



THE HIGH COURT OF DELHI AT NEW DELHI

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Judgment delivered on: 23.09.2008

+ **ITA 301/2007**

**THE COMMISSIONER OF INCOME
TAX DELHI-II**

... Appellant

- versus -

KHAITAN CHEMICALS & FERTILIZERS LTD ... Respondent

Advocates who appeared in this case:

For the Appellant : Mr R.D. Jolly

For the Respondent : Mr Satyen Sethi

CORAM:-

HON'BLE MR JUSTICE BADAR DURREZ AHMED

HON'BLE MR JUSTICE RAJIV SHAKDHER

1. Whether Reporters of local papers may be allowed to see the judgment ? Yes
2. To be referred to the Reporter or not ? Yes
3. Whether the judgment should be reported in Digest ? Yes

BADAR DURREZ AHMED, J (ORAL)

1. This appeal is directed against the order dated 26.03.2006 passed by the Income-tax Appellate Tribunal in ITA No.1261/Del/2004 pertaining to the assessment year 2000-01. After hearing the counsel for the parties, we are of the opinion that the following substantial question of law arises for our consideration:-



“Whether the Income-tax Appellate Tribunal was correct in law in holding that the Assessing Officer failed to appreciate that the net profit (as referred to in Section 115 JA of the Income-tax Act, 1961) of the assessee company is to be computed only after deducting the expenses on prior period / extraordinary items which are business expenditure, but shown separately in the profit and loss account due to the specific requirement of the Accounting Standards prescribed by the Institute of Chartered Accountants of India ?”

2. Consequently, we admit this appeal. The filing of paper books is dispensed with and the counsel for the parties have been heard on the above question.

3. The facts are that the assessee initially filed its return of income on 30.10.2000 declaring a loss of Rs 193.31 lakhs. Due to the merger of Khaitan Soya Limited with the assessee with effect from 01.04.1999, a revised return was filed by the assessee. The assessee calculated the taxes payable as per Section 115 JA of the Income-tax Act, 1961 (hereinafter referred to as ‘the said Act’) and for that purpose the net profit as per the profit and loss account was computed after reducing prior period expenses / extraordinary items and profit from generation of power plant and the resultant book profit was indicated as



	Khaitan Chemicals & Fertilizers (lacs)	Khaitan Soya Ltd. (lacs)	Total
Net Profit as per P&L A/c	220.33	20.33	240.56
Less: Prior Period Expenses / Extra Ordinary Items	0.82	57.21	58.03
Less: Profit from Generation of Power	80.64	0	80.64
Resultant Book Profit	133.87	(-) 36.99	101.88

It is pertinent to mention that the item 'profit from generation of power' is not in issue before us nor was it in issue before the Tribunal.

4. Looking at the table above, the only question that has arisen is with respect to the figure of Rs 58.03 lakhs which has been indicated as prior period expenses / extraordinary items. The case of the revenue is that the net profit would be the figure of Rs 240.56 and the amount of the prior period expenses / extraordinary items cannot be deducted from the same for arriving at the figure of net profits for the purposes of Section 115 JA(2) of the said Act.

5. According to the learned counsel for the revenue, the only deductions that are possible are those which are covered in clauses (i) to (ix) of the Explanation to Section 115 JA(2) of the said Act. Prior



these clauses and, therefore, the net profit would have to be taken as the figure of Rs 240.56 lakhs for the purposes of computing book profit under Section 115 JA(2).

6. The learned counsel for the respondent / assessee has drawn our attention to the provisions of Section 115 JA and in particular to sub-section (2) thereof which reads as under:-

“Deemed income relating to certain companies.

(1) XXXX XXXX XXXX XXXX XXXX.

(2) Every assessee, being a company, shall, for the purposes of this section prepare its profit and loss account for the relevant previous year in accordance with the provisions of parts II and III of Schedule VI to the Companies Act, 1956.”

