

**IN THE INCOME TAX APPELLATE TRIBUNAL
“A” BENCH: BANGALORE**

**BEFORE SHRI CHANDRA POOJARI, ACCOUNTANT MEMBER
AND
SMT. BEENA PILLAI, JUDICIAL MEMBER**

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| ITA No.222/Bang/2023 |
| Assessment Year: 2018-19 |

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| M/s. BEML Limited 23/1, BEML Soudha, 4 th Main Road Sampangiramanagara Bangalore Karnataka 560 027 PAN NO : AAACB8433D | Vs. | Deputy Commissioner of Income- tax Circle-1(1)(1) Bangalore |
| APPELLANT | | RESPONDENT |

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| ITA No.291/Bang/2023 |
| Assessment Year: 2018-19 |

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| Deputy Commissioner of Income-tax Circle-1(1)(1) Bangalore | Vs. | M/s. BEML Limited Bangalore Karnataka 560 027 |
| APPELLANT | | RESPONDENT |

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| Appellant by | : | Shri R.E. Balasubramaniyan, A.R. |
| Respondent by | : | Shri Sankar Ganesh K., D.R. |

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| Date of Hearing | : | 19.07.2023 |
| Date of Pronouncement | : | 19.07.2023 |

O R D E R

PER CHANDRA POOJARI, ACCOUNTANT MEMBER:

These cross appeals are directed against order of NFAC passed u/s 250 of the Income-tax Act,1961 [‘the Act’ for short] for the assessment year 2018-19 dated 25.1.2023.

ITA No.222/Bang/2023:

2. First, we will take up the assessee’s appeal in ITA No.222/Bang/2023 wherein the assessee raised a ground with regard to disallowance of an amount claimed by assessee as provision

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for obsolescence for inventory. The facts of the issue are that the Id. A.R. submitted in the assessment year under consideration that assessee has debited an amount of Rs.7,74,99,000/- as provision for obsolescence of stock. This amount was calculated on the basis of a scientific method based on the nature of business, age/useful life of spares and also due to technological changes. The methodology is approved by the Board of Directors and has been consistently followed by the assessee. However, the AO observed that this expenditure cannot be allowed since the assessee has not proved with the reasonable certainty as given in the provisions of section 37(1) of the Act and not provided documentary evidence in this regard.

2.1 The Id. A.R. further submitted that the Assessee is a manufacturing company engaged in manufacturing of heavy earth moving equipment and railway rolling stock having plants all over the country. It gets orders to manufacture customized large machinery like, defense vehicles, railway cars, heavy earth moving equipment, etc., at which stage the cost as well as the price for such order is determined.

2.2 In due course of completing such contracts, the Assessee procures raw materials and spares which are used for the production of finished goods. The cost of such inputs is included in determining the price of the contract. To maintain the uniformity in production activities and to further streamline the movement of stock, an SAP software has been implemented company wide.

2.3 The equipment produced have to be tried and tested at different rations and in various weather conditions which

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involves a significant amount of time. During such time the authorized personnel of the parties to the contract inspect stock and other materials. They provide feedback for improvement of the products so manufactured. This requires the Assessee to implement new technology and new methods of production which render some of the existing stock material obsolete, which leads to a reduction in value of the inventory.

2.4 Since the cost of raw materials and spares has been pre-approved by each party to the contract, they are generally rigid against changes in valuation of raw materials and spares.

2.5 According to Ind AS 2 on Inventories, the Assessee is required to value all its inventory at lower of Cost or Net realizable value. The same principle is reiterated in the Income Computation and Disclosure Standard (ICDS)-2. In the given case, due to obsolescence, realizable value of inventory falls below the Cost.

2.6. In order to conform to this standard, the Assessee normally will have two methods of recording such reduction in the value of inventory:

a. The inventory may be shown at Net Realizable Value directly in the Profit and Loss account;

OR

b. A provision may be created for such a reduction in value, by debiting the Profit and loss account and creating a provision which stands reduced from the Value of inventory in the Balance sheet.

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2.7. Under both these methods, the value of inventory will stand reduced to the net realizable value, as required by the relevant accounting standard and ICDS so as to reflect the true and fair value of the profit.

2.8 It was submitted by Id. A.R. that the Assessee has to create a provision for obsolescence to meet the requirements of standards which is necessary since a direct reduction in the value of the Raw materials and Spares would affect the Cost as per the contract. Due to the stringent contractual obligations which require the Assessee to justify the costing and pricing of each project, it is not feasible to manually alter the value of inventory in the implemented SAP to bring them to Net realizable value. If any such alteration is made, the Cost/profit of a particular project would be at variance with the approved/agreed cost. Hence, for the convenience of accounting and to conform with the standards, the Assessee follows the second method as mentioned above.

