessment proceedings under Section 143 it was noticed by the Department that the assessee had debited to its Profit & Loss Account a sum of Rs. 41,06,746.00 out of which a sum of Rs. 29,49,088.00 was the unrealized loss due to foreign exchange fluctuation on the last date of the accounting year. The AO held that the liability as on the last date of the previous year under consideration was a contingent liability, it was not an ascertained liability and consequently it had to be added back to the total income of the assessee. Accordingly, he added back Rs. 29,49,088.00 being the unrealized loss due to foreign exchange fluctuation. In other words, the debit to the P&L account was disallowed. This order of the AO was upheld by the CIT(A) *vide* decision dated

29.11.2001. Being aggrieved, the assessee went in appeal to the Tribunal. By judgment and order dated 1.4.2005 the Tribunal relying on its earlier decision in the case of M/s Woodward Governor India P. Ltd. for the assessment years 1995-96, 1996-97 and 1997-98 held that the claim of the assessee for deduction of unrealized loss due to foreign exchange fluctuation as on the last date of the previous year had to be allowed. This decision of the Tribunal has been upheld by the Delhi High Court *vide* the impugned judgment dated 30.4.2007, hence, this Civil Appeal is filed by the Department.

6. Shri Parag Tripathi, learned Additional Solicitor General, appearing on behalf of the Department submitted that, in this case, the assessee(s) claims deduction under Section 37, which is a residuary provision, as there is no specific provision dealing with adjustment based on foreign exchange fluctuations on the Revenue account (akin to Section 43A, which deals with such adjustments in the Capital account). According to the learned counsel, the essence of deductibility under Section 37 is that the increase in liability due to foreign exchange fluctuations must fulfill the twin requirements of “expenditure” and the factum of such expenditure having been “laid out or expended”. According to the learned counsel, the expression “expenditure” is “what is paid out” and “something which is gone irretrievably”. In this connection, learned counsel placed reliance on the judgment of this Court in the case of Indian Molasses Co. (Private) Ltd. v. CIT reported in 37 ITR 66. According to the learned counsel, the increase in liability at any point of time prior to payment cannot fall within the meaning of the word “expenditure” in Section 37(1). Therefore, according to the learned counsel, the requirement of expenditure is not met in this case. According to the learned counsel, similarly the requirement of money being “expended or laid out” is also not satisfied and thus

additional liability arising on account of fluctuation in foreign exchange rate is not deductible under Section 37(1).

7. Shri C.S. Aggarwal, learned senior counsel appearing for M/s Woodward Governor India P. Ltd. (Civil Appeal arising out of S.L.P.(C) No. 593/08), submitted that the assessee had debited a sum of Rs. 41,06,748.00 to its P&L account of which a sum of Rs. 29,49,088.00 stood for the unrealized loss due to foreign exchange fluctuation. According to the learned counsel, the assessee has been following mercantile system of accounting. According to the learned counsel, under mercantile system of accounting, which is also known as accrual system of accounting, whenever the amount is credited to the account of the payee (creditor) liability stands incurred by the assessee even though the amount is actually not paid. In this connection, learned counsel placed reliance on the definition of the word “paid” in Section 43(2). According to the learned counsel, in the past in some years when the value of the rupee becomes stronger vis-à-vis US\$, the Department had taxed the gains as income. Therefore, according to the learned counsel, when it comes to “income”, the Department says that accrual is enough for taxability and “payment” is irrelevant but when it comes to “loss”, the Department says that “payment” alone is relevant for taxability. According to the learned counsel, such double standards cannot be countenanced. Learned counsel further gave the following example in support of his contentions:

1. Where amount is borrowed and used in business:

2. The liability thus was, since by way of loan, the increased liability of Rs. 500/- was towards business increased by Rs. 500/- which resulted into business loss as a result of modification of existing liability. Likewise if on fluctuation, the dollar rate is reduced to Rs. 32/- per dollar, the liability will get

reduced by Rs. 300/- and there would be a business gain of Rs. 300/-.

8. In the light of the above illustration, learned counsel urged that when the assessee(s) borrows 100 US\$ on 1.4.1999 he incurs a crystallised liability, however, the value of that liability undergoes a change by 31.3.2000 on account of the fall in the rupee value. In other words, the rate of exchange fluctuated from Rs. 35 per dollar as on 1.4.1999 to Rs. 40 per dollar as on 31.3.2000, thus, increasing the liability of the assessee by Rs.500. According to the learned counsel, the assessee was entitled therefore to deduction under Section 37(1) for such enhanced liability. Similarly, if the dollar rate had reduced from Rs. 35 to Rs. 32 per dollar, then the assessee's liability would stand reduced by Rs. 300 and there would be a gain of Rs. 300 which would become taxable. From this hypothetical example, learned counsel urged that the liability stood incurred on the date on which the assessee borrows 100 \$ which in the above example is 1.4.1999, however, on account of fluctuation in the dollar rate, the liability may enhance or may reduce by 31.3.2000. This has to be taken into account by the Department. The learned counsel submitted that whenever the dollar rate stood reduced, the Department has taxed in the past the business gains, therefore, as a corollary, the Department has to allow deduction in the year in which the assessee incurs business loss on account of the increase in the dollar rate. Therefore, according to the learned counsel, there is no warrant for interfering in the impugned judgment of the High Court.

