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Court : Income Tax Appellate Tribunal ITAT Delhi

Decided On : May-21-1986

Reported in : (1986)19ITD540(Delhi)

Judge : S Narayanan, S Kapur

Appellant : Gem India Ltd.

Respondent : inspecting Assistant

Judgement :

1. The assessee, a resident limited company, is in appeal. The assessment year involved being 1982-83, the relevant accounting period ended on 30-6-1981.

1.1 The learned Commissioner (Appeals) erred in upholding the addition of Rs. 19,84,665 to the closing stock of refrigerators.

1.2 The learned Commissioner (Appeals) erred in stating that the appellant had not filed copies of the relevant sale bills after 11-4-1981.

1.3 The learned Commissioner (Appeals) erred in holding/price of warranty is part and parcel of the cost of refrigerators ignoring the principles of accountancy and the detailed submissions made before him by the assessee.

1.4 The learned Commissioner (Appeals) erred in holding that the appellant was dealing in a commodity like warranty.

7.5 The learned Commissioner (Appeals) erred in not considering the submissions of the appellant that the warranty charges were an item debitable to profit and loss account and therefore could not be included in calculating the cost of refrigerators for purposes of closing stock.

2.1 The learned Commissioner (Appeals) erred in upholding the addition of Rs. 11,200 being perquisite in respect of use of the car by managing director.

2.2 The learned Commissioner (Appeals) erred in upholding the addition of Rs. 1,717 as telephone expenses for the personal office/home of the managing director as a perquisite.

3. The learned Commissioner (Appeals) erred in upholding the addition of Rs. 16,774 out of bonus paid to the staff.

3. As regards ground Nos. 1.1 to 1.5, in fairness to both the parties, we are reproducing hereunder in verbatim from the impugned order of the learned Commissioner (Appeals), the facts of the case and the stand of the parties along with the reasoning of the learned lower authorities as detailed in paragraph 2 of the impugned order : During the relevant accounting period the manufacturers, i.e., Kelvinator of India Ltd. allowed the appellant company to exercise the option to buy the warranty or not to buy the same. Up to 10-4-1981, the suppliers of the refrigerators were submitted one bill that the cost of these items are covered in the cost of goods as well as cost of warranty against the manufacturing defects discovered in the complete unit during a period of 12 months after the date of sale and cost of warranty against the manufacturing defects discovered in the sealed-in system included in the unit for a period of four years after the expiry of the 12 months from the date of sale. With effect from 11-4-1981 the manufacturers took the view that the cost of warranty against the manufacturing defects in the sealed-in unit is not cost of manufacture and they separated the cost and gave the option to the appellant company to buy the warranty separately and pay for the same separately. Accordingly, the manufacturer started issuing two bills-one for the cost of refrigerator plus warranty for a period of 12 months and a separate bill for the cost of warranty for the sealed unit. The appellant company exercised these options and purchased the warranty with effect from 11-4-1981 to the close of the

accounting period, i.e., 30-6-1981 and total amount of warranty paid in respect of refrigerators and deep freezers purchased during this period amounting to Rs. 51,35,250. The above amount was debited as expenditure/outgoings in the profit and loss account. During the relevant period the appellant sold most of the refrigerators and recovered the warranty amounting to Rs. 51,35,250 minus Rs. 19,84,665, i.e., Rs. 31,50,585. The closing stock of the refrigerators of various sizes was shown on 1,244-286 litres, 4,826-165 litres, 80-135 litres, 58-90 litres, and 6-65 litres.

'Similarly, the appellant also has shown closing stock of the deep-freezes numbering 3, 22 and 17 of the capacity of 425 litres, 277 litres and 85 litres, respectively. The total closing stock in respect of refrigerators and deep-freezes of different sizes was, therefore, shown at 6,256 in numbers.

