



Supreme Court ruled that the provision for warranty is an allowable expenditure

Recently, in the case of Rotork Controls India (P) Ltd.¹ the Supreme Court (SC) held that the provision made for the likely warranty claim in relation to the sophisticated equipments is allowable as business expenditure under section 37(1) of the Income-tax Act, 1961 (the Act) and it cannot be considered as contingent liability.

Facts of the case

- The taxpayer company was in the business of sophisticated valve actuators. At the time of sale, taxpayer was providing a standard warranty to the customers. This warranty was valid till 12 months from the date of commissioning or 18 months from the date of dispatch whichever is earlier.
- The taxpayer was rectifying or replacing the defective part free of charge and the provision for the warranty was created by the taxpayer on account of warranty claims likely to arise on the sales affected by it.
- The statistical data over the years also indicated that being sophisticated item no customer was prepared to buy valve actuator without a warranty. Therefore, warranty was integral part of the sale price of the valve actuators. In other words, warranty stood attached to the sale price of the product.
- The taxpayer was utilising the provision amount by actual expenditure incurred by it and was claiming only the actual expenditure under section 37 of the Act. Further, the excess in the provision account at the end of warranty period was offered to tax. The above method was followed consistently by the taxpayer.

¹ Rotork Controls India (P) Ltd. v. CIT (Civil Appeal no. 3506-3510 of 2009 dated 12 May 2009)

- The Assessing Officer (AO) and Commissioner of Income tax (Appeals) [CIT(A)] disallowed the above treatment on the grounds that the liability was merely a contingent liability not allowable as a deduction under Section 37 of the Act whereas the Income tax Appellate Tribunal (the Tribunal) allowed the above expenditure.
- However, the High Court rejected decision of the Tribunal and held that the taxpayer was not entitled to deduction as:
 - No obligation was ever cast on the date of sale, and hence, there was no accrual of liability
 - The liability was not confirmed on the date of sale
 - Since the liability was not crystallised against the taxpayer the provision was created for the unascertained liability

Issue before the Supreme Court

- Whether the provision created by the taxpayer on account of warranty claims expected to arise was allowable as business expenditure under section 37 of the Act?

Taxpayer's Contentions

- The provision of the warranty claim likely to arise was calculated on a scientific basis and such method was consistently followed by the taxpayer from last several years.
- The taxpayer was following the concept of 'reversal' wherein the excess provision created as against the claim of the customer was offered to tax in the next year. Thus, there was no escapement of income and the entire process was revenue neutral.
- The taxpayer was making the provision for warranty claims as per the commercial accounting principles.
- Looking at the line of business of the taxpayer, a certain item of expenditure (warranty claim) was bound to incur year after year in different degrees. Hence, the liability would be arisen and therefore, it cannot be considered as contingent liability.
- Thus, the provision so created should be allowed as business expenditure under section 37 of the Act.

Tax Department's contentions

- Provision for warranty was towards unforeseen liability, which was neither certain nor it could be foreseen with precision in the relevant year and hence, claim of warranty as well as liability in respect thereof was contingent.

- Section 37 of the Act refers to “deduction permissible on account of actual expenditure incurred”. Therefore, the contingent liability is not allowable under section 37 of the Act.
- The goods sold may be defective or may not be defective and, therefore, warranty provision was made only to earn goodwill and stay in business.
- The amount provided for or kept apart cannot be held to be expenditure, actually incurred and consequently deduction was not admissible.
- Accounting treatment cannot decide whether the warranty claim was actual liability, accrued liability or contingent liability. The taxpayer cannot claim deduction by merely making an entry in its books of accounts or by making a mere provision in its books of accounts

The SC’s Ruling

- The SC held that the provision is a liability which can be measured only by using a substantial degree of estimation. A provision is recognised when -
 - an enterprise has a present obligation as a result of a past event;
 - it is probable that an outflow of resources will be required to settle the obligation; and
 - a reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision can be recognised.

- Liability was defined as a present obligation arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits and the past event that leads to a present obligation is called as an obligating event. Thus, for an obligating event there should be a provision.
- In the present case, the provision created for estimated warranty claims was a present obligation, which had arisen due to the past event i.e. sale of the equipments. Further, it had resulted into an outflow of resources i.e. expenses towards repairs and replacement of the equipments, which had been reliably estimated by the taxpayer based on the past trend. Accordingly, the SC held that obligation towards warranty was a provision.
- The SC also held that provision created based on the past experience and past data was the most appropriate basis since it had fulfilled both the accrual concept and matching concept. Further, the argument for claiming deduction in the year in which it incurred was not sustainable as it was against the mercantile system of accounting.

- In the case of a manufacture and sale of one single item the provision for warranty could constitute a contingent liability not entitled to deduction under Section 37 of the Act. However, when there was manufacture and sale of an army of items running into thousands of units of sophisticated goods, the past event of defects being detected in some of such items leads to a present obligation which results in an enterprise having no alternative to settling that obligation.
- The taxpayer should scrutinise the past data and trend of the actual expenditure and provision. Based on the above data an appropriate estimate should be made to provide for the warranty. Further, such estimate needs to be reassessed every year.

Our Comments:

This matter has been subject to a long drawn litigation. The SC by upholding the deductibility of provision for warranty has provided a relief to the manufacturing companies who provide for warranty on a scientific basis in respect of obligation incurred in the course of regular business. However, it is important to note that the accounting system followed by the taxpayer should appropriately capture the relationship between the warranty provision and the actual expenditure incurred against the same.

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