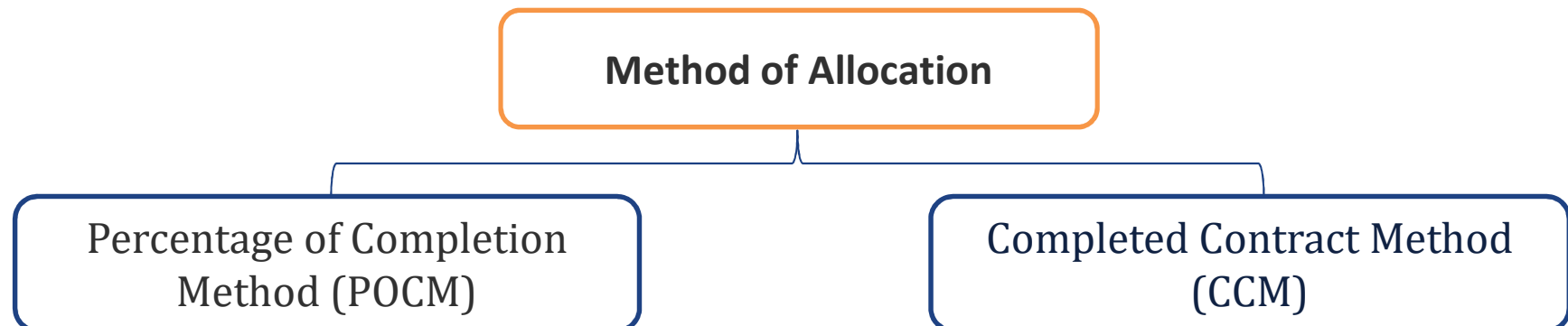


ICDS – III
Construction
Contracts –
*Standardization &
Complications*

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BACKGROUND

- Generally, a construction contract is spread over more than one accounting period.
- Thus, there arises the need to allocate the Contract Revenue and the Contract Cost over the accounting periods.
- To ensure uniformity - Accounting Standard 7 (AS-7) Construction Contracts
- Methods for allocation of cost and revenue:



***Not allowed as per revised AS-7
w.e.f. 2002***

PURPOSE

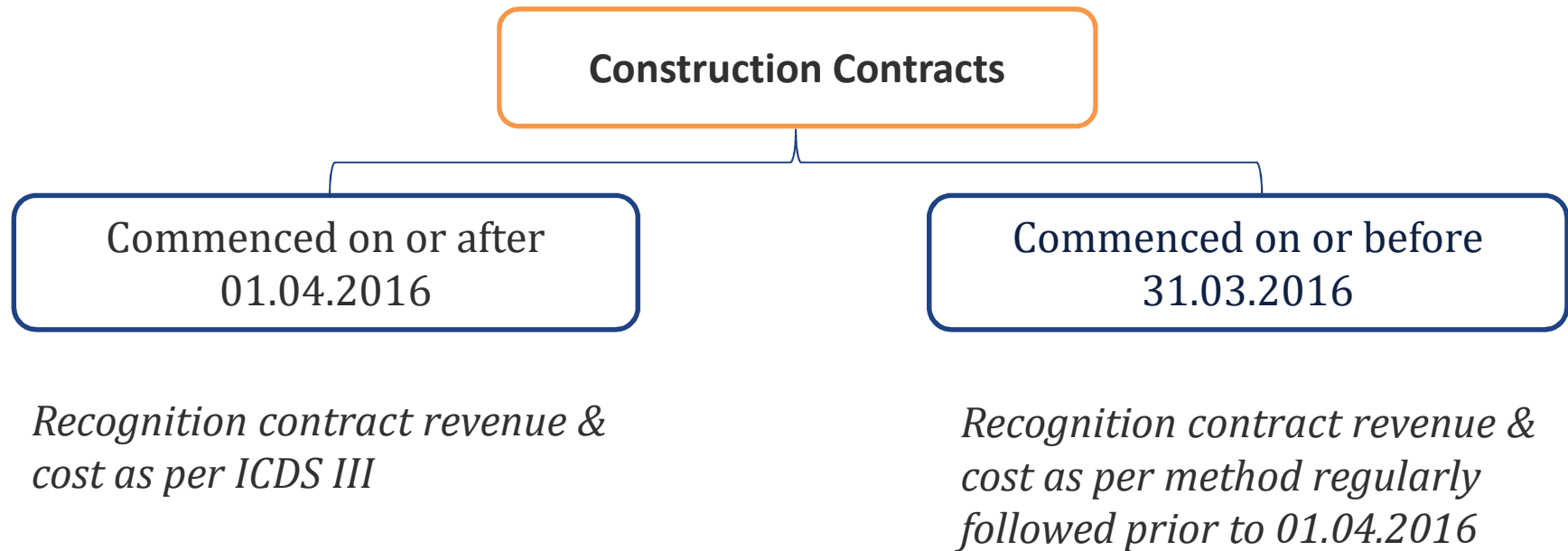
- AS-7 has been judicially recognized as an acceptable for tax purpose also.
- Ostensibly, with an objective to reduce accounting alternatives and to address uncertainty and avoid litigation on several specific issues arising in Construction Contract accounting, CBDT has notified ICDS dealing with construction contracts and has large part of AS 7 in the ICDS with certain deviations

