

**IN THE INCOME TAX APPELLATE TRIBUNAL,
MUMBAI BENCHES "C" (SPECIAL BENCH), MUMBAI.**

**Before S/Shri D.Manmohan, Vice President, S.V.Mehrotra, Accountant
Member & D.K.Agarwal, Judicial Member**

**I.T.A No.4404 & 1883/Mum/2004
Assessment year: 1999-2000 & 1998-99**

The DCIT (IT)-1(1),
Room No.117, Scindia House, N.M.Road,
Ballard Pier, Mumbai-01.

v. M/s. Bank of Bahrain & Kuwait,
BSC, Jolly Maker Chamber-III,
225, Nariman point, Mumbai-21.
PA No.**AAACB 2140 F**

(Appellant)

(Respondent)

Appellant by: Shri Ajit Kumar Sinha (CIT-DR)
Respondent by : Shri F.V.Irani

ORDER

Per S.V.Mehrotra(AM)

The present Special Bench has been constituted u/s.255 (3) of the Income tax Act, 1961.

2. The constitution of Special Bench resulted as under:

The assessee is a non-resident company carrying on banking business in India. It enters into forward contracts with its clients to buy or sell foreign exchange at an agreed price on a future date. On the date of maturity, the contract is executed which may result in the profits or losses to the assessee. There is no dispute between the parties in respect of losses arising on execution of the contracts within the same year. However, in some cases, the date of maturity of the contract falls beyond the end of the accounting period. In such cases, the assessee evaluates the unmatured forward contracts on the last day of the accounting period on the basis of rate of foreign exchange prevailing on that date and books the loss or profit, accordingly. This methodology was adopted keeping in view the guidelines laid down by the Reserve Bank of India as per rates notified by Foreign Exchange Dealers Association of India (FEDAI). The

revenue's stand is that in view of the decision of the Hon'ble Madras High court in the case of Indian Overseas Bank, 183 ITR 200(Mad), this method of accounting is not correct because the loss is incurred on the date of maturity of the contract and there cannot be any loss prior to such date. The assessee's stand is based on the decision of the Mumbai Tribunal in the case of Deutsche Bank A.G., 86 ITD 431(Mum) and FEDAI guidelines. In the reference order, it is pointed out that the decision in the case of Deutsche Bank A.G. (supra) proceeded on the basis that forward contract constitutes stock-in-trade, and, therefore, same could be valued at the end of the year, which may result into loss. It is further pointed out that in Deutsche Bank (supra) the decision of the Hon'ble Madras High court was distinguished on the ground that the Court was concerned with the issue as to whether notional or anticipated loss could be allowed as deduction or not, while the Tribunal was concerned with the valuation of stock-in-trade. The Bench referred the matter, since the assessee, as a banker, only enters into contract to sell/buy the foreign currency at a future date but does not buy or sell such contracts from or in the market. It is observed that the assessee is not holding these contracts as stock-in-trade and, therefore, the decision in the case of Deutsche Bank A.G.(supra) was not applicable. Accordingly, the Bench framed the following question for reference:-

"Whether on facts and circumstances of the case, can it be said that where a forward contract is entered into by the assessee to sell the foreign currency at an agreed price at a future date falling beyond the last date of accounting period, the loss is incurred to the assessee on account of evaluation of the contract on the last date of the accounting period i.e. before the date of maturity of the forward contract."

The Hon'ble President, after considering the reference petition, referred the entire appeal for disposal. We, accordingly, proceed to decide the appeal on merits.

3. Facts are similar in both the assessment years; therefore, we discuss the facts as obtaining in the assessment year 1999-2000. At this juncture, we may also point out that Id CIT (A) has followed the order for A.Y. 1998-99 and, therefore, while considering the facts for A.Y. 1999-2000, the Id CIT (A)'s order for A.Y. 1998-99 is to be referred. Brief facts of the case are that the assessee is a non resident banking company. It filed its return of income showing total loss of Rs.6,29,90,894/-. Thereafter, the assessee

filed revised return at Rs. Nil. The book profit u/s.115A was worked out at a loss of Rs.31,69,009/-, on the basis of original return of income. The Assessing Officer determined the total income at Rs.6,86,37,276/-, *inter alia*, making the following additions:

i)	Interest accrued on investments	:	Rs.2,58,79,931/-
ii)	Broken period interest on securities lying in stock-in-trade.	:	Rs. 8,95,011/-
iii)	Loss on forward exchange transaction:		Rs. 12,42,648/-
iv)	Deferred guarantee commission (Rs.1,70,46,547 –Rs.25,19,337/-)	:	Rs. 1,45,27,210/-
v)	Interest attributable to investments in Shares	:	Rs. 1,01,34,587/-

4. For the assessment year 1998-99 also, the Assessing Officer determined the total income at Rs.2,77,54,853/-, *inter alia*, making similar additions as in the assessment year 1999-2000.

5. Id CIT (A) while partly allowing the assessee's appeals, has deleted the aforementioned disallowances made by the AO for both the assessment years. Being aggrieved with the decision of Id CIT (A), the department is in appeal before the Tribunal for both the assessment years.

6. Ground No.1 similar to both the assessment year is as under:-

"On the facts and circumstances of the case and in law, the Id CIT (A) has erred in holding that, income arising from securities and on debenture to the assessee is liable to be taxed on due basis and not on the basis of day to day."

7. Facts apropos this issue are that in the books of account, the assessee had recognized income from interest on securities on day to day accrual basis. However, in the return filed, the assessee had claimed that interest, which had not become due for payment during the previous year, should not be included as income. The AO did not agree with assessee's contention. After considering the various figures, he concluded that the assessee had not offered for tax Rs.67,20,565/- being interest accrued but not due. He noted that in earlier years also, the assessee was following same system of

accounting but it was not accepted. The AO further observed that the income accrues as and when the assessee acquires a right to receive such income or the right becomes vested in it. In this regard, the AO pointed out that in the case of Government securities although the interest becomes due for payment only at six monthly intervals, such interest certainly accrues from day to day, which is evident from the fact that when assessee purchases certain securities, it pays not only cost of securities, but also the interest which had accrued on day to day basis from the last date of payment of interest to the date of purchase. Similarly, he pointed out that when the assessee sells the securities, it received not only sale value but also the broken period interest, which had accrued on the securities till the date of sale. Thus, he pointed out that interest accrued day to day and the quantum of interest accruing is also known to the assessee. He relied on the decision of the Hon'ble Supreme Court in the case of *E.D.Sasoon & Co.*, 26 ITR 27 and *Shri Govardan Ltd.*, 69 ITR 675 (SC). He further pointed out that the Hon'ble Supreme Court admitted the SLP filed by the department against the decision of the Hon'ble Karnataka High Court in the case of Canara Bank. He, accordingly, held that since the assessee was following mercantile system of accounting, the profit or loss at the end of the accounting year will be based not on the difference between what was actually received or paid but on the difference between the right to receive and the liability to pay.

8. Before Id CIT (A), it was, inter alia, contended that with the abolition of sections 18, 19 and 20 of the I.T.Act w.e.f. 1.4.1989, no provision is made in the Act to define separately the scope of interest on securities which could be taxable. Consequently, the interest on securities assessable would be the amount which could be charged under the charging provisions of section 5, which, apart from charging income on receipt basis, also provides for charging of income when it accrues or is deemed to accrue to the assessee. Section 145 of the Act provides that the income from business should be computed in accordance with the method of accounting regularly employed by the assessee. Such computation has to be within the ambit of section 5 and cannot override the provisions of the said main charging section. The interest on securities accrues only on fixed days, generally on a six monthly basis twice a year and does not accrue from day to day. Therefore, the owner of securities who is registered on the due dates is

entitled to receive the entire six monthly interest, irrespective of the fact whether he held the said securities for the entire earlier six months period or not. The previous holder of the securities who has sold the securities has no right to receive from the disbursing authority any interest from the last due date upto the date of sale. Reliance was placed on the decision of the Hon'ble Karnataka High Court in the case of Canara Bank, 195 ITR 66.

9. Ld CIT (A) referred to the decision of the Hon'ble Karnataka High court in the case of *Canara Bank*, (Supra) wherein, it was held that the interest on Government Securities does not accrue before the stipulated date of payment and as such only such interest would be taxable in the assessment year under consideration which has fallen due for payment during the previous year. The SLP filed by the department against the decision of the Hon'ble Karnataka High Court in the case of *Canara Bank* (supra) has been dismissed by the Hon'ble Supreme Court. He also referred to the decision of the ITAT Jaipur Bench in the case of *State Bank of Bikaner and Jaipur*, 74 ITD 203 , wherein, it was held that even if the bank had accounted for interest on day to day basis in its books, the provisions of section 5 of the I.T.Act could not be ignored and the method of accounting followed by the bank could not override the provisions of section 5. He, accordingly, allowed the assessee's appeal. The department is in appeal before us.

10. Ld CIT (DR) relied on the order of the Assessing officer.

11. Ld Counsel for the assessee submitted that this issue is covered in assessee's own case for the assessment years 1992-93, 1993-94, 1995-96 and 1996-97. Ld Counsel submitted that interest on Government Securities does not accrue on day to day basis but on fixed dates and the entry made in the books are not relevant for income tax purposes.

