

DISCUSSION PAPER

ON

**TAX ACCOUNTING
STANDARDS**

OCTOBER 2011

**Government of India
Ministry of Finance
Department of Revenue
Central Board of Direct Taxes**

1. Background

1.1 Section 145 of the Income-tax Act, 1961 ('the Act') provides that the method of accounting for computation of income under the head "Profits and gains of business or profession" and "Income from other sources" can either be the cash or mercantile system of accounting. The Finance Act, 1995 empowered the Central Government to notify Accounting Standards for any class of assessee or for any class of income. Explaining the reason for introduction of this provision, it was stated that there is flexibility in the standards issued by the Institute of Chartered Accountants of India (ICAI) which makes it possible for an assessee to avoid the payment of correct taxes by following a particular system and therefore, there is an urgent need to standardize one or more of the alternatives in various standards so that income for tax purpose can be computed precisely and objectively.

1.2 Since the introduction of these provisions, two Accounting Standards relating to disclosure of accounting policies and disclosure of prior period and extraordinary items and changes in accounting policies have been notified. In July 2002, the Central Government had constituted a committee on formulation of Accounting Standards under the Act ['the Committee (2002)'].

1.3 The Committee (2002) submitted its final report in November 2003 which contained the following main recommendations:

- (i) It would be impractical for a tax payer to maintain two sets of books of account – one in accordance with the Accounting Standards issued by the ICAI and another set in accordance with the Accounting Standards to be notified under the Act. The Committee (2002), therefore, recommended that the Accounting Standards issued by the ICAI should be notified under the Act without any modifications.
- (ii) Appropriate legislative amendments should be made to the Act to prevent any scope for leakage of revenue on account of notification of Accounting Standards issued by the ICAI.

1.4 The recommendations of the Committee (2002) could not be implemented because of the following:-

- (i) The implementation of the recommendation of the Committee (2002) would have required extensive amendment to the Act resulting in complexity and litigation, and would have negated the concept of notification of accounting standards under the Act to provide certainty.
- (ii) As the Accounting Standards issued by ICAI keep on evolving /changing by way of issue of new standards, interpretation and revision, it would have been cumbersome for the Ministry of Finance to keep track of all changes in the Accounting standards issued by the ICAI and to move simultaneous amendments to the Act.

1.5 There have been significant developments since the Committee (2002) submitted its report, notable among them are:

- (i) The Government of India, through the Ministry of Corporate Affairs (MCA), has notified twenty eight Accounting Standards issued by the ICAI, under the Companies Act, 1956.
- (ii) The Government of India has decided to converge Indian Accounting Standards with the International Financial Reporting Standards (IFRS). In February, 2011, the MCA, being the nodal agency for this convergence, has placed thirty five Indian Accounting Standards converged with International Financial Reporting Standards (termed as IND AS) on its website.
- (iii) In the absence of notification of Accounting Standards under the Act, uncertainty and litigation continues on various accounting related issues such as accounting for construction contracts, foreign exchange fluctuations and government grants.

2. New Accounting Standards Committee

2.1 The Central Board of Direct Taxes (CBDT) constituted a new Accounting Standard Committee ('the Committee') comprising of departmental officers and professionals vide Order No. 134/48/2010-SO (TPL) dated 20th December 2010. The terms of reference of this Committee are as under:

- i) to study the harmonization of Accounting Standards issued by the ICAI with the direct tax laws in India, and suggest Accounting Standards which need to be adopted under section 145(2) of the Act along with the relevant modifications;
- ii) to suggest method for determination of tax base (book profit) for the purpose of Minimum Alternate Tax (MAT) in case of companies migrating to IFRS (IND AS) in the initial year of adoption and thereafter; and
- iii) to suggest appropriate amendments to the Act in view of transition to IFRS (IND AS) regime.

3. Main recommendations of the Committee

3.1 The Committee submitted its Interim Report in August 2011. The main recommendations of the Committee with regard to the first term of reference are as under.

