

Chapter 4

ICDS III : Construction Contracts

1. Introduction

1.1 ICDS III deals with construction contracts. A construction contract is a contract negotiated for the construction of an asset or a combination of assets. A construction contract, by nature entails time and resources. In cases where the activity continues for more than a year, the question is whether the contractor is to be taxed in the year in which the work is completed or proportionately over all the years? Does the contractor earn his income on a day to day basis (or at least periodically) or on completion of the contract? No guidance in this connection was forthcoming from the Act. There is no uniform practice how income from construction contracts is being offered to tax.

1.2 The Delhi High Court in *Tirath Ram Ahuja (P.) Ltd. v CIT [1976] 103 ITR 15 (Del)* [affirmed by the Supreme Court in (1990) 186 ITR 428 (SC)] held that in the case of a contract, the profits can be estimated on the basis of receipts in each year and one need not wait till the completion of contract. The ICAI issued AS 7 in the year 1983 under which a contractor could recognize income either under the percentage of completion method (POCM) or completed contract method (CCM). The tax department, however, has been taking a position that the income should be offered as per POCM method.

1.3 ICAI revised AS 7 with effect from 01.04.2003. In the revised AS 7, the ICAI recommended that the revenue from construction contracts should be recognized only on POCM basis. Despite this prescription, from a tax perspective, an argument continued that a contractor cannot be compelled to follow POCM method. With a view to put at rest the controversy, the Central Government exercising power under section 145(2), has notified ICDS III relating to construction contracts.

2. Preamble

“This Income Computation and Disclosure Standard is applicable for computation of income chargeable under the head “Profits and gains of business or profession” or “Income from other sources” and not for the purpose of maintenance of books of account.

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In the case of conflict between the provisions of the Income-tax Act, 1961('the Act') and this Income Computation and Disclosure Standard, the provisions of the Act shall prevail to that extent.

3. Scope

"1. This Income Computation and Disclosure Standard should be applied in determination of income for a construction contract of a contractor."

3.1 Paragraph 1 outlines the scope of this ICDS. It states that this ICDS should be applied in determination of income from a construction contract of a contractor. The term 'construction contract' is defined in paragraph 2(1). The term 'contractor' is however not defined. Para 2(2) states that words and expressions used and not defined in the ICDS but defined in the Act shall have the meaning respectively assigned to them in the Act. There is no definition of the term 'contractor' in the Act either. Under such circumstances, the said term would have to be understood in the light of its natural meaning. The Advanced Law Lexicon by P Ramanath Iyer ,3rd Edition defines the term 'contractor' to mean "A person who makes a contract, especially a builder who works by contract. A "contractor" is a person who, in the pursuit of an independent business, undertakes to do specific jobs or work for other persons, without submitting himself to their control in respect to the detail of the work." The Shorter Oxford Dictionary 5th edition defines the term 'contractor' to mean "a person who enters into a contract or agreement. Now chiefly spec. a person or firm that undertakes work by contract, especially for building to specified plans."

3.2 The differentiation between a contractor and a builder has also been accepted by ICAI in interpretation to AS 7 issued earlier. The 'TAS Committee' in the final report published during August 2012 in para 8.1.5 observed that a separate ICDS dealing with income recognition by the real estate developers would be notified. The CBDT has clarified in the FAQ issued on 23rd March, 2017 vide Circular No 10/2017 (Reply to Question No. 12) that this ICDS is not applicable to real estate developers.

4. Definitions

"2(1) The following terms are used in this Income Computation and Disclosure Standard with the meanings specified:

- (a) ***"Construction contract" is a contract specifically negotiated for the construction of an asset or a combination of assets***

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that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use and includes:

- (i) contract for the rendering of services which are directly related to the construction of the asset, for example, those for the services of project managers and architects;*
- (ii) contract for destruction or restoration of assets, and the restoration of the environment following the demolition of assets.*
- (b) "Fixed price contract" is a construction contract in which the contractor agrees to a fixed contract price, or a fixed rate per unit of output, which may be subject to cost escalation clauses.*
- (c) "Cost plus contract" is a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus a mark up on these costs or a fixed fee.*
- (d) "Retentions" are amounts of progress billings which are not paid until the satisfaction of conditions specified in the contract for the payment of such amounts or until defects have been rectified.*
- (e) "Progress billings" are amounts billed for work performed on a contract whether or not they have been paid by the customer.*
- (f) "Advances" are amounts received by the contractor before the related work is performed.*

2(2) Words and expressions used and not defined in this Income Computation and Disclosure Standard but defined in the Act shall have the meaning respectively assigned to them in the Act.

3. A construction contract may be negotiated for the construction of a single asset. A construction contract may also deal with the construction of a number of assets which are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.

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4. Construction contracts are formulated in a number of ways which, for the purposes of this Income Computation and Disclosure Standard, are classified as fixed price contracts and cost plus contracts. Some construction contracts may contain characteristics of both a fixed price contract and a cost plus contract, for example, in the case of a cost plus contract with an agreed maximum price.”