9. Shri S. Ganesh, learned senior counsel appearing for M/s Maruti Udyog Ltd. (Civil Appeal arising out of SLP (C) No. 18967/08), adopted the argument advanced by Shri C.S. Aggarwal. In addition, he pointed out that the assessee had maintained its accounts right from 1985 on accrual system of accounting. He submitted that during the assessment years 1985-86 to 1989-90 loss claimed was

allowed. It was pointed out on facts that the assessee borrowed loans in dollar and yen. It was pointed out that in the assessment year 1990-91, the dollar rate stood increased but the yen rate stood reduced resulting in gain, which was offered as income and which was accordingly taxed. But when it came to the year in question, namely, assessment year 1991-92, in which year there was a loss on account of fluctuation in the foreign exchange rate, the Department has taken a contradictory stand that accrual of liability is irrelevant and that the year of payment/repayment is relevant. The point which the learned counsel made was that having accepted the system of accounting undertaken by the assessee, it was not open to the Department to introduce a new system of accounting. According to the learned counsel, the liability to repay the loan in US\$ or in yen accrues the moment the contract is entered into. It has nothing to do with the time of payment/repayment. According to the learned counsel, the date of payment has nothing to do with the accrual of liability. According to the learned counsel, at the end of the accounting year, namely, 31.3.1991 the assessee had to value the liability which it had incurred during the accounting year in question. He urged that Section 145 of the Income-tax Act, 1961 ties down the AO to the Accounting System followed by the assessee in the past which accounting system has been accepted by the Department over the years and if the AO seeks to introduce a new system of accounting he has to give reasons in his order pointing out defects in the existing accounting system. Learned counsel pointed out that, in this case, there is no such finding. According to the learned counsel, valuation of asset and liability is a matter of accounting system. The AO cannot depart from the existing accounting system without giving reasons for such departure. According to the learned counsel, the existence of liability stands crystallized on the date of the contract. It has nothing to do with payment and valuation of liability at a later date. According to the learned counsel, the income of

the assessee is decided only in terms of the system of accounting. Therefore, according to the learned counsel, in the facts of the case in M/s Maruti Udyog Ltd., the overall loss suffered by the assessee cannot be disallowed on the ground that such loss has occurred on account of fluctuation in the foreign exchange rate. According to the learned counsel, for the above reasons, there is no need to interfere in the impugned judgment.

10. As stated above, on facts in the case of M/s Woodward Governor India P. Ltd., the Department has disallowed the deduction/debit to the P&L account made by the assessee in the sum of Rs. 29,49,088.00 being unrealized loss due to foreign exchange fluctuation. At the very outset, it may be stated that there is no dispute that in the previous years whenever the dollar rate stood reduced, the Department had taxed the gains which accrued to the assessee on the basis of accrual and it is only in the year in question when the dollar rate stood increased, resulting in loss that the Department has disallowed the deduction/debit. This fact is important. It indicates the double standards adopted by the Department.

11. The dispute in this batch of civil appeals centers around the year(s) in which deduction would be admissible for the increased liability under Section 37(1).

12. We quote hereinbelow Section 28(i), Section 29 Section 37(1) and Section 145 of the 1961 Act, which read as follows:

Profits and gains of business or profession:

Section 28 :

“The following income shall be chargeable to income-tax under the head "Profits and gains of business or profession", -

- (i) the profits and gains of any business or profession

which was carried on by the assessee at any time during the previous year.”

Income from profits and gains of business or profession, how computed:

Section 29:

“The income referred to in section 28 shall be computed in accordance with the provisions contained in sections 30 to 43D.”

General:

Section 37 :

“(1) Any expenditure (not being expenditure of the nature described in sections 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".

Explanation.- For the removal of doubts, it is hereby declared that any expenditure incurred by an assessee for any purpose which is an offence or which is prohibited by law shall not be deemed to have been incurred for the purpose of business or profession and no deduction or allowance shall be made in respect of such expenditure.”

(emphasis supplied)

Method of Accounting:

Section 145:

“(1) Income chargeable under the head "Profits and gains of business or profession" or "Income from other sources" shall, subject to the provisions of sub-section (2), be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee.

(2) The Central Government may notify in the Official Gazette from time to time accounting standards to be followed by any class of assesseees or in respect of any class of income.