3.2 Since the Accounting Standards to be notified under section 145(2) of the Act would need to be in harmony with the provisions of the Act, the Accounting Standards issued by the ICAI cannot be notified without modification. The notified Accounting Standards should provide specific rules, which would enable computation of income with certainty and clarity. To ensure horizontal equity and uniformity, the notified Accounting Standards would also need elimination of alternatives, to the

extent possible. Accordingly, separate Accounting Standards should be notified under Section 145(2) of the Act.

3.3 It would be burdensome for affected tax payers to maintain two sets of books of account i.e. one in accordance with the Accounting Standards issued by the ICAI/notified under the Companies Act, 1956; and another in accordance with the Accounting Standards notified under the Act. Accordingly, the Accounting Standards notified under the Act should be made applicable only to the computation of taxable income and a taxpayer should not be required to maintain books of account on the basis of Accounting Standards notified under the Act.

3.4 Two different sets of Accounting Standards may cause confusion for taxpayers and other stakeholders. Accordingly, the Accounting Standards notified under the Act should be termed as “Tax Accounting Standards” (TAS) to distinguish them from the Accounting Standards issued by the ICAI/notified under the Companies Act, 1956.

3.5 Since the TAS are based on the mercantile system of accounting, the TAS should be applicable to all tax payers who follow the mercantile system of accounting, and should not be applicable to those taxpayers who follow the cash basis of accounting.

3.6 As the TAS are intended to be in harmony with the provisions of the Act, it should be expressly provided in the TAS, that in case of conflict, the provisions of the Act shall prevail over the TAS.

3.7 Currently, the starting point for computation of income under the head “Profits and gains of business or profession” and “Income from other sources” is the income as per the financial statements. Since the provisions of the TAS may not be the same as the corresponding provisions used for preparation of the financial statements, a reconciliation between the income as per the financial statements and the income as computed per the TAS should be presented.

4. Draft TAS

4.1 Draft of the TAS on Construction Contracts and Government Grants, recommended by the Committee, are annexed hereto. Draft of other TAS will be issued for comments/suggestions by all stakeholders in due course.

4.2 Comments/suggestions are invited on the recommendations of the Committee and draft of the TAS annexed hereto. The comments/suggestions may be e-mailed at dirtpl3@nic.in by 11th November, 2011.

Tax Accounting Standard [TAS]

Tax Accounting for Construction Contracts

Preamble

This Tax Accounting 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.

In the case of conflict between the provisions of the Income-tax Act, 1961(‘the Act’) and this Tax Accounting Standard, the provisions of the Act shall prevail to that extent.

Scope

1. This Tax Accounting Standard should be applied in determination of income for a construction contract of a contractor.

Definitions

- 2 (1) The following terms are used in this Tax Accounting Standard with the meanings specified:
 - (a) A “**construction contract**” is a contract specifically negotiated for the construction of an asset or a combination of assets 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) A “**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) A “**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 Tax Accounting 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.
 - 4. Construction contracts are formulated in a number of ways which, for the purposes of this Tax Accounting 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.

Combining and Segmenting Construction Contracts

- 5. The requirements of this Tax Accounting 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 Tax Accounting 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
 - (b) the price of the asset is negotiated without having regard to the original contract price.

Contract Revenue

9. 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.
10. 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.

Contract Costs

11. 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 Tax Accounting Standard on Borrowing Costs.

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.

12. 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.
13. 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.

- 14. 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.

Recognition of Contract Revenue and Expenses

- 15. 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.
- 16. 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, resulting in the reporting of revenue, expenses and profit which can be attributed to the proportion of work completed.
- 17. 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.

- 18. 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.
- 19. 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.

Changes in Estimates

20. The percentage of completion method is applied on a cumulative basis in each accounting period 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.

Disclosure

21. 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.
22. A person shall disclose the following for contracts in progress at the reporting date:
- (a) Amount of costs incurred and recognized profits (less recognized losses) upto the reporting date;
 - (b) the amount of advances received; and
 - (c) the amount of retentions.