4.1 The definition of the terms ‘construction contract’, ‘fixed price contract’ and ‘cost plus contract’ are similar to the definitions contained in AS-7. A construction contract could be negotiated for the construction of an asset or a group of closely interrelated assets. Para 3 outlines an example when a construction contract could be regarded to have been entered in respect of a single asset or in respect of a combination of closely interrelated or inter-connected assets.

4.2 The second limb of the definition of ‘construction contract’ deems certain contracts as construction contracts. A contract for rendering of services would be a construction contract [Para 2(1)(a)(i)] provided the service contract is directly related to the construction of the asset. The expression ‘directly related’ postulates a nexus of first degree. Service contract with project managers and architects have a first degree nexus with the construction of assets. Another instance could be fire equipment inspection service in a newly constructed building.

4.3 A contract for destruction or restoration of assets, and the restoration of the environment following the demolition of the asset is also to be regarded as a ‘construction contract’. [Clause 2(1)(a)(ii)]. This clause covers contracts of demolition of buildings, breaking of ships, clearing of debris after train accident or mining accident.

4.4 A ‘fixed price contract’, is a construction contract in which consideration for the construction work is pre-determined subject to an adjustment / revision due to cost escalation clauses. This definition envisages two types of fixed price contracts. The first type is where the contract price is agreed upon as a fixed amount. A simple example of this type of contract is construction of a dam by a contractor for a fixed price of say Rs. 300 lakh. The second type of fixed price contract is where the contract price is determined based on a unit-of-measure. This type of a contract is generally entered where it is feasible to measure the underlying asset in terms of units. An example of such type of contract is a road

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construction contract. In a road construction contract it is possible to agree to the price on a per kilometer basis.

4.5 The ICDS also defines 'cost plus contract'. As per the definition, a construction contract in which the costs incurred by a contractor in constructing the asset is reimbursed with a mark-up is known as cost plus contract. The first attribute of the definition is '*reimbursement*'. The Supreme Court in *Tata Iron and Steel Co. Ltd. v Union of India, (2001) 2 SCC 41* observed "*In common acceptance, the word 'reimburse' means and implies 'pay back' or 'refund'. It denotes restoration of something paid in excess; to indemnify.*" In the present context, the said term would mean 'to repay' or 'payback' the costs incurred by a contractor. The second attribute of the definition is that the reimbursement should be of 'allowable or defined costs'. The expression 'allowable or defined costs' denotes that the contract should outline the type, purpose and extent to which a contractor can incur costs. Costs which would be reimbursed to the contractor should either be allowable under the contract or defined under the contract. The third attribute of the definition is that the contractor should get a mark-up over and above the costs. The mark-up could be based on the reimbursed costs or be a fixed amount. The terms of the contract should specify whether the basis of mark-up is the costs incurred or is a fixed amount.

4.6 The ICDS also defines the terms 'retentions', 'progress billings' and 'advances'. These definitions are identical to the definitions contained at Para 40 of AS 7. The definition of 'retentions' outlines two situations where progress billings are to be regarded as retentions. The first situation is where the amount of progress billing is not paid to the contractor until the conditions laid down in the contract are satisfied. The second situation is where the amount of progress billing is not paid for the reason that certain defects are yet to be rectified by the contractor. It is not necessary that every construction contract has a clause stipulating a retention condition.

4.7 The term 'progress billings' is defined to mean amounts billed by the contractor for work performed under the contract. Whether the customer (contractee) has made the payment or not is inconsequential. The term 'advances' is defined to mean amounts received by the contractor before the related work is performed. The definition is in line with the commercial understanding of the term 'advance' as something paid to a person before execution of work. The character changes from advance to consideration when the related work is performed or completed. The stage of completion of

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work would help characterize the amount received from the contractee as advance or consideration.

5. Combining and Segmenting Construction Contracts

“5. The requirements of this Income Computation and Disclosure Standard shall be applied separately to each construction contract except as provided for in paragraphs 6, 7 and 8 herein. For reflecting the substance of a contract or a group of contracts, where it is necessary, the Income Computation and Disclosure Standard should be applied to the separately identifiable components of a single contract or to a group of contracts together.

6. Where a contract covers a number of assets, the construction of each asset should be treated as a separate construction contract when:

- (a) separate proposals have been submitted for each asset;*
- (b) each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and*
- (c) the costs and revenues of each asset can be identified.*

7. A group of contracts, whether with a single customer or with several customers, should be treated as a single construction contract when:

- (a) the group of contracts is negotiated as a single package;*
- (b) the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and*
- (c) the contracts are performed concurrently or in a continuous sequence.*

8. Where a contract provides for the construction of an additional asset at the option of the customer or is amended to include the construction of an additional asset, the construction of the additional asset should be treated as a separate construction contract when:

- (a) the asset differs significantly in design, technology or function from the asset or assets covered by the original contract; or*

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(b) *the price of the asset is negotiated without having regard to the original contract price.*

5.1 The requirements of this ICDS are to be applied separately to each construction contract. However, in certain circumstances, it would be necessary to apply the ICDS to the separately identifiable components in order to reflect the substance of a contract or a group of contracts. Paras 5 to 8 of the ICDS outline the rules to be followed for determining when a contract can be treated as a separate contract or *vice versa*. These are identical to the prescriptions in paras 7 to 9 of AS 7.

