



* **IN THE HIGH COURT OF DELHI AT NEW DELHI**

Reserved on: 6th November, 2019

Pronounced on: 6th February, 2020

+ ITA 541/2019

**HOUSING AND URBAN DEVELOPMENT CORPORATION
LTD THROUGH ITS AUTHORIZED SIGNATORY..... Appellant**

Through: Mr. Gagan Kumar and Mr. Amit
Kaushik, Advocates.

versus

**ADDITIONAL COMMISSIONER OF
INCOME TAX RANGE 12 NEW DELHI Respondent**

Through: Mr. Zoheb Hossain and Mr. Deepak
Anand, Advocates.

CORAM:

HON'BLE MR. JUSTICE VIPIN SANGHI

HON'BLE MR. JUSTICE SANJEEV NARULA

J U D G M E N T

SANJEEV NARULA, J

1. This appeal under Section 260A of the Income Tax Act, 1961 (herein after referred to as the "Act") filed by the Housing and Urban Development Corporation Ltd - HUDCO (hereinafter referred to as "the appellant") assails the order dated 21st December, 2018 passed by Income Tax Appellate Tribunal, Delhi Bench 'C': New Delhi (hereinafter referred to as "ITAT") in ITA No:- 5705/Del/2014 for the Assessment Year (AY)2007-08(herein after "the impugned order").



2. On 6th November, 2019, after hearing the learned counsels for the parties, the following questions of law were framed:

“1. Whether the Hon'ble ITAT erred in confirming the disallowance of the claim of provision for salary of Rs. 1,60,00,000/- on the ground that it did not accrue and the same was merely a contingent liability without appreciating the legal precedents as well the facts of the case.

*II. Whether the Hon'ble ITAT erred in confirming the disallowance of the claim of provision for salary of Rs. 1,60,00,000/-- without appreciating that pay revision of the employees of the Appellant being a Public Sector Enterprise is due every 10 years and with the expiry of one wage settlement or agreement, invariably, there is a time lag when another fresh wage revision agreement is negotiated and entered and this Hon'ble Court in the case of in the case of **CIT v. Bharat Heavy Electricals Ltd. 352 ITR 88 (Del)** while dealing with a similar provision made on account of wage revision, held, that the deduction claimed for that period cannot 'be termed as contingent because the wage and the probable revision or rates of revision would be within the fair estimation of the employer.*

III. Whether the Hon'ble ITAT erred in confirming the addition of Rs. 1,28,00,000/- on account of change in accounting policy of revenue recognition for application fee, front end fees, administrative fee and processing fee of loans from the date of signing of loan agreement to the date of realization on the ground that the same was not in accordance with the provisions of the Act without appreciating the legal precedents as well the facts of the case.”



3. The factual background of the case giving rise to the present appeal is that the appellant, a Public Sector Undertaking (PSU), filed its return of income for the AY 2007-08 on 30th October, 2007 declaring an income of Rs. 351,93,26,019/-. The same was revised on 24th October, 2008 wherein the income of Rs. 331,58,74,360/- was declared. Appellant's case was selected for scrutiny and an assessment order under Section 143(3) of the Act was passed on 30th December, 2009, assessing the total income of the appellant as Rs. 355,28,96,515/-. The Commissioner of Income Tax [herein after referred to as "CIT (A)"] examined the records and vide order dated 24th February, 2012 exercised his jurisdiction under Section 263 of the Act, directing the Respondent to reframe the assessment *inter alia* on the ground that Assessing Officer (AO) had not disallowed the provision for salary of Rs. 1.60 crores and has erred in not making an addition of Rs. 1.28 crores on account of the financial impact due to change in the accounting policy with respect to revenue recognition for application fee, front end fees, administrative fee and processing fee of loans from the date of signing of the loan agreement to the date of realization.

4. Pursuant to the aforesaid directions, the AO framed the assessment order dated 28th March, 2013 under Section 263/143(3) of the Act, and made certain additions/disallowances which *inter alia* includes the disallowance of the claim for provision of salary of Rs.1.60 crores and addition of Rs. 1.28 crores on account of financial impact due to change in accounting policy. In the appeal, CIT (A) vide order dated 28.08.2014 upheld the order of the AO and sustained the disallowance and the addition.

5. The appellant challenged the order of the CIT (A) before the Income



Tax Appellate Tribunal (“ITAT”). Revenue also filed an appeal regarding the disallowance made by AO under Section 14A of the Act read with Rule 8D of Income Tax Rules. The two cross appeals were heard and decided by way of the impugned judgment and order dated 21st December, 2018.

6. The appellant has preferred the present appeal questioning the correctness of the impugned order, *inter alia* on the ground that the ITAT has erred in confirming disallowance of the claim for provision of salary of Rs. 1.60 crores, and the addition of Rs. 1.28 crores on account of change in accounting policy with respect to revenue recognition for application fee, front end fees, administrative fee and processing fee of loans.