(3) Where the Assessing Officer is not satisfied about the correctness or completeness of the accounts of the assessee, or where the method of accounting provided in sub-section (1) or accounting standards as notified under sub-section (2), have not been regularly followed by the assessee, the Assessing Officer may make an assessment in the manner provided in section 144.”

13. As stated above, one of the main arguments advanced by the learned Additional Solicitor General on behalf of the Department before us was that the word “expenditure” in Section 37(1) connotes “what is paid out” and that which has gone irretrievably. In this connection, heavy reliance was placed on the judgment of this Court in the case of *Indian Molasses Company (supra)*. Relying on the said judgment, it was sought to be argued that the increase in liability at any point of time prior to the date of payment cannot be said to have gone irretrievably as it can always come back. According to the learned counsel, in the case of increase in liability due to foreign exchange fluctuations, if there is a revaluation of the rupee vis-à-vis foreign exchange at or prior to the point of payment, then there would be no question of money having gone irretrievably and consequently, the requirement of “expenditure” is not met. Consequently, the additional liability arising on account of fluctuation in the rate of foreign exchange was merely a contingent/notional liability which does not crystallize till payment. In that case, the Supreme Court was considering the meaning of the expression “expenditure incurred” while dealing with the question as to whether there was a distinction between the actual liability in *presenti* and a liability *de futuro*. The word “expenditure” is not defined in the 1961 Act. The word “expenditure” is, therefore, required to be understood in the context in which it is used. Section 37 enjoins that any expenditure not being expenditure of the nature described in Sections 30 to 36 laid out or expended wholly and exclusively for the purposes of the business should be allowed in computing the income chargeable under the head “profits and gains of business”. In Sections 30 to 36, the expressions “expenses incurred” as well as “allowances and depreciation” has also been used. For example, depreciation and allowances are dealt with in Section 32. Therefore, Parliament has used the expression “any expenditure” in Section 37 to cover both. Therefore, the expression “expenditure” as used in Section 37 may, in

the circumstances of a particular case, cover an amount which is really a “loss” even though the said amount has not gone out from the pocket of the assessee.

14. In the case of *M.P. Financial Corporation v. CIT* reported in 165 ITR 765 the Madhya Pradesh High Court has held that the expression “expenditure” as used in Section 37 may, in the circumstances of a particular case, cover an amount which is a “loss” even though the said amount has not gone out from the pocket of the assessee. This view of the Madhya Pradesh High Court has been approved by this Court in the case of *Madras Industrial Investment Corporation Ltd. v. CIT* reported in 225 ITR 802. According to the *Law and Practice of Income Tax by Kanga and Palkhivala*, Section 37(1) is a residuary section extending the allowance to items of business expenditure not covered by Sections 30 to 36. This Section, according to the learned Author, covers cases of business expenditure only, and not of business losses which are, however, deductible on ordinary principles of commercial accounting. (see page 617 of the eighth edition). It is this principle which attracts the provisions of Section 145. That section recognizes the rights of a trader to adopt either the cash system or the mercantile system of accounting. The quantum of allowances permitted to be deducted under diverse heads under Sections 30 to 43C from the income, profits and gains of a business would differ according to the system adopted. This is made clear by defining the word “paid” in Section 43(2), which is used in several Sections 30 to 43C, as meaning actually paid or incurred according to the method of accounting upon the basis on which profits or gains are computed under Section 28/29. That is why in deciding the question as to whether the word “expenditure” in Section 37(1) includes the word “loss” one has to read Section 37(1) with Section 28, Section 29 and Section 145(1). One more principle needs to be kept in mind. Accounts regularly maintained in the course of

business are to be taken as correct unless there are strong and sufficient reasons to indicate that they are unreliable. One more aspect needs to be highlighted. Under Section 28(i), one needs to decide the profits and gains of any business which is carried on by the assessee during the previous year. Therefore, one has to take into account stock-in-trade for determination of profits. The 1961 Act makes no provision with regard to valuation of stock. But the ordinary principle of commercial accounting requires that in the P&L account the value of the stock-in-trade at the beginning and at the end of the year should be entered at cost or market price, whichever is the lower. This is how business profits arising during the year needs to be computed. This is one more reason for reading Section 37(1) with Section 145. For valuing the closing stock at the end of a particular year, the value prevailing on the last date is relevant. This is because profits/loss is embedded in the closing stock. While anticipated loss is taken into account, anticipated profit in the shape of appreciated value of the closing stock is not brought into account, as no prudent trader would care to show increase profits before actual realization. This is the theory underlying the Rule that closing stock is to be valued at cost or market price, whichever is the lower. As profits for income-tax purposes are to be computed in accordance with ordinary principles of commercial accounting, unless, such principles stand superseded or modified by legislative enactments, unrealized profits in the shape of appreciated value of goods remaining unsold at the end of the accounting year and carried over to the following years account in a continuing business are not brought to the charge as a matter of practice, though, as stated above, loss due to fall in the price below cost is allowed even though such loss has not been realized actually. At this stage, we need to emphasise once again that the above system of commercial accounting can be superseded or modified by legislative enactment. This is where Section 145(2) comes into play. Under that section, the