2.9 According to Id. A.R., this provision for obsolescence is created as a certain percentage of the inventory carrying value only for slow/non-moving inventory of raw material and components and stock of spares (for resale) based on ageing of inventory. Age of an item of inventory is determined by the latest consumption date or latest purchase date whichever is later. In case it is determined at a later date that any such obsolete stock may be used for production, a reversal of such provision is made. The amount so reversed is credited to the P&L A/c. This method of creating provision for obsolescence has been consistently followed in previous Assessment Years 2017-18 and 2016-17.

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2.10 He submitted that in the relevant AY, an amount of Rs. 774.99 Lakhs was debited to the Profit & Loss A/c as "Provision for Obsolescence" which is given in Note 37 to the audited financial statements as part of "Other Expenses". Such amount is arrived at after providing for obsolescence of stock of Raw Material amounting to Rs. 196.36 Lakhs and Stock of Spares amounting to Rs. 578.63 Lakhs. There was also a write back of provision for obsolescence of stock of spares to the tune of Rs. 34.72 Lakhs which was offered to tax as "Other Income" disclosed in Note 31 to the Financial Statements.

2.11 He drew our attention to Note 12 to the Financial Statements, wherein the above provisions are deducted from their respective inventory values in order to arrive at the net inventory value as disclosed in the Balance Sheet.

2.12 According to ld. A.R., the action of Ld. CIT(A) in confirming the disallowance made by the Ld. AO of the provision for obsolescence of inventory was erroneous and bad-in-law inasmuch as he failed to appreciate that this amount was only a downward revision of the closing stock to its realizable value calculated on a scientific method based on the nature of business, age/useful life of spares etc.

2.13 The ld. A.R. relied on the decision of **Honorable Karnataka High Court in the case of Commissioner of Income-tax, Bangalore v IBM India Ltd. [2015] 55 taxmann.com 515 (Karnataka)** where it was held as follows:

"The facts are not in dispute. The assessee carries a large number of computer parts, accessories, etc., in its inventory. Due to rapid technological changes that the computer industry has been facing

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in the last decade, the assessee periodically undertakes the exercise of reviewing its inventory items. The value of the inventory items found obsolete on such review is debited to the scrap account. The amount debited to scrap account during the year includes provision towards such obsolescence. The assessee was required to file computation of Rs.5,79,77,000/- being provision for obsolescence and explain its basis and justify its deductibility. In response, the assessee has given complete details of provision for obsolescence specifying items, quantity, rates/value and the percentage at which the provision has been made in respect of various products/spares. The said provision is created in accordance with the method of accounting regularly employed by the assessee and has been created in respect of

(a) Products which had lost their market value on account of being obsolete;

(b) Products which are damaged and which could not be sold to customers; and

(c) Products which were returned by customers and could not be re-sold.

(para 6)

11 The said provision is created essentially in a situation, where the market value of the stock and spares in hand as on the last date of the financial year, is lower than the cost of such stock and spares. The said accounting treatment is in compliance with the provisions of Accounting Standard-2 issued by the Institute of Chartered Accountants of India which states that the closing stock would need to be valued at cost or net realizable value whichever is lower. It is also on record that a similar provision for obsolescence aggregating to Rs.6,06,27,459/- has been created in the earlier years too. (para 7)

The grievance is, in the profit and loss account, net realizable value is not taken into account. On the contrary, the cost price of obsolete item is taken and, in the provision, made for obsolescence, net realizable value is given which finds a place in the balance sheet and therefore, it was contended that though the net result is the same, the way accounts are reflected is not proper. (para 8)

We do not see any substance in the said contention. Accounting Standards notified under Section 145(2) in particular Accounting Standard-I categorically states that the accounting treatment and presentation in financial statements of transactions should be covered by a substance and not merely by legal form. Further Section 145(A) provides notwithstanding anything to the contrary

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contained in section 145, the valuation of purchase and sale of goods and inventory for the purposes of determining the income chargeable under the head "Profits and gains of business or profession" shall be-(a) in accordance with the method of accounting regularly employed by the assessee. (para 9)

Therefore, what is to be seen is how the assessee is maintaining the accounts regularly in the course of his business and the accounting treatment and presentation of financial statement of transactions should be covered by the substance and not merely by the legal form. It is the principle which is to be kept in mind by both the appellate authorities. The aforesaid material clearly demonstrates instead of showing cost price as nil in the profit and loss account, cost price of the items are given in profit and loss account and a provision is made for obsolescence in inventory showing that the market value is nil and that is the mode in which the assessee was also following even for the previous years. Under these circumstances, we do not see any justification to interfere with the well-considered order passed by both the authorities. Accordingly, substantial questions of law are answered in favour of the assessee and against the revenue. No merit. The appeal is dismissed." (para 10)

2.14 Therefore, the Id. A.R. submitted that the addition confirmed by the Ld. CIT(A) of the provision for obsolescence is untenable and the same ought to be deleted.