QUESTION I & II:

7. The appellant claimed deduction of Rs. 1.60 crores on account of the provision for revision of pay in the books of account. The deduction was made in light of the Pay Revision Committee (hereinafter referred to as “PRC”) appointed by the Government of India. The AO disallowed the claim, holding that the expenditure was purely a provision against unascertained liability and could not be claimed as expenditure for Assessment Year 2007-08. The relevant findings of the AO on this issue are as under:

“Neither, the said liability accrued nor crystallized during the year under consideration. As per the recommendations of the central Sixth Pay Commission/Ministry of Finance etc. It was decided that 60% of arrears worked out on the implementation of Sixth Central Pay Commission was ordered by the Central govt.



to be paid in Financial Year 2008-09 relevant to A. Y. 2009-10 and balance 40% was ordered to be paid in F. Y. 2009-10 relevant to A. Y. 2010-11. Accordingly, the assessee could have claimed the expenditure on account of revision of pay in the A. Y. 2009-10 and the balance amount of expenditure w.e.f. 1-4-2008 to the implementation of Sixth Pay commission should have been claimed in A. Y. 2010-11. Even the Ld CIT-IV after careful consideration of the issue in question, has observed that the liability on account of revision of pay in consequence of report of Sixth Central Pay Commission has not accrued and crystallized during the F. Y. 2006-07 relevant to A. Y. 2007-08 because the implementation of the said report in respect of public sector undertaking and State Govt. Employees has been carried out only after September, 2008 beyond the close of the instant financial year relevant to A. Y. 2007-08 and accordingly, the provision of such revision of pay amounting to Rs. 1,60,00,000;- is unascertained liability which is not eligible for deduction for the year under consideration.

Even from the documents filed during fresh proceedings along with its reply dated 30.11.2012 in the form of a note marked as annexure-III and further marked as "Finance Wing;" with the subject: Provision against pay revision of Executives, clearly states that "during discussions regarding Annual Account for the year 2006-07 on 10.10.2007 in CMD's Chamber when DF was also present, it was decided that suitable provision on account of pay revision of Executives w.e.f. 01.01.2007 should also be made in the Annual accounts for the year 2006-07. Accordingly, an ad hoc provision of Rs. 1.60 crores is proposed to be made in the accounts for the period of three months for executives only from 01.01.2007 to 31.3.2007. On the back side of the said note it is mentioned as under:-



<i>Note No.</i>	<i>Existing Note</i>	<i>Suggested Note</i>
<i>II (b)</i>	<i>The Pay Revision of Public Sector executives was due w.e.f. 01.01.2007 and a pay revision committee has been appointed by Govt. of India, the report of which is pending. In view of this no provision for revised pay has been made in account of 2006- 07.</i>	<i>The Pay Revision of Public Sector executives was due w.e.f. 01.01.2007 and a pay revision committee has been appointed by Govt. of India, the report of which is pending. Ad hoc provision of Rs.1.60 crores has been made in the accounts for the financial year 2006-07.</i>

Submitted for approval please.

Sd/- ACF(S) 13.10.2007”

This note was finally approved on 15.10.2007.

The accounts for the year under consideration are from 1.4.2006 to 31.3.2007 and are closed on 31.3.2007. That the deduction claimed is on account of creation of provision. Additionally, the "Provision" is an "an ad hoc provision". Neither the liability for revision of pay accrued during the year before 31.3.2007 nor crystallized before 31.3.2007. Additionally, no payment of the same was made before 31.3.2007. All proposals were made in the month of October 2007 after the close of the accounting year. As per the recommendations of the Central Sixth Pay Commission the assessee should have claimed such expenses of revised pay of its employees only in the assessment year 2009-10 and 2010-11. Hence, the provision rather ad hoc provision of Rs. 1,60,00,000/- is hereby disallowed”.

[Emphasis Supplied]



8. CIT (A) while dismissing the appeal of the assessee, held that there was no decision of the Central Government in the current financial year (2006-07) which may have a bearing on the revision of pay of executives of the appellant Company and therefore it cannot be held that such liability had crystallized during Financial Year 2006-07. In the absence of finality, there was no justification on part of the appellant company to have made a provision in the current year. The relevant portion of the order of the ITAT relating to the aforesaid disallowance reads as under:

“(3.1) In the facts of the case before us, we have already noticed that that the Pay Revision Committee had not completed its deliberations before the end of the FY 2006-07 and was yet to submit its report at the time when the FY 2006-07 came to an end; and furthermore, that the pay revision was finally implemented in pursuance of aforesaid Office Memorandum dated 26.11.2008 in No.2(70)/08-DPE(WC) of Ministry of Heavy Industries & Public Enterprises. Under these facts and circumstances, we conclude that the liability for Rs. 1,60,00,000 deduction for which was claimed by the Assessee on account of ad hoc provision for pay revision, had not accrued during the relevant FY i.e., 2006-07 (AY 2007-08). Merely because Pay Revision Committee was constituted during the year, it cannot be said that liability towards pay revision had accrued during the year, when we consider the facts that the Pay Revision Committee had not completed its deliberations before the end of the FY 2006-07 and was yet to submit its report at the time when the FY 2006-07 came to an end; and furthermore, that the pay revision was finally implemented in pursuance of aforesaid Office Memorandum dated 26.11.2008 in No.2(70)/08-DPE(WC) of Ministry of Heavy Industries & Public Enterprises. During FY 2006-07 (AY 2007-08), there was neither any statutory liability nor any legally enforceable liability against the Assessee in respect of the Assessee's claim for Rs. 1,60,00,000 deduction for which was claimed by the Assessee on account of ad hoc provision for pay revision. In



fact, there was no such liability at all. Even if there was a liability, it was purely a contingent liability which is not deductible for income tax purposes.”

9. Mr. Gagan Kumar, learned counsel for the appellant has assailed the aforesaid findings and argued that the tax authorities and the Tribunal have ignored the fact that the provision of salary of Rs.1.60 crores was an ‘ascertained liability’ in light of the recommendation of PRC, appointed by Department of Public Enterprises (herein after referred to as “DPE”) on 30th November, 2006. He submits that the effective date of commencement of the revised pay is important and not the date of signing of the agreement or its approval granted by DPE. In support of his submission, the learned counsel has relied upon the judgment of this Court in ***Commissioner of Income-tax vs. Bharat Heavy Electrical, Limited*** 352 ITR 88 (Delhi); ***Bharat Earth Movers vs. Commissioner of Income-tax***, 245 ITR 428 (SC). Besides, the learned counsel also relied upon the DPE - guidelines relating to wage policies and related matters.