Central Government is empowered to notify from time to time the Accounting Standards to be followed by any class of assessee or in respect of any class of income. Accordingly, under Section 209 of the Companies Act, mercantile system of accounting is made mandatory for companies. In other words, accounting standard which is continuously adopted by an assessee can be superseded or modified by Legislative intervention. However, but for such intervention or in cases falling under Section 145(3), the method of accounting undertaken by the assessee continuously is supreme. In the present batch of cases, there is no finding given by the AO on the correctness or completeness of the accounts of the assessee. Equally, there is no finding given by the AO stating that the assessee has not complied with the accounting standards.

15. For the reasons given hereinabove, we hold that, in the present case, the “loss” suffered by the assessee on account of the exchange difference as on the date of the balance sheet is an item of expenditure under Section 37(1) of the 1961 Act.

16. In the light of what is stated hereinabove, it is clear that profits and gains of the previous year are required to be computed in accordance with the relevant accounting standard. It is important to bear in mind that the basis on which stock-in-trade is valued is part of the method of accounting. It is well established, that, on general principles of commercial accounting, in the P&L account, the values of the stock-in-trade at the beginning and at the end of the accounting year should be entered at cost or market value, whichever is lower – the market value being ascertained as on the last date of the accounting year and not as on any intermediate date between the commencement and the closing of the year, failing which it would not be possible to ascertain the true and correct state of affairs. No gain or profit can

arise until a balance is struck between the cost of acquisition and the proceeds of sale. The word “profit” implies a comparison between the state of business at two specific dates, usually separated by an interval of twelve months. Stock-in-trade is an asset. It is a trading asset. Therefore, the concept of profit and gains made by business during the year can only materialize when a comparison of the assets of the business at two different dates is taken into account. Section 145(1) enacts that for the purpose of Section 28 and Section 56 alone, income, profits and gains must be computed in accordance with the method of accounting regularly employed by the assessee. In this case, we are concerned with Section 28. Therefore, Section 145(1) is attracted to the facts of the present case. Under the mercantile system of accounting, what is due is brought into credit before it is actually received; it brings into debit an expenditure for which a legal liability has been incurred before it is actually disbursed. (see judgment of this Court in the case of United Commercial Bank v. CIT reported in 240 ITR 355). Therefore, the accounting method followed by an assessee continuously for a given period of time needs to be presumed to be correct till the AO comes to the conclusion for reasons to be given that the system does not reflect true and correct profits. As stated, there is no finding given by the AO on the correctness of the accounting standard followed by the assessee(s) in this batch of Civil Appeals.

17. Having come to the conclusion that valuation is a part of the accounting system and having come to the conclusion that business losses are deductible under Section 37(1) on the basis of ordinary principles of commercial accounting and having come to the conclusion that the Central Government has made Accounting Standard-11 mandatory, we are now required to examine the said Accounting Standard (“AS”).

18. AS-11 deals with giving of accounting treatment for the effects of changes in foreign exchange rates. AS-11 deals with effects of Exchange Differences. Under para 2, reporting currency is defined to mean the currency used in presenting the financial statements. Similarly, the words “monetary items” are defined to mean money held and assets and liabilities to be received or paid in fixed amounts, e.g., cash, receivables and payables. The word “paid” is defined under Section 43(2). This has been discussed earlier. Similarly, it is important to note that foreign currency notes, balance in bank accounts denominated in a foreign currency, and receivables/payables and loans denominated in a foreign currency as well as sundry creditors are all monetary items which have to be valued at the closing rate under AS-11. Under para 5, a transaction in a foreign currency has to be recorded in the reporting currency by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the transaction. This is known as recording of transaction on Initial Recognition. Para 7 of AS-11 deals with reporting of the effects of changes in exchange rates subsequent to initial recognition. Para 7(a) *inter alia* states that on each balance sheet date monetary items, enumerated above, denominated in a foreign currency should be reported using the closing rate. In case of revenue items falling under Section 37(1), para 9 of AS-11 which deals with recognition of exchange differences, needs to be considered. Under that para, exchange differences arising on foreign currency transactions have to be recognized as income or as expense in the period in which they arise, except as stated in para 10 and para 11 which deals with exchange differences arising on repayment of liabilities incurred for the purpose of acquiring fixed assets, which topic falls under Section 43A of the 1961 Act. At this stage, we are concerned only with para 9 which deals with revenue items. Para 9 of AS-11

recognises exchange differences as income or expense. In cases where, e.g., the rate of dollar rises vis-à-vis the Indian rupee, there is an expense during that period. The important point to be noted is that AS-11 stipulates effect of changes in exchange rate vis-à-vis monetary items denominated in a foreign currency to be taken into account for giving accounting treatment on the balance sheet date. Therefore, an enterprise has to report the outstanding liability relating to import of raw materials using closing rate of exchange. Any difference, loss or gain, arising on conversion of the said liability at the closing rate, should be recognized in the P&L account for the reporting period.