5.2 Para 6 stipulates that a single construction contract covering a number of assets would have to be segmented into separate contracts if the stipulated conditions are cumulatively satisfied. To illustrate, ABC Ltd negotiates with XYZ Ltd for construction of two petroleum refineries located at two different places. It submits separate proposals for both the refineries. The negotiations are also conducted independently for each of the refineries. XYZ Ltd ultimately awards the contract by executing a single agreement specifying separately the price for each of the refineries. Evidently, all the conditions contained in Para 6 are satisfied in this case. There is a single contract. The contract covers more than one asset. For each asset, ABC Ltd submitted a separate proposal. Negotiations are conducted independently for each of the assets. The contract specifies the price for each of the assets. As a result, the contract entered by ABC Ltd with XYZ Ltd would have to be segmented into two separate contracts notwithstanding the fact that there is only one written document. ABC Ltd would have to maintain two separate contract accounts in its books of account, recognizing revenues and costs separately for each refinery.

5.3 Para 7 covers a situation where a group of contracts is to be treated as a single contract. The fact that the contractor has negotiated the said group of contracts with a single customer or with several customers is irrelevant if the stipulated conditions for being regarded as a single contract are cumulatively satisfied. The first circumstance influencing such a conclusion is the contract having been negotiated as a single package. The second circumstance is close interrelation of the contracts with each other having an impact on the overall profit margin of the contractor. The interdependence could be in relation to design, function or use of the assets. The third circumstance is that the contracts are performed concurrently or sequentially.

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5.4 All the three conditions referred to herein above would be satisfied in a case where a contractor (say RP & Co) enters into two separate contracts with a customer (say PP Ltd) one for preparing the technical design of a power plant and another for civil construction of the said plant. The civil construction work is based on the technical design. Negotiations are conducted for the two contracts and for sequential delivery of the assets in a span of 18 months. The decision on pricing of contracts is taken by PP Ltd after considering the bids made by RP & Co. RP & Co negotiates the contracts as a single package. The tasks to be performed under both the contracts are interrelated in terms of technology, function and use. All the three conditions of Para 7 of ICDS III would be satisfied to regard the two contracts [contract for technical designing and civil construction] as a single contract. RP & Co would therefore, be required to recognize revenues and costs for both the contracts as one single contract.

5.5 An additional asset may be required to be constructed by the contractor at the option of the customer or due to an amendment in the original contract. Whether construction of such an additional asset would tantamount to a new contract or an extension of an existing contract? Para 8 declares that a contractor needs to treat the construction of an additional asset as a separate contract if any of the following conditions are satisfied:

- (i) the additional asset differs significantly in terms of design, technology or function from the asset or assets covered by the original contract; or
- (ii) the price of the additional asset is negotiated without regard to the original contract price.

Illustration – In the contract between PP Ltd and RP & Co [illustration at Para 5.4], an option was available to the latter to extend the scope of work to build residential quarters for employees and a guest house near the power plant. At the end of 18th month, RP & Co extends the scope of work under the original contract. A separate price is agreed upon for the extended scope of work. RP & Co would have to treat the construction of residential quarters and guest house as separate construction contracts for the reason that the new assets viz., residential quarters and the guest house differ significantly in design, technology or function from the assets covered under the original contract.

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6. Contract Revenue

“9. Contract revenue shall be recognised when there is reasonable certainty of its ultimate collection.

10. Contract revenue shall comprise of:

- (a) the initial amount of revenue agreed in the contract, including retentions; and**
- (b) variations in contract work, claims and incentive payments:**
 - (i) to the extent that it is probable that they will result in revenue; and**
 - (ii) they are capable of being reliably measured.**

11. Where contract revenue already recognised as income is subsequently written off in the books of accounts as uncollectible, the same shall be recognised as an expense and not as an adjustment of the amount of contract revenue.”

6.1 Para 9 stipulates that contract revenue is to be recognized when there is a reasonable certainty of its ultimate collection. Para 21 of AS 7 recommends that contract revenue should be recognized if the outcome of a construction contract can be estimated reliably. The TAS Committee in its final report published during August 2012 addressing the reason for this difference, observed *“As per AS-7, contract revenues are recognized if it is possible to reliably measure the outcome of a contract. This issue being subjective in nature has resulted in litigation and postponement of tax liability. Therefore, this condition is removed.”*

6.2 As per Advanced Law Lexicon, 3rd Edition, the expression ‘reasonable certainty’ means ‘being free from reasonable doubt’. The concept of reasonable certainty in collection of revenue has been explained in para 9.2 of AS 9 as under:

“9.2 Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g., for escalation of price, export incentives, interest etc., revenue recognition is postponed to the extent of uncertainty involved. In such cases, it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made. Where there is no uncertainty as to ultimate collection, revenue is recognised at the time of sale or rendering of service even though payments are made by installments.”