10. Mr. Zoheb Hossain, senior standing counsel for Revenue along with Mr. Deepak Anand on the other hand supported the decision of the ITAT and argued that the provision for salary was not finally ascertained and determined, and thus the appellant could not have made a deduction for the same on *ad hoc* basis. They relied upon the judgments in ***Commissioner of Income-Tax, Bombay vs. M/S Morarji Goculdas Spinning and Weaving Co. Ltd., Bombay***, 2000(2) Mh.L.J.; ***Nonsuch Estate Ltd. vs. The Commissioner of Income –Tax, Madras***, (1975) 3 SCC 443 and ***Indian***



***Molasses Co. (Private) Ltd vs Commissioner of Income Tax, West Bengal,
AIR 1959 SC 1049.***

11. We have given our due consideration to the submissions advanced by both the learned counsels on the aforesaid issue. Before expressing our views, it is essential to briefly note the history of the provision relating to deduction on account of pay revision. The appellant is a PSU under Government of India. A PRC was constituted by the Ministry of Heavy Industries and Public Enterprises, under the Chairmanship of Hon'ble (Retd.) Justice M. Jagannadha Rao, Supreme Court of India, vide resolution dated 30th November, 2006. The pay revision fell due during the Assessment Year 2007-08, with effect from 1st January, 2007. The committee held a total of 39 meetings out of which 4 meetings were held during the Assessment Year 2007-08, and it furnished its final report on 26th November, 2008. Pursuant to the recommendations of PRC, the appellant declared expenditure of Rs.1.60 crores on account of provision for revision of pay in books of account from 1st January 2007, since the effective date of implementation was not known. The report of the PRC was implemented later in September, 2008; nevertheless, this would not render the expenditure to become "unascertained liability", making it ineligible for deduction for the year under consideration i.e. 2007-08. The appellant has placed on record a note of the Finance Wing relating to aforesaid provision which reads as under:

"Finance Wing" with the subject: Provision against pay revision of Executives, clearly states that "during discussions regarding Annual Account for the year 2006-07 on 10.10.2007 in CMD's Chamber when DF was also present, it was decided



that suitable provision on account of pay revision of Executives w.e.f. 01.01.2007 should also be made in the Annual accounts for the year 2006-07. Accordingly, an ad hoc provision of Rs.1.60 crores is proposed to be made in the accounts for the period of three months for executives only from 01.01.2007 to 31.3.2007. On the back side of the said note it is mentioned as under:-

<i>Note No.</i>	<i>Existing Note</i>	<i>Suggested Note</i>
<i>11(b)</i>	<i>The Pay Revision of Public Sector executive was due w.e.f. 01.01.2007 and a pay revision committee has been appointed by Govt. of India, the report of which is pending. In view of this no provision for revised pay has been made in account of 2006-07.</i>	<i>The Pay Revision of Public Sector executive was due w.e.f. 01.01.2007 and a pay revision committee has been appointed by Govt. of India, the report of which is pending. Adhoc provision of Rs.1.60 crores has been made in accounts for the financial year 2006-07.</i>

Submitted for approval please.

Sd/- ACF(S) 13.10.2007”

12. The pay revision of employees of the appellant, a PSU is due every ten years with the expiry of one wage settlement or agreement. Invariably, there is a time lag between expiry of a wage revision and negotiation of a fresh wage revision. The appellant had made provision of Rs.1.60 crores on scientific foundation and on the basis of its past experience in its accounts for Financial Year 2006-07. The provision was made for the period 1st



January, 2007 to 31st March, 2007 and deduction was claimed on the standpoint that appellant is under an obligation to pay revised pay to its employees with effect from 1st January, 2007, determination whereof, was a matter of time. The appellant, thus had a reasonable basis to make provision for this expenditure. Similar provisions were also made in subsequent years in the following manner.

<i>Financial Year</i>	<i>Amount (Rs. in crores)</i>	<i>Cumulative Amount (Rs. in Crores)</i>
2006-07	1.60	1.60
2007-08	6.61	8.21
2008-09	15.79	24.00

13. Having noted the facts of the case, we now turn to the judgments relied upon by the parties. Appellant has relied upon ***Bharat Heavy Electrical Limited*** (supra), which is squarely applicable to the facts of the present case. The relevant paragraph is reproduced as under:

“Question No.1 - Whether the provisions made claiming deduction for wage revision, allowed by the Tribunal was justified in the circumstances of the case?”

The assessee, BHEL, had during the relevant assessment years 1988-89 and 1998-99 claimed, in its schedule in the balance sheet, addition of its liability on account of wage revision. Accordingly, a provision for wage revision was factored. The assessee submitted that even though the wage revision proposals had been submitted to the competent bodies or authorities, the liability was certain and ascertained on the basis of its past experience and after taking into consideration the previous Pay Commission's reports, union demands and the ability of the employer to bear the additional burden. These provisions also took into account factors such as



price index in adjustment inflation etc. The assessee, a public sector unit, had stated that since the liability being ascertained, even the Comptroller and Auditor General had not communicated them to be contingent liabilities. The Assessing Officer, for both the relevant years, held that the provision could not be allowed and that the claim or deduction was allowable when actually the entire quantum of liability could be calculated. The order of the AO was upheld in appeal. The Tribunal relying the Supreme Court's decision in *Bharat Earth Movers v. CIT* [2000] 245 ITR 428/ 112 Taxman 61 allowed the assessee's claim. The Tribunal noticed as follows: -

