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IN THE INCOME TAX APPELLATE TRIBUNAL
'A' BENCH, BENGALURU

BEFORE SHRI SUNIL KUMAR YADAV, JUDICIAL MEMBER
and
SHRI INTURI RAMA RAO, ACCOUNTANT MEMBER

ITA Nos.422 & 423/Bang/2018
(Assessment years: 2013-14 & 2014-15)

M/s. Apple India Pvt. Ltd.
19th Floor, Concorde Tower C UB City,
No.24, Vittal Mallya Road,
Bengaluru-56001. ... Appellant
PAN:AABCA 1906 H

Vs.

Deputy Commissioner of Income-tax,
Circle 1(1)(1),
Bengaluru. ... Respondent

Appellant by : Shri Venkataraman, Senior Advocate.
Respondent by : Shri C.H.Sundar Rao, CIT(DR).

Date of hearing : 05/06/2018
Date of pronouncement : 03/08/2018

O R D E R

Per INTURI RAMA RAO, AM :

These are appeals filed by the assessee directed against different orders of the learned Commissioner of Income-tax (Appeals)-1 [CIT(A)], Bengaluru, dated 30/10/2017 for the assessment years 2013-14 and 2014-15.

2. Since identical issue is involved in both the appeals, we proceed to dispose of the same vide this common order.

3. For the sake of clarity and convenience, facts relevant to assessment year 2013-14 in IT(TP)A No.422/Bang/2017 are stated herein.

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4. The assessee raised the following grounds of appeal:

A. Denial of deduction - Provision for warranty

1. The order passed by the learned Assessing Officer ["learned AO"] and the learned Commissioner of Income Tax (Appeals) ["learned CIT(A)"] is arbitrary, contrary to law and opposed to principles of natural justice and is liable to be quashed.

2. The learned CIT(A) and the learned AO has erred in law and facts in concluding that the conditions laid down by the Hon'ble Supreme Court in the case of M/s Bosch Control India Private Limited (214 ITR 62) with regard to provision for warranty are not satisfied in the present case.

3. The learned CIT(A) and the learned AO has erred in concluding that the methodology for creating provision for warranty followed by the Appellant is not scientific based on actual utilization is contrary to principle laid down by the Hon'ble Supreme Court in the case of Bosch Control India Private Limited (supra).

4. The learned CIT(A) has grossly misinterpreted the order of the Hon'ble Supreme Court in the case of Bosch Control India Private Limited (supra), and erred in not giving cognizance to the nature of industry or the nature of products sold by the Appellant.

5. The learned CIT(A) and the learned AO has grossly erred in disallowing provision for warranty for want of historical trend data without appreciating that new products were launched during the year for which the trend analysis would be for the period after launch, and could be limited to the initial weeks or even days.

6. The learned CIT(A) has grossly erred in law and facts by following an inconsistent and arbitrary approach by disposing the batch of appeals for four years by allowing the deduction for AY 2009-10 and AY 2012-13 wherein the methodology adopted for computing provision for warranty is the same as was adopted for creating the provision for AY 2013-14.

B. Provision for warranty allowed as deduction only to the extent of 2.14 percentage of sales

7. The learned AO has erred in disallowing Rs 82,56,00,000 being provision for warranty created in excess of 2.14 percentage of sales relying on the directions of the learned Dispute Resolution Panel ["learned DRP"] in Appellants own case for AY 2011-12. The learned CIT(A) has erred in confirming the disallowance of Rs 82,56,00,000, being provision for warranty created in excess of 2.14 percentage of sales, without providing any analysis as to why 2.14 percentage of sales should only be allowed as provision for warranty.

8. The learned CIT(A) has erred in stating that 2.14 percentage of sales is optimal percentage being the factual finding for AY 2003-04, to allow provision for warranty without appreciating the nature and size of the business of the Appellant in the current AY.

9. The learned CIT(A) failed to appreciate that the directions of the learned DRP for AY 2011-12 based on which the learned AO had framed the assessment for AY 2012-13 has been reversed by Honorable Income Tax Appellate Tribunal ["Hon'ble ITAT"] vide order dated 22 September 2017.

10. The learned CIT(A) erred in not following judicial discipline, by not following the order of the Hon'ble ITAT, for AY 2011-12 in appellant's own case, inspite of there being no change in methodology adopted by the Appellant in creating provision for warranty.