APPLICABILITY

The ICDS is applicable to all Assesses (except for individuals and HUFs who are not liable to Tax Audit) who are maintaining books on mercantile system of accounting and having

- Income from Business or Profession or
- Income from Other Sources

TRANSITIONAL PROVISIONS



Construction Contract :

Contract for construction of an asset or combination of interrelated or interdependent assets

Also includes:

- Contract for rendering construction related services
- Contract for destruction or restoration of assets & environment post demolition

Fixed Price Contract

Cost plus Contract

Combination

Contract Revenue :

(To be recognized when there is reasonable certainty of its ultimate collection)

- Initial Agreement Amount
- **Retentions**
- Variations in contract work
- Claims
- Incentive payment

Contract Cost* :

- Direct Costs
- General Cost attributable to the contract
- Other Specific Costs
- **Allocated borrowing costs computed as per ICDS IX - Borrowing Cost**

** To be reduced by incidental income other than interest, dividend or capital gain*

Recognition of Construction Revenue & Contract Cost :

Based on :
Percentage Of Completion Method

$$\frac{\text{Cost incurred till date}}{\text{Estimated Total Cost}}$$

Survey of Work
Performed

Completion of a
physical proportion of
the contract

During the early stages of a contract, where the outcome of the contract cannot be estimated reliably contract revenue is recognised only to the extent of costs incurred. The early stage of a contract shall not extend beyond 25 % of the stage of completion.

Key Features

- In case of early stages of contract (up to 25% of the stage of completion), revenue is to be recognized only to the extent of cost incurred
- Retention money is considered as part of contract revenues and hence, shall be recognized on POCM basis.
- ICDS also provides as to what constitutes contract costs which even includes allocated borrowing costs.
- Pre-construction income in the nature of interest, dividend and capital gains is specifically not allowed to be reduced from the cost of construction.
- Losses incurred on a contract are allowed only in proportion to the stage of completion
Further, any future or anticipated losses are not considered allowable, unless actually incurred.

Disclosures to be made

- The amount of contract revenue recognised as revenue in the period; and
- The methods used to determine the stage of completion of contracts in progress
- Amount of costs incurred and recognised profits (less recognised losses) upto the reporting date
- The amount of advances received
- The amount of retentions

Key deviation from Indian GAAP (AS 7) :

No.	Particulars	Position under Indian GAAP (AS7)	Position under ICDS
1	Revenue recognition during early stage of contract	No guidance; Most contractors apply POCM from day 1	Revenue to be recognised once contract crosses 25% stage of completion
2	Retention money	Silent; Recognised only when right to receive such sum established	Recognised on POCM basis
3	Recognition of actual losses	Recognised fully upfront	Allowed on POCM basis
4	Provision for anticipated losses	Recognised fully	Not allowed (unless actually incurred)

Key deviation from Indian GAAP (AS 7) :