"13. In the assessee's case also, it is noticed that the provision for the wage revision is factored on the basis of past experience, interim pay commissions of govt. employees, available pay commission reports of public sector employees, union demands and other relevant factors required for a scientific computation. Obviously, when one wage agreement comes to an end and other is executed, there would be a passage of time, but the new wage agreement would come into effect from the end of the earlier wage agreement. This being so, the liability is certain in the assessee's case though the quantum of such liability is variable and it is further noticed that the assessee has categorically admitted that the provision as done is invariable short of the final agreement and the difference as ultimately emerging are always booked as expenses in the year in which the payment is made. This being so, we are of the view that the provisions made on account of wage revision is not a contingent liability and is allowable in the year of making such provisions made. In the circumstances, this issue is held in favour of the assessee and the addition on this account stands deleted."

[Emphasis Supplied]



14. In *Bharat Earth Movers* (supra), the Supreme Court has held that it is not the date of signing of the agreement or the grant of approval by the Government, but the effective date of commencement of the wage revision under the agreement that is of relevance. The relevant portion of the said judgment reads as under:

“The law is settled: if a business liability has definitely arisen in the accounting year, the deduction should be allowed although the liability may have to be quantified and discharged at a future date. What should be certain is the incurring of the liability. It should also be capable of being estimated with reasonable certainty though the actual quantification may not be possible. If these requirements are satisfied, the liability is not a contingent one. The liability is in praesenti though it will be discharged at a future date. It does not make any difference if the future date on which the liability shall have to be discharged is not certain.”

15. A similar view was also expressed by the Kerala High Court in the case of *Commissioner of Income-tax vs. Kerala State Financial Enterprises Ltd.*[2009] 178 Taxman 449 (Ker), where, while dealing with a similar provision made on account of wage revision, the High Court followed the decision of the Supreme Court in the case of *Bharat Earth Movers* (supra).

16. Pertinently, the CIT (A) has also categorically held that the provision had been computed on a scientific basis and it was erroneously mentioned as an *ad hoc* provision. In *Rotork Controls India (P.) Ltd. vs. Commissioner of Income-Tax* 314 ITR 62, the judgment relied upon by the appellant, the Court has defined the concept of provision in the following words:



“What is a provision? This is the question which needs to be answered. 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.”

17. It is a well settled principle of law that an assessee, following the mercantile system of accounting, is not entitled to claim deduction until the liability for which deduction is claimed has accrued. The Act makes a distinction between actual liability *in praesenti* and a liability *de future* which, for the time being is only contingent. The former is deductible but not the latter. The question to be decided in each case is whether any present liability has accrued against the assessee. In light of the facts noted above, the case laws relied upon by the appellant are squarely applicable to the facts and circumstances of the present case.

18. Per contra, the judgments relied upon by the counsels for the respondents are distinguishable on facts. In *Morarji Goculdas Spinning and Weaving Co. Ltd. (Supra)*, the court while considering whether deduction could be claimed on account of excise duty based on show cause notices, rejected the claim of the assessee on the ground that there was no ‘demand’ by the Excise department and the liability of the assessee was merely contingent, which would not constitute an expenditure for taxation purposes. In *Nonsuch Estate Ltd.(Supra)*, the court while deciding the question of



deduction on account of 'managing agency remuneration', held that the assessee is not entitled to the same until liability for the sum for which deduction is claimed has actually accrued. The court observed that the liability would not accrue unless the Central Government conveyed its approval as mandated as per Section 326 of the Companies Act. In *Indian Molasses Co. (Private) Ltd (Supra)*, the court considered whether the payments made to the trustees to create a life insurance in the name of the retiring Managing Director of the assessee company would constitute 'expenditure' so as to claim deduction. It was held that the liability was contingent and the expenditure which is deductible for income tax purposes is one which is towards a liability actually existing at the time. Merely putting aside money which may become expenditure on the happening of an event in future is not an expenditure that is deductible.

19. The position in the current case is that the liability had already arisen with certainty. The committee was constituted for the purpose of wage revision. That the wages would be revised was a foregone conclusion. Merely because the making of the report and implementation thereof took time, it could not be said that there was no basis for making the provision. In view of the above, we hold that the ITAT and CIT (A) have fallen in error by disallowing the expenditure of Rs.1.60 crores on account of anticipated pay revision in Assessment Year 2007-08. The first and second questions of law are thus answered in favour of the appellant. Accordingly, it is directed that the revenue shall now pass consequential orders accepting the deduction of Rs. 1.60 crores.



QUESTION III:

20. The next question pertains to addition of Rs.1.28 crores on account of financial impact due to change in accounting policy in respect of revenue recognition of application fee, front end fees, administrative fee and processing fee of loans (hereinafter collectively referred as 'fees') from the date of signing of the loan agreement to the date of realization. The background of the aforesaid addition is that the appellant was following accrual/mercantile system of accounting and was accounting the 'fees' as its revenue from the date of signing of the loan agreement. The amount was finally deducted/ realized from the loan amount, when it was actually disbursed to the borrower. There were instances when the loan agreement was signed and the borrower would not take the disbursement and, accordingly, fees would not be realized. The CAG objected to the same on the ground that the accounting treatment was not in accordance with Accounting Standards (hereinafter referred as 'AS-9'), issued by ICAI which provides guidance for determination of income on accrual basis. Appellant, vide letter dated 6th November, 2006, assured the CAG that the accounting policy shall be reviewed for FY 2006-07 and, accordingly, the Board approved the change in accounting policy in its meeting held on 27th September, 2007. The revised accounting policy recognized the aforementioned fees as on the date of its realization, instead of date of signing of the loan agreement. The AO made an addition of Rs. 1.28 crores on the ground that the change had resulted in under-statement of profits and also because the change was introduced after the closing of the financial year.



