



★ IN THE HIGH COURT OF DELHI AT NEW DELH

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Reserved on: September 24, 2009. 9

Pronounced on: September 25, 2009.

1. ITA No.843/2007

THE COMMISSIONER OF INCOME TAX .....Appellant

Through: Ms. Prem Lata Bansal, Advocate.

VERSUS

ERICSSON COMMUNICATIONS PVT. LTD. ....Respondent

Through: Mr. M.S.Syali, Senior Advocate with  
Ms. Mahua Kalra, Advocate.

2. ITA NO. 696/2007

THE COMMISSIONER OF INCOME TAX .....Appellant

Through: Ms. Prem Lata Bansal, Advocate.

VERSUS

ERICSSON COMMUNICATIONS PVT. LTD. ....Respondent

Through: Mr. M.S.Syali, Senior Advocate with  
Ms. Mahua Kalra, Advocate.

3. ITA NO. 714/2007

THE COMMISSIONER OF INCOME TAX .....Appellant

Through: Ms. Prem Lata Bansal, Advocate.

VERSUS

ERICSSON COMMUNICATIONS PVT. LTD. ....Respondent



Through: Mr. M.S.Syali, Senior Advocate with  
Ms. Mahua Kalra, Advocate.

4. ITA NO. 721/2007

THE COMMISSIONER OF INCOME TAX .....Appellant  
Through: Ms. Prem Lata Bansal, Advocate.

VERSUS

ERICSSON COMMUNICATIONS PVT. LTD. .... Respondent

Through: Mr. M.S.Syali, Senior Advocate with  
Ms. Mahua Kalra, Advocate.

5. ITA NO. 733/2008

THE COMMISSIONER OF INCOME TAX .....Appellant

Through: Ms. Prem Lata Bansal, Advocate.

VERSUS

ERICSSON COMMUNICATIONS PVT. LTD. ....Respondent

Through: Mr. M.S.Syali, Senior Advocate with  
Ms. Mahua Kalra, Advocate.

**CORAM:**

**HON'BLE MR. JUSTICE A. K. SIKRI**

**HON'BLE MR. JUSTICE VALMIKI J.MEHTA**

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



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**VALMIKI J. MEHTA, J**

1. The common issue which arises in these appeals under Section 260A of the Income Tax, 1961 from the order of the Income Tax Appellate Tribunal is whether the assessee/respondent was entitled to make a provision for warranty charges holding the same to be definite business liability allowable as deduction during the relevant assessment years.

2. The facts of the case are that the assessee company is engaged in the business of installation/erection and setting up/commissioning of various tele-communications projects. In these projects executed by the assessee, the contracts in question provide for warranty clauses in favour of the customers which is the normal industry practice. By virtue of the inclusion of the warranty clauses in the contract, the assessee company sought to make a provision for the anticipated costs of the assessee company's liability under the warranties in respect of the projects executed by it. The amounts thereafter actually paid pursuant to the warranty clauses in the warranty period are subsequently met out of this provision. The assessee company claimed that the expenses to be incurred by the assessee company during the warranty period of the project are provided for by a provision on the basis of technical evaluation carried out and the provision towards expenses is computed scientifically as a percentage of its



total turnover on the basis of its worldwide experience with respect to su  
warranty clauses towards repairs and replacements. The assessee company  
thereafter makes a reversal entry after actual payments against the warranty  
claims from the provision created in preceding year i.e. the balance amount  
except to the extent of actually paid during the warranty period is duly credited  
to the profit and loss account and offered for taxation under Section 41(1) of  
the Act. The business of the assessee company commenced in the assessment  
year 1997-98 when the provision was first made.

3. The only issue which was argued before the Tribunal was whether such a  
provision made for warranty is towards liabilities which are only contingent or  
the same are in present, though the same are discharged at a future date.

4. At the outset, the senior counsel for the respondent has contended that the  
issue in this regard as to whether provision for a warranty is a contingent  
liability or a liability in present is now fully covered in favour of the assessee  
by the decision of the Supreme Court in *Rotork Controls India P. Ltd Vs.  
Commissioner of Income Tax (2009) 314 ITR 62*. In this judgment, the  
Supreme Court has held that where valve actuators were sold by a company and  
for which a warranty was provided by an assessee company then the warranty  
became the integral part of the sale price and consequently the warranty  
provisions had to be recognized because the assessee had a present obligation as



a result of past events resulting in an outflow of resources and a reliable estimate should be made of the amount of the obligation. The Supreme Court, therefore, held that the assessee incurs a liability for which it is entitled to deduction under Section 37 of the Act. The Supreme Court, however, also noted the certain pre conditions which were required to be satisfied before allowing the making of such a provision. The relevant portions of the judgment are reproduced below:

“The present value of a contingent liability, like the warranty expense, if properly ascertained and discounted on accrual basis can be an item of deduction under section 37. The principle of estimation of the contingent liability is not the normal rule. It would depend on the nature of the business, the nature of sales, the nature of the product manufactured and sold and the scientific method of accounting adopted by the assessee. It would also depend upon the historical trend and upon the number of articles produced.”

“A provision is a liability which can be measured only by using a substantial degree of estimation. A provision is recognized when (a) an enterprise has a present obligation as a result of a past event; (b) it is probable that an outflow of resources will be required to settle the obligation, and (c) a reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision can be recognized.”

“The principle is that if the historical trend indicates that a large number of sophisticated goods were being manufactured in the past and the facts show that defects existed in some of the items manufactured and sold, then provision made for warranty in



respect of such sophisticated goods would be entitled to deduction from the gross receipts under section 37.”