19. A company imports raw material worth US \$ 250000 on 15.1.2002 when the exchange rate was Rs. 46 per US \$. The company records the transaction at that rate. The payment for the imports is made on 15.4.2002 when the exchange rate is Rs. 49 per US \$. However, on the balance sheet date, 31.3.2002, the rate of exchange is Rs. 50 per US \$. In such a case, in terms of AS-11, the effect of the exchange difference has to be taken into P&L account. Sundry creditors is a monetary item and hence such item has to be valued at the closing rate, i.e. Rs. 50 at 31.3.2002, irrespective of the payment for the sale subsequently at a lower rate. The difference of Rs. 4 (50-46) per US \$ is to be shown as an exchange loss in the P&L account and is not to be adjusted against the cost of raw materials.

20. In the case of *Sutlej Cotton Mills Ltd. v. CIT* reported in 116 ITR 1 this Court has observed as under:

“The law may, therefore, now be taken to be well settled that where profit or loss arises to an assessee on account of appreciation or depreciation in the value of foreign currency held by it, on conversion into another currency, such profit or loss would ordinarily be a trading profit or loss if the foreign currency is held by the assessee on revenue

account or as a trading asset or as a part of circulating capital embarked in the business. But, if on the other hand, the foreign currency is held as a capital asset or as fixed capital, such profit or loss would be of capital nature.”

(emphasis supplied)

21. In conclusion, we may state that in order to find out if an expenditure is deductible the following have to be taken into account (i) whether the system of accounting followed by the assessee is mercantile system, which brings into debit the expenditure amount for which a legal liability has been incurred before it is actually disbursed and brings into credit what is due, immediately it becomes due and before it is actually received; (ii) whether the same system is followed by the assessee from the very beginning and if there was a change in the system, whether the change was bona fide; (iii) whether the assessee has given the same treatment to losses claimed to have accrued and to the gains that may accrue to it; (iv) whether the assessee has been consistent and definite in making entries in the account books in respect of losses and gains; (v) whether the method adopted by the assessee for making entries in the books both in respect of losses and gains is as per nationally accepted accounting standards; (vi) whether the system adopted by the assessee is fair and reasonable or is adopted only with a view to reducing the incidence of taxation.

Facts in M/s Honda Siel Power Products Ltd.

[Civil Appeal arising out of SLP(C) No. 7632/08]

– CAPITAL ACCOUNT CASE:

22. The main issue which arises for determination in this batch of civil appeals is: whether the assessee was entitled to adjust the actual cost of imported assets acquired in foreign currency on account of fluctuation in the rate of exchange at each balance sheet date pending actual payment of the varied liability. In this batch of civil appeals, we are concerned with increase in the existing liability on

account of foreign exchange fluctuations on “capital account”.

23. Before coming to the arguments, we quote hereinbelow Section 43A, as it stood prior to 1.4.2003:

“43A. *Special provisions consequential to changes in rate of exchange of currency*—(1) Notwithstanding anything contained in any other provision of this Act, where an assessee has acquired any asset from a country outside India for the purposes of his business or profession and, in consequence of a change in the rate of exchange at any time after the acquisition of such asset, there is an increase or reduction in the liability of the assessee as expressed in Indian currency for making payment towards the whole or a part of the cost of the asset or for repayment of the whole or a part of the moneys borrowed by him from any person, directly or indirectly, in any foreign currency specifically for the purpose of acquiring the asset (being in either case the liability existing immediately before the date on which the change in the rate of exchange takes effect), the amount by which the liability aforesaid is so increased or reduced during the previous year shall be added to, or, as the case may be, deducted from, the actual cost of the asset as defined in clause (1) of section 43 or the amount of expenditure of a capital nature referred to in clause (iv) of sub-section (1) of section 35 or in section 35A or in clause (ix) of sub-section (1) of section 36, or, in the case of a capital asset (not being a capital asset referred to in section 50), the cost of acquisition thereof for the purposes of section 48, and the amount arrived at after such addition or deduction shall be taken to be the actual cost of the asset or the amount of expenditure of a capital nature or, as the case may be, the cost of acquisition of the capital asset as aforesaid.”