21. The CIT (A) confirmed the addition holding that change in accounting policy was not in accordance with the provisions of the Act. The relevant finding of the CIT (A) on this issue is as under:

"Regarding the Ground No.2 of the appeal relating to disallowance of Rs.1.28 crores on account of understatement of profit due to change in accounting policy of revenue recognition in respect of processing fees of loans etc., I find that the appellant was regularly following the accounting practice upto 31.03.2007 by which such incomes were accounted for on accrual basis. Subsequently, in view of its Board's decision in the meeting dated 27.09.2007, the appellant company revised its accounts in the light of the advice from the statutory auditors and thereby changed the accounting policy and recognized the revenue in respect thereof on receipt basis. I find that the CAG audit party had raised the observation that accounting of such receipts at the time of signing of loan agreement was not in conformity with the Accounting Standard 9 to which the appellant company had assured vide letter dated 06.11.2006 that the accounting policy shall be reviewed in F. Y.2006-07. Subsequently, in the Board meeting of the appellant company of September, 2007, the following resolution was passed:

"Resolved that the changes in accounting policy from the year 2006-07 be and are hereby approved as detailed in the agenda item"

The detailed note for comparing existing policy and the revised policy shows that the Board of the company took this decision by assuming that there was no financial impact and there was only change in language. However, the very basis of this decision that



there was no financial impact was incorrect, as the proposed change had resulted in reduction in the taxable profit under the Income Tax Act, 1961. Further, AO's observation that the decision was taken only after the F. Y. is over was also note-worthy, even though such decision was taken with retrospective effect.

Evidently, the appellant is a company incorporated under Companies Act 1956. As per Accounting Standards, it follows mercantile system of accounting. Therefore, even though the company may have changed the accounting policy, which as mentioned was on a faulty premise that it did not have financial impact; in line with the Accounting Standards as per Section 145 A of the Act, it could have added back the amount of Rs.1.28 crores on account of such receipts in the computation of income. This would have ensured compliance with the CAG objections as also compliance with the provisions of the Act. Moreover, the decision of the Company's Board cannot override the provisions of the statute. Keeping in view the above, the addition made on this ground is upheld and this ground is accordingly dismissed.”

[Emphasis Supplied]

22. The ITAT upheld the addition holding as under:

“(4.1.1) The Assessee is now in appeal against the aforesaid order dated 28.8.2014 of the Ld. CIT(A). At the time of hearing before us, the Ld. AR of the Assessee submitted that the change in the Accounting Policy was made in order to comply with objection/observation of the Audit Party of Comptroller & Auditor General. The Ld. CIT(DR) relied on the orders of the AO and the Ld. CIT(A).



(4.2) The position in law is unambiguous. U/s 145(1) of I.T. Act, it is provided that 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. The Assessee is not permitted to follow cash system of accounting for some of the items while following mercantile system of accounting for rest of the items in computation of income chargeable under the head "Profits and gains of business or profession" or "Income from other sources" as the mixed system of accounting has lost statutory mandate w.e.f. AY 1989-90 in view of the amendment to Section 145 of I.T. Act. Thus, the Assessee was in clear error of law in changing the method of accounting to selectively adopt cash system of accounting for certain items, while following mercantile system of accounting for rest of the items. Even if the accounting policy was changed in pursuance of observation of Audit Party of Comptroller & Auditor General ("CAG" for short), even then, statutory provisions under I.T. Act will prevail over any observation/objection/remark of Audit Party of CAG. Moreover, despite having changed the accounting policy, in pursuance of observation of Audit Party & CAG, the Assessee would have added back the aforesaid amount of Rs. 1.28 crores in the computation of Total Income for Income Tax purposes. That would have ensured compliance with statutory provisions under I.T. Act, as well as with observation of Audit Party & CAG. The Assessee is a company incorporated under the Companies Act, 1956 and follows mercantile system of accounting. An Assessee company registered under the Companies Act, 1956 is required to maintain accounts in accordance with provisions of The Companies Act, 1956. However, the profits computed in



this manner need not necessarily be the same as Total Income for the purposes of I.T. Act. The computation of Total Income for the purposes of Income Tax Act requires giving effect to statutory provisions under I.T. Act, by making necessary adjustments/ modifications /alterations/ variations to profits compounded in accordance with provisions of the Companies Act, 1956. In view of this, the Assessee was in clear error of law by not adding back the aforesaid amount of Rs. 1.28crores in the computation of Total Income for the purposes of I.T. Act. This error of law is further aggravated by the error of fact, in that the change of accounting policy was based on faulty premise (i.e, error of fact) that there was no financial impact. The fact is, there was financial impact to the extent of aforesaid amount of Rs. 1.28 crores. In view of the foregoing discussion and unambiguous position in law; and the clear error of law and fact on the part of the Assessee, we uphold the addition of aforesaid amount of Rs. 1.28 crores. The Ld. AR of the Assessee failed to bring to our notice any specific provisions of law or any judicial precedents to support this ground of appeal. We find that the order of the Ld. CIT(A) is well reasoned and in accordance with law in the facts and circumstances of this case. The Assessee has failed to make any case for inference with the impugned order of the Ld. CIT(A) on this issue. Therefore, the second ground of appeal in the appeal filed by the Assessee in the ITA No. 5705/Del/2014 is dismissed and the impugned order of the Ld. CIT(A) on this issue, sustaining the aforesaid addition of Rs. 1,28,00,000.”