Tax Accounting Standard [TAS]

Tax Accounting For Government Grants

Preamble

This Tax Accounting 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.

In case of conflict between the provisions of the Income Tax Act, 1961 (‘the Act’) and this Tax Accounting Standard, the provisions of the Act shall prevail to that extent.

Scope

1. This Tax Accounting Standard deals with the treatment of Government grants. The Government grants are sometimes called by other names such as subsidies, cash incentives, duty drawbacks, waiver, concessions, reimbursements, etc.
2. This Tax Accounting Standard does not deal with:
 - (a) Government assistance other than in the form of Government grants;
 - (b) Government participation in the ownership of the enterprise.

Definitions

- 3(1) The following terms are used in the Tax Accounting Standard with the meanings specified:
 - (a) “**Government**” refers to the Central Government, State Governments, agencies and similar bodies, whether local, national or international.
 - (b) “**Government grants**” are assistance by Government in cash or kind to a person for past or future compliance with certain conditions. They exclude those forms of Government assistance which cannot have a value placed upon them and the transactions with Government which cannot be distinguished from the normal trading transactions of the person.
- 3(2) Words and expressions used and not defined in this Tax Accounting Standard but defined in the Act shall have the meaning assigned to them in the Act.

Recognition of Government grants

- 4(1) Government grants should not be recognized until there is reasonable assurance that (i) the person shall comply with the conditions attached to them, and (ii) the grants shall be received.
- 4(2) Recognition of Government grant shall not be postponed beyond the date of actual receipt.

Treatment of Government grants

5. Where the Government grant relates to a depreciable fixed asset or assets of a person, the grant shall be deducted from the actual cost of the asset or assets concerned or from the written down value of block of assets to which concerned asset or assets belonged to.
6. Where the Government grant relates to a non-depreciable asset or assets of a person requiring fulfillment of certain obligations, the grant shall be recognized as income over the same period over which the cost of meeting such obligations is charged to income.
7. Where the Government grant is of such a nature that it cannot be directly relatable to the asset acquired, so much of the amount which bears to the total Government grant, the same proportion as such asset bears to all the assets in respect of or with reference to which the Government grant is so received, shall be deducted from the actual cost of the asset or shall be reduced from the written down value of block of assets to which the asset or assets belonged to.
8. The Government grant that is receivable as compensation for expenses or losses incurred in a previous financial year or for the purpose of giving immediate financial support to the person with no further related costs, shall be recognized as income of the period in which it is receivable.
9. The Government grants other than covered by paragraph 5, 6, 7, and 8 shall be recognized as income over the periods necessary to match them with the related costs which they are intended to compensate.
10. The Government grants in the form of non-monetary assets, given at a concessional rate, shall be accounted for on the basis of their acquisition cost.

Refund of Government Grants

11. The amount refundable in respect of a Government grant referred to in paragraphs 6, 8 and 9 shall be applied first against any unamortized deferred credit remaining in respect of the Government grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount shall be charged to profit and loss statement.
12. The amount refundable in respect of a Government grant related to a fixed asset or assets shall be recorded by increasing the actual cost or written down value of block of assets by the amount refundable. Where the actual cost of the asset is increased, depreciation on the revised actual cost or written down value shall be provided prospectively at the prescribed rate.

Disclosure

13. Following disclosures shall be made in respect of Government grants:
- (a) Nature and extent of Government grants recognised during the previous year by way of deduction from the actual cost of the asset or assets or from the written down value of block of assets during the previous year.
 - (b) Nature and extent of Government grants recognised during the previous year as income.
 - (c) Nature and extent of Government grants not recognised during the previous year by way of deduction from the actual cost of the asset or assets or from the written down value of block of assets and reasons thereof.
 - (d) Nature and extent of Government grants not recognised during the previous year as income and reasons thereof.