The total warranty paid by the appellant company pertaining to these refrigerators and deep-freezes (which were) shown as closing stock was Rs. 19,84,665. As stated earlier, the appellant had debited the entire amount of Rs. 51,35,350 paid as warranty amount to the manufacturers of the freezers in respect of refrigerators, etc., purchased during the period of 11th April to 30th June, 1981. The appellant did not show the warranty paid in respect of refrigerators and deep-freezes shown as closing stock in the trading account. The contention of the appellant was that the appellant had paid the entire amount and was entitled to the deduction of the expenditure as outgoings and as the warranty paid to the manufacturing company was not part of the cost of the refrigerators but a separate item there was no reason to show the balance amount of warranty pertaining to the refrigerators, etc., held in stock either as part of the value of the closing stock or as separate item. The IAC, however, rejected the contention of the appellant and added the above amount to the value of the closing stock of the refrigerators and deep-freezes. The contention of the appellant was that the IAC was not justified in making the said addition as it was the option of the purchasers either to buy the warranty or not to buy the warranty. The appellant company had exercised its option while purchasing the warranty from the manufacturers and had paid the above amount was outgoing and rightly debited to the profit and loss account and as the customers were at liberty either to buy the warranty or not to buy the

warranty. The appellant was not required to show the balance amount on the credit side or as part of the value of the closing stock as the above amount was not part of the cost of the refrigerators, etc., but a separate item. During the appellate proceedings, the appellant was specifically required to state whether there was any option given to the customers either to purchase the warranty or not to purchase the warranty. It was admitted that no such option was given to the customers. As far as the sale of the refrigerators, etc., is concerned, the appellant was again specifically required to file the copies of the sale bills after 11-4-1981 to verify whether the warranty was shown separately or not. The appellant has not filed copies of the relevant sale bills. Ordinarily, the cost of the refrigerators to the customers includes the warranty for both the items, namely, warranty for manufacturing defects for a period of 12 months or the date of purchase as well as warranty for the sealed-in unit for a further period of four years. As there was no option with the customer the question of treating the above amount separately and not being the part of the cost of refrigerators does not arise. As one sale bill is prepared as far as the customer is concerned, which includes the cost of the refrigerator including the cost of both the types of warranty closing stock has to be computed on the basis of cost of refrigerator as well as the warranty as paid by the appellant to the manufacturer and in turn charged by the appellant from the customers. The price of warranty is part and parcel of the cost of refrigerators as the same stands embedded and included in the sale price as advertised by the appellant. The appellant while selling its refrigerators does not show the sale price of the refrigerators and sale price of the warranty separately but as one item, i.e., sale price which is inclusive of warranty. The contention that the above warranty is in the nature of after sale service or consumer service is not well founded. The warranty which gives a right to purchaser to get replaced in case there is a manufacturing defect in the sealed-in unit for a period of four years beyond the period of 12 months from the date of purchase. The above right of a purchaser or a customer to get the sealed-in unit replaced is entirely different in the nature from the after sale service or consumer service. The contention that the warranty with a right to get the sealed-in unit replaced is the same to the consumer service is without any basis. It is also not acceptable that even if the appellant allows option to a purchaser of a refrigerator to either purchase the warranty or not to purchase

the warranty there will not be any such customer which will take risk to buy the refrigerator without buying the warranty against the manufacturing defects either in the refrigerator or in the sealed-in unit. As stated earlier even this option was not available to any customer during the relevant period. Even if it is assumed that the appellant-company was dealing in something called warranty a separate item then it will be treated as if the appellant is dealing in a commodity like warranty by purchasing the warranty from the manufacturer of the refrigerators and in turn selling the warranty to the customer. As the appellant has purchased warranties in respect of thousands of refrigerators and deep-freezes during the period 11th April onwards and has also sold warranties in respect of thousands of refrigerators sold to the customers during the above period the balance amount of warranty purchased by the appellant in respect of refrigerators in stock will be a separate item and the above commodity has to be shown at cost price as available in the stock with the appellant. In these circumstances and for the reasons as discussed above and in the assessment order in details, I hold that the IAC was justified in making the said addition of Rs. 19,84,665 to the closing stock of the appellant being the cost of the warranty pertaining to the refrigerators, etc., held in stock at the close of the accounting period. This is specifically so in view of the fact that no option was allowed to the customers and the sale price advertised by the appellant and the sale price shown in the bills was inclusive of warranty charged from the customers.

4. On the above issues, the learned authorised representatives of the parties were heard at length on 21-4-1986 and 24-4-1986 when the hearing concluded. Assessee's paper book (51 pages) have been duly noted. It, inter alia, contains copy of letter dated 6-4-1981 from Kelvinator of India Ltd. to the assessee regarding separate charge for four years' additional optional warranty ; copy of sample bill ; sample sale invoices, extract from international accounting standard dealing with valuation and presentation of inventories in the context of the historical cost system -booklets issued by the Institute of Chartered Accountants of India, and International Accounting Standards Committee.