[Emphasis Supplied]

23. Learned counsel for the appellant has argued that the appellant follows mercantile system of accounting and under the said system of accounting, unless there is a reasonable certainty of its realization, income cannot be



said to have accrued. The Tribunal erred in confirming the addition without appreciating AS-9, issued by ICAI which provides for recognition of income on accrual basis only when there is a certainty of its realization. The change in accounting policy had been duly reflected in detailed note for comparing the existing and revised policy and the financial impact due to the said change was shown in 'Schedule T' of the financial statements. It was also urged that the change is revenue neutral and there is no loss to the Department as the same has been realized in the Financial year 2008-09, and has been offered to tax in the AY 2009-10. In support of his submission, counsel has relied upon the decisions in *Commissioner of Income-Tax, Chennai vs. Shriram Investments Ltd.*[2015] 62 Taxman 298 (Madras); *Commissioner of Income-tax vs. Bharat Aluminium Co. Ltd.*[2010] 187 Taxman 111(Delhi); *Commissioner of Income-tax-VI vs. Virtual Soft Systems Ltd.*[2018] 92 taxman.com 370 (SC); *Commissioner of Income-tax vs. Woodward Governor India (P.) Ltd.*[2007] 162 Taxman 60 (Delhi) and *Commissioner of Income Tax vs. Excel Industries Limited*, 358 ITR 295 (SC).

24. Mr. Zoheb Hossain and Mr. Deepak Anand, learned counsels for the revenue, on the other hand urged that the assessee was required to make the book of accounts in accordance with the provisions of the Companies Act, 1956. However, profits computed as per the provisions of the Companies Act need not necessarily be the same as Total Income for the purposes of Income Tax Act. The computation of total income requires giving effect to statutory provisions under the Act by making necessary adjustments. Appellant has erred by not adding back the amount of Rs. 1.28 crores and



therefore, the findings of the tax authorities are in consonance with the provisions of the Act and the judicial pronouncements on this issue.

25. We will first reflect on the decisions and viewpoints expressed by the courts on this issue. The appellant has relied upon the judgment of the Supreme Court in *Excel Industries Limited* (supra). The observations made in Paragraph Nos. 18 and 19 of the said case are of relevance, and the same read as under:

17. "First of all, it is now well settled that income tax cannot be levied on hypothetical income. In CIT v. Shoorji Vallabhdas & Co. [1962]46 ITR 144(SC) it was held as follows:-

Income-tax is a levy on income. No doubt, the Income-tax Act takes into account two points of time at which the liability to tax is attracted, viz., the accrual of the income or its receipt; but the substance of the matter is the income. If income does not result at all, there cannot be a tax, even though in book-keeping, an entry is made about a 'hypothetical income', which does not materialize. Where income has, in fact, been received and is subsequently given up in such circumstances that it remains the income of the recipient, even though given up, the tax may be payable. Where, however, the income can be said not to have resulted at all, there is obviously neither accrual nor receipt of income, even though an entry to that effect might, in certain circumstances, have been made in the books of account."



18. *“The above passage was cited with approval in Morvi Industries Ltd. v. CIT (Central), [1971] 82 ITR 835 (SC) in which this Court also considered the dictionary meaning of the word “accrue” and held that income can be said to accrue when it becomes due. It was then observed that: “.....the date of payment does not affect the accrual of income. The moment the income accrues, the assessee get vested with the right to claim that amount even though it may not be immediately.”*

19. *“This court further held, and in our opinion more importantly, that income accrues when there ‘arises a corresponding liability of the other party from whom the income becomes due to pay that amount.”*

20. *“It follows from these decisions that income accrues when it becomes due but it must also be accompanied by a corresponding liability of the other party to pay the amount. Only then can it be said that for the purposes of taxability that the income is not hypothetical and it has really accrued to the assessee.”*

21. *“In so far as the present case is concerned, even if it is assumed that the assessee was entitled to the benefits under the advance licenses as well as under the duty entitlement pass book, there was no corresponding liability on the customs authorities to pass on the benefit of duty free imports to the assessee until the goods are actually imported and made available for clearance. The benefits represent, at best, a hypothetical income which may or may not*



materialize and its money value is therefore not the income of the assessee.”

[Emphasis Supplied]

26. The factual situation in the said case is quite similar to the case in hand. In the aforementioned case, the question was with respect to assessee's entitlement to benefits under the 'advance license' as well as under the 'duty entitlement passbook'. The Court observed that there was no corresponding liability on the customs authority to pass the benefit of duty-free imports to the assessee until the goods are actually imported and made available for clearance; the benefits represent a hypothetical income which may or may not materialize and its money value is not the income of the assessee.

27. In *Commissioner of Income-Tax, Coimbatore vs. Annamalai Finance Ltd*, [2009] 319 ITR 196 (Madras), judgment relied upon by the appellant, the following observations are essential to note:

“4. The assessee had submitted that in respect of overdue charges, the assessee-company, keeping in line with the norms of the Reserve Bank of India as well as the credit rating agency, has been recognizing income by way of overdue charges only to the extent of actual collection i.e., the assessee is admitting income only on cash basis. The assessee-company has also placed reliance upon the Accounting Standard 9 of ICAI which lays down that when uncertainties exist regarding determination of the amount or its collectability, the revenue shall not be treated as accrued and hence shall not be recognised until collection.



