

KERALA HIGH COURT

Commissioner of Income Tax

Vs

Kerala State Drugs And Pharmaceuticals Limited

(K.P. Balanarayana Marar, J.)

25.03.1991

JUDGEMENT

K.P. Balanarayana Marar, J.

- (1.) AT the instance of the Revenue, the following question has been referred to this court for decision : "Whether, on the facts and in the circumstances of the case and considering the mercantile system of accounting followed by the assessee and also considering that the reopening of accounts is impermissible under Indian law, the Tribunal is right in holding - (i) that the amount credited as the price of medicine supplied to Government does not represent accrued income or income received ? (ii) that entries made in accounts represent mere claims ?"

(2.) THE respondent-assessee is a public sector undertaking of the Government of Kerala and the subsidiary of the Kerala State Industrial Enterprises Ltd. It is engaged in the manufacture and sale of pharmaceutical products. We are concerned with the assessment year 1978-79 for which the corresponding previous year ended on March 31, 1978. The entire production of the assessee is supplied to the Health Services Department of the Kerala Government. The Government had been sanctioning ad hoc advances to be adjusted later against the supplies. Some difficulties arose in following this practice and the Director of Health Services pointed out to the Government that adjustment of advances could not be made because the prices of the items have to be fixed by the Government of India. Further advance could not be made to the assessee-company and that created a grave financial situation for the assessee. The Director of Health Services, therefore, suggested to the Government that the advances already paid may be adjusted on the basis of the tentative price approved by the firm and further advances may be sanctioned so as to enable them to continue further production. An indemnity bond was executed by the chairman of the company to the effect that if the price structure fixed by the Government is lower than the rate fixed by the firm, the excess payment would be adjusted against future supplies. If the price fixed was higher, a claim could be referred for the balance amount. This proposal was agreed to by the Government. During the accounting year under consideration, the assessee preferred a claim for Rs. 41,86,349 as excess amount receivable over and above the price

tentatively agreed for the products supplied. The claim was not accepted by the Government and the Joint Secretary of the Industries 'Department turned down the claim. The amount had been shown in the profit and loss account as amount receivable and the original return has been filed by the assessee on this basis. In the course of proceedings under section 144B, the company filed a revised return claiming exclusion of this amount from the total receipts. By that time, the Government had already turned down the assessee's claim. The Income-tax Officer was not willing to accept the assessee's claim for exclusion. According to him, the assessee was following the mercantile system of accounting and credit once taken cannot be excluded on a reconsideration of finalised accounts. On appeal, the Commissioner of Income-tax (Appeals) held that the claim was unilateral and a mere claim cannot have the characteristics of income. According to him the amount claimed had not become the income of the assessee at any point of time and he, therefore, held that this amount should be deleted. On further appeal before the Income-tax Appellate Tribunal, the appellate authority came to the conclusion that the price of the products supplied was fixed only tentatively and was subject to ultimate fixation by the Government of India. The Tribunal observed that the price initially charged did not represent the correct price of the product supplied and a mere claim made cannot be equated with the incurring of liability or a receipt. Relying on the decision of the Supreme Court in *Shoorji Val-labhdas and Co.*¹ and the decision of the Gujarat High Court in *Western India Engineering Co.*², the Tribunal agreed with the view of the Commissioner of Income-tax (Appeals).

(3.) THE reference application by the Commissioner of- Income-tax was originally disposed of by the Tribunal by drawing up a statement of the case on January 31, 1986, referring one question out of the two questions suggested by the Department. In respect of the question which was not referred, the Department moved this court by O. P. 8758 of 1986. This court directed the Tribunal to refer that question also. It was thereafter that the aforesaid question was referred to this court for decision. It is urged on behalf of the Revenue that the assessee is following the mercantile system of accounting and credit once taken cannot be excluded on a reconsideration of finalised accounts. This contention found favour with the assessing authority who refused to exclude the amount as required by the assessee. It is settled law that the income of the assessee will have to be determined according to the provisions of the Income-tax Act and in consonance with the method of accounting followed by the assessee. The precise question which we are called upon to consider in this reference is whether the amount sought to be excluded is the real income of the assessee. To ascertain whether it is real income or not, it is advantageous to look into the distinguishing feature of the mercantile system of accountancy from the other system, viz., cash system of accounting. Two broad systems of accounting to determine the profits and gains of a business are referred to as "cash basis" and "mercantile basis". The distinction between the mercantile system and the cash system has been explained by the Supreme Court in *CIT v. A. Krishnaswami Mudaliar*³ The Supreme Court observed (p. 129) : - "Among Indian businessmen, as elsewhere, there are current two principal systems of book-keeping. There is, firstly, the cash system in which a record is maintained of actual receipts and actual disbursements, entries being posted when money or money's worth is actually received, collected or disbursed. There is,

secondly, the mercantile system, in which entries are posted in the books -of account on the date of the transaction, i.e., on the date on which rights accrue or liabilities are incurred, irrespective of the date of payment. For example, when goods are sold on credit, a receipt entry is posted as on the date of sale, although no cash is received immediately in payment for such goods ; and a debit entry is similarly posted when a liability is incurred although payment on account of such liability is not made at the time." .;

Cases Referred.

1[1962] 46 ITR 144

2[1971] 81 ITR 712

3[1964] 53 ITR 122