12. We have heard both the sides and perused the records of the case. We find that the issue is covered by the decision of the Tribunal in assessee's own case for the

assessment years 1992-93, 1993-94, 1995-96 and 1996-97. In A.Y. 1996-97, the Tribunal has allowed the assessee's appeal, inter alia, observing as under:-

"We have carefully perused the order of the Tribunal cited above. In that case also, the issue was identical, namely, whether in the case of Government securities, interest accrues on day to day basis or only on the coupon dates. The Tribunal held that interest accrues only on the coupon dates and not on day to day basis. In coming to this conclusion, the Tribunal placed reliance on the judgment of the Lahore High court in Haveli Shah Sardarilal v CIT, Punjab, 4 ITR 297, the Full Bench of the Patna High Court in Ranjit Prasad Singh v CIT, Bihar & Orissa (4 ITC 264) and the Karnataka High Court judgment in Addl CIT, Mysore v. The Vijay Bank Ltd., Mangalore (1976) Tax LR 524. It was also noticed by the Tribunal that the contention advanced on behalf of the revenue before Tribunal in that case was totally contradictory to the contention advanced by the revenue before the Karnataka High court in the case of Vijay Bank (supra) before the Tribunal. The department had placed reliance on the judgement of the Hon'ble Bombay High court in the case of American Express International banking Corporation v CIT, 258 ITR 602 and Taparia Tools Ltd v. JCIT, 269 ITR 102. These two judgments have been considered by the Tribunal in paragraphs 14 to 17 of the order cited above and it was held that these judgements are not applicable to the facts of Union Bank's case. In paragraphs 20 and 21, the Tribunal has also considered the objection of the department that the assessee cannot credit the interest on government securities in the profit & loss account on day to day basis but contended that for purposes of income tax only the interest that accrued on the coupon dates can be assessed. The Tribunal noticed the judgement of the Supreme Court in the case of another bank, namely United Commercial Bank, 240 ITR 355. In this case, the Supreme Court has reversed the judgement of the Calcutta High Court, which held that the assessee cannot prepare the computation of its income for income tax purposes in a manner different from the method under which it keeps accounts. Applying this judgment of the Supreme Court, the Tribunal held that Union Bank of India cannot be prevented from urging in the return that the interest on govt. securities accrued only on the specified coupon dates notwithstanding that credit has been taken in the profit & loss account for the interest on day to day basis. Thus, the issue has been decided in favour of the view that the interest accrues only on the specified coupon dates and not on day to day basis. Since the facts of the present are identical, following the order of the Tribunal in the case of Union Bank of India (supra), we uphold the action taken by the CIT (Appeals) and dismiss the appeal."

Consistent with the precedents, we dismiss this ground of the revenue.

13. Ground No.2 for the assessment year 1999-2000 is similar to Ground No.3 for the assessment year 1998-99, i.e. Id CIT (A) erred in deleting the disallowance on account of broken period interest paid by the assessee.

14. The Assessing Officer noticed that the assessee bank had paid an amount of 8,95,911/- as broken period interest on securities purchased during the year and lying in the closing stock. He noticed that the assessee bank followed the practice of debiting the P&L account with the interest paid and crediting the same with the interest received, treating the interest component as a revenue item. The AO was of the opinion that since the interest element was a part of lumpsum consideration, therefore, to the extent, the securities were lying in the stock, the interest paid on the same could not be disallowed as deduction, inter alia, observing that since they were current investments, the amount of interest paid on assets, which were purchased and sold during the year, was ignored. The AO had relied on the decision of the Hon'ble Supreme Court in the case of Vijay bank, 187 ITR 541, wherein, it was held that the broken period interest paid is a part of capital cost of the asset.

15. Before Id CIT (A), the assessee submitted that the interest pertained to the period during which, the securities were held by the assessee did not accrue to the assessee but to the vendors. Accordingly, although the assessee received such interest from the issuer, it did not belong to the assessee and, hence, the same could not be subjected to tax in its hands. Ld CIT (A) pointed out that the facts in the case of Vijay Bank were different and the assessee's case was identical to the case of American Express International Banking Corporation. He, accordingly, allowed the assessee's appeal on this count.

16. Ld CIT D.R.in the written submissions, pointed out that it is only when securities which are not sold during the year that the broken period interest has not been allowed. Ld CIT D.R.pointed out that in the case of American Express International Banking Corporation, the decision of the Hon'ble Supreme Court in the case of Vijay Bank (supra) was distinguished on account of the fact that in the case of American Express International Banking Corporation(supra), the securities were held as trading asset

whereas in the case of Vijay Bank (supra), the securities were held as investment/capital asset. Therefore, the basic dispute is regarding the question of fact as to whether the securities are held as trading asset or capital asset. In this regard, he referred to CBDT Circular No.665 of 5.10.1993, wherein, it has been prescribed that the AO shall determine on the facts and circumstances of each case whether the securities constitute stock-in-trade or capital asset taking into account RBI guidelines in this regard from time to time. He referred to the annual report submitted alongwith return of income and pointed out that in the Schedule-8, government securities and other securities have been classified as investment and not as stock-in-trade. He clarified that the AO's observation in this regard for the A.Y. 1994-95 are mis-placed as Schedule-8 to the balance sheet does not state that the securities are held as current investment and hence, they are stock-in-trade. Therefore, since the securities were held as investments/capital asset, the decision of the Hon'ble Bombay High court in the case of American Express International Banking Corporation is not applicable. He further pointed out that during the year under consideration, Schedule-8 of the balance sheet of the assessee is in respect of investment and, there is no such item as current investment in the balance sheet, which can be treated as stock-in-trade of the assessee. He, therefore, in sum and substance, submitted that since the securities were capital asset, the broken period interest is to be capitalized with the cost of securities. However, he fairly admitted out that the AO had already allowed the broken period interest in respect of securities sold during the year, therefore, even if the securities are held as trading assets, the assessee would not be entitled to any further deduction and the disallowance of broken period interest with reference to securities not sold during the year was to be upheld. He submitted that in the present case, the decision in the case of Vijay bank (supra) is applicable. He further submitted that in case of any doubt in this regard, the matter may be restored back to the file of the AO to verify the same in view of RBI guidelines and Board's circular No.665. Alongwith written submissions, he has filed an Article giving details of RBI guidelines regarding securities by M.S.Prasad.

17. Ld counsel for the assessee submitted that in assessee's own case for the assessment year 1992-93, the issue has been decided in favour of the assessee. He pointed out that the CIT (DR) in his submissions conceded that if the securities are held

as trading asset, then the broken period interest would be allowable. He clarified that the profit made by the bank on sale of the securities has been taxed as business profit and not as capital gain. In this regard, he referred to the AO's computation at the end of the assessment order. He further pointed out that this fact has been mentioned by the ITAT in its order in assessee's own case for the assessment year 1992-93.

18. In reply to Id D.R.'s submissions that the securities were shown in the balance sheet in Schedule -8 as investments, Id Counsel for the assessee pointed out that the said classification is for the limited purposes of compliance with the Banking Regulation Act. He pointed out that these very arguments raised by Ld CIT D.R.in A.Y. 1992-93 have duly been considered by ITAT. In this regard, Id Counsel for the assessee placed reliance on the decision of the Hon'ble Supreme Court in the case of United Commercial Bank, 240 ITR 255 (SC), wherein, the Hon'ble Supreme court observed that preparation of balance sheet in accordance with the statutory provisions would not disentitle the assessee in submitting the income tax return on real taxable income in accordance with the method of accounting adopted by the assessee consistently and regularly. He further pointed out that the entire interest received on the due date has been offered to tax and in fact taxed as income and, therefore, the broken period interest paid at the time of purchase had to be allowed as deduction.

19. We have considered the rival submissions and perused the record of the case. The only objection of Id CIT (DR) is that the securities had been classified as investments in Schedule -8 to the balance sheet. However, he has not controverted the findings recorded in A.Y. 1992-93 regarding these securities being held as stocks-in-trade. On the contrary, in all fairness he has accepted this fact in view of AO's findings. That being so, and in view of the decision of the Hon'ble Supreme Court in the case of United Commercial Bank(supra), merely the classification of the securities as investment in balance sheet is of no consequence and the real income is to be determined as per the return filed by the assessee. We find that this issue is squarely covered by the decision of ITAT in assessee's own case for A.Y. 1992-93, wherein, in para 5, the Tribunal following the decision of the Hon'ble Jurisdictional High Court in the case of American Express International Banking Corporation(supra), and the decision of the

ITAT in assessee's own case for A.Ys. 1991-92, 1993-94 and 1994-95, we confirm the order of Id CIT (A). This ground is dismissed.

20. Ground No.4 raised in both the assessment years is against deletion of the addition on account of deferred guarantee commission.

21. Facts are that the AO required the assessee to submit the details of guarantee commission received during the year and whether the same had been accounted for as income or not. The assessee submitted that it was following mercantile system of accounting and, therefore, accounting the guarantee commission related to the year only. The AO was of the opinion that the transaction involving bank guarantee is only in the year the guarantee is given. The assessee got the right to receive the said commission in the said year. He observed that guarantee commission was not advance commission received and, therefore, there was no question of deferring the same to future year. He, accordingly, considered the entire income relating to guarantee commission in the year in which the guarantee was given.

22. Before Id CIT (A), it was contended that since the assessee was following mercantile system of accounting and had been offering to tax the guarantee commission during the currency of the period of guarantee, there was no justification to assess the same on receipt basis. Id CIT (A) after considering the concept of accrual observed that since the obligation extended to the entire period for which guarantee was given, therefore, the guarantee commission also spreads over the entire period of guarantee. In this regard, he relied on the decision of the Hon'ble Supreme Court in the case of *Madras Industrial Investment Corporation Ltd v CIT (225 ITR 802)*, where while dealing with the issue of allowability of discount on debentures, the Hon'ble Court held that the entire discount liability cannot be allowed as a deduction in one year and authorized spread over of the committed obligation to be discharged in later years. He also referred to the decision of the Hon'ble Calcutta High Court in the case of *CIT v. Bank of Tokyo Ltd. (71 Taxman 85)*, wherein, the Hon'ble High Court, inter alia, observed as under:-

"..... It may or may not fructify into an actual right to receive for the subsequent period of the term of the guarantee as the sooner

determination of the guarantee is a contingency not ruled out by the agreement. It is only upon certain conditions being fulfilled, viz, the guarantee running the full course or period of the debt guaranteed, that the right to the entirety of the commission can be said to have accrued."