7. A plain reading of the said provision would show that it stipulates that every assessee, being a company, shall, for the purposes of Section 115 JA, prepare its profit and loss account for the relevant previous year in accordance with the provisions of Parts II and III of Schedule VI to the Companies Act, 1956. The learned counsel then drew our attention to Section 211 of the Companies Act, 1956. Sub-section (1) of Section 211 of the Companies Act, 1956 pertains to balance sheets and it requires that the company shall draw up its balance sheet in the form set out in Part I of Schedule VI. Sub-section



the purposes of this appeal, stipulates that every profit and loss account of a company shall give a true and fair view of the profit and loss of the company for the financial year and shall, subject as indicated in sub-section (1), comply with the requirements of Part II of Schedule VI, so far as they are applicable thereto. Sub-section (3A) of Section 211 stipulates that every profit and loss account and balance sheet of the company shall comply with the accounting standards. Sub-section (3B) provides that where the profit and loss account and the balance sheet of the company do not comply with the accounting standards, such company shall disclose in their profit and loss accounts and balance sheets the following, namely:-

- (a) the deviation from the accounting standards ;
- (b) the reasons for such deviation; and
- (c) the financial effect, if any, arising due to such deviation.

Sub-section (3C) provides that for the purposes of Section 211, the expression “accounting standards” means the standards of accounting recommended by the Institute of Chartered Accountants of India (ICAI) constituted under the Chartered Accountants Act, 1949, as may be prescribed by the Central Government in consultation with the National Advisory Committee on Accounting Standards established under sub-section (1) of Section 210A. This sub-section carries a



ICAI shall be deemed to be the Accounting Standards until the accounting standards are prescribed by the Central Government under this sub-section. It is the contention of the learned counsel for the assessee that since no accounting standards have been prescribed by the Central Government, the Accounting Standards specified by the ICAI would be applicable.

8. A reference was, therefore, made by the learned counsel for the respondent / assessee to Accounting Standards (AS) 5 (hereinafter referred to as 'AS 5') prescribed by ICAI. The said Accounting Standard was revised in 1997 and the revised Accounting Standard would be applicable to the present case inasmuch as it deals with the previous year relating to the assessment year 2000-01. The scope of the said Accounting Standard reveals that it should be applied by an enterprise in presenting profit or loss from ordinary activities, extraordinary items and prior period items in the statement of the profit and loss, in accounting for changes in accounting estimates, and in disclosure of changes in accounting policies. The said AS 5 defines 'prior period items' as under:-

“Prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods.”



Under the head “Net Profit or Loss for the Period”, paragraphs 5 to 7 of

AS 5 read as under:-

“5. All items of income and expense which are recognised in a period should be included in the determination of net profit or loss for the period unless an Accounting Standard requires or permits otherwise.

6. Normally, all items of income and expense which are recognized in a period are included in the determination of the net profit or loss for the period. This includes extraordinary items and the effects of changes in accounting estimates.

7. The net profit or loss for the period comprises the following components, each of which should be disclosed on the face of the statement of profit and loss:

- (a) profit or loss from ordinary activities; and
- (b) extraordinary items.”

Under the head “Prior Period Items”, paragraphs 15 and 19 of the said

Accounting Standard read as under:-

“15. The nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on the current profit or loss can be perceived.

XXXX XXXX XXXX XXXX XXXX XXXX

19. Prior period items are normally included in the determination of net profit or loss for the current period. An alternative approach is to show such items in the statement of profit and loss after determination of current net profit or loss. In either case, the objective is to indicate the effect of such items on the current profit or loss.”



9. In view of the aforesaid Accounting Standard, it was the submission of the learned counsel for the respondent / assessee that the prior period expenses / extraordinary items form part of the net profit or loss of the company. He submitted that they are only to be given separate treatment so that the statement of profit and loss indicates the impact of these items on the current profit or loss. He submitted that this does not mean that the prior period expenses and the extraordinary items are to be treated as deductions from the net profit. He submitted that it is only because separate treatment is to be given to prior period expenses and the extraordinary items that they are shown separately. Net profit is to be computed only after taking into account the prior period expenses and the extraordinary items.