3. On the other hand, the Id. D.R. submitted that the first appellate authority has called for a statement showing the actual sale in future years out of the goods amounting to Rs.7,74,99,000/- for which provision for obsolescence of stock was created. The NFAC also asked whether the same scientific method for granting provision for obsolescence is utilized in previous year as well, the statement referred herein above to be furnished for the assessment year 2017-18 and AY 2016-17. However, the assessee chose to not to respond to the specific query and instead based its contention on legal interpretation alone. While conceding that the provisions for obsolescence created based on scientific and statistical model, it has

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to be allowed, the onus remains on the assessee to satisfy that the provision was indeed created in such a manner. Hence, the claim of the assessee is not allowed by NFAC and same to be confirmed.

4. We have heard the rival submissions and perused the materials available on record. The contention of ld. A.R. is that the assessee has debited the net provision for obsolescence of stock to the P&L account and same has been claimed as a deduction. However, it was not demonstrated before us that there was no under-valuation of this inventory and the excess provision, if any, was written back in the succeeding year or in year of sale of obsolete stock, etc. nor was it demonstrated that obsolete stock was valued at lower of cost or net realizable value. In the circumstances, in principle, we hold that the provision for obsolete stock is allowable but it requires to be satisfied that the value of obsolete items of inventory is valued on the cost or market price, whichever is less. In the circumstances, we remit the matter back to the file of AO with a direction that the provision for obsolete stock be allowed as a deduction subject to satisfying himself that the valuation is done based on the principle that at cost or market price or not realizable value, whichever is less. Further, there cannot be double deduction in one assessment year when the provision is made and another time when it was actually written off in its books of accounts of assessee. The assessee shall satisfy the AO that nowhere the assessee has claimed double deduction towards obsolescence of stock at any time. Accordingly, the issue in dispute is remitted to the file of AO for fresh consideration in the light of above observations.

4.1 In the result, the appeal of the assessee in ITA No.222/Bang/2023 is partly allowed for statistical purposes.

ITA No.291/Bang/2023:

5. In this appeal, the first ground is with regard to allowing expenditure of Rs.7.98 crores on scientific research u/s 35(2AB) of the Act although Department of Scientific & Industrial Research (“DSIR”) has not quantified the same in that certificate. Facts of the issue are that the assessee has claimed following expenditure on research & development:

| Deduction u/s 35(2AB) of the Act | Actual (Rs. in Cr.) | Weighted (Rs.in Cr.) |
|----------------------------------|---------------------|----------------------|
| Capital | 7.98 | 11.97 |
| Revenue | 46.56 | 69.84 |
| Total | 54.54 | 81.81 |

| As per figures certified by the DSIR: | | |
|---------------------------------------|---------------------|----------------------|
| Deduction u/s 35(2AB) of the Act | Actual (Rs. in Cr.) | Weighted (Rs.in Cr.) |
| Capital | 7.98 | 11.97 |
| Revenue | 38.62 | 57.93 |
| Total | 46.60 | 69.90 |
| Difference | 7.94 | |

5.1 As seen from the above, the expenditure on scientific research in respect of capital expenditure is Rs.7.98 Crores which has been allowed by the AO as certified by the DSIR. However, in case of revenue expenditure, out of Rs.46.66 crores, it was certified by DSIR only to the extent of Rs.38.62 crores and the balance amount of Rs.7.94 crores were not certified by the DSIR. This claim was disallowed by the AO. However, the Id. CIT(A) allowed the said sum of Rs.7.94 crores u/s 37 of the Act as it was incurred for the purpose of business. Against this revenue is in appeal before us.