23. Ld CIT D.R.submitted that the bank provides bank guarantee to its customers to cover their liability and against this, charges its commission one time, which may or may not be refundable on revocation of guarantee before its maturity date. He pointed out that it is a question of fact which needs to be ascertained. He submitted that the decision in the case of American Express International Banking Corporation(supra),relied upon by Id CIT (A) is not applicable to the facts of the case because in the said decision, it was the expenditure which was claimed for spread over whereas in the case of the assessee, it is the income which has been received at the time of giving bank guarantee. Further in the case of debentures, the discount though accrued was payable in future spread over of debentures which is not the case of the assessee. Similarly, the decision in the case of Bank of Tokyo Ltd (supra), is not applicable because in the said case, the guarantee commission was refundable in case the bank guarantee was revoked before the time of full time period of guarantee. But in the present case, the AO has observed that the guarantee commission is not in the nature of advance commission. Thus, the decision in the case of Bank of Tokyo Ltd (supra) is not applicable. He submitted that the spread over of the guarantee commission can be allowed only if the commission was refundable on premature revocation of guarantee. He submitted that fact whether the commission was refundable or not has not been examined and, therefore, the matter may be restored to the file of the AO.

24. Ld counsel for the assessee relied on the order of Id CIT (A), the decision of the Hon'ble Calcutta High Court in the case of *Bank of Tokyo Ltd (supra)* and also the decision of the Hon'ble Supreme Court in the case of *Madras Industrial Investment Corporation Ltd (supra)*. He submitted that in view of the decision of the Hon'ble Supreme Court in the case of *Madras Industrial Investment Corporation Ltd (supra)*, the guarantee commission is required to be spread over the period of guarantee on the principle of matching.

25. We have considered the rival submissions and perused the record of the case. The fundamental principle of taxing the income under the mercantile system of accounting is time of its accrual. It is not material whether the amount has been received at the time of accrual or not. The income is said to accrue when the assessee acquires the right to receive the same. Therefore, the basic question to be answered is as to at what stage the assessee acquired the absolute right to receive the income. The principle has been succinctly enunciated by the Hon'ble Supreme Court in the case of E.D.Sasoon & Co. and others (supra), wherein, after considering the observations of Hon'ble Justice Mukerji, J in the case of *Rogers Pyatt Shellac & Co. v Secretary of State for India(1925) 1 ITC 363 at page 371* considered the term "accrues, arises and is received" and also the observations of Lord Justice Fry quoted by Hon'ble Justice Mukerji, J in **Colquhoun v Brooks** and others decisions, observed as under:-

"It is clear therefore that income may accrue to an assessee without the actual receipt of the same. If the assessee acquires a right to receive the income, the income can be said to have accrued to him though it may be received later on its being ascertained. The basic conception is that he must have acquired a right to receive the income. There must be a debt owed to him by somebody."

In the light of above decision, the issue needs to be examined. Ld CIT (DR) has pointed out that the deciding factor would be whether the guarantee commission is refundable or not. If the guarantee commission was refundable then it cannot be said that absolute right to the commission had accrued in favour of the assessee at the time of execution of contract for furnishing guarantee by it but if the guarantee commission was not depended upon the period of guarantee and, thus, had accrued in favour of the assessee on the date of execution of contract for furnishing guarantee then the same has to be taxed in the year in which the guarantee was furnished irrespective of the period to which guarantee remained alive. This is so because the guarantee commission cannot be apportioned with reference to the period over which the guarantee extended. Even in the case of *Bank of Tokyo Ltd (supra)* heavily relied upon by Id Counsel for the assessee, this principle has been accepted, which is evident from the observations noted in para 22 above. We, therefore, restore this matter back to the file of the AO to examine the issue in the light of above discussion and if he finds that as per the term, the commission was refundable on the revocation of guarantee, then the guarantee

commission is to be spread over the period for which the guarantee is given else it is to be taxed in the year the guarantee had actually been given irrespective of the period for which it spread. This ground is allowed for statistical purposes.

26. Ground No.5 similar to both the assessment years is that Id CIT (A) erred in deleting the addition being interest attributable to investment, dividends from which is exempt from tax.

27. The Assessing officer noticed that the assessee had earned dividend of Rs.1,13,63,468/- out of shares of various companies. He was of the opinion that since income from dividend was exempt from tax, therefore, proportionate disallowance was called for out of interest paid on borrowed fund. The assessee in its submissions pointed out that the investment was made out of its own funds and no expenditure had specifically been incurred wholly and exclusively for the purpose of earning such income. The AO did not accept the assessee's contention that since no specific borrowings were made for investment in shares, therefore, proportionate interest on borrowing should not be disallowed. He observed that the borrowed funds meant for the purposes of business had been diverted towards investment in shares and since the income was not taxable under the business head u/s.56, therefore, on account of its being exempt u/s.10(33), only net dividend is to be considered for exemption. He also pointed out that section 14A has been inserted in the Act, which provides that no deduction shall be allowed in respect of expenditure incurred by the assessee in relation to income which does not form part of the total income under this Act.

28. Ld CIT(A) after considering the assessee's statement showing the position of non interest bearing funds and the amount of investment in shares reproduced at page 16 of his order, observed that in the year of investment, the assessee had sufficient funds available which were interest free funds, which has not been examined by the AO. He, therefore, allowed the assessee's appeal, inter alia, observing that no nexus had been established between the investment in shares and interest bearing funds.

29. Ld CIT D.R.submitted that the Special Bench of ITAT Mumbai in the case of Daga Capital Management, 117 ITD 169 has held that section 14(2) and 14A(3) as well as Rule 8D are retrospective in effect and, therefore, the disallowance is to be computed as

per Rule 8D. He, therefore, submitted that the matter may be restored back to the file of the AO.

30. Ld Counsel for the assessee reiterated the submissions made before the lower authorities and pointed out that the assessee has sufficient funds from which investments were made in shares.

31. We have considered the rival submissions and perused the record of the case. The applicability of section 14A cannot be disputed in view of the decision in the case of Daga Capital Management (supra), wherein, it has been held that section 14a(2) & 14A(3) including Rule 8D are retrospective in nature. At the time of hearing, it was brought to the notice of both the parties that the issue is pending before the Hon'ble Bombay High Court in regard to 14A issue and, therefore, the appeal may be adjourned sine die till the disposal of the same by the Hon'ble High Court. However, both the parties agreed that the matter may be restored back to the file of the AO in view of the decision in the case of Daga Capital Management (supra). We, therefore, restore this issue to the file of the AO. This ground is treated as allowed for statistical purposes.

32. Ground No.2 for the assessment year 1998-99 and Ground No.3 for the assessment year 1999-2000 in regard to which reference has been made to the Special Bench reads as under:

"Whether on facts and circumstances of the case, can it be said that where a forward contract is entered into by the assessee to sell the foreign currency at an agreed price at a future date falling beyond the last date of accounting period, the loss is incurred to the assessee on account of evaluation of the contract on the last date of the accounting period i.e. before the date of maturity of the forward contract."

33. Facts in brief are that the AO noticed that the assessee had booked a loss on revaluation of forward foreign exchange contracts, which were unmatured on the date of balance sheet, of an amount of Rs.12,42,648/-. He noted that the assessee enters into forward contracts with clients to buy or sell foreign exchange at an agreed price on a future date. This future price was estimated according to certain norms such as forward premium rates for certain currencies. He noted that when such contract was entered into, the bank normally booked loss or profit depending upon the difference between the prevailing exchange rate on that date and contract rate. On the maturity

of contract, the same profit or loss booked earlier was reversed and the actual profit or loss incurred based on the difference between the exchange rate on that date and the contract rate was booked. He pointed out that for transactions which mature during the year, the notional profit or loss gets replaced by actual profit or loss. There is no dispute in this regard and the same has been treated as revenues profits/loss. However, since in the forward contracts, the liability to purchase or sale of foreign exchange arises only on the date of maturity of the contract, therefore, the loss or gain depends upon the rate prevailing on that date and the contracted rate. Thus, he was of the opinion that the date of maturity of the contract is the relevant date for determining the profit or loss, accruing to an assessee, in pursuance to the forward foreign exchange contract. The assessee pointed out that as per RBI's guidelines, the banks were required to revalue unmatured contracts as per rates of exchange notified by Foreign Exchange Dealer's Association of India (FEDAI). Accordingly, on the balance sheet date, based on the exchange rate on that date, provision of profit/loss substitutes the figures booked at the time of contract. Thus, revalued loss/profit was debited to the profit and loss account. Further, this treatment was as per principles of accounting which required the current assets to be marked to the market rate. The AO did not agree with this modus operandi in regard to unmatured forward contracts. He further pointed out that in case foreign exchange is a current asset, the easier method of accounting would be to book the sale when it was done and the purchase when it was executed, which will determine gain or loss of the transaction. He further observed that the method followed by the assessee may be fair accounting principle to estimate the net worth but the principles of taxation required that actual profit or loss was brought to tax. He also observed that there are number of provisions in the I.T.Act which require the assessee to follow a different method than followed in its books of account. In this regard, the Assessing Officer referred to the decision in the case of *CIT v. Motor Industries Company Limited (229 ITR 137)*, wherein, it has been held that the income tax law does not allow as expenses all the deductions a prudent trader would make in computing his profits. It is only the actual liability in present which is allowable and not liability in future which for the time being, is only contingent. It was also held that what a prudent trader sets apart to meet a liability, not actually present but only contingent, cannot bear the character of expenses till the liability becomes real. He also referred to the decision of

the Hon'ble Supreme Court in the case of *Indian Molasses' case (37 ITR 66)*, wherein also, it was held that where the liability is contingent, the same is not allowable. The Hon'ble Supreme Court observed as under:-

"The expenditure which is deductible for income tax purposes is one which is towards a liability actually existing at the time, but the putting aside of money which may become expenditure on the happening of an event is not expenditure."