Sample of warranty card, the subject-matter of controversy has also been placed on our file at page 9 of assessee's paper book.

5. The controversy seems to fall in very narrow compass and it is as to whether on the stated facts warranty can be treated as a part of the cost of refrigerator, hence stock-in-trade of the assessee. The warranty is against the manufacturing defects discovered in the complete unit during a period of 12 months after the date of sale and against the manufacturing defects discovered in the sealed-in system included in the unit for a period of 4 years after the expiry of 12 months from the date of the sale. In plain and simple language we can say that this warranty is for advantage to be derived in future after sale in the cases and the eventualities stipulated therein, viz., manufacturing defect in the complete unit and the manufacturing unit in the sealed-in system included in the unit. The former advantage being for one year from the date of sale and the latter being for four years from the date of sale. Now this advantage can in no case be said to be goods or a property, but is an advantage and a warranty gives right to the person, who buys a refrigerator, a right to sue. A mere right to sue cannot be said to be any goods, much less, property since a mere right to sue is not an actionable claim even. Section 12 of the Sale of Goods Act, 1930 defines 'Conditions and Warranties' and reads as under : 12. Conditions and Warranties (1) A stipulation in a contract of sale with reference to goods which are the subject thereof may be a condition or a warranty.

(2) A condition is a stipulation essential to the main purpose of the contract, the breach of which gives rise to a right to treat the contract as repudiated.

(3) A warranty is a stipulation collateral to the main purpose of the contract, the breach of which gives rise to a claim for damages but not to a right reject the goods and treat the contract as repudiated.

(4) Whether a stipulation in a contract of sale is a condition or a warranty depends in each case on the construction of the contract. A stipulation may be a condition, though called a warranty in the contract.

According to the above definition a warranty is a stipulation collateral to the main purpose of the contract, but not a right to reject the goods or else a right to treat the contract as repudiated.

It means that a warranty gives rise to a right to sue in case of breach and gives rise to a cause of action to claim damages, but breach of warranty in itself does not give rise either to reject the goods or to repudiate the contract of sale. If warranty is a part and parcel of the goods then the warranty must give the right to reject the goods as also right to repudiate the contract but according to Section 12 this being not the position, the warranty cannot be said to be goods, property or else as a stock-in-trade.

Desired support to the above finding can be had from Section 59 of the Sale of Goods Act, which reads as under : Remedy for breach of warranty.-(1) Where there is a breach of warranty by the seller, or where the buyer elects or is compelled to treat any breach of a condition on the part of the seller as a breach of warranty, the buyer is not by reason only of such breach of warranty entitled to reject the goods ; but he may- (a) set up against the seller the breach of warranty in diminution or extinction of the price ; or (2) The fact that a buyer has set up a breach of warranty in diminution or extinction of the price does not prevent him from suing for the same breach of warranty if he has suffered further damage.

This section deals with the topic 'remedy for breach of warranty'. It provides that in case of a breach of warranty by the seller or where the buyer elects or is compelled to treat any breach in the condition on the part of the seller as a breach of warranty, the buyer is not, by reason only of such breach of warranty entitled to reject the goods.

The said section provides further that in such a situation, the buyer can set up, against the seller, for breach of warranty, a claim for damages for breach of warranty ; and (it) a claim for diminution or extinction of the price. So under this Section 59, the right of the purchaser is limited under a warranty and under the law of the land to claim damages or claim diminution or extinction of the price. Again, according to this section, the claim is limited as provided in the section and the buyer in case of a breach of warranty is not entitled to reject the goods. So the irrejutable inference is that the warranty is an advantage and not a goods, much less, a part of the property or the goods covered by the warranty.

On the facts and in the circumstances of the case and in view of Sections 12 and 59 the warranty cannot be said to be a goods or property, but gives rise only to a right sue for damages. The warranty amount, as such, made subject-matter of addition as closing stock of the assessee was not warranted in the light of discussion as above. The same stands deleted.

6. That apart, the assessee has placed on our file, a booklet issued by the Institute of Chartered Accountants of India titled as Accounting Standard -Valuation of Inventories. Paragraph 6 in the said booklet deals with 'definitions' and reads as under : 6. Definitions : The following terms are used in the statement with the meanings specified : (iii) for consumption in the production of goods or services for sale, including maintenance, supplies and consumable other than machinery spares.