5. The recognition of revenue on accrual basis presupposes the satisfaction of two conditions viz., the revenue is measurable and that the revenue is collectable without any uncertainty. Taking into account these standards also, the assessee submitted that the overdue on financial charges on hire purchase and lease had been admitted only on cash basis. Rejecting the said submission, the Assessing Officer passed the assessment order.

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In the instant case, learned counsel for the Revenue is not in a position to demonstrate or satisfy us that due to the change of accounting method adopted by the respondent/assessee, which is permissible in law as per the ratio laid down in (i) CIT v. Matchwell Electricals (I.) Ltd.[2003] 263 ITR 227 (Bom.) and (ii) Hela Holdings (P.) Ltd. v. CIT[2003] 263 ITR 129 (Cal.),the Revenue suffered any loss or such a change of methodology attracts tax evasion. Concededly, there is no finding to that effect in the assessment order or in the order of the Commissioner of Income-tax (Appeals). The change of method of accounting of overdue charges from the mercantile basis to cash system, method of accounting, as followed by an assessee, does not create any income; but the method of accounting only recognizes income. Therefore, either to apply the accrual system or cash system, recognition of income is a paramount factor. In the present case, the disputed amount is the overdue charges receivable by the assessee from various parties on the basis of hire-purchase and lease agreements. As per the terms of the agreements, overdue charges are payable by the parties concerned to the assessee when they make defaults in paying the installments as per the schedule of payments. When the installment itself is overdue is not collected,



there is no basis for making out a case that the additional overdue charges payable by the parties would be collectible with certainty. The terms of the agreements which enable the assessee-company to demand overdue charges is only an enabling provision and that enabling provision does not guarantee the collection of overdue charges. It only gives a cause of action to the assessee. In such cases it is very difficult to recognize income against overdue charges.

We are, therefore, of the considered opinion that the Tribunal has rightly deleted the additions made towards overdue charges, acknowledging the change of method of accounting of overdue interest alone on cash basis.”

[Emphasis Supplied]

28. The Court in the above noted case was considering the question regarding the overdue charges payable by parties concerned to the assessee when they make defaults in paying the installment as per the schedule of payments. It was held that the Clause in the agreement which allows the assessee to demand such charges is only an enabling Clause, and does not guarantee the collection of the overdue charges and when the installment itself is overdue and not collected/ realised, there is no basis for making out a case that the additional overdue charges payable by the parties would be collectable with certainty. Similarly, the Supreme Court in its decision in *Commissioner of Income Tax vs. Virtual Soft System Limited (supra)*, considered the question as to whether the deduction on account of lease equalization charges from the leasing rental income can be allowed under Income Tax Act on the basis of guidance note issued by the ICAI. Answering this question, it was held that the Court may take help of external



aids such as the ICAI guidelines and standards if the Act is silent, and there exists no internal aid for the interpretation of the same. The relevant portion of the decision reads as under:

“16. The method of accounting followed, as derived from the ICAI's Guidance Note, is a valid method of capturing real income based on the substance of finance lease transaction. The rule of substance over form is a fundamental principle of accounting, and is in fact, incorporated in the ICAI's Accounting Standards on Disclosure of Accounting Policies being accounting standards which is a kind of guidelines for accounting periods starting from 1-4-1991. It is a cardinal principle of law that the difference between capital recovery and interest or finance income is essential for accounting for such a transaction with reference to its substance. If the same was not carried out, the respondent would be assessed for income tax not merely on revenue receipts but also on non-revenue items which is completely contrary to the principles of the IT Act and to its scheme and spirit.

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18. Without a doubt, in a catena of cases, this Court has discussed the relevancy of the Guidance Note. While dealing with one of such matters, this Court, in CIT v. Punjab Stainless Steel Industries [CIT v. Punjab Stainless Steel Industries, (2014) 15 SCC 129] held as under: (SCC p. 134, para 17)

“17. So as to be more accurate about the word “turnover”, one can either refer to dictionaries or to material which are published by bodies of accountants. The Institute of Chartered Accountants of India (hereinafter referred to as “ICAI”) has published some material under the head “Guidance Note on Tax Audit under Section 44-B of the Income Tax Act”. The said



material has been published so as to guide the members of ICAI. In our opinion, when a recognised body of Accountants, after due deliberation and consideration publishes certain materials for its members, one can rely upon the same.”

19. In the present case, the relevant assessment year is 1999-2000. The main contention of the Revenue is that the respondent cannot be allowed to claim deduction regarding lease equalisation charges since as such there is no express provision regarding such deduction in the IT Act. However, it is apt to note here that the respondent can be charged only on real income which can be calculated only after applying the prescribed method. The IT Act is silent on such deduction. For such calculation, it is obvious that the respondent has to take course of Guidance Note prescribed by the ICAI if it is available. Only after applying such method which is prescribed in the Guidance Note, the respondent can show fair and real income which is liable to tax under the IT Act. Therefore, it is wrong to say that the respondent claimed deduction by virtue of Guidance Note rather it only applied the method of bifurcation as prescribed by the expert team of ICAI. Further, a conjoint reading of Section 145 of the IT Act read with Section 211 (unamended) of the Companies Act makes it clear that the respondent is entitled to do such bifurcation and in our view there is no illegality in such bifurcation as it is according to the principles of law. Moreover, the rule of interpretation says that when internal aid is not available then for the proper interpretation of the statute, the court may take the help of external aid. If a term is not defined in a statute then its meaning can be taken as is prevalent in ordinary or commercial parlance. Hence, we do not find any force in the contentions of the Revenue that the accounting standards prescribed by the Guidance Note cannot be used to bifurcate the lease rental to reach the real income for the purpose of tax under the IT Act.