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6.3 The expression 'reasonable certainty' would, accordingly mean that the contractor should recognize contract revenues only if there is no doubt about collection of such revenues.

6.4 Under the income tax regime, business receipts are assessable in the year in which the same accrue to the assessee [Section 5 read with section 145(1)]. The concept of 'accrual' postulates crystallization of a right in favour of the assessee to receive the income. An income accrues when the payer acknowledges a debt in his favour. In *CIT v Excel Industries Ltd (2013) 358 ITR 295 (SC)*, the Supreme Court after referring to various decisions laid down the following three tests to determine the accrual of income [Para 27 of the decision].

- (i) Whether the income accrued to the assessee is real or hypothetical;
- (ii) Whether there is a corresponding liability of the other party to pay the amount;
- (iii) Whether there is a realistic probability of realisation of the amounts by the assessee.

6.5 The stipulation of Para 9 of this ICDS reiterates the third test mentioned above. Mere satisfaction of the same would not, however, amount to accrual of income. For accrual of income under section 5 of the Act, all the three tests outlined above would have to be satisfied. Also, there has to be a corresponding liability on the other party to pay the amount. As the provisions of section 5 prevail over ICDS, the contract revenue should be recognized on satisfaction of the test of accrual and not merely on the basis of reasonable certainty of collection of contract revenue.

6.6 Para 10 of the ICDS enumerates the components of contract revenue. Clause (a) of Para 10 states that contract revenue shall comprise of initial amount of revenues agreed in the contract including retentions. The ICDS however stipulates that the retention monies are part of the contract revenue. In applying the percentage of completion method (discussed infra), the income recognition should factor retention amounts also as contract revenue. Whether retention monies accrue before satisfaction of conditions stipulated, remains debatable in the light of the legal understanding of 'accrual' under section 5.

6.7 Para 16 of this ICDS mandates that contract revenue should be recognized by reference to the stage of completion of a contract, commonly known as percentage of completion method. Retention monies also have to

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be recognized proportionately. The TAS Committee in its final report has recommended that retention money accrues proportionately on the basis of work completed by the contractor and therefore needs to be recognized for tax purposes as per percentage of completion method. The relevant extract from the TAS Committee's final report reads as follows (Para 5.2.5):

“The Tax Accounting Standard for Construction Contracts [TAS (CC)] is based on the Accounting Standard-7 (AS-7) for Construction Contracts issued by the ICAI. While recommending the TAS (CC), the Committee made the following changes to AS-7:

AS-7 is silent about treatment of accrual of income in respect of the retention money. There are some judicial pronouncements holding that the retention money is not deemed to have accrued for tax purposes. To overcome this unintended meaning, the TAS (CC) specifically provides that the retention money shall accrue to the person for computing revenue based on the percentage of completion method.”

6.8 A reference may also be made to the clarifications on ICDS contained in Circular no. 10/2017, dated 23rd March 2017 issued by the CBDT. Question no. 11 and answer there to are reproduced below:

Question 11: *Whether the recognition of retention money, receipt of which is contingent on the satisfaction of certain performance criterion is to be recognized as revenue on billing?*

Answer: *Retention money, being part of overall contract revenue, shall be recognised as revenue subject to reasonable certainty of its ultimate collection condition contained in para 9 of ICDS-III on Construction contracts.*

6.9 Despite the recommendation of the TAS Committee and the clarification contained in the Circular referred above, one would have to ascertain whether the test of accrual under section 5 of the Act would be satisfied. This is because, section 5 being a part of the Act would prevail over ICDS in case there is any conflict between the two. It may be noted that the definition of 'accrual' in Para 2(c) of ICDS I is for the purposes of section 145(2). A similar definition already existed in AS I issued under section 145(2) vide Notification No. 9949, dated 25-1-1996. It was nobody's contention that the said definition altered the understanding of accrual under section 5. The definition of accrual in ICDS I being in a similar setting, should not assume a different meaning or purpose.

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6.10 The ICDS states that amount of retentions constitutes contract revenue. This proposition was never in doubt. The issue was with regard to the year in which such revenue satisfied the test of accrual. Courts have held that a contractor cannot be said to have earned the retentions in terms of section 5 of the Act unless the conditions stipulated in the contract are satisfied or defects are rectified. No enforceable right arises till the conditions are satisfied or defects are rectified. Till such time the right to receive vis-à-vis retentions is contingent in nature [*CIT v Simplex Concrete Piles (India) (P) Ltd [1989] 179 ITR 8 (Cal)*, *CIT v P&C Constructions (P) Ltd [2009] 318 ITR 113 (Mad)*, *Amarshiv Construction (P) Ltd v DCIT [2014] 367 ITR 659 (Guj)*].