As regards the assessee's contention that bank was recording its income and expenditure on accrual basis, which was as per the provisions of Section 145 and the same could be disputed only if the profits or gains were not properly deductible from the same, the AO pointed out that the accounting method followed does not have much relation to the accrual basis of accounting. He observed that in forward contracts, liability arises only on the date contract matures. He pointed out that before the sale, it is only a contingent liability as the assessee could not foresee the rate of exchange which would prevail on the date of maturity of the contract. The AO referred to the decision of the Hon'ble Madras High Court in the case of *Indian Overseas Bank(183 ITR 200)*, wherein, similar issue was examined and it was held that before settlement of contracts in foreign currency, no actual profit could accrue. It was held that the amounts in question represented notional profits only. Drawing analogy from this decision, the AO disallowed the loss of Rs.12,42,648/- treating the same as notional loss. The AO, however, allowed the amount which was disallowed on this count in earlier years.

34. Before Id CIT (A), it was contended that the assessee was required to revalue its outstanding forward foreign exchange contracts as per the rates of exchange notified by the Foreign Exchange Dealer's Association of India on March 31, every year as per RBI guidelines. The gain or loss on revaluation of the outstanding contracts was booked in the profit and loss account as per the mandatory requirements of RBI guidelines. The assessee relied on the decision of the Hon'ble Supreme Court in the case of *United Commercial Bank v CIT, 240 ITR 355* and also on following decisions:-

1. Bank of Tokyo v IAC, 13 ITD 32
2. State Bank of Mysore v CIT, 114 ITR 704 (Kerala)
3. CIT v. Canara Bank, 63 ITR 328 (sc)
4. ONGC v DCIT, 83 ITD 151 (Delhi)

Ld CIT (A) allowed the assessee's appeal, inter alia, observing that the assessee was offering profits resulting from such revaluation as and when they so arise and the AO had never objected to the profits which was shown on revaluation of outstanding foreign exchange forward contracts. In this regard, Ld CIT (A) relied on the decision of ITAT Mumbai in the case of Deutsche Bank A.G v DCIT, 86 ITD 431, wherein, it has been held that income/loss on revaluation of forward foreign exchange contracts is not notional in nature and, therefore, needs to be considered in preparing computation of total income of the assessee. He also pointed out that in this case the decision of the Hon'ble Madras High Court in the case of Indian Overseas Bank (supra) has been distinguished.

35. Ld CIT D.R. Shri Ajit Kumar Sinha submitted that the assessee is carrying on banking business in India and it is not the assessee's business to deal in forward contracts. It entered into forward contracts with its clients to buy or sell foreign currency at an agreed price on a future date in order to protect the interest of the bank. He submitted that it is a tool to safeguard the assessee's interest. Ld CIT D.R. submitted that these contracts are entered into in order to avoid wide fluctuation in foreign currency. He submitted that there is no dispute in regard to contracts which matured during the year in which they were entered into and the loss/profit was claimed as deduction/income, had been allowed/taxed, accordingly. The dispute is only in regard to those forward contracts, date of maturity of which fall after the end of the accounting year. The assessee revalued its profit/loss on notional basis as per rate of exchange prevailing on the balance sheet date and claimed the same. Ld CIT D.R. submitted that the reference to the Special Bench has been made because the decision of ITAT in the case of Deutsche Bank A.G., 86 ITD 431(supra) and that of the decision of the Hon'ble Bombay High Court in the case of Bank of India, 218 ITR 371 relied upon by the assessee proceeded on the footing that the securities were stock-in-trade but as far as the forward contract is concerned, the same is not stock-in-trade and, therefore, those decisions are not applicable. He pointed out that there is no material to prove that forward contract to buy or sell foreign currency itself constitutes the stock-in-trade as the assessee does not trade in such forward contract. He, therefore, submitted that the decision which proceeded on the basis of foreign currency being stock-in-trade cannot be relied upon in the present set of facts. He further pointed out that these

transactions are not recorded in the books of account and hence, there cannot be any liability from income tax point of view. Thus, there cannot be any question of computing any notional loss for the purposes of income tax. He submitted that the foreign exchange contract cannot be considered on the same footing on which foreign exchange currency being stock-in-trade is considered. In this regard, Ld CIT D.R. referred to the decision of the Hon'ble Supreme Court in the case of CIT v. Woodward Governor of India, 312 ITR 254 (SC) and pointed out that in para 18, while considering the applicability of AS-11, the Hon'ble Supreme Court noted that exchange difference arising on foreign currency transaction have to be recognized as income or as expenses in the period for which they arise, except as stated in paras 10 & 11, which deals with exchange difference on repayment of liabilities incurred for the purpose of acquiring fixed asset. It was, inter alia, observed that AS-11 stipulates effect of changes in exchange rate vis-à-vis monetary items denominated in a foreign currency to be taken into account for giving accounting treatment on the balance sheet date. Ld CIT D.R. pointed out that in the present case, since no transaction has been entered into in the books of account, there was no monetary item requiring adjustment of exchange rate difference. Ld CIT D.R. thus, submitted that the manner of holding foreign currency is relevant and if the same is held as stock-in-trade then in view of the decision of the Hon'ble Supreme Court in the case of Woodward Governor of India (supra), the exchange rate difference on the balance sheet date has to be considered for tax purposes. Ld CIT D.R. referred to the decision of the Hon'ble Bombay High Court in the case of CIT v. Kamani Metals and Alloys Ltd, 208 ITR 1017 (Bom), wherein, the facts were that the assessee had entered into a contract with MMTC on August 27, 1974 for purchase of 49,981 kgs copper cathodes at the rate of Rs.33,825/- per M.T. The assessee had opened an irrevocable letter of credit on 28th September, 1974. However, till the end of the relevant accounting year, no material was received by the assessee. The MMTC announced price of copper cathodes at Rs.25,461/- per M.T. for the quarter January to March, 1975. The assessee received the material on 12.3.1975. In the backdrop of these facts, the assessee made a provision amounting to Rs.4,18,021/- for the anticipated loss in the purchase account representing the difference between the contract price and the market price on the date of receipt of the material as the market price of the copper cathodes was less than the contract price. The assessee's claim was

allowed by the Tribunal . However, when the matter traveled before the Hon'ble High Court, it was held that under the contract in question, no raw material was in fact purchased by the assessee during the relevant accounting year. The material was received in the next accounting period on 12.3.1975. The Hon'ble High Court held that since there was no closing stock of the material in the hands of the assessee and only contract with MMTC was there, therefore, the material contracted to be purchased could not be regarded as assessee's stock-in-trade and hence, could not be valued in the accounts as such. Accordingly, the anticipated loss was disallowed by the Hon'ble High Court. Ld CIT D.R.relying on this decision submitted that this covers the issue before us and on same parity of reasoning; the forward foreign exchange contract remaining unsettled at the closing balance sheet date could not be treated as stock-in-trade.

36. Ld CIT D.R. further submitted that the decision in the case of Deutsche Bank A.G. (supra) relied upon by Id CIT (A) is not applicable as the same proceeds on a wrong premise that unsettled forward foreign exchange contracts as on balance sheet date constitute the stock-in-trade. Thus, the very premise is wrong on which the decision was delivered. He submitted that the circular No.664 dated 5.10.93 referred to in the case of Deutsche Bank (supra) talks only about securities and not forward contracts. Therefore, the said circular is not applicable in the present facts. Ld CIT D.R.further referred to the decision of the Hon'ble Supreme Court in the case of Indian Molasses Co. Ltd v CIT, 37 ITR 66 (SC), wherein, the Hon'ble Supreme Court, inter alia, observed that income tax law does not allow as expenses all the deductions a prudent trader would make in computing his profits. It was further held that in finding out what profits there be, the normal accountancy practice may be to allow as expense any sum in respect of liabilities which have accrued over the accounting period and to deduct such sums from profits. He, therefore, submitted that unless the liability actually accrued on maturity of the contracts, there could not be any allowable expense on account of variation in the rate of exchange as compared to contracted rate at the end of the financial year.

37. As regards the assessee's submissions that the valuation was done as per the guidelines of FEDAI, Ld CIT D.R.submitted that the income or expense is to be

determined as per the requirements of Income tax Act and as per the guidelines prescribed for preparation of accounts.

38. Ld CIT D.R.further referred to the decision of the ITAT Calcutta Bench Third Member in the case of Eveready Industries India Ltd v. DCIT, 78 ITD 175 (Cal)TM, wherein, it was held that exchange fluctuation loss of un-matured forward covers (i.e. forward contract) could not be allowed on accrual basis. However, since the assessee claimed that such contract got settled during the year and only remittance was made, the issue was set aside to the AO to ascertain the fact and reconsider the claim of the assessee in accordance with law. Ld CIT D.R.referred to section 145 of the I.T.Act and pointed out that as per sub-section (3), if the AO is not satisfied about the correctness or completeness of the accounts of the assessee, or where the method of accounting or accounting standard have not been regularly followed, then the AO can make assessment u/s.144. He submitted that the main object of section 145 is to compute the correct profits and if the correct profits cannot be deduced from the accounts then he has to compute the profits on his own. Ld CIT D.R.further referred to the decision of the Hon'ble Calcutta High Court in the case of Bestobell India Ltd, 117 ITR 789(Cal), wherein, the facts were that the loan of £ 37,500, being about Rs.5 lakhs was taken by the assessee from its subsidiary company to be repaid at the expiry of one year or earlier. However, the loan could not be repaid within the stipulated period and on account of devaluation of Rupee, there was increase in loan liability on account of sterling loan. It was held that increase in liability was inextricably connected with assessee's indebtedness and was capital in nature. Thus, in sum and sub stance, the arguments of Ld CIT D.R. are as under:-

- i) Unsettled forward foreign exchange contracts does not constitute stock-in-trade and, therefore, there is no question of its valuation.
- ii) No transaction has been recorded in the books of account in regard to unsettled forward foreign exchange contracts and, therefore, there is no question of its valuation being done at the end of the accounting year.