(c) other costs incurred in the normal course of business in bringing the inventories up to their present location and condition.

6.3 'Cost of purchase' consists of the purchase price including duties and taxes, freight inwards and other expenditure directly attributable to acquisition, less trade discounts, rebates, duty drawbacks and subsidies, in the year in which they are accounted, whether immediate or deferred, in respect of such purchase.

(i) costs which are specially attributable to units of production, i.e., direct labour, direct expenses and sub-contracted work ; and (ii) production overheads, ascertained in accordance with either the direct costing or absorption costing method, Production overheads exclude expenses which relate to general administration, finance, selling and distribution.

6.5 'Direct costing' is the method whereby the cost of inventories is determined so as to include the appropriate share of variable costs only, all fixed costs being charged against revenue in the period in which they are incurred.

6.6 'Absorption costing' is the method whereby the cost of inventories is determined so as to include the appropriate share of both variable and fixed costs, the latter being allocated on the basis of normal level of production.

6.7 'Variable costs' are those costs of production which vary directly, or nearly directly, with the volume of production.

6.8 'Fixed costs' are those costs of production which by their very nature remain relatively unaffected in a defined period of time by variation in the volume of production.

6.9 'Net realisable value' is the actual/estimated selling price in the ordinary course of business, less cost of completion and cost necessarily to be incurred in order to make the sale.

Paragraph 7 in the said booklet is an 'Explanation' about historical cost as the basis of inventory valuation. It reads as under : 7. Inventories are held in the expectation of deriving revenue directly or indirectly from their sale or use. In order to determine the results of a business for a given period it is necessary to carry forward the cost related to inventories until the inventories are sold or consumed. However, if there is no reasonable expectation that net realisable value would cover the cost incurred (as a result, for example, of deterioration, obsolescence or a change in demand), it is necessary that cost which cannot be recovered should be charged against the revenue of the current period. Therefore, inventories are normally stated at the lower of historical cost and net realisable value.

A reading of the above paragraphs makes it clear that 'inventories' means tangible property held : (iii) For consumption in the production of goods or services for sale, including maintenance, supplies and consumables other than machinery spares.

So according to this Accounting Standard-Valuation of Inventories, inventories should be a tangible property and a warranty is not a tangible property, since as discussed above, within the meaning of Sections 12 and 59 a breach of warranty only gives rise to a right to sue. A right to sue, as such cannot be said to be 'tangible property', hence, cannot form part of an inventory.

7. International accounting standard-Valuation and presentation of inventories in the context of the historical cost system as authorised by International Accounting Standard Committee as in paragraphs 4 to 11 put the same thing as under : 4. The

following terms are used in this statement with the meanings specified :
Inventories are tangible property (a) held for sale in the ordinary course of business, (b) in the process of production for such sale, or (c) to be consumed in the production of goods or services for sale.

Historical cost of inventories is the aggregate of costs of purchase, costs of conversion, and other costs incurred in bringing the inventories to their present location and condition.

Costs of purchase comprise the purchase price including import duties and other purchase taxes, transport and handling costs, and any other directly attributable costs of acquisition less trade discounts, rebates, and subsidies.

Costs of conversion are those costs, in addition to the costs of purchase, that relate to bringing the inventories to their present location and condition.

Net realisable value is the estimated selling price in the ordinary course of business less costs of completion and less costs necessarily to be incurred in order to make the sale.

5. Inventories comprise a significant portion of the assets of many enterprises. The valuation and presentation of inventories therefore have a significant effect in determining and presenting the financial position and results of operations of those enterprises.

6. In determining historical cost as defined in paragraph 4, different interpretations arise in practice as regards production overhead, other overheads, and the cost formula to be used.

7. Production overhead is comprised of costs incurred for production other than direct materials and labour. Examples are indirect materials and labour, depreciation and maintenance of factory buildings and equipment, and in the cost of factory management and administration.

8. Production overhead requires analysis to determine the portion related to bringing the inventories to their present location and condition and, thus, to be

included in the costs of conversion when determining the historical cost of inventories.

9. Both fixed and variable production overhead incurred during production are usually allocated to costs of conversion. That practice is based on the view that they are both incurred in putting inventories in their present location and condition. Fixed production overhead is sometimes excluded in whole or in part from costs of conversion on the grounds that it is not considered to relate directly to putting inventories in their present location and condition.