11. The learned CIT(A) and learned AO failed to appreciate the fact that if only 2.14 percentage of sales is allowed as provision for warranty, then the Appellant will never get deduction for the amount actually utilized against the provision created.

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C. Facts of the Appellant and findings of the learned CIT(A) and learned AO

12. The learned CIT(A) has failed to appreciate that the Appellant is only a distributor of Apple products in India and the details with respect to warranty like failure rates, cost of repair etc., are maintained at a global level by a specialized warranty team of the Appellant group.

13. The learned CIT(A) and the learned AO failed to consider the submission made by the Appellant that high percentage of provision was created due to sale of new variant of iPhone, which is launched only in quarter 3 of the financial year and hence the closing balance carried forward to next year was high compared to preceding years.

14. The learned CIT(A) and learned AO has erred in denying provision for warranty on incorrect analysis that the provision created during each year and closing balance of such provision is increasing year on year without appreciating the substantial increase in sales value for new product, (iPhone), increase in cost, inflation, increase in exchange rate etc.

15. The learned CIT(A) and learned AO has grossly erred in adopting percentage comparison as a tool in concluding that the method followed by the Appellant is not scientific as against the linear regression model followed by the Appellant for creating provision based on past trend.

16. The learned AO has erred in adopting contradicting views in his own order. Where on one side a conclusion is drawn that over the years, figures have to be recalled and changed to suit the changing rate of defects and on the other side, on the basis of varying percentages a conclusion has been drawn that provision for warranty is not scientific.

17. The learned CIT(A) has grossly erred in stating that the Appellant launches products in India after it is tried and tested in several locations and hence all defects before the launch are addressed.

The learned CIT(A) ought to have appreciated that nature of industry is such that all defects cannot be addressed at the testing stage of a product, and also until the final use by customers of a particular region.

18. The learned CIT(A) failed to appreciate that the Appellant after launching the products in India, initiates the corrective course of action in the subsequent batch of products manufactured based on experience that could affect customer usage, which is the reason for lower provision rate in subsequent years for the same product.

D. Alternative claim

19. Notwithstanding and without prejudice to the above that entire provision for warranty is created on scientific basis and is allowable as deduction under section 37(1) of the Act, the learned CIT(A) and the learned AO has erred in granting deduction only to the extent of 2.21% of sale amounting to Rs. 64,24,00,301 as against actual expenditure incurred by the Appellant amounting to Rs. 85,31,10,651.

The learned CIT(A) has erred in not adjudicating on the alternative plea of the Appellant i.e. allow actual utilization of Rs. 85,31,10,651.

The Appellant craves for leave to add, to alter, to amend, to rescind or to modify the grounds herein above or produce further documents, facts and evidence before or at the time of hearing this appeal.

For the above and any other grounds which may be raised at the time of hearing, it is prayed that necessary relief may be provided.

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5. Briefly, the facts of the case are that the assessee is a company duly incorporated under the provisions of the Companies Act, 1956. It is engaged in the business of marketing and related services for software products of M/s. Apple Co. The return of income for the assessment year 2013-14 was filed on 28/11/2013 declaring income of Rs.162,73,33,230/-. Against the said return of income, the assessment was completed by the Dy. Commissioner of Income-tax, [AO], Circle 1(1), Bengaluru, vide order dated 29/12/2016 at total income of Rs.245,29,33,230/-. The disparity between the returned income and the assessed income is on account of disallowance of provisions for warranty expenses to the extent of Rs.82,56,00,000/- alleging to be excessive not based on historical data/reliable. The AO noticed that the assessee-company claimed deduction of provision for warranty expenses of Rs.147,40,08,630/-. This provision is in addition to opening provision for warranty expenses of Rs.21,41,30,976/-. The AO agreed in principle on the allowability of the provision for warranty expenditure. The AO, in order to examine whether the provision created for the year is in line with guidelines laid down by the Hon'ble Apex Court in the case of *Rotork Controls India (P.) Ltd. vs. CIT* (314 ITR 62)(SC), called upon the assessee-company to furnish certain details vide his questionnaire dated 21/10/2016. AO called upon the assessee-company to furnish the following details vide the above questionnaire:

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"Based on the decision of the Hon'ble Supreme Court in the case M/s.Rotork Controls India Pvt. Ltd. vs. CIT, the following details are to be ascertained to allow the claim of the provision for warranty. Please furnish the following facts and figures:

1. *Please list out the defects existed in the items manufactured and sold for the FY 2012-13, FY Y 11-12 and F. Y 2010-11, and historical trend of the same defects.*

2. *Please furnish the number of items manufactured with the defects mentioned above for the FY 12-13, FY. 11-12 and FY 2010-11.*

3. *Please furnish the reasonable estimate made towards amount of obligation based on the above-mentioned defects and number of such item, for the F Y 2012-13, F Y 11-12 and F Y 2010-11.*

4. *Please furnish the actual outflow of resources to settle the above-mentioned obligation for the FY.2012-13, F.Y 11-12 and FY2010-11.*

5. *Please explain the method followed to determine the reasonable estimate mentioned in question no.3."*

6. In response to this questionnaire, the assessee-company filed a detailed explanation on 08/12/2016. Based on the data furnished by the assessee-company, the AO observed that the closing balance of provision for warranty is increasing tremendously on account of non-utilization and therefore, he inferred that the provision for warranty was not created in a robust way and further the provision of warranty in terms of percentage of sale is not constant and varies from year to year which increased from 2% to 10%. Based on this analysis, the AO inferred that provision created based on ad-hoc basis and no scientific method was adopted nor based on the historical trends. Therefore, AO held that such ad-hoc provision

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should not be allowed as a deduction. Further AO noticed that the assessee-company had not reversed the excess provision created in earlier year after expiry of the warranty period. As a result, the provision for warranty gets accumulated and the assessee-company is deriving advantage of not offering excess provision to tax. The AO analyzed the data for the provisions for warranty and actual expenses incurred on warranty and keeping in view the order of Tribunal for the assessment year 2003-14 held that provision for warranty expenditure should be restricted to 2.14% of the sales and accordingly, the AO had allowed Rs.64.84 crores as against the claim of Rs.147.74 crores thereby disallowing the sum of Rs.82.56 crores.

7. Being aggrieved by the above assessment order, an appeal was preferred before the ld.CIT(A) who, vide impugned order, had confirmed the action of the AO after due analysis of provision created during the year and utilization in the earlier year as well as in the subsequent periods.

8. Being aggrieved, the assessee is in appeal before us in the present appeal. Learned senior counsel for assessee vehemently submitted that provision for warranty was based on global policy of the group companies for warranty provision. Global policy conforms to the principles of accrual and prudence. He further submitted that the provision for warranty is required to be made even in terms of para.14 of Accounting Standard 29. He further submitted that the provision for warranty is only tax neutral as it is only a timing

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difference. He also placed reliance on the decision of the Hon'ble Delhi High Court in the case of *CIT vs. Ericssion Communications (P.) Ltd.* (185 taxman.160) wherein the Hon'ble High Court held that the provision for warranty made following global policy was held to be allowable deduction. He submitted that there is no specific method laid down to arrive at the reliable estimate of the warranty expenditure and therefore, resort to any statistical tool which takes into consideration past experience in computing the estimate and the global policy of the company is to adopt linear regression method which takes into account actual number of products received back by the company during the period from the beginning of the previous calendar year till the month preceding the month in which the provision is being made. The annualized rate of return or failure rate of the product is computed by the global warranty team based on past experience of various Apple products to determine the frequency of repairs for each part on a global basis. Where provisions are introduced in a particular region, the global warranty team uses the experience in other regions and uses the same to compute the failure rate. It is submitted that the global warranty team provides adjustment entries for additional provision reversal as at the end of each quarter based on actual in order to ensure that the provision outstanding represents best estimate of the expected outflow based on warranty claim in the previous quarter. It is further submitted that repair cost is also on scientific basis based on past experience. Based on annualized rate of return and the cost of repairs, amount of warranty provision to be maintained towards

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future warranty claim will be determined. In support of the methodology followed by the appellant it was stated that detailed working was provided to the AO which is as under:

AY (1)	Opening balance (2)	Provision debited P&L a/c (3)	Actual expenses incurred (4)	Closing balance (5)	Sales (6)	* (3)/(6)	** (5)/(6)	*** (4)/(3)
07-08	25,816,507	89,937,776	80,726,671	[illegible]959,062	1,300,251,846	6.48	2.36	89.97
08-09	34,959,062	71,570,257	67,375,028	35,146,251	2,109,[illegible]707	3.77	1.47	100.98
09-10	37,146,751	144,013,067	129,267,613	5[illegible]897,869	4,436,[illegible]	3.25	1.17	86.29
10-11	51,897,669	177,[illegible]	127,307,272	101,580,205	[illegible]	3.80	2.23	72.00
11-12	107,698,006	197,841,953	185,[illegible]	176,701,470	5,239,815,233	3.16	1.30	97.20
12-13	185,011,[illegible]	425,293,372	316,[illegible]625	[illegible]	19,[illegible]	2.16	1.20	79.55
13-14	219,130,976	1,[illegible],700,530	853,[illegible],051	325,[illegible]	30,[illegible],106,354	4.30	1.78	[illegible]
14-15	835,020,155	[illegible],775,926	[illegible],740,575	2,810,751,[illegible]	[illegible],721	[illegible]	5.15	54.35
15-16	2,613,754,826	[illegible],832,[illegible],980	[illegible],150,164,[illegible]	3,445,762,747	62,[illegible]	[illegible]	5.49	76[illegible]
16-17	3,495,762,7[illegible]	5,133,519,095	3,531,[illegible]407	3,917,[illegible]	[illegible],403,020,748	5.20	5.07	70.71
17-18	1,597,[illegible]	7,[illegible],000	1,375,519,56[illegible]	4,[illegible]	[illegible],000,000	3.34	1.98	115.[illegible]

This policy is being consistently followed and which is in conformity with the para-meters laid down by the Hon'ble Supreme Court in the case of *Rotork Controls India (P) Ltd.* (supra). It is submitted that the order of the AO as well as the ld.CIT(A) is based on the finding that the appellant company did not reverse any excess provision before closure of the financial year so as to reduce excess provision created. However, it is submitted that this finding is contrary to the fact that the global team advises the amount of provision required to be made taking into consideration the actual number of items returned and the repair cost of such items. Thus, it was submitted that the policy adopted by the assessee-company is in consonance with the para-meters laid down by the Hon'ble Supreme Court in the case of *Rotork Controls India (P) Ltd.* (supra) and the same is allowable as deduction.

9. On the other hand, the ld.CIT(DR) placed heavy reliance on the orders of the lower authorities and submitted that the policy adopted by the assessee-company is not robust ad-hoc provision as

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there was no system of evaluation of outstanding provisions and the system of reversal of the excess provision.

10. We heard rival submissions and perused the material on record. The only issue involved in the present appeal is whether the methodology of the assessee-company for computation of provision for warranty is ad hoc and not consonance with parameters laid down by the Hon'ble Supreme Court in the case of *Rotork Controls India (P) Ltd.* (supra) or not. It must be noted that the AO as well as the ld.CIT(A) had not disputed in principle the allowability of the provision for warranty expenditure. But the only dispute is with regard to methodology adopted by the appellant for computing provision for warranty expenditure, whether it is based on scientific method or based on historical data of the past years or not. The AO as well as the ld.CIT(A) inferred that excess provision for warranty over and above the percentage of sales adopted in earlier year cannot be allowed as a deduction and accordingly restricted the claim to the extent of Rs.2.14% of sales. Before us, learned senior counsel for assessee had drawn our attention to the table extracted at para.5 above to show that provision for warranty is based on global policy of the company, the provision was not made on ad-hoc basis but on scientific method of linear regression method. The Hon'ble Apex Court as well as the Accounting Standard 29 laid down the para-meters on which provision for warranty expenses can be allowed as a deduction:

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a) an enterprise has a present obligation as a result of a past event;

b) it is probable that an outflow of resources will be required to settle the obligation; and

c) a reliable estimate can be made of the ;amount of the obligation.

If these conditions are not met, no provision can be recognized.

11. In the present case, there is no dispute as to the satisfaction of condition (a) and (b) above. The dispute is only with regard to whether provision made for warranty expenditure is reliable estimate of obligation to be settled. The Hon'ble Supreme Court, in the case of *Rotork Controls India (P) Ltd.* (supra) laid down that if the warranty is based on past experience i.e. historical trend, the estimate can be said to be reliable. It is further held as follows:

> ñ13. . . . . .A detailed assessment of the warranty provisioning policy is required particularly if the experience suggests that warranty provisions are generally reversed if they remained unutilized at the end of the period prescribed in the warranty. Therefore, the company should scrutinize the historical trend of warranty provisions made and the actual expenses incurred against it. On this basis a sensible estimate should be made. The warranty provision for the products should be based on the estimate at year end of future warranty expenses. Such estimates need reassessment every year. As one reaches close to the end of the warranty period, the probability that the warranty expenses will be incurred is considerably reduced and that should be reflected in the estimation amount. Whether this should be done through a *pro rata* reversal or otherwise would require assessment of historical trend. If warranty provisions are based on experience and historical trend(s) and if the working is robust then the question of reversal in the subsequent two years, in the above example, may not arise in a significant way. In our view, on the facts and circumstances of this case, provision for warranty is rightly made by the appellant-enterprise

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because it has incurred a present obligation as a result of past events. . . ò

12. In the present case, on perusal of chart showing provision for preceding as well as succeeding assessment years of the year under consideration, year-end provision is getting accumulated disproportionate to increase in turnover which goes to suggest that the system of accounting for provision for warranty is not robust/reliable. There is a huge difference in the amount of provision made and actual utilization. Further, there is nothing to show that there is any system of re-assessment or evaluation of provision for warranty at the yearend or any reversal of pro rata based on actual expenditure incurred in respect of period for which warranty had expired. Further it is not demonstrated before us that the global policy of the company to provide for warranty expenditure meets the conditions laid down by the Hon'ble Apex Court in the case of *Rotork Controls India (P.) Ltd.*(supra). Nor was the working of the provision furnished demonstrating that the amount of provision worked out was in accordance with stated policy of the company for provision for warranty expenditure.

13. The Hon'ble Delhi High Court in the case of *Ericssion Communications (P.) Ltd.*(supra), relied upon by the appellant, nowhere laid down the proposition of law that when the methodology adopted by the assessee-company for the provision of warranty expenditure does not meet the parameters laid down by the Hon'ble Apex Court in the case of *Rotork Controls India (P.) Ltd.*(supra) and Accounting Standard 29, still it could be allowed as

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a deduction. The ratio laid down in the said case is not applicable to the present case on account of distinguishing facts. In the said case, there was no accumulation of provision for warranty expenditure disproportionate to the increase in turnover. The Hon'ble Delhi High Court made a clear observation that the increase in the provision is only on account of increase in turnover and also unutilized portion of the provision was offered to tax in subsequent years. In these given facts, the Hon'ble High Court rendered a finding that there was no mala-fides on the part of the assessee-company to defer its income and accordingly, held that the methodology adopted was on a scientific basis and allowed the deduction and held that when a company was following a global policy, the same cannot be termed as ad-hoc provision.

Whereas in the present case, as observed by us supra, there was no system of reversal of provision created earlier and the percentage of sales adopted for computation of provision for warranty expenditure goes on increasing from year to year, thereby resulting in accumulation of provision for warranty expenditure. Thus, the ratio of the decision of the Hon'ble Delhi High Court in the case of *Ericssion Communications (P.) Ltd.*(supra) cannot be applied to the case on hand.

14. In the light of above factual situation, we are of the considered opinion that the assessee derived advantage by deferring its income to the extent of excess warranty provision to subsequent years. Therefore, such excess provision cannot be allowed as a

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deduction. Therefore, in our considered opinion, the provision made for warranty cannot be said to be reliable. The AO, as confirmed by the ld.CIT(A) had rightly restricted the amount of allowable provision for warranty at the rate of 2.14% of sales. Therefore, we do not find any fallacy in the reasoning of the order of the ld.CIT(A). Accordingly, the grounds of appeal of the assessee are dismissed.

15. The facts and circumstances and grounds of appeal for assessment year 2014-15 are similar to assessment year 2013-14. For parity of reasons given in the appeal for assessment year 2013-14, the grounds of appeal for assessment year 2014-15 are also dismissed.

16. In the result, the appeals filed by the assessee for assessment years 2013-14 and 2014-15 are dismissed.

Order pronounced in the open court on 03rd August, 2018

Sd/-
(SUNIL KUMAR YADAV)
JUDICIAL MEMBER

sd/-
(INTURI RAMA RAO)
ACCOUNTANT MEMBER

Place : Bengaluru.
D a t e d : 03/08/2018
srinivasulu, sps

Copy to :

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5 DR, ITAT, Bangalore.
6 Guard file

By order

Senior Private Secretary
Income-tax Appellate Tribunal
Bangalore