- iii) The anticipated loss is primarily in the nature of notional liability and, therefore, does not accrue/arise at the end of the previous year and hence, not allowable.
- iv) The liability accrues or arise only on the date of maturity of the contract and prior to that purely on the basis of estimated liability as per FEDAI guidelines it cannot be allowed under I.T.Act.
- v) Various decisions relied upon by Id CIT (A) relate to stock-in-trade and not to unsettled forward foreign exchange contract.
- vi) The issue is squarely covered by the following decisions:-
 - a) Indian Overseas Bank Ltd., 246 ITR 206(Mad)
 - b) Indian Overseas Bank Ltd., 151 ITR 446 (Mad)
 - c) Kamani Metals & Alloys Ltd., 208 ITR 1017 (Bom)
 - d) Bank of India, 218 ITR 371 (Bom)
 - e) Eveready Industries (I) Ltd., 78 ITD175 (Cal)
 - f) Indian Molasses Co. Ltd., 37 ITR 66 (SC)

39. Shri F.V.Irani, Id Counsel for the assessee submitted that there is no dispute regarding allowability of assessee's claim and the only dispute is regarding timing i.e. year of allowability. The whole controversy is whether on the balance sheet date the estimated loss as per the FEDAI notification as per RBI guidelines is accrued loss or notional loss. Ld Counsel for the assessee referred to page 8 para 5.3 of Id CIT (A)'s order for A.Y. 1998-99 and pointed out that he has taken note of the fact that as per the RBI guidelines, the assessee was required to revalue its outstanding foreign exchange forward contract as per the rates notified by the FEDAI on March 31st every year. Ld Counsel submitted that the assessee had to re-assess the anticipated loss at the end of the year in accordance with the method of accounting consistently followed by it. Therefore, it was allowable. Ld counsel submitted that now the issue stands settled by

the decision of the Hon'ble Supreme Court in the case of Woodward Governor of India Ltd., 312 ITR 254(SC). Ld Counsel pointed out that the Hon'ble Supreme Court has affirmed the decision of the Hon'ble Delhi High Court in the case of CIT v. Woodward Governor of India Ltd., 294 ITR 451 (Del). In this regard, Ld Counsel referred to page 469 and pointed out that in regard to revenue account cases, the Hon'ble Delhi High Court has, inter alia, observed in para 32 that the liability stands accrued the minute the contract was entered into. In support of his contention, Ld Counsel has advanced various propositions before us which are discussed herein-below.

1. **The loss claimed by the assessee is in accordance with a recognized method of accounting. The AO, admittedly, not having invoked the provisions of section 145(3) of the Act, is bound by the assessee's aforesaid method and, therefore, is obliged to allow the loss.**

40. In this regard, Ld Counsel for the assessee referred to the assessment order for the assessment year 1998-99 and pointed out that in para 5.2 at page 5, the AO observed as under:

"In case foreign exchange is a current asset, the easier method of accounting would be to book the sale when this is done and the purchase when it is executed."

Ld Counsel further referred to page 1 of the assessment order and pointed out that the AO has taken note of the fact that the assessee was following mercantile system of accounting. He further pointed out that the assessment has been completed u/s.143(3) and, thus, it is clear that the assessee's books of account have not been rejected. Ld Counsel for the assessee referred to the decision of the Hon'ble Supreme Court in the case of Investment Ltd v CIT, 77 ITR 533 (SC), wherein, it has been held at pages 537 to 538 that the method of accounting consistently and regularly followed by the assessee cannot be discarded by the departmental authorities on the view that he should have adopted a different method of keeping account or of valuation. The method of accounting regularly employed may be discarded only if, in the opinion of the taxing authorities, income of the trade cannot be properly deduced therefrom. He further referred to the decision of the Hon'ble Bombay High Court in the case of CIT v.

TISCO, 106 ITR 363 (Bom), wherein also, similar view was taken. In support of this proposition, he also relied on the decision of the Hon'ble Supreme Court in the case of CIT v. Woodward Governor India P. Ltd., 312 ITR 254 (SC), wherein, the Hon'ble Supreme Court has, inter alia, observed as under:-

"For the reasons given hereinabove, we hold that, in the present case, the "loss" suffered by the assessee on account of the exchange difference as on the date of the balance sheet is an item of expenditure under s. 37(1) of the 1961 Act.

In the light of what is stated hereinabove, it is clear that profits and gains of the previous year required to be computed in accordance with the relevant Accounting Standard. It is important bear in mind that the basis on which stock-in-trade is valued is part of the method of accounting. It is well established, that, on general principles of commercial accounting, in the P&L account, the values of the stock-in-trade at the beginning and at the end of the accounting year should be entered at cost or market value, whichever is lower- the market value being ascertained on the last date of the accounting year and not as on any intermediate date between the commencement and the closing of the year, failing which it would not be possible to ascertain the true and correct state of affairs. No gain or profit can arise until a balance is struck between the cost of acquisition and the proceeds of sale. The word "profit" implies a comparison between the state of business at two specific dates, usually separated by an interval of twelve months. Stock-in-trade is an asset. It is a trading asset. Therefore, the concept of profit and gains made by business during the year can only materialize when a comparison of the assets of the business at two different dates is taken into account. Sec. 145(1) enacts that for the purpose of s. 28 and s. 56 alone, income, profits and gains must be computed in accordance with the method of accounting regularly employed by the assessee. In this case, we are concerned with s. 28. Therefore, s. 145 is attracted to the facts of the present case. Under the mercantile system of accounting, what is due is brought into credit before it is actually received; it brings into debit an expenditure for which legal liability has been incurred before it is actually disbursed. (See judgment of this Court in the case of United Commercial Bank vs. CIT (1999) 156 CTR (SC) 380 : (1999) 240 ITR 355 (SC). Therefore, the accounting method followed by an assessee continuously for a given period of time needs to be presumed to be correct till the AO comes to the conclusion for reasons to be given that system does not reflect true and correct profits. As stated, there is no finding given by the AO the correctness of the Accounting Standard followed by the assessee(s) in this batch of civil appeals."

40.1 Ld Counsel also relied on the decision of the ITAT Delhi Bench in the case of DCIT v Maruti Udyog Ltd., 99 ITD 666 (Del) and ONGC v DCIT, 83 ITD 151 (Del)(SB), wherein also, it was, inter alia, held that additional liability incurred by the assessee on

account of variation in foreign exchange rate was an allowable trading liability where borrowed foreign currency was utilized to meet need of working capital. Ld Counsel for the assessee submitted that there is no distinction between the loan transaction and foreign contract and these decisions are squarely applicable to the present set of facts because the contract had already been entered into in the relevant previous year.

(2) The loss claimed by the assessee is not a notional/contingent loss, but is an actual loss which it is entitled to as a deduction.

40.2 Ld Counsel for the assessee pointed out this aspect is evident from the fact that the loss of Rs.1,52,20,000/- disallowed by the AO in A.Y. 1998-99 has been allowed by the AO as a revenue deduction in assessment year 1999-2000. Ld Counsel for the assessee referred to the written submissions filed by Id CIT (DR) and pointed out that one of the definitions of forward foreign exchange contract is as under:-

"Agreement to exchange at a given future date currencies of different countries at a specified rate (forward rate). A forward contract is a foreign currency transaction. The gain or loss on the contract is typically included in determining net income. The amount of gain or loss, except on a speculative forward contract (designed as a risky investment rather than as a hedge), is computed by multiplying the foreign currency amount of the forward contract by the difference between the spot rate at the balance sheet date and the spot rate at the date of inception of the contract."

"Agreement that obligates an investor to deliver a specified quantity of one currency in return for a specified amount of another currency.

Forward exchange contracts.

A forward exchange contract (or forward contract) is a binding obligation to buy or sell a certain amount of foreign currency at a pre-agreed rate of exchange, on a certain future date.

Summary

A forward contract is an obligation to buy or sell a certain amount of foreign currency at a pre-determined date. Even if your requirements change over the term of the forward contract, you are still obliged to deal.

A forward contract obliges you to deal at a specific rate – you are not in a position to benefit from any favourable movements in exchange rates between booking the contract and completing the deal.

No premium is payable."

He submitted therefore, the minute forward exchange contract is entered into; the bank becomes liable to honour the same. A binding obligation arises against the bank which it is required to discharge. He, therefore, submitted that the physical delivery of foreign currency on the date of maturity does not wipe out the present liability incurred by the bank. He relied on the decision in the case of ONGC (supra), wherein, it was, inter alia, observed as under:-

"Before concluding, we would like to point out that the assessee's claim for loss arising as a result of fluctuation in foreign exchange rates on the closing day of the year has been disallowed by the AO, inter alia, on the ground that this liability was a contingent liability and the loss was a notional one. The main ingredient of a contingent liability is that it depends upon happening of a certain event. We are of the considered opinion that in the case of the assessee, the "event" i.e. the change in the value of foreign currency in relation to Indian currency has already taken place in the current year. Therefore, the loss incurred by the assessee is a *fait accompli* and not a notional one."