5. The learned Senior Counsel for the respondent in the facts of the present appeals further contended by referring to the provisions made and actual loss in the subsequent years that in the subsequent years higher amounts of claims towards warranty in fact took place. The counsel invited our attention to the assessment years 2004-05 and 2005-06 where provisions which were made during the year were Rs.90,412,453/- and Rs.95,279,000/- respectively and against which the actual payments were Rs.60,152,183/- and Rs.64,711,000/-. The learned Senior Counsel contended that consequently in the subsequent years the claims of warranty therefore were a high percentage of the provision made. It was further contended that it is not as if a huge provision is made every year because there is a reversal in each subsequent year i.e. although no doubt in each year provision is made as a percentage of turnover, in net effect, it is only the higher difference if there is a higher turnover, then there is a net additional provision in as much as the extent of provision made in the earlier year which is not paid of as warranty charges is to the extent of not utilised in payment of the warranty claims credited to the profit and loss account. The counsel, therefore, contended that it may appear that every year a huge figure is debited, however, that is in reality not the correct picture. Of course, we may note that even the counsel for the revenue does not dispute this position as



according to her only the difference is being disallowed by the Assesi  
Officer.

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6. In response to the arguments and the preliminary contention of the respondent, the counsel for the appellant/revenue has by referring to a chart made for the assessment years 1997-98, (which is the first year of operation of the company) to 2001-02 strenuously contended that the huge differences in the provisions made and the actual payment for warranty charges indicates that there is no scientific basis for making of the provision and relying on various observations of the Supreme Court in *Rotork Control's case* (supra) it is urged that it is only a reliable estimate of a warranty amount which can be made as a provision. She further contended that the factual figures in the chart show that only a small portion of the warranty provision is utilised in the subsequent years towards making payment of the warranty claims clearly showing that a sensible estimate has not been made. She referring to the chart further contended that historical trend shows that question of reversal in the subsequent years would not have arisen if the provision was made on a scientific basis. For the purpose of convenience we reproduce the chart relied upon by the revenue which is as under:

**Details of Provision for Warranty**

Assessment	Opening	Actual	Balance	Fresh	Balance as
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year	Balance	Warranty expenses Claimed during the year.		Provision made during the year	on last date of accounting year
1998	-----	16,176	-----	65,01,000	65,01,000
1999	65,01,000	13,25,118	51,75,882	11,20,963	62,96,845
2000	62,96,845	13,46,566	49,50,279	91,34,884	1,4085,163
2001	1,40,85,163	36,95,453	1,03,89,711	2,19,01,507	3,22,91,218
2002	3,22,91,218			2,77,48,547	

(1) Assessee was giving warranty for 12 months.

(2) Provision was created @ 2% of project revenue and @ 1% of trading income.

7. To understand the figures in the aforesaid chart in the proper perspective we should also refer to the subsequent years figures thereafter as provided by the senior counsel for the respondent and which are as under:-

Assessment Year	Provided During the year from Profit and loss account	Paid During the year/actual expenses Incurred
2002-2003	33,935,196	8,940,242
2003-2004	88,898,820	4,303,350
2004-2005	90,412,453	60,152,183
2005-2006	95,279,000	64,711,000



8. We feel that in the facts of the present case, the contentions of the respondent merits acceptance and the appeals are liable to be dismissed. This is because the entire stress of the counsel for the revenue on the aspect of the historical trend is not well founded in as much as the respondent company commenced operation only in the year 1997-98 and in a period of 3 to 4 years it cannot be said that a 'historical trend' emerges. It is not a matter of dispute that the respondent assessee company is a multi-national company and carries out business throughout the world. The policy as prevalent for making a provision for warranty claims is universally applied by the assessee company in various countries throughout the world where it carries on the business. The counsel for the respondent has placed reliance on its internal directives contained in its Manual for the warranty provision. These policy directives with respect to the warranty provides in detail clauses and directions for warranties for supply contract; for hardware; spare parts and software and so on. The policy document further provides for warranty periods for different types of subjects and also deals with the requirement of financial terms for the warranty to be made. This is a nine page document and it is difficult for us to reproduce the same in the body of this order, however, it is quite clear that the policy and principles with respect to provisions for warranties which are made by the assessee company is not simply an adhoc method without any scientific basis.



The scientific basis is consistently applied by the assessee company for business throughout the world. We may also note that it is not as if the assessee company takes a huge benefit year after year by making a huge provision because in fact, it is only the provision which is made in the first year which is carried forward in the subsequent years and in which subsequent years the provision is only for the additional difference on account of a higher turnover. It is only this difference of net amount which is additionally debited in the provision account because the difference in the earlier years is credited and a reversal entry made to the profit and loss accounts by non utilised amount being offered to tax as income. The consistency being maintained with reference to application of this principle irons out the creases of any undue benefit to the assessee company over a period of time and which can be said to be similar to the principle of valuation of closing stock in certain businesses at either cost or market price whichever is lower. It is reiterated that the consistent application of the policy of provision which removes any issue of mala fides or dishonest intention on the part of an assessee company for deferring its income because it could be that in particular year actual warranty claims may exceed the provision which is made.

9. That the appellant revenue had sought framing of the following question of law:



“Whether on the facts and in the circumstances of the present case


Tribunal was right in law in deleting the addition made on account of provision for warranty charges holding the same to be definite business liability allowable as deduction during the year under consideration?”

We frame this question of law and in view of above discussion answer the said question of law as under:

The assessee company is entitled to make provision for the warranty charges holding the same to be a definite business liability allowable as a deduction during the years under consideration since the same is based on a scientific basis and a consistent policy applied by the assessee company throughout the world including India and that consistent application of the same principle over the years would remove any advantage which according to the revenue the assessee may have by deferring of its income to the extent of warranty provision to the next year.

11. The present appeal is accordingly dismissed.

  
VALMIKI J. MEHTA, J

  
A.K. SHRI, J.

September 25, 2009

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