10. Having heard the counsel for the parties, we are of the view that the question which arises in this appeal has to be decided in the affirmative. This means that the Income-tax Appellate Tribunal was correct in law in holding that the Assessing Officer had failed to appreciate that the net profit for the purposes of Section 115 JA of the said Act was to be computed only after deducting the prior period expenses / extraordinary items. We feel that the fundamental flaw that entered into the Assessing Officer's approach was that he was under an impression that the assessee was claiming a reduction in the net profit



The assessee had all along contended that the net profit was to be computed on the basis of the profit and loss account which, in turn, was to be in accordance with the provisions of Parts II and III of Schedule VI to the Companies Act. Such a computation of net profit, in view of the prescribed Accounting Standard (AS 5), required the prior period expenses / extraordinary items to be shown separately. This did not mean that because these items were shown separately, they did not constitute part of net profit. Paragraph 5 of the Accounting Standard (AS 5), which has been extracted above, specifically requires that all items of income and expenses which are “recognised in a period” should be included in the determination of net profit or loss for the period unless an accounting standard requires or permits otherwise. We have already extracted the definition of prior period items as given in AS 5. It clearly stipulates that prior period items are income or expenses which arise “in the current period” as a result of errors or omissions in the preparation of the financial statements of one or more prior periods. Therefore, the income or expenses relating to prior period items are those which arise in the current period, i.e., the period relevant for the purposes of computing the net profit or loss. Clearly, prior period items are to be included in the determination of net profit or loss. Furthermore, paragraph 7 of AS 5 stipulates that the net profit or loss, *inter alia*, comprises of extraordinary items and the same



From this, it is clear that both, ‘prior period items’ as well as ‘extraordinary items’ are to be included in the determination of net profit or loss. If a prior period item is an expense, it is obvious that it will go towards reducing the net profit or increasing the loss, as the case may be. On the other hand, if the prior period item is an income, it would go towards increasing the net profit or reducing the loss, as the case may be. The same is the position with extraordinary items which may be income or expenses. The conclusion that one can arrive at from this discussion is that prior period items and extraordinary items form part of the net profit or loss.

11. Paragraph 15 of AS 5, which has been extracted earlier, makes it clear that the nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on the “current” profit or loss can be perceived. Two approaches have been indicated in paragraph 19 of the said accounting standard (AS 5). The normal approach is to include prior period items in the determination of net profit or loss for the current period. The alternative approach is to show such items in the statement of profit and loss after determination of current net profit or loss. As indicated in the accounting standard, in either case, the objective is to indicate the effect of such items on the current profit or loss. It is obvious that



by the assessee in view of the provisions of Section 115 JA (2) read with Section 211 of the Companies Act, 1956, the assessee was required to show the prior period items / extraordinary items separately so that their impact on the current profit or loss could be perceived. The fact that the assessee adopted the alternative approach of showing such items in the statement of profit and loss after determination of current net profit or loss, does not mean that these items are not to be taken into account in computing net profit as envisaged in Section 115 JA of the said Act. Thus, what the assessee had done was only to indicate prior period items / extraordinary items separately. This did not mean that the figure of net profit was to be arrived at *de hors* these items.

12. The foregoing discussion makes it clear that these items were components of net profit as shown in the profit and loss account prepared under Section 115 JA (2). The assessee was not claiming any reduction in the net profit on the basis of any of the clauses appearing in the Explanation. The assessee's claim was that the prior period items / extraordinary items were, in any event, subsumed in the computation of net profit. It is only that they were to be shown separately so that their impact on the current net profit or loss could be perceived.



13. In view of this discussion, the question is answered in the affirmative and against the revenue. The decision of the Income-tax Appellate Tribunal is upheld and the appeal is dismissed.

BADAR DURREZ AHMED, J

RAJIV SHAKDHER), J

September 23, 2008

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