40.3 Ld Counsel for the assessee pointed out that in these cases also, the loans were payable at some future date but the liability was allowed on the basis of revaluation of foreign exchange on the date of balance sheet. Ld counsel pointed out that the decision in the case of ONGC (supra) and Maruti Udyog (supra) was affirmed by the Hon'ble Delhi High Court in the case of Woodward Governor India (P)Ltd. (supra) and it has been held that the additional liability on account fluctuation in foreign currency as on 31st March, 1991 of foreign currency loans outstanding on that date was an allowable revenue loss and was not notional or contingent one. He further submitted that the decision of the Hon'ble Delhi High Court stands affirmed by the Hon'ble Supreme Court and, therefore, it has to be followed, particularly, because the Hon'ble Delhi High Court has considered the decision in the case of Indian Molasses and also in the case of Indian Overseas bank (supra). Ld Counsel for the assessee also pointed out that similar view has been taken in the case of Silcon Graphics v ACIT, 105 TTJ 591 (Delhi) and CIT v. Brockhoven BV, (Mumbai ITAT). Ld Counsel for the assessee submitted that from the above decisions, it is evident that the additional liability arisen on account of foreign exchange fluctuation as at the end of the year, is not a contingent or notional liability and hence, allowable. Further, it is not necessary for such additional liability to be allowable, that it must relate to stock-in-trade because all the above cases were cases of

loans and not stock-in-trade. The only requirement is that it must be on revenue account, which is not disputed in assessee's own case.

- 3) **The loss on the revaluation of the outstanding forward exchange contracts is allowable on the well recognized principle that an assessee's stock/circulating capital has to be valued at cost or market price, wherever is lower.**

40.4 Ld Counsel for the assessee submitted that in any event, forward foreign exchange contracts are in the nature of stock-in-trade and on this count also they have to be valued at cost or market price, whichever is lower and, therefore, any resultant loss on fluctuation of Indian Rupee has to be allowed as a deduction on normal principles of commercial accounting. In this regard, he relied on the following decisions:-

- i) Bank of Tokyo v IAC, 13 ITD 32(Cal) affirmed by Hon'ble Calcutta High Court.
- ii) Deutsche Bank A G v DCIT, Spl. Range (ITA No.7251/B/91 & C.O.924/B/92), wherein, in para 26, the Tribunal has taken note of the fact that the Hon'ble Calcutta High Court refused to direct the Tribunal to refer a question with reference to the decision of the Tribunal.
- iii) Deutsche Bank A.G. v ACIT (ITA No.5327/M/01). In this case, the Tribunal taking note of the fact that in assessee's own case the addition on account of notional profit on unsettled forward exchange contract had been taxed the loss claimed by the assessee on the same count was held allowable.
- iv) Deutsche Bank A.G. v DCIT, 86 ITD 431(Mum), wherein also, similar view was taken.
- v) Shree Capital Services Limited, 121 ITD 498(Kol)(SB), wherein, it has been observed that the derivative derives its value from the underlying assets. In other words, the underlying assets are represented by derivatives. When the underlying asset of any derivative is share or stock for all practical purposes, the treatment given to such derivatives should be similar to stock and securities.

Ld Counsel for the assessee, therefore, pointed out that as there is no dispute that foreign currency is bank's stock-in-trade and since in the forward foreign exchange contract, the underlying security is foreign currency, therefore, it should be taken as stock-in-trade.

4) **The loss has to be allowed on the matching principle laid down by the Supreme Court in the case of Madras Industrial Investment Corporation.**

Ld Counsel for the assessee referred to the following hypothetical example which is reproduced herein-below:

"A" the Bank's method "matches" the total profit of Rs.300 to the respective periods to which it relates viz

- Rs.100 to the year ended 31st March, 1998
- Rs.200 to the period ended 31 March, 1999"

40.5 In the last leg of his argument, Id Counsel submitted that if at all a conclusion is reached that there is a cleavage of judicial opinions, the view favouring the assessee has to be adopted. In this regard, he referred to the decision of the 5 Members Special Bench in the case of Narang Overseas v ACIT, 114 ITJ (Mum) 433.

41. In the rejoinder, Ld CIT D.R. submitted that the decision in the case of Woodward Governor of India Ltd, 312 ITR 254 (SC) and 294 ITR 541 (Del) and ONGC (supra) has to be considered in the context in which the same is delivered. He pointed out that the Hon'ble Supreme Court in the case of Woodward Governor (supra) held that the foreign currency notes, balance in bank accounts denominated in foreign currency and receivables/payables and loans denominated in foreign currency as well as sundry creditors are all 'monetary items', which have to be valued at closing rate at the end of the accounting year as per AS-11. He pointed out that this judgment is mainly with reference to stock-in-trade and applies to foreign exchange liabilities in respect of raw materials or stock-in-trade and at the most it can be extended to monetary items noted above. But in the present case, forward foreign exchange contracts are not similar to this specified item. He submitted that in forward foreign exchange contract, no investment of foreign currency was made at any time prior to the date of its maturity and, therefore, it cannot even be said that such contracts indirectly represent stock-in-trade or trading assets of the assessee. Further, no accounting entry had been made before the settlement of contract. He submitted that the following decisions relied upon by Id Counsel for the assessee proceeded on the assumptions that there was stock-in-trade:

- i) Bank of India, 218 ITR 371 (Bom) – Here foreign exchange held in its foreign branches constituted stock-in-trade.
- ii) Bank of Tokyo, 13 ITD 32 (Cal) – Proceeded on the assumption that foreign exchange contract constitute stock-in-trade which is not correct.
- iii) State Bank of Mysore, 114 ITR 704 (Kar) – delivered in respect of foreign currency held by bank.
- iv) Nedungadi Bank Ltd., 264 ITR 545 (Ker)- delivered in the context whether Government securities can be treated as stock-in-trade or not.
- v) Mashreque bank, 18 SOT 233 (Mum). This case proceeded on wrong assumption that forward foreign exchange contracts constitute stock- in-trade.
- vi) United Commercial Bank, 240 ITR 355 (SC). The question was whether government securities held by bank are stock- in- trade or not.
- vii) Brockhoven BV (ITA No.8344/B/90. In this case, the question before the Hon'ble Bombay High court was loss on account of difference in foreign exchange rate in respect of amount due by the assessee to its head office, which was held to be allowable.

42. We have considered the rival submissions and perused the record of the case. There is no dispute that if the date of maturity of the contract falls within the same financial year then the difference between the exchange rate as prevailing on the balance sheet date and contracted rate is an allowable deduction. The moot point for consideration is whether keeping in view the nature of contract, can it be said that a liability accrued on 31st March in respect of unmatured forward foreign exchange contract on account of fluctuation in rate of foreign currency or not. Therefore, it is necessary to first examine the nature of contract entered into by the assessee. Forward Foreign exchange contract means an agreement to exchange different currencies at a forward rate. Forward rate is a specified rate for exchange of currency at a specified date. The assessee enters into forward contract with clients to buy or sell foreign exchange at an agreed price at a future date in order to hedge against the possible future financial loss on account of wide fluctuation in the rate of foreign currency. Thus, firstly, forward foreign exchange contract creates a continuing binding obligation on the

date of contract against the assessee to fulfill the same on the date of maturity and secondly, it is in the nature of hedging contract because it is a contract entered into against possible financial losses. Let us take a hypothetical example. Suppose 'X & Co.' is assessee's client. It entered into a contract with 'Y & Co.' on 15.2.2010 for supply of goods at 1,00,000 \$, for which payment was to be made after three months on 15.5.2010. Suppose, on the date of contract, the value of Dollar vis-à-vis Rupee was Rs.45. After three months, 'X & Co.', keeping in view the prevailing economic conditions etc., anticipated wide fluctuation in exchange rate. Therefore, it entered into with its bank (assessee) to purchase 1,00,000 \$ on 15.5.2010 at say Rs.47/-. Thus 'X & Co.' had hedged the loss at Rs.2/- which it distributed over two periods. However, as far as the assessee was concerned, it came to know of actual loss/profit only on 15.5.2010 and not prior to that date. However, at the same time it could anticipate the loss on 31st March with reasonable accuracy, keeping in view the day to day fluctuation in the foreign currency rates and also that as prevailing on 31st March. The assessee-bank, accordingly, makes provision in its accounts on 31st March in line with the prudent commercial accounting principles, which requires that all accrued losses have to be taken into consideration on 31st March. Having considered the nature of contract, we will examine whether on account of existing obligation, a liability accrues as per I.T. provisions on 31st March or not. In order to find answer to this intricate issue, we have to keep in mind certain settled accounting propositions which have received judicial recognition. They can briefly be summed up as under:-

- i) The income is to be accounted for only when right to receive the same has accrued in favour of a person thereby creating realizable debt in his favour. A legally enforceable right should have accrued in favour of assessee.
- ii) All the anticipated losses though not ascertainable with precise accuracy, which have accrued on the date of balance sheet, have to be accounted for as per prudent accounting policy.
- iii) Stock-in-trade is valued at the end of the previous year in accordance with the principle of matching in order to find out true profit/loss accruing to the assessee.

- iv) The method of accounting consistently followed by the assessee should not be discarded casually without giving strong reasons for the same. Merely because the AO feels that other method of accounting would be better, the assessee's method of accounting cannot be rejected.

