Future losses accounted as per the Accounting Standard 7 is allowable as business expenditure

Summary – Recently, the Mumbai Bench of Income-tax Appellate Tribunal (the Tribunal) in the case of ITD Cementation India Ltd. (the taxpayer) held that the future losses accounted for incomplete construction contracts as per the provisions of the Accounting Standard 7 (AS-7) issued by the Institute of Chartered Accountants of India (ICAI) is an allowable business expenditure under Section 37(1) of the Income-tax Act, 1961 (the Act). Further, the Tribunal held that the taxpayer's audited books of accounts without any adverse comments by the auditors cannot be rejected by Assessing Officer (AO).

Facts

- The taxpayer was engaged in the business of infrastructure development i.e., building roads, bridges, tunnels, etc. In the Tax Return filed for Assessment Year 2004-05, the taxpayer claimed future losses on incomplete construction contracts as per AS-7 issued by ICAI.
- The AO proceeded to reject the books of account under Section 145(3) of the Act on the grounds that the taxpayer did not maintain day to day registers, ledger accounts, etc. Thereafter, the AO completed the assessment made as judgment assessment under Section 144 of the Act and estimated the business income of the taxpayer at 5 percent of the total turnover.
- On appeal, the Commissioner of Income-tax (Appeals) [CIT(A)], concluded that there was no case for invoking the provisions of Section 145(3) of the Act and accordingly disapproved the action of AO. However, in relation to the issue of claiming deduction of future losses, the CIT(A) ruled against the taxpayer by giving the following reasons:

  - The taxpayer's claim of future losses on incomplete contracts was outside the framework of Section 37(1) of the Act. CIT(A) relied upon various Supreme Court judgements; and

  - Accounting standards do not override the statutory provisions of the Income Tax Act.

Held

- The Tribunal observed that there is no case made by the AO that the method of accounting followed by the taxpayer is not in accordance with the standard notified. Further, there is no finding in the assessment order that the books of account are incorrect or incomplete.
- The major reason for rejection of books of account is the unverifiable nature of expenses and non- maintenance of stock register, the explanations to which have been furnished by the taxpayer and considered by the CIT(A).

- The Tribunal also observed that the books of accounts have been audited and the auditors have not given any adverse comments with respect to the maintenance of books of account or stock registers.
- Accordingly, the Tribunal confirmed the order of the CIT(A) on this aspect.
- With regard to the allowability of future losses the Tribunal held that the provisions of section 145 of the Act provide that the Accounting Standards notified by the Central Government have to be followed by taxpayers. However, this does not mean that the standards laid down by the ICAI in this regard could not be followed by the taxpayers. After a careful examination of the AS-7 and the facts of the case, the Tribunal held that the issue is covered by the judicial precedents relied upon by the taxpayer and held that the taxpayer is entitled to claim deduction for foreseeable losses under section 37(1) of the Act.