No.	Particulars	Position under Indian GAAP (AS7)	Position under ICDS
5	Pre-construction income (interest, dividend, capital gains)	Reduced from the cost of Construction	Not allowed to be reduced from the cost of construction
6	Contract costs relating to future activity	Recognised as asset if it is probable that such costs are recoverable	Recognised as asset irrespective of recovery probability

- **Applicability :**

- ICDS would significantly affect non-company assesses Partnerships, Limited Liability Partnerships (LLPs), Sole Proprietorships, etc. which have been following Completed Contract Method for tax purposes till date and which had been accepted judicially.
- Further, ICDS even applies to service providers such as architects, project managers, etc. who generally, render services which are directly related to the construction contract. These categories of taxpayers will now be mandatorily required to compute their taxable income on POCM basis.

- **Threshold for Revenue Recognition :**
 - Practically, many contractor companies have been recognising profits in their books of account from day 1 irrespective of the percentage of contract completion. Hence, the 25% threshold specified under ICDS in relation to recognition of profits for tax purposes may create differences vis-à-vis the accounting treatment followed by such contractors.
 - As a result, there could be a mismatch between the accounting profit and the taxable income which may have MAT implications.

- **Recognition of Retention Money on POCM basis :**

- Various judicial pronouncements have held that retention money accrues to the contractor only when there is a right to receive such income, which, generally, accrues only at a later point of time upon completion of the attached conditions as per the relevant contract.
- The ICDS provides for recognition of retention money on POCM basis.
- In this regard, one may observe that the provisions of ICDS are in conflict with the basic concept of real income theory under the Act and may consider evaluating the tax treatment under ICDS with the charging provisions i.e. Sections 4 and 5 of the Act.

- **Deduction of non recovery of Receivable amounts :**

- ICDS does not govern accounting aspects, any amount treated as receivable under ICDS (like retention money) may not get reflected as a debt in the books of account on the basis of prudence.
- In the event that such amount is not reflected in the books of account, how taxpayer will subsequently writ off the same in its books of accounts?
 - Second proviso to Section 36(1)(vii) Inserted by Finance Act, 2015 : *Such amounts shall be **deemed to be written off** as irrecoverable in the books of accounts and accordingly deduction shall be allowed*

- **Capitalisation of Borrowing Costs related to construction contracts :**
 - Allocated borrowing costs in accordance with ICDS IX, shall be Contract cost.
 - Under Section 36(1) (iii) of the Act which provide that interest costs can be claimed so long as the borrowed funds are used for business purposes .on Borrowing.
 - Given the preamble of ICDS, one may take position that the provisions of the Act prevail and accordingly, borrowings costs pertaining to construction contract should still be allowed as a deduction post ICDS.

- **Pre-construction income in the nature of interest, dividend or capital gains not to be reduced from cost of construction:**
 - ICDS specifically prohibits reducing such income from the cost of construction of the project.
 - As a result, preconstruction income (like interest from advances given to sub-contractors, etc.) could get taxed as income in the year of accrual.
 - Judicial Decisions –
 - *Tuticorin Alkali Chemicals and Fertilizers Limited vs. CIT* (227 ITR 172)
 - *CIT vs. Bokaro Steel Ltd.* (236 ITR 315) – **Different view**

- **Applicability of ICDS III to Real Estate Developers:**

- Developing housing projects on own account and at one's own risk for sale to the public – Applicability of ICDS III ???
- Sale of units on pre-completion sale basis - ???
- Guidance note on Accounting for Real Estate Transactions

An illustration featuring a variety of hands in different colors (yellow, brown, orange, red, green, purple, pink) reaching upwards. Above the hands are several question marks in various colors (red, orange, green, blue, yellow). The background is a light, textured grey.

QUESTIONS WELCOME!

‘न चोर हर्षं न च राज्ञ हर्षं न भ्रातृ
भाज्यं न च भारकरि
व्ययं कृते वर्धत एव नित्यं
विद्यधनं सर्वधनप्रधानम्’

Knowledge is the **Wealth** that:
The **Thief** cannot **Steal**,
The **King** cannot **Acquire**,
The **Brothers** cannot **Share**,
Does not Weigh on You,
Grows Forever as you **share** ,
Truly, **Knowledge** is the **Greatest Wealth**.