43. The assessee's contention is that this contract has to be revalued in accordance with FEDAI guidelines as notified by RBI and, therefore, the assessee had no option but to determine the profit/loss in regard to unmatured forward foreign exchange contracts in accordance with the currency rate prevailing on 31st March. Further, a binding obligation had also accrued against the assessee. Ld CIT D.R. has rightly submitted that this treatment in books of account *per se* does not give right to the assessee to claim the loss under Income tax Act. However, Ld CIT D.R.'s contention needs to be examined having regard to fundamental commercial principles which have received judicial recognition. It is settled principle that deduction is allowable under the Income-tax Act in respect of those liabilities which crystallise during the previous year. Therefore, the concept of crystallisation of liability under Income-tax Act assumes significance vis-à-vis commercial principles in vogue. As per the commercial principles of policy of prudence, all anticipated liabilities have to be accounted for but as per I.T.Act, only that liability will be allowed which has actually accrued. As a matter of fact, Courts have time and again given due weightage to commercial principles in deciding such issues. However, those anticipated liabilities are not allowable which are contingent in nature but, if an anticipated liability is coupled with present obligation and only quantification can vary depending upon the terms of contract, then a liability is said to have crystallised on the balance sheet date. It is in conformity with the principles of prudence also. A contingent liability depends purely on the happening or not happening of an event whereas if an event has already taken place, which, in the present case, is of entering into the contract and undertaking of obligation to meet the liability, and only consequential effect of the same is to be determined, then, it cannot be said that it is in the nature of contingent liability

43.1 We have to bear in mind that the issues relating to accrual of income cannot be decided on the same footing and considerations on which the issues relating to loss/expense is to be decided. In case of loss/expense, it is the concept of reasonable certainty to meet an existing obligation which comes into play which in legal terminology is said to be 'crystallisation of liability'. When outflow of economic resources in settlement of present obligation can be anticipated with reasonable accuracy then it is to be recognized as crystallised liability. This is in consonance with the principle of prudence as considered by the Hon'ble Supreme Court in the case of Woodward Governor of India Pvt.Ltd. (supra). The revenue's main contention is that liability can arise only when the contract matures. This plea, in our humble opinion, is completely divorce of the principles of commercial accounting and, therefore, cannot be accepted. Both legal obligation and commercial principles have to be taken into consideration for deciding such issues.

44. From the above discussion, it is evident that the anticipated losses on account of existing obligation as on 31st March, determinable with reasonable accuracy, being in the nature of expenditure/accrued liability, have to be taken into account while preparing financial statements. In this regard we may refer to the observations of Hon'ble Supreme Court in the case of Bharat Earth Movers, 245 ITR 428 (SC):

". 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. 5. In Metal Box Co. of India Ltd. vs. Their Workmen (1969) 73 ITR 53 (SC) the appellant company estimated its liability under two gratuity schemes framed by the company and the amount of liability was deducted from the gross receipts in the P&L a/c. The company had worked out on an actuarial valuation its estimated liability and made provision for such liability not all at once but spread over a number of years. The practice followed by the company was that every year the company worked out the additional liability incurred by it on the employees putting in every additional year of service. The gratuity was payable on the termination of an employee 's service either due to retirement, death or termination of service—the exact time of occurrence of the latter two events

being not determinable with exactitude beforehand. A few principles were laid down by this Court, the relevant of which for our purpose are extracted and reproduced as under : (i) For an assessee maintaining his accounts on mercantile system, a liability already accrued, though to be discharged at a future date, would be a proper deduction while working out the profits and gains of his business, regard being had to the accepted principles of commercial practice and accountancy. It is not as if such deduction is permissible only in case of amounts actually expended or paid; (ii) Just as receipts, though not actual receipts but accrued due are brought in for income-tax assessment, so also liabilities accrued due would be taken into account while working out the profits and gains of the business; (iii) A condition subsequent, the fulfilment of which may result in the reduction or even extinction of the liability, would not have the effect of converting that liability into a contingent liability. (iv) A trader computing his taxable profits for a particular year may properly deduct not only the payments actually made to his employees but also the present value of any payments in respect of their services in that year to be made in a subsequent year if it can be satisfactorily estimated. So is the view taken in *Calcutta Co. Ltd. vs. CIT (1959) 37 ITR 1 (SC) : TC 16R.197* wherein this Court has held that the liability on the assessee having been imported, the liability would be an accrued liability and would not convert into a conditional one merely because the liability was to be discharged at a future date. There may be some difficulty in the estimation thereof but that would not convert the accrued liability into a conditional one; it was always open to the tax authorities concerned to arrive at a proper estimate of the liability having regard to all the circumstances of the case."

45. One more aspect which needs to be discussed with reference to commercial accounting principles is with reference to the arguments of Ld CIT D.R. that no transaction has been recorded in the books of account before the date of maturity of contract and, therefore, there is no question of any liability accruing on 31st March. The elements of financial statement can be broadly divided into following five groups, viz; assets, liabilities, equity, income/gains & expenses/loss. These items are recognized in a financial statement if both the following criteria are met:

- a) Future economic benefit will be there from the said events,
- b) The event can be measured in monetary terms.

In the present case, the AO himself has observed in the assessment order that at the time of entering into the contract, the assessee has recorded the income/loss on the basis of difference between the contracted rate and the spot rate. Thus, to say that the contract was incapable of being recognized in the books of account, is not correct. The assessee recorded only the net effect of the transaction and not the entire transaction. Whether the deduction is allowable or not, therefore, cannot be guided by this factor.

46. With regard to observations of the AO regarding method of accounting, we may observe that it is well settled law that a method of accounting regularly employed by the assessee cannot be disregarded unless AO is of the opinion that profits are not correctly deductible from such method of accounting as per the provisions of section 145(3) of the Act. The AO cannot reject the method of accounting followed by the assessee merely on the ground that a better method of accounting could be the alternate one. However, in the present case, though observations have been made by the AO to this effect but actual disallowance has been made by treating the impugned amount as contingent liability.

47. Now, we will consider the issue with reference to Accounting Standard -11 (AS-11). The Hon'ble Supreme Court in the case of Chellapali Sugar Mills, 98 ITR 167 and the Hon'ble Delhi High court in the case of Woodward Governor of India P.Ltd (supra) observed that the accounting standards issued by the Institute of Chartered Accountants of India required that accounting policies must be governed by the principle of prudence. Accounting Standards are prepared by ICAI keeping in view of the principle of prudence and this principle has received judicial recognition. In other words, provisions should be made for loan liabilities and losses even though the amount cannot be determined with certainty and represents only the basic estimate in the light of available information. The Accounting Standard issued by ICAI which are mandatory for preparation of financial statements and have to be followed inasmuch as the deviation from the same is to be reported in the audit report. Section 145(2) gives power to the Central Government to notify the accounting standards to be followed by any class of assesses or in respect of any class of income.

48. The Hon'ble Supreme Court in the case of Woodward Governor of India (P) Ltd.,(supra) has observed at page 265 para 17 that the Central Government has made AS-11 mandatory. Therefore, compliance with this has to be made.

49. We find that in AS-11 in paras 9 to 12, it has been observed as under:

9. Exchange differences arising on foreign currency transactions should be recognized as income or as expense in the period in which they arise, except as stated in paras 10 and 11 below.
10. Exchange differences arising on repayment of liabilities incurred for the purpose of acquiring fixed assets, which are carried in terms of historical cost, should be adjusted in the carrying amount of the fixed assets. The carrying amount of such fixed assets should, to the extent not already so adjusted or otherwise accounted for, also be adjusted to account for any increase or decrease in the liability of the enterprise, as expressed in the reporting currency by applying the closing rate, for making payment towards the whole or a part of the cost of the assets or for repayment of the whole or a part of the monies borrowed by the enterprise from any person, directly or indirectly, in foreign currency specifically for the purpose of acquiring those assets.
11. The carrying amount of fixed assets which are carried in terms of revalued amounts should also be adjusted in the manner described in para 10 above. However, such adjustment should not result in the net book value of a class of revalued fixed assets exceeding the recoverable amount of assets of that class, the remaining amount of the increase in liability, if any, being debited to the revaluation reserve, or to the profit and loss statement in the event of inadequacy or absence of the revaluation reserve.
12. An exchange difference results when there is a change in the exchange rate between the transaction date and the date of settlement of any monetary items arising from a foreign currency transaction. When the transaction is settled within the same accounting period as that in which it occurred, the entire exchange difference arises in that period. However, when the transaction is not settled in the same accounting period as that in which it occurred, the exchange difference arises over more than one accounting period.
50. Therefore, this Accounting Standard mandates that in a situation like in the present case, since the transaction is not settled in the same accounting period, the effect of exchange difference has to be recorded on 31st March. Ld CIT D.R. has rightly pointed out that the expenses required to be charged against revenue as per accounting standard do not *ipso facto* imply that the same are always deductible for Income-tax purposes but at the same time its relevance does not, in any manner, gets mitigated. The Hon'ble Supreme Court in the case of Woodward Governor of India (P) Ltd.,(supra) with reference to working capital loan, which was also repayable after the end of accounting period, has held that loss occurred to the assessee, on account of fluctuation in the rate of foreign exchange, as on the date of the balance sheet, is an item of expenditure u/s.28(i) of the I.T.Act. Hon'ble Supreme Court observes as under:-

“Under section 28(i), one needs to decide the profits and gains of any business which is carried on by the assessee during the previous year. Therefore, one has to take into account stock-in-trade for determination of profits. The 1961 Act makes no provision with regard to valuation of stock. But the ordinary principle of commercial accounting requires that in the profit and loss account the value of the stock-in-trade at the beginning and at the end of the year should be entered at cost or market price, whichever is the lower. This is how business profits arising during the year need to be computed. This is one more reason for reading section 37(1) with section 145. For valuing the closing stock at the end of a particular year, the value prevailing on the last date is relevant. This is because profits/loss is embedded in the closing stock. While anticipated loss is taken into account, anticipated profit in the shape of appreciated value of the closing stock is not brought into account, as no prudent trader would care to show increased profits before actual realization. This is the theory underlying the rule that closing stock is to be valued at cost or market price, whichever is the lower. As profits for income tax purposes are to be computed in accordance with ordinary principles of commercial accounting, unless such principles stand superseded or modified by legislative enactments, unrealized profits in the shape of appreciated value of goods remaining unsold at the end of the accounting year and carried over to the following year’s account in a continuing business are not brought to the charge as a matter of practice, though, as stated above, loss due to fall in the price below cost is allowed even though such loss has not been realized actually.”