20. To sum up, we are of the view that the respondent is entitled for bifurcation of lease rental as per the accounting standards



prescribed by the ICAI. Moreover, there is no express bar in the IT Act regarding the application of such accounting standards.”

[Emphasis Supplied]

29. The Supreme Court has held that accounting process is to ensure the real income from the transactions in the form of revenue receipts is accounted for the purpose of income tax. The application of accounting standard is to show fair and real income which is liable to tax under the Act. The accounting standards of ICAI lays down that when uncertainties exist regarding determination of the amount in its collectability, the revenue shall not be treated as accrued and shall not be recognized until collection. It would be apposite to extract the relevant portion of the AS-9, issued by ICAI with regards to the effect of uncertainties on revenue recognition. The same reads as under:

“9.1 Recognition of revenue requires that revenue is measurable and that at the time of sale or the rendering of the service it would not be unreasonable to expect ultimate collection.

9.2 Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g., for escalation of price, export incentives, interest etc., revenue recognition is postponed to the extent of uncertainty involved. In such cases, it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made. Where there is no uncertainty as to ultimate collection, revenue is recognised at the time of sale or rendering of service even though payments are made by installments.



9.3 When the uncertainty relating to collectability arises subsequent to the time of sale or the rendering of the service, it is more appropriate to make a separate provision to reflect the uncertainty rather than to adjust the amount of revenue originally recorded.

9.4 An essential criterion for the recognition of revenue is that the consideration receivable for the sale of goods, the rendering of services or from the use by others of enterprise resources is reasonably determinable. When such consideration is not determinable within reasonable limits, the recognition of revenue is postponed.

9.5 When recognition of revenue is postponed due to the effect of uncertainties, it is considered as revenue of the period in which it is properly recognised.”

[Emphasis Supplied]

30. Let's now advert to the facts of the case, before we express our views. The appellant's income on account of the fees did not accrue with certainty on the date of signing of the loan agreement. The income fell due only when the loan was disbursed, as the fee was to be collected at that stage. It cannot be said that on the date of signing, the income accrued in conformity with the mercantile system and AS-9 adopted by the appellant. The contention of the Appellant is in line with the settled position of law as laid down by the Supreme Court and other High Courts as well as the AS-9. There was no reasonable certainty of the realization of the amount of Rs. 1.28 crores, and that since it follows the mercantile system of accounting, the same can be treated as an income only if it had convincingly accrued. The amount here is



not determinable and there is no certainty about the same, since it remains uncertain whether the borrower -who has signed the loan agreement, would, eventually, avail of the loan, or not. Merely because the appellant may have signed the agreement with the borrower, that, by itself, does not lead to the ‘certainty’ of income accruing to the Appellant, so as to bring it within the ambit of ‘income’. Here, the addition has resulted on account of change in accounting policy by recognizing the realised revenue, instead of the assumed revenue on the date of signing of loan agreement. The tax authorities fell in error by laying emphasis on the impressibility of change in accounting in the context of section 145 of the Act. The conspectus of the case law cited by both parties is that, even for an income to be recognized under mercantile law, it is necessary that income should have accrued with certainty. It is trite law that there can be no liability to pay Income Tax on hypothetical income. The regular method of accounting determines only the mode of computing the taxable income and the particular stage at which the tax liability arises. If there is no income, then merely because the assessee had followed the mercantile system of accounting and has in his books of account reflected certain receipt or credits or debits in a particular way, it cannot be said that income has accrued. The position of law on “accrual of income” is well settled. Income accrues only when there is a right to receive such income, regardless of the fact if it is actually received or not. To decide this crucial question, one would have to examine, whether, there is a legal right vested in favour of the assessee to claim the same. This is the crux of the matter and the tax authorities seem to have lost sight of the same. The tax authorities should have proceeded to determine and ascertain as to whether, the income has in reality accrued to the assessee, or not,



notwithstanding the change in accounting policy. If the income had indeed accrued, the addition would have been permissible. However, to determine this, in our opinion, the treatment given in the assessee's books of account would not be necessary, but would be dependent on the answer to the question as to whether the income has indeed accrued, having regard to the test as discussed hereinabove. The question whether real income has materialized or not, has to be scrutinized, having regard to the commercial and business certainties and realities of the situation in which the assessee is positioned, and not with reference to system of accounting. The answer to such decision would then relate to the chargeable accounting year in which such profits actually arose and assessee would be liable to tax accordingly. Applying this yardstick, we do not find that any income accrued at the point of mere execution of the agreement and, thus, the income did not accrue in the relevant AY. The financial impact has since been factored in the subsequent year.

31. We also find merit in the submissions of the appellant that the change in accounting policy is a result of the audit objection raised by CAG on 10th October, 2006. The appellant has claimed deduction in profits in the computation of the total income, and added it as income in the subsequent assessment year, which has been accepted by the AO. The change is, thus, revenue neutral. The reliance placed by the Revenue upon the decision of the Supreme Court in **[2000] 110 Taxman 134 (SC)/ 244 ITR 764 (SC)**, is misplaced. The dispute in the said case was with respect to the interpretation of the provisions of the Electricity Act, and the additions made in the



income as per the provision of Section 41 of the Act. The factual scenario in the said case is clearly distinguishable from the facts of the present case.

32. Having regard to the reasoning that we have given, we have no hesitation in setting aside the order of the Tribunal. Accordingly, the appeal is allowed. The questions are answered in favour of the Appellant/Assessee.

SANJEEV NARULA, J

VIPIN SANGHI, J

FEBRUARY 06, 2020

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