6.11 Clause (b) of Para 10 states that variations in contract work, claims and incentive payments would constitute contract revenue provided the following conditions are satisfied:

- (i) It is probable that these items would result in revenue; and
- (ii) They are capable of being reliably measured.

6.12 The above limb of the definition of 'contract revenue' is identical to Para 10(b) of the definition of 'contract revenue' under AS 7. Under such circumstances, the explanations given under paras 11 to 14 of AS 7 could be referred for understanding the scope of clause (b) of Para 10 of the ICDS. The variations, claims and incentives referred to above are to be understood from the contractor's viewpoint.

Contract revenue written off from books as uncollectible – Dealt with in Para 11 of ICDS - Situation I

6.13 Para 11 of this ICDS deals with a situation where any contract revenue which has already been recognized as income is written off from the books for the reason that the same is uncollectible. Para 11 recommends that the amount written off should be claimed as a deductible expense.

6.14 Section 36(1)(vii) of the Act envisages two situations when bad debts can be allowed as a deduction. The first situation envisages any bad debt or part thereof written off as irrecoverable in the accounts of the assessee. The prescription under para 11 of the ICDS that the written off amount should be claimed as an expense is therefore in line with the operative portion of section 36(1)(vii) of the Act.

6.15 Another stipulation of para 11 is that the amount of contract revenue written off in the books should not be adjusted from the contract revenue.

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Adjustment of contract revenue on account of reversal would have disturbed the incomes already offered to tax on POCM basis in the earlier years. The prescription under Para 11 that bad debts should be recognized as an expense and not as an adjustment from the contract revenue would preserve the contract revenue already offered to tax on POCM basis.

Contract revenue not recorded in books but offered to tax as per ICDS turned bad - Not dealt with in ICDS III - Situation II

6.16 This ICDS does not cover the second situation envisaged in section 36(1)(vii) viz., where contract revenue not recorded in the books of account, but offered to tax as per ICDS, turns bad. An assessee cannot write-off a debt which was not recorded in the books of account but offered to tax. In such a case, Para 11 of the ICDS cannot be invoked to claim deduction of uncollectible amounts as the same cannot be written-off in the books of account. To illustrate, retention amount is generally recognized in the books of account when the right to receive the same is established. However as per the ICDS, retention amount is to be recognized as contract revenue for tax purposes in proportion to the stage of completion. The assessee having paid tax on the whole or a part of the retention monies would not be in a position to claim deduction towards the uncollectable retention amount as the condition of writing off the bad debts in the books of account would not be satisfied. The deduction under such a situation would, however, be available by virtue of second proviso to section 36(1)(vii). As per the said proviso, bad-debts could be claimed as deduction without a write off in books of account. The condition precedent is that the amount of debt or part thereof has been taken into account in computing the income of the assessee of the previous year in which the amount of such debt or part thereof becomes irrecoverable or of an earlier previous year.

7. Contract Costs

“12. Contract costs shall comprise of:

- (a) costs that relate directly to the specific contract;***
- (b) costs that are attributable to contract activity in general and can be allocated to the contract;***
- (c) such other costs as are specifically chargeable to the customer under the terms of the contract; and***
- (d) allocated borrowing costs in accordance with the Income Computation and Disclosure Standard on Borrowing Costs.***

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These costs shall be reduced by any incidental income, not being in the nature of interest, dividends or capital gains, that is not included in contract revenue.

13. Costs that cannot be attributed to any contract activity or cannot be allocated to a contract shall be excluded from the costs of a construction contract.

14. Contract costs include the costs attributable to a contract for the period from the date of securing the contract to the final completion of the contract. Costs that are incurred in securing the contract are also included as part of the contract costs, provided

- (a) they can be separately identified; and***
- (b) it is probable that the contract shall be obtained.***

When costs incurred in securing a contract are recognised as an expense in the period in which they are incurred, they are not included in contract costs when the contract is obtained in a subsequent period.

15. Contract costs that relate to future activity on the contract are recognised as an asset. Such costs represent an amount due from the customer and are classified as contract work in progress.”

7.1 Para 12 of the ICDS outlines constituents of contract costs. Clause (a) states that contract costs should comprise of costs which are directly related to a specific contract. Such costs comprise of labour costs, cost of materials, depreciation on plant and machinery, plant and machinery hiring charges, sub-contractor charges, architect fees, soil testing charges, etc. One may, in this connection, refer Para 16 of AS 7 wherein other examples of costs directly related to a specific contract have been enumerated. The same reads as under:

“Costs that relate directly to a specific contract include:

- (a) site labour costs, including site supervision;*
- (b) costs of materials used in construction;*
- (c) depreciation of plant and equipment used on the contract;*
- (d) costs of moving plant, equipment and materials to and from the contract site;*
- (e) costs of hiring plant and equipment;*

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- (f) *costs of design and technical assistance that is directly related to the contract;*
- (g) *the estimated costs of rectification and guarantee work, including expected warranty costs; and*
- (h) *claims from third parties.”*

7.2 Clause (b) of para 12 covers costs that are attributable to contract activity in general and can be allocated to the contract. There are two conditions for an expense to fall within clause (b). The first condition is that the costs should be attributable to the construction contract activity. The term ‘attributable’ has a wide connotation. It covers costs having direct as well as indirect nexus. The second condition is that such costs should be allocable to a contract.

