



Provision for Warranty – Checkpoints

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- Provision for meeting warranty period expenses is a standard feature, as no consumer products can be sold, unless there is some warranty period attached to them.
- The warranty card attached with the product sold specifies the nature of defects covered by warranty and the warranty period. This document binds the dealer to perform the acts provided therein within the specified period.

The issue for consideration is whether provision for warranty claims is allowable as business expenditure or whether it's just a contingent/unascertained liability?

- Section 28 of the Income-tax Act, 1961 enumerates certain incomes which shall be chargeable to income-tax under the head 'Profits and gains of business or profession'.
- Section 29 of the Act directs that the income from business or profession shall be computed in accordance with the provisions of sections 30 to 43D of the Act. Sections 30 to 36 specifically mention the expenditure which is allowable in computing the business income, viz., rent, depreciation, interest on borrowed capital, etc.
- Section 37 is the residuary provision which permits deduction of any expenditure, (except expenditure covered by sections 30 to 36 and expenditure of capital or personal nature) laid out wholly and exclusively for the purposes of business or profession.

Expenditure which is contingent on the happening of certain event is not allowable, unless it meets certain criteria. A provision is a liability which can be measured only by using a substantial degree of estimation.

What is a provision?

A provision is recognized when:

- (a) an enterprise has a present obligation as a result of a past obligating event;
- (b) it is probable that an outflow of resources will be required to settle the obligation;
- (c) a reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision can be recognized. Hence, it is only the obligation arising from past events existing independently of the future conduct of the business of the enterprise that is recognized as provision.

What is a liability?



Liability is defined as a present obligation arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits

What is an obligating event?



- A past event that leads to a present obligation is called as an obligating event.
- The obligating event is an event that creates an obligation which results in an outflow of resources.
- When there is manufacture and sale of an army of items running into thousands of units of sophisticated goods, the past event of defects being detected in some of such items leads to a present obligation which results in an enterprise having no alternative except to settle that obligation.

Where from historical trend it was evident that provision for warranty made by assessee in respect of after sale services was a fair and reasonable estimate of post sales expenses to be incurred by assessee in respect of goods supplied by it, same was to be allowed. **[Jt.**

CIT v. Mil India Ltd. [2015] 59 taxmann.com 334 (Delhi Trib.)

The warranty provision was computed as a three step process to quantify such provision:

- (a) the assessee determines, on the basis explained above, percentage of defects likely to occur in the product sold by the assessee;
- (b) the assessee determines, based on the past experience and the repair cost estimate received from the vendors, average per unit likely repair costs; and
- (c) the assessee determines the likely number of units which are likely to have such defects, by adopting percentage:
 - (a) to the total units sold, and estimates the provision required by multiplying the number of units so likely to receive warranty service, with the average cost incurred on such service as a result of,
 - (b) above.

This method, in our considered view, a fairly scientific basis, supported by historical data, and it meets the tests laid down by the **Hon'ble Supreme Court in Rotork Controls India (P.) Ltd.'s** case (supra) above.

Accordingly, provision for warranty claims made by assessee in respect of software products on scientific basis and historical data, was to be allowed as deduction - **Dy. CIT v. Elitecore Technologies (P.) Ltd.**

With the above observations the Hon'ble Supreme Court in Rotork Controls India (P.) Ltd. v. CIT [2009] 180 Taxman 422/314 ITR 62 held that, If the historical trend indicates that large number of sophisticated goods were being manufactured in the past and the facts also show that defects existed in some of the items manufactured and sold, then the provision made for warranty in respect of the army of such sophisticated goods would be entitled to deduction from the gross receipts under section 37. It would all depend on the data systematically maintained by the assessee.

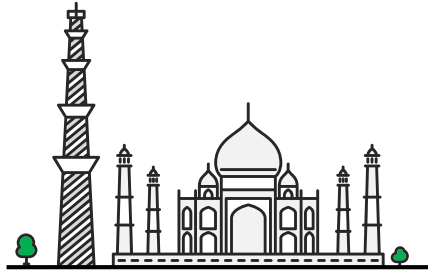
1. Warranty calculations should be based on historical data
2. Where historical data is not available, the warranty provision should be calculated based on scientific basis (Preferably, should be certified/verified by an Actuary)
3. Provisioning for warranty should be consistent year-on-year. Ad-hoc provisioning should be avoided to the best extent possible

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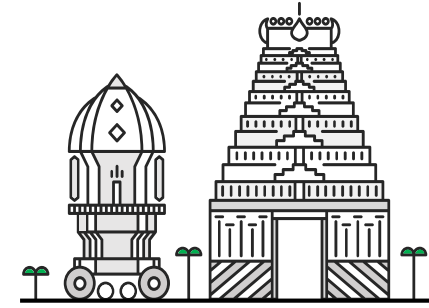
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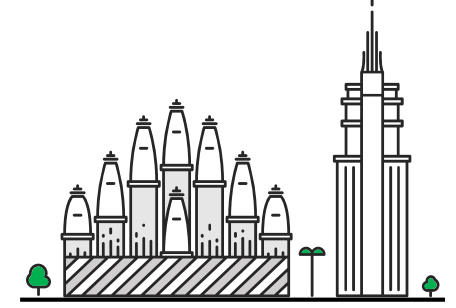
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