Ld CIT D.R.’s submission is that this decision is with reference to monetary items as referred to in AS-11 and since forward foreign exchange contracts do not come within the monetary items, therefore, the said decision cannot be applied. However, we have already discussed in the concept of recognition of various events in financial statements and have noted that the assessee, in fact, has recorded net effect in its profit and loss account. Therefore, on this count, the department’s plea cannot be accepted. Thus, in view of the decision of the Supreme Court in the case of Chellapali Sugar Mills (supra), and also in view of decision of the Hon’ble Supreme Court in the case of Woodward Governor India (P)Ltd., (supra), assessee’s plea deserves to be accepted.

51. Now, coming to the objection of Id CIT D.R. with reference to various decisions relied upon by Id counsel for the assessee on the ground that in the said decisions, the issue was relating to stock-in-trade but in the present case, there is no stock-in-trade. Admittedly, the assessee has not shown any closing stock of unmatured forward foreign exchange contracts as on balance sheet date and has only booked the profit and loss in

that regard. There is no dispute that the foreign exchange currency held by the assessee bank is its stock-in-trade and as is evident from the hypothetical example considered earlier, the assessee had entered into forward foreign exchange contracts in order to protect its interest against the wide fluctuation in the foreign currency itself. Therefore, this contract was incidental to assessee's holding of the foreign currency as current asset. Therefore, in substance, it cannot be said that the forward contract had no trappings of the stock-in-trade. Ld Counsel has rightly relied upon the decision of the Calcutta ITAT (SB) in the case of Shree Capital Services Limited,(supra) in this regard and, therefore, the various decisions relied upon by Ld Counsel for the assessee as discussed in his submissions are applicable to the facts of the case.

52. Now coming to the argument of Ld CIT (DR) with reference to the decision in the case of Indian Overseas Bank (supra), we find that the said decision was rendered with reference to taxing of notional profits and not with reference to anticipated losses, as is the case before us. The department is trying to draw analogy from the said decision but the said decision cannot be applied as the considerations are entirely different in regard to the issue relating to notional profits vis-à-vis anticipated losses. Profits are considered only when actual debt is created in favour of assessee but in case of anticipated losses, if an existing binding obligation, though dischargeable at a future date, is determinable with reasonable certainty, then the same is allowable.

53. Ld CIT D.R. has also heavily relied on the decision of the Hon'ble Bombay High Court in the case of CIT v. Kamani Metals and Alloys Ltd (supra). This decision, in our opinion, is of little help to the department inasmuch as the same has been rendered with reference to contract for purchase of raw material. The contracted price was more than the market price as the price went down and the material had not been received at the end of the accounting year. Under these facts, the Hon'ble High court held that notional loss claimed by the assessee on the balance sheet date was not allowable because there was merely the contract to purchase the material at a future date. Neither any payment was made by the assessee nor any material was received. This case, in our opinion, cannot be applied to the facts of the present case as in the present case, we are concerned about the anticipated loss booked by the assessee on

account of foreign exchange rate fluctuation as on balance sheet date, which was in accordance with RBI guidelines as well as in accordance with AS-11. Moreover, a binding obligation arose the minute the contract was entered into. However, now the decision of the Hon'ble Supreme Court in the case of Woodward Governor India P. Ltd (supra) covers the issue on account of variation in foreign exchange rate with reference to current assets. The facts in the case of CIT v. Kamani Metals and Alloys Ltd (supra) are more akin to such a situation where the assessee has simply ordered for purchase of material at a particular rate but the material has not been supplied by the seller by the end of the accounting period. No liability is accounted for in respect of such ordered goods because the basic elements of contract have not been fulfilled. In the present case, we have already observed that the forward contract is incidental to the foreign currency held by the assessee as stock-in-trade and, therefore, the decision in the case of CIT v. Kamani Metals and Alloys Ltd (supra) is clearly distinguishable on facts.

54. Ld CIT D.R. has also relied on the decision in the case of Eveready Industries (supra). The view expressed in the said decision also cannot be upheld in view of the decision of the Hon'ble Supreme Court in the case of Woodward Governor India P.Ltd (supra). The facts in the case of *Indian Molasses' case(supra)* are entirely different. The said decision proceeded on the premise that till the date of retirement of Managing Director, the assessee company itself had dominion over the sum paid through trustees and insurance society and there was no irrecoverable liability created. Thus, the impugned amounts were treated as part of profits set apart to meet a contingency by the assessee without any corresponding liability being there as the liability was only contingent in nature. There cannot be any quarrel with the proposition that the liability *in praesenti* is an allowable deduction but a liability *in futuro*, which for the time being is only contingent, is not allowable. As already pointed out this principle is to be applied keeping in view the principles of prudence and applicable Accounting Standards. In our opinion, the complete answer has been given long back by the Hon'ble Supreme Court in the case of Bharat Earth Movers Ltd, 245 ITR 428 (SC), wherein, it was held that the provision made by the assessee for meeting the liability incurred by it under the leave encashment scheme proportionate with the entitlement earned by the employees of the

company was entitled to deduction out of the gross receipts of the accounting year in which the provisions were made.

55. Ld CIT D.R. has also relied on the decision of the Hon'ble Calcutta High Court in the case of Bestobell India Ltd ((supra), which decision has been considered in detail by the Hon'ble Delhi High Court in the case of Woodward Governor India (P)Ltd (supra), wherein, it has been observed as under:-

"The revenue relied upon the decision of the Calcutta High Court in Bestobell (India) Ltd.,(1979) 117 ITR 789 in support of the submission that the increased liability on repayment of a loan borrowed in foreign exchange for business purposes as a result of exchange rate fluctuation would be a capital loss and not a trading loss. What weighed with the Calcutta High Court there appears to be that there was no outflow of funds during the year, as has been urged by the revenue before us. However, a closer scrutiny of the said decision indicates that the Calcutta High Court in this case relied upon its earlier judgement in Sulej Cottons Mills Ltd v CIT (1971) 81 ITR 641. It will be recalled that the Hon'ble Supreme Court in Sulej Cotton Mills Ltd v CIT(1979) 116 ITR 1 reversed the aforesaid decision of the Calcutta High Court on this point and held that such liability would be treated as a trading loss. In that view of the matter, the reliance placed by the revenue on the judgement of the Calcutta High Court in Bestobell (India Ltd., (1979) 117 ITR 789 appears misplaced."

56. The controversy stands now resolved in view of the decision of the Supreme Court in the case of Sulej Cotton Mills Ltd., 116 ITR 1 (SC), wherein, it has been held that fluctuation on account of foreign exchange rate is an allowable deduction and is not capital in nature. The observation of the Hon'ble Supreme Court is as under:-

"The law may, therefore, now be taken to be well settled that where profit or loss arises to an assessee on account of appreciation or depreciation in the value of foreign currency held by it, on conversion into another currency, such profit or loss would ordinarily be a trading profit or loss if the foreign currency is held by the assessee on revenue account or as a trading asset or as a part of circulating capital embarked in the business. But, if on the other hand, the foreign currency is held as a capital asset or as fixed capital, such profit or loss would be of capital nature(emphasis supplied)"

57. At the end we may further observe that when profits are being taxed by the department in respect of such unmatured forward foreign exchange contracts then there was no reason to disallow the loss as claimed by assessee in respect of same contracts

on the same footing. In this regard, we may refer to the details furnished by assessee vide their letter dt. August 05, 2010 to establish that the Department has assessed the Bank in respect of the profit shown by the Bank on restatement of outstanding forward foreign exchange contracts for A.Ys.2002-03 and 2003-04. There is no dispute on this count and, therefore, we refrain from referring the details.

58. In view of the above discussion, we allow the assessee's appeal for the following reasons:-

- i) A binding obligation accrued against the assessee the minute it entered into forward foreign exchange contracts.
- ii) A consistent method of accounting followed by assessee cannot be disregarded only on the ground that a better method could be adopted.
- iii) The assessee has consistently followed the same method of accounting in regard to recognition of profit or loss both, in respect of forward foreign exchange contract as per the rate prevailing on March 31.
- iv) A liability is said to have crystallised when a pending obligation on the balance sheet date is determinable with reasonable certainty. The considerations for accounting the income are entirely on different footing.
- v) As per AS-11, when the transaction is not settled in the same accounting period as that in which it occurred, the exchange difference arises over more than one accounting period.
- vi) The forward foreign exchange contracts have all the trappings of stock-in-trade.
- vii) In view of the decision of Hon'ble Supreme Court in the case of Woodward Governor India (I) P.Ltd., the assessee's claim is allowable.
- viii) In the ultimate analysis, there is no revenue effect and it is only the timing of taxation of loss/profit.

59. We, accordingly, hold that where a forward contract is entered into by the assessee to sell the foreign currency at an agreed price at a future date falling beyond the last date of accounting period, the loss is incurred to the assessee on account of

evaluation of the contract on the last date of the accounting period i.e. before the date of maturity of the forward contract.”

60. While parting with, we may place on record our deep appreciation for the extensive arguments advanced by both the sides, which helped us to decide this issue.

61. In the result, appeals filed by the revenue are partly allowed for statistical purposes.

Pronounced in the open court on 13th August, 2010

Sd/-
(D.MANMOHAN)
VICE PRESIDENT

sd/-
(D.K.AGARWAL)
JUDICIAL MEMBER

sd/-
(S.V.MEHROTRA)
ACCOUNTANT MEMBER

Dated, 13th August, 2010

Copy to:-

- 1) *The Appellant.*
- 2) *The Respondent.*
- 3) *The CIT (A) concerned.*
- 4) *The CIT concerned.*
- 5) *The Departmental Representative, C" Bench, I.T.A.T., Mumbai.*

Parida

By Order

//true copy//

*Asst. Registrar,
I.T.A.T., Mumbai.*