7.3 Para 17 of AS 7 contains examples of costs which are attributable to contract activity in general and allocable to specific contracts. These include (a) insurance, (b) costs of design and technical assistance not related to a specific contract, and (c) construction overheads such as preparation and processing of construction personnel payroll. The allocation should be done using a systematic and rational method. As recommended in para 17 of AS 7, the level of construction activity could be taken as a base for allocating these costs to specific contracts.

7.4 Clause (c) of para 12 covers costs that are specifically chargeable to the customer under the terms of the contract. These include administration costs and research costs which are agreed to be reimbursed by the contractee.

7.5 Clause (d) of para 12 of the ICDS stipulates that borrowing cost allocable to a construction contract would also constitute contract cost. As this Standard itself contains the mandate for including borrowing costs as part of construction cost, ICDS IX is not to be referred for the purpose of determining whether borrowing cost forms part of the contract cost.

Borrowing cost attributable to a construction contract not covered under proviso to section 36(1)(iii)

7.6 Section 36(1)(iii) of the Act deals with deduction of interest paid in respect of capital borrowed for the purposes of the business. Proviso to section 36(1)(iii) stipulates that interest paid on capital borrowed for acquisition of an asset is not allowable as deduction if the same relates to a period beginning from the date of borrowing till the date on which such asset

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is first put to use. The condition precedent for applicability of the proviso to section 36(1)(iii) is that the assessee should have borrowed the capital for the purpose of acquisition of an asset. Capital borrowed by a contractor for the purpose of executing a construction contract is not in the nature of capital borrowed for acquisition of an asset. A contractor does not acquire an asset under a construction contract. As a result, interest paid on capital borrowed by a contractor attributable to a construction contract would not be hit by the embargo created under proviso to section 36(1)(iii) of the Act. As a result, interest paid on capital borrowed by a contractor attributable to a construction contract would be allowed as a deduction.

Borrowing cost attributable to a construction contract not covered under ICDS IX

7.7 Borrowing costs attributable to a construction activity carried by a contractor is not covered under ICDS IX. According to para 3 of ICDS IX, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset shall be capitalized as part of the cost of that asset. Para 2(1)(b) therein defines the term 'qualifying asset'. The definition contains three clauses. None of these clauses specifically mention that an asset being created under a construction contract constitutes a qualifying asset. Clause (iii) of the definition states that inventories which require a period of twelve months or more to bring them to a saleable condition, constitute a qualifying asset. Whether a construction contract constitutes an inventory of a contractor? Para 2(1)(a) of ICDS II defines the term 'inventories' to mean (i) assets held for sale in the ordinary course of business; (ii) assets in the process of production of such sale; and (iii) assets in the form of materials or supplies to be consumed in the production process or in the rendering of services. An asset or group of assets constructed by a contractor is not an asset which is held for sale by the contractor. The asset or combination of assets is constructed by the contractor for the contractee. The asset or combination of assets constructed by the contractor would not thus satisfy the definition of "inventory". Para 1(a) of ICDS II supports such an understanding. Para 1(a) states that ICDS II shall be applied for valuing the inventories except work-in-progress arising under 'construction contract' which is dealt with by ICDS III. This indicates that an asset or group of assets constructed under a construction contract does not constitute inventory of the contractor. As ICDS III and IX would not be applicable regarding the treatment of borrowing costs, the deductibility of the same would be governed by section 36(1)(iii). For the reasons detailed in para 7.6, interest

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paid on capital borrowed by a contractor attributable to a construction contract would be allowable as a deduction.

7.8 Para 12 of the ICDS declares that incidental incomes which do not form part of contract revenue shall be reduced from the contract costs. An example of incidental income is sale of surplus materials and the disposal of plant and equipment at the end of the contract [Para 16 of AS 7]. Incidental income for this purpose does not include incomes in the nature of interest, dividends and capital gains. These incomes would be taxed separately in accordance with the applicable provisions of the Act.

7.9 Para 13 declares that costs that do not satisfy the conditions laid down in clause (b) of Para 12 cannot form part of contract costs. One could, in this connection refer to Para 19 of AS 7, which lists out examples of such costs to include (a) general administration costs for which reimbursement is not specified under the contract; (b) selling costs; (c) research and development costs for which reimbursement is not specified under the contract; and (d) depreciation of idle plant and equipment that is not used on a particular contract.