24. We also quote hereinbelow Section 43A, as it stands in the Statute book after substitution by the Finance Act 2002 w.e.f. 1.4.2003:

“43A. Notwithstanding anything contained in any other provision of the Act, where an assessee has acquired any asset in any previous year from a country outside India for the purposes of his business or profession and, in consequence of a change in the rate of exchange during any previous year after the acquisition of such asset, there is an increase or reduction in the liability of the assessee as expressed in Indian currency (as compared to the liability existing at the time of acquisition of the asset) at the time of making payment.”

(emphasis supplied)

25. We also quote hereinbelow provisions of Section 43(1):

“43. In sections 28 to 41 and in this section, unless the context otherwise requires –

(1) “actual cost” means the actual cost of the assets to the assessee, reduced by that portion of the cost thereof, if any, as has been met directly or indirectly by any other person or authority.”

26. Shri Parag Tripathi, learned Additional Solicitor General appearing on behalf of the Department, submitted that in Section 43A (as it stood prior to Finance Act, 2002) the expression “for making payment” is in the context of increase or decrease of liability and the same hinges on “making the payment towards the whole or a part of ...”. According to the learned counsel, the expression “towards the whole or a part of” makes it clear that Section 43A as it stood referred to whole or a part of the payment and therefore to the point of payment. According to the learned counsel, under the pre-amended Section 43A, the effect of increase or decrease of liability arose only at the point of payment because the point of accrual shifted to the point of payment. In this connection, learned counsel urged that the difference between accrual and payment of a liability is that normally the point of accrual and the point of payment represent two different time milestones. However, according to the learned counsel, in the case of a contingent liability, like that of foreign exchange fluctuations, the point of accrual and the point of payment become the same. According to the learned counsel, under the pre-amended dispensation of Section 43A, the effect of increase or decrease of liability could only arise at the point of payment, as the point of accrual shifts to the point of payment.

27. Learned counsel next contended that on a proper and true interpretation of the amendment to Section 43A, introduced by Finance Act, 2002, Section 43A is clarificatory. According to the learned counsel, the occasion for the clarificatory amendment arose in view of the judgments of the various High Courts, which interpreted the unamended provision as laying down the proposition that in case of

increase or decrease of liability due to foreign exchange fluctuations, the same is to be recognized at the end of each financial year, irrespective of whether such “incremental liability” had accrued and had been paid or not. According to the learned counsel, Section 43A, as amended, recognizes the fact that in case of foreign exchange fluctuations, the accrual of liability is co-terminus with the payment of liability and therefore the amendment to Section 43A is clarificatory and not amendatory, notwithstanding the fact that the amendment operates w.e.f. 1.4.2003.

28. In reply, Shri Ajay Vohra, learned counsel appearing on behalf of the assessee, submitted that Section 43A (even prior to the amendment) was inserted to provide for adjustment in the actual cost of assets pursuant to change in foreign currency exchange rates. As a consequence of Section 43A (unamended), it became possible to adjust to increase/decrease in liability relating to acquisition of capital assets on account of exchange rate fluctuation, in the actual cost of the assets acquired in foreign currency and for depreciation to be allowed with reference to such increased/decreased cost. According to the learned counsel, the provisions of Section 43A (unamended) are *pari materia* with para 10 of AS-11 which *inter alia* provides for adjustment in the carrying cost of fixed assets acquired in foreign currency, due to foreign exchange fluctuation at each balance sheet date. In this connection, learned counsel has placed reliance on the judgment of this Court in the case of CIT v. Arvind Mills Ltd. reported in 193 ITR 255.

29. To answer the controversy, we need to analyse Section 43A (unamended). The period in question in the batch of Civil Appeals is prior to Finance Act, 2002, therefore, we are required to consider the scope of Section 43A (unamended).

30. Section 43A starts with a *non obstante* clause. Section 43A(1) overrides the other provisions only as regards cases falling under that sub-section. For instance, in a case where the asset is acquired, or the liability to pay in foreign exchange arises, *after* the change in the rate of exchange, the said sub-section has no application and the general principles of law must be applied in deciding whether the actual cost is increased or reduced as a result of such change. In other words, Section 43A(1) applies only where as a result of change in the rate of exchange there is an increase or reduction in the liability of the assessee in terms of the Indian rupee to pay the price of any asset payable in foreign exchange or to repay moneys borrowed in foreign currency specifically for the purpose of acquiring the asset. Section 43A(1), therefore, has no application unless the asset is acquired and the liability existed, *before* the change in the rate of exchange takes effect. In such a case, Section 43A contemplates recomputation of the cost of the assets for the purposes of depreciation [Sections 32 and 43(1)], and also as regards capital assets for scientific research [Section 35(1)(iv)] and also regarding patent rights or copyrights [Section 35A].