6. We have heard the rival submissions and perused the materials available on record. Admittedly, there was no dispute that the assessee has incurred capital expenditure of Rs.7.98 crores on

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scientific research which is entitled for weighted deduction u/s 35(2AB) of the Act and the balance amount of Rs.46.56 crores, which was revenue expenditure spent on scientific research. Out of this, assessee claimed only a sum of Rs.38.62 crores u/s 35(2AB) of the Act and the balance amount of Rs.7.94 crores cannot be claimed u/s 35(2AB) of the Act on the reason that it was not certified by DSIR. However, this expenditure of Rs.7.94 crores has been incurred by the assessee for the purpose of business and this fact is not disputed by the AO and in our opinion, assessee is entitled for deduction on this amount u/s 37 of the Act. This view of ours is fortified by the judgement of order of the Tribunal in the case of Auto Ignition Ltd. in ITA No.3248/Del/2017 dated 11.8.2021 wherein held as under:

“9. Coming to the appeal of the assessee, we found that out of total expenditure incurred by the assessee of Rs.477.39 lakhs, form 3CL computed the deduction allowable to the assessee only on sum of Rs.468.98 lakhs. Therefore, admittedly the assessee is not eligible for weighted deduction on the sum of Rs. 8.41 lakhs. However, the assessee has been denied deduction on this sum u/s 37(1) of the Act itself also. We find that such R&D expenditure though not eligible for weighted deduction u/s 35(2AB) but is allowable as deduction u/s 37(1) of the Act to the extent of amount of expenditure incurred by the assessee. The assessee should have been allowed deduction of above sum as normal allowable expenditure u/s 37 (1) of the act. The Id CIT(A) did not deal with this aspect. In view of this, we direct the Id AO to allow the assessee deduction u/s 37(1) of the Act at a sum of Rs. 8.41 lakhs. Accordingly, appeal of the assessee is allowed.”

6.1 In view of the above discussion, we dismiss this ground of appeal of the revenue.

7. Next ground in this appeal is with regard to allowability of liquidity damages for delay in supply of goods amounting to Rs.1,74,74,000/-, which was disallowed by AO on account of non-compliance of terms & conditions of the contract u/s 37(1) of the Act.

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Facts of the issue are that the assessee has debited a sum of Rs.1,74,74,000/- under the heads "liquidity damages on sales". The assessee is engaged in the business of supplying specialized products, which are tailor-made as per specifications received from the parties and in the course of aforesaid transactions, it has incurred damages due to non-compliance of business promotions or non-fulfilment by assessee company as deduction while computing the income of the assessee. Since it was left by parties after negotiations on account of negligence or non-compliance of business promotions, the AO of the opinion that the said amount has been incurred by the assessee on account of infringement of law and it is in favour in nature. However, the ld. CIT(A) allowed the claim of the assessee holding that the said expenditure is paid as a compensation for breach of contractual obligation and it is not incurred for default of any infringement of law and directed the AO to allow this expenditure of Rs.1,74,74,000/-. Against this revenue is in appeal before us.

8. We have heard the rival submissions and perused the materials available on record. As seen from the facts of the issue, the above expenditure has been incurred as a compensation for breach of contractual obligation. In our opinion, there is a difference between penalty for infraction of law and damages for breach of contract in the context of deduction u/s 37(1) of the Act and this issue was considered by Hon'ble Gujarat High Court in the case of Principal CIT Vs. Mazda Ltd. reported in (2017) 86 taxmann.com 27 (Guj.), wherein held as under:

14. "Full Bench of Punjab and Haryana High Court in case of Jamna Auto Industries v. CIT [2008] 299 ITR 92/167 Taxman 192 highlighted the difference between the penalty for infraction of law and damages for breach of contract in the context of deduction under section 37(1) of the Act. The Court held that whenever

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damages are to be paid by an assessee for a breach of contract, such damages are treated to be normal expenses of business. It was further held that where an assessee has to pay damages to other party to fulfill the contract entered into by him in the ordinary course of his business, the amount of damages to be paid is allowable deduction if it is in the ordinary course of business and is not opposed to public policy.”

8.1 In view of the above, we are of the opinion that ld. CIT(A) is justified in allowing the claim of the assessee in respect of compensation paid for breach of contractual obligation. This ground of appeal of the revenue is dismissed.

9. In the result, the appeal of the revenue in ITA No.291/Bang/2023 is dismissed.

Order pronounced in the open court on 19th July, 2023

Sd/-
(Beena Pillai)
Judicial Member

Sd/-
(Chandra Poojari)
Accountant Member

Bangalore,
Dated 19th July, 2023.
VG/SPS

Copy to:

1. The Applicant
2. The Respondent
3. The CIT
4. The CIT(Judicial)
5. The DR, ITAT, Bangalore.
6. Guard file

By order

Asst. Registrar,
ITAT, Bangalore.