7.10 Para 14 of the ICDS stipulates that costs incurred from the date of securing the contract to the date of completion of contract should form part of contract costs. It also stipulates that costs incurred to secure the contract should also be included in contract costs subject to fulfillment of the following two conditions:

- (i) Such costs should be capable of being separately identified; and
- (ii) Such costs should have been incurred with a probability of obtaining the contract.

Cost of tender forms and site visit charges paid to technicians for initial assessment are examples of costs incurred for securing the contract.

7.11 It could happen that certain costs are incurred for securing the contract in a particular financial year but the contract is secured in the subsequent year. The question is whether the costs incurred for securing the contract would have to be claimed in the year of incurrence or in the year in which contract is secured? The first limb of para 14 stipulates that contract costs include costs incurred from the date of securing the contract to the date of completion of the contract. It further provides that costs incurred in securing the contract are also included as a part of the contract costs on satisfaction of specified conditions. The last limb of para 14 stipulates that when costs

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incurred in securing a contract have been recognized as an expense in the year of incurrence, such costs are not to be included again as a part of contract costs in the year in which contract is obtained.

7.12 Para 15 of the ICDS covers situations where costs are incurred in advance for a contract work of subsequent years. Para 15 directs that such costs should not be claimed as a deduction as the same represents amount due from customers. The ICDS provides that such costs are in the nature of an asset and should be characterised as work-in-progress. Para 15 of the ICDS corresponds to Para 26 of AS 7. However, Para 15 of the ICDS does not contain the requirement that it should be probable that such costs will be recovered as provided in AS 7. Since the reference is to the amount due from the customer, in any case even under Para 15 of the ICDS, the requirement of the probability of recovery is implied. To illustrate, ABC Pvt Ltd enters into a contract during January 2017 to construct a multistorey building. The construction activity is to be completed within 36 months. During February 2017, ABC Ltd procures electrical fittings to be used in all the floors at a cost of Rs 10 lakhs. The electrical work is scheduled to be undertaken during August 2018. The amount of Rs 10 lakhs cannot be claimed as deduction in the return of income filed for the AY 2017-18 as the same relates to a work which would be undertaken in the subsequent financial year. Another instance could be of advance payment in December 2017 to an agency for installing wireless routers in common area of a residential project. The installation work is to be undertaken during June 2018. The payment to the agency cannot be claimed as a part of the construction costs in the return of income for A Y 2018-19 as the same relates to a work which would be undertaken in the subsequent financial year.

8. Recognition of Contract Revenue and Expenses

“16. Contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the reporting date.

17. The recognition of revenue and expenses by reference to the stage of completion of a contract is referred to as the percentage of completion method. Under this method, contract revenue is matched with the contract costs incurred in reaching the stage of completion,

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resulting in the reporting of revenue, expenses and profit which can be attributed to the proportion of work completed.

18. The stage of completion of a contract shall be determined with reference to:

- (a) the proportion that contract costs incurred for work performed upto the reporting date bear to the estimated total contract costs; or**
- (b) surveys of work performed; or**
- (c) completion of a physical proportion of the contract work.**

Progress payments and advances received from customers are not determinative of the stage of completion of a contract.

19. When the stage of completion is determined by reference to the contract costs incurred upto the reporting date, only those contract costs that reflect work performed are included in costs incurred upto the reporting date. Contract costs which are excluded are:

- (a) contract costs that relate to future activity on the contract; and**
- (b) payments made to subcontractors in advance of work performed under the subcontract.**

20. 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.”

8.1 In terms of para 16, contract revenue and contract costs should be recognized as revenue and expenses respectively by reference to the stage of completion of the construction activity at the reporting date. Para 17 states that recognition of revenue and expenses by reference to the stage of completion is referred as the percentage of completion method. Under this method, contract revenue is matched with the contract costs actually incurred in reaching the stage of completion of construction activity. Para 17 states that percentage of completion method results in reporting of revenue, expenses and profit attributable to the proportion of work completed on the reporting date.

8.2 The pre-condition for recognizing contract revenue and contract costs under this ICDS is actual performance of work. Based on the

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recommendation of the TAS Committee, the ability of making a reliable estimate of the outcome of the contract before recognizing revenues and costs has been deleted. The TAS Committee had opined that recognition of revenue based on reliable estimates of outcome of contract is a subjective condition and results in postponement of tax liability. Consequently, the ICDS does not envisage reliable estimation of the outcome of a contract as a condition precedent of recognizing contract revenue or costs.

8.3 The aforementioned difference between this ICDS and AS 7 could have implications on account of MAT. ICDS requires recognition of revenue in the year in which work is performed on percentage of completion method even if the contractor is unable to make a reliable estimate of outcome of contract. In a subsequent year, when the contractor is able to reliably estimate the outcome of a contract, the contract revenue would be 'accounted' as income in the books of account [as per Para 21 of AS 7]. Having paid tax in the first year on the basis of ICDS, the tax payer may be exposed to a MAT liability in the subsequent year due to the recognition of income in the books of account.