10. In a period of low production or if there is idle plant, it is customary to restrict the allocation of fixed production overhead to the costs of conversion by relating it to the capacity of the production facilities and not to the actual level of throughput (sic). Capacity of the production facilities is variously interpreted, for example, as the normal production expected to be achieved over a number of periods or seasons or as the maximum production that as a practical matter can be achieved. The interpretation is determined in advance and applied consistently, and is not modified for temporary conditions.

11. 'Similarly, exceptional amounts of waste-material, labour, or other expenses-which do not relate to bringing the inventories to their present location and condition are excluded from conversion costs.' 8. The above definition and the other discussion in the 'International Accounting Standard Committee brochure' is to the same effect as that of the other one, referred to above and issued by the Institute of Chartered Accountants of India. The crux of the matter boils down to that to fall within the definition of inventories, it should be tangible property and once it is so then only inclusion of the same as goods is warranted. On the facts of the assessee's case a warranty cannot be said to be a tangible property, hence, cannot be included as 'inventories'. On this reasoning also, amount of Rs. 19,84,665 was not includible as closing stock being cost of refrigerators in the hands of the present assessee. The addition stands deleted. We hold and direct accordingly.

9. As regard ground No. 2.1, the reasoning of the learned Commissioner (Appeals) is that for the immediate preceding year, this addition was upheld by the first

appellate authority and in view of this, we having not been enlightened about the fate of the assessee's case at the Tribunal stage the disallowance stands upheld. Ground No. 2.1 stands rejected.

10. As regard ground No. 2.2, the reasoning of the learned Commissioner (Appeals) as also ours remain the same as for ground No. 2.2 and in that view of the matter, this also stands rejected.

11. As regard ground No. 3, the reasoning of the learned Commissioner (Appeals) is that the disallowance has been computed by the learned IAC in respect of bonus paid to the employees drawing salary between Rs. 750 per month to Rs. 1,600 per month, keeping in view the provisions contained in the Payment of Bonus Act which provides that in respect of staff drawing salary in excess of Rs. 750 and up to Rs. 1,600 per month, the bonus will be computed as if the staff was drawing a salary of Rs. 750. The assessee has been paying bonus at the rate of 20 per cent to all its employees right from the accounting period ending on 30-6-1977, i.e., relevant to the assessment year 1978-79 and all along it has been allowed. We have, for ourselves, perused assessee's paper book, pages 72 to 76 which are copies of employment letters issued by the assessee as employer to various employees whereby it is proved that payment of bonus at the rate of 20 per cent of the salary is a term of employment in all cases and in view of this, the payment of bonus to an employee has to form a part of the salary, hence, is allowable under Section 37(1) of the Act.

Section 36(1)(ii) of the Act under which disallowance has been sustained by the learned lower authorities, reads as under : (1) The deductions provided for in the following clauses shall be allowed in respect of the matters dealt with therein, in computing the income referred to in Section 28- (ii) any sum paid to an employee as bonus or commission for services rendered, where such sum would not have been payable to him as profits or dividend if it had not been paid as bonus or commission : Provided that the deduction in respect of bonus paid to an employee employed in a factory or other establishment to which the provisions of the Payment of Bonus Act, 1965 (21 of 1965) apply, shall not exceed the amount of bonus payable under that Act : Provided further that the amount of the bonus (not

being bonus referred to in the first proviso) or commission is reasonable with reference to- (b) the profits of the business or profession for the previous year in question ; and 12. Even this provision of law entitles the assessee to a claim of bonus if it is reasonable with reference to the pay of the employee and the condition of his service and is conformably to the general practice in similar business or profession also keeping in view the profits of the business for the previous year. Now in the case of the assessee as pages 72 to 76 of assessee's paper book reveal, payment of bonus is a stipulation of employment, i.e., a contract of service as a part of salary and it is specifically mentioned in all the three appointment letters that 20 per cent of salary shall be paid as bonus, hence, even Section 36(1)(ii), (proviso) the claim is admissible as deduction. We hold and direct accordingly. On ground No. 3, the assessee succeeds.

13. In the net result, the appeal stands allowed partly, since on ground Nos. 1 and 3, the assessee succeeds and on ground No. 2, the assessee fails.

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