31. As held in Arvind Mills case (*supra*) increase or decrease in liability in the repayment of foreign loan should be taken into account to modify the figure of actual cost in the year in which the increase or decrease in liability arises on account of the fluctuation in the rate of exchange. Thus, the adjustments in the actual cost are to be made irrespective of the date of actual payment in foreign currency made by the assessee. This position also finds place in the clarification issued by the Ministry of Finance dated 4.1.1967 which *inter alia* reads as under:

“2. The Government agrees that for the purposes of the calculation of depreciation allowance, the cost of capital assets imported before the date of devaluation should be written off to the extent of the full amount of the additional rupee liability incurred on account of devaluation and not what is actually paid from year to year. The

proposed legal provision in the matter is intended to be framed on this basis.”

(emphasis supplied)

32. One more aspect needs to be mentioned. Section 43(1) defines actual cost for the purpose of grant of depreciation etc. to mean “the actual cost of the assets to the assessee”. Till the insertion of the unamended Section 43A there was no provision in the Income-tax Act for adjustment of the actual cost which was fixed once and for all, at the time of acquisition of the asset. Accordingly, no adjustment could be made in the actual cost of the assets for purposes of grant of depreciation for any increase/decrease of liability subsequently arising due to exchange fluctuation. Consequently, Section 43A was introduced in the Act by Finance Act, 1967 w.e.f. 1.4.1967 in the above terms to provide for adjustment in the actual cost of assets pursuant to change in the foreign currency exchange rates. As a consequence of the insertion of the said section, it became possible to adjust the increase/decrease in liability relating to acquisition of capital assets on account of exchange rate fluctuation, in the actual cost of the assets acquired in foreign currency and for, *inter alia*, depreciation to be allowed with reference to such increased/decreased cost. This position is also made clear by Circular No. 5-P dated 9.10.1967 issued by CBDT. One more point needs to be mentioned. Section 43A (unamended) corresponds to para 10 of AS-11 similarly providing for adjustment in the carrying cost of fixed assets acquired in foreign currency, due to foreign exchange fluctuation at each balance sheet date. The relevant para reads as follows:

“10. Exchange differences arising on repayment of liabilities incurred for the purpose of acquiring fixed assets, which carried in terms of historical cost, should be adjusted in the carrying amount of the respective fixed assets. The carrying amount of such fixed assets should, to the extent not already so adjusted or otherwise accounted for, also be adjusted to account for any increase or decrease in the liability of the enterprise, as expressed in the reporting currency by applying the closing rate, for making payment towards the whole or a part of the cost of the

assets or for repayment of the whole or a part of the monies borrowed by the enterprise from any person, directly or indirectly, in foreign currency specifically for the purpose of acquiring those assets.”

33. As stated above, what triggers the adjustment in the actual cost of the assets, in terms of unamended Section 43A of the 1961 Act is the change in the rate of exchange subsequent to the acquisition of asset in foreign currency. The section mandates that at any time there is change in the rate of exchange, the same may be given effect to by way of adjustment of the carrying cost of the fixed assets acquired in foreign currency. But for Section 43A which corresponds to para 10 of AS-11 such adjustment in the carrying amount of the fixed assets was not possible, particularly in the light of Section 43(1). The unamended Section 43A nowhere required as condition precedent for making necessary adjustment in the carrying amount of the fixed asset that there should be actual payment of the increased/decreased liability as a consequence of the exchange variation. The words used in the unamended Section 43A were “for making payment” and not “on payment” which is now brought in by amendment to Section 43A *vide* Finance Act, 2002.

34. Lastly, we are of the view that amendment of Section 43A by the Finance Act, 2002 w.e.f. 1.4.2003 is amendatory and not clarificatory. The amendment is in complete substitution of the section as it existed prior thereto. Under the unamended Section 43A adjustment to the actual cost took place on the happening of change in the rate of exchange whereas under the amended Section 43A the adjustment in the actual cost is made on cash basis. This is indicated by the words “at the time of making payment”. In other words, under the unamended Section 43A, “actual payment” was not a condition precedent for making necessary adjustment in the carrying cost of the fixed asset acquired in foreign currency, however, under

amended Section 43A w.e.f. 1.4.2003 such actual payment of the decreased/enhanced liability is made a condition precedent for making adjustment in the carrying amount of the fixed asset. This indicates a complete structural change brought about in Section 43A *vide* Finance Act, 2002. Therefore, the amended section is amendatory and not clarificatory in nature.

Conclusion:

35. For reasons given hereinabove, we find no infirmity in the impugned judgments of the Delhi High Court and accordingly the Civil Appeals filed by the Department stand dismissed with no order as to costs.

.....J.
(S. H. Kapadia)

.....J.
(Aftab Alam)

New Delhi;
April 8, 2009.