8.4 Para 18 of the ICDS outlines three parameters on the basis of which the stage of completion of contract is determined. The first is the contract costs incurred till the reporting date. The second parameter is the survey of actual work performed till the reporting date. The third parameter is the stage of completion of a physical proportion of the contract work. A contractor could choose any one of these criteria to determine the stage of completion of contract. Progress payments and advances received from customers cannot be adopted as a criterion for determining the stage of completion of contract.

8.5 Para 19 of the ICDS stipulates that where contract costs incurred upto the reporting date is chosen as the factor for determining the stage of completion of contract, only such costs that are relatable to work performed should be included. Other costs would have to be excluded. Examples of costs to be excluded are (a) contract costs that relate to future activity and (b) advance payment to sub-contractors.

8.6 Para 20 of the ICDS stipulates that contract revenue should be recognized only to the extent of costs incurred till the reporting date. Revenue recognition can be postponed in the initial phase of the contract, which in no case shall exceed 25% of the contract work. The language does

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not mandate a recognition of income only after the threshold of 25% completion is reached.

Allowance of losses

8.7 Para 35 of AS 7 provides that expected losses shall be recognized in the financial statements and not in proportion to percentage of completion of contract. Similar prescription is absent in the ICDS. The TAS Committee in Para 5.2.5 of its report stated that only the “actual losses” (and not expected losses) are to be recognized. ICDS I also says that expected losses shall not qualify as a deduction unless otherwise specifically permitted under any ICDS. Thus only actual losses are allowable under the ICDS.

8.8 The actual loss made by the tax payers would be eligible for the deduction in compliance with the provision of section 28 or 37 of the Income-tax Act. One will also have to make a distinction between incurred loss and expected loss. ICDS only prohibits allowability of expected loss and not an incurred loss.

9. Changes in Estimates

“21. The percentage of completion method is applied on a cumulative basis in each previous year to the current estimates of contract revenue and contract costs. Where there is change in estimates, the changed estimates shall be used in determination of the amount of revenue and expenses in the period in which the change is made and in subsequent periods.”

9.1 Para 21 of the ICDS recognizes that the percentage of completion method is based on the current estimates of contract revenue and contract costs. It further stipulates that any change in estimates of contract revenue and contract costs would have to be given effect in the year in which such change is made and to the subsequent years. The change in estimate would not affect the contract revenue and costs recognized in the prior years. To illustrate, RB Pvt Ltd enters into a construction contract with NK Pvt Ltd during FY 2016-17 for constructing a wind mill. The contract revenue and contract costs estimated at the time of entering the contract are Rs 10 crores and Rs.8.5 crores respectively. The contract revenue and costs are revised on account of escalation in prices of wind turbine to Rs 10.5 crores and Rs.9 crores respectively in the subsequent year (FY 2017-18). The effect of the change in estimates of contract revenue and contract costs would have to be given effect in the assessment year 2018-19 [relevant to FY 2017-18] and

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subsequent assessment years. Contract revenue and costs offered to tax in assessment year 2017-18 (relevant to FY 2016-17) would remain unchanged.

10. Transitional Provisions

“22.1 Contract revenue and contract costs associated with the construction contract, which commenced on or after 1st day of April, 2016 shall be recognized in accordance with the provisions of this ICDS.

22.2 Contract revenue and contract costs associated with the construction contract, which commenced on or before the 31st day of March, 2016 but not completed by the said date, shall be recognized based on the method regularly followed by the person prior to the previous year beginning on the 1st day of April, 2016.”

10.1 As regards transitional provisions, para 22 of the ICDS contains twin prescriptions. The first prescription is that this ICDS would apply to contracts which have commenced on or after 01.04.2016. Thus, this ICDS is not applicable for construction contracts that commenced prior to financial year 2016-17. The second prescription is that the contract revenue, contract costs in respect of contracts commenced prior to financial year 2016-17 would have to be offered to tax as per the method regularly followed by the contractor. If a contractor has continuously followed completed contract method, the contract revenue and costs in relation to contracts commenced prior to financial year 2016-17 would have to be recognised under the said method and not as per this ICDS.

11. Disclosure

“23. A person shall disclose:

- (a) the amount of contract revenue recognised as revenue in the period; and***
- (b) the methods used to determine the stage of completion of contracts in progress.***

24. A person shall disclose the following for contracts in progress at the reporting date, namely:-

- (a) amount of costs incurred and recognised profits (less recognised losses) upto the reporting date;***

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(b) *the amount of advances received; and*

(c) *the amount of retentions.*”

11.1 Paras 23 and 24 outline the disclosure requirements under this ICDS. As the ICDS do not apply to the manner of maintaining books of account, these disclosures have to be made in tax audit report in clause 13(d) to (f) of Form 3CD. It is also clarified that the disclosure requirement will also apply to the new contracts as per transitional provisions contained in Para 22.