1.4.1999	- "X" borrows \$ 100/- - debits the loan A/c by Rs. 3500/- (at Rs. 35/- per dollar) on the basis of prevailing market rate. - Amount borrowed is utilized in business.
31.3.2000	- Rate of exchange fluctuated and it became Rs. 40/- per Dollar. - Liability increased by Rs. 500/-.

ITEM NO. 1-A
Judgment)

(For

COURT No.3

SECTION IIIA

**SUPREME COURT OF INDIA
RECORD OF PROCEEDINGS**

Civil Appeal No.2206 of 2008 @ SLP(C)No. 593 of 2008

Commissioner of Income Tax, Delhi

.. **Appellant(s)**

Versus

M/s Woodward Governor India P. Ltd.

.. **Respondent(s)**

WITH

Civil Appeal No. 2214/09 @ SLP (C) No. 7632/08

Civil Appeal No. 2212/09 @ SLP (C) No. 4708/08

Civil Appeal No. 2207 /09 @ SLP (C) No. 18967/08

Civil Appeal No. 2213/09 @ SLP (C) No. 6911/08

Civil Appeal No. 2226/09 @ SLP (C) No. 6321/09

Civil Appeal No. 221509 @ SLP (C) No. 24601/08

Civil Appeal No. 2210/09 @ SLP (C) No. 2159/09

Civil Appeal No. 2235/09 @ SLP (C) No. 25893/08

Civil Appeal No. 2208/09 @ SLP (C) No. 1300/09

Civil Appeal No. 2209/09 @ SLP (C) No. 1297/09

Civil Appeal No. 2211/09 @ SLP (C) No. 850/09

Civil Appeal No. 2216/09 @ SLP (C) No. 4752/09

Civil Appeal No. 2217/09 @ SLP (C) No. 8924/08

Civil Appeal No. 2218/09 @ SLP (C) No. 9819/08

Civil Appeal No. 2219/09 @ SLP (C) No. 14194/08

Civil Appeal No. 2220/09 @ SLP (C) No. 14199/08

Civil Appeal No. 2221/09 @ SLP (C) No. 16124/08

Civil Appeal No. 2222/09 @ SLP (C) No. 2155/09

Civil Appeal No. 2223/09 @ SLP (C) No. 16086/08

Civil Appeal No. 2224/09 @ SLP (C) No. 899/09

Civil Appeal No. 2225/09 @ SLP (C) No. 5013/09

Civil Appeal No. 2227/09 @ SLP (C) No. 11516/08

Civil Appeal No. 2228/09 @ SLP (C) No. 11534/08

Civil Appeal No. 2229/09 @ SLP (C) No. 11530/08

Civil Appeal No. 2230/09 @ SLP (C) No. 11517/08

Civil Appeal No. 2231/09 @ SLP (C) No. 11524/08

Civil Appeal No. 2232/09 @ SLP (C) No. 11535/08

Civil Appeal No. 2233/09 @ SLP (C) No. 11518/08

Civil Appeal No. 2234/09 @ SLP (C) No. 11523/08

Civil Appeal No. 2237/09 @ SLP (C) No. 8718/09 (CC No. 2868/09)

Civil Appeal No. 2236/09 @ SLP (C) No. 8717 /09 (CC No. 3007/09)

Civil Appeal No.2238/09 @ SLP (C) No.8719/09 (CC No. 1999/09)

DATE : 08/04/2009 These matters were called on for pronouncement of judgment today.

For Petitioner(s) Ms. Arti Gupta, Adv.
Mr. Kunal Bahri, Adv.
Ms. Anubha Agrawal, Adv.
Mr. Arijit Prasad, Adv.
Mr. H.R. Rao, Adv.
Ms. Shweta Garg, Adv.
Ms. Ashish Gopal Garg, Adv.
Mr. B.V. Balaram Das, Adv.

in 20900/2007: Mr. Ajay Vohra, Adv.
Ms. Kavita Jha, Adv.
Mr. Sandeep S. Karhail, Adv.

For Respondent(s) Mr. Bhargava V. Desai, Adv.
Mr. Rahul Gupta, Adv.
Ms. Reema Sharma, Adv.
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in 18967/2008: Mr. S. Sukumaran, Adv.
Ms. Meera Mathur
Mr. Anand Sukumar, Adv.

in 14199/2008: Mr. Ajay Vohra, Adv.
Ms. Kavita Jha, Adv.
Mr. Sandeep S. Karhail, Adv.

Hon'ble Mr. Justice S.H. Kapadia pronounced the judgment of the Bench comprising his Lordship and Hon'ble Mr. Justice Aftab Alam.

Delay condoned.

Leave granted.

The Civil Appeals filed by the Department stand dismissed in terms of the signed judgment which is placed on the file. There shall be no order as to costs.

[S. Thapar]
PS to Registrar

[Madhu Saxena]
Court Master

[Signed reportable judgment is placed on the file]