

IN THE HIGH COURT OF KERALA AT ERNAKULAM

PRESENT

THE HONOURABLE MR.JUSTICE S.V.BHATTI

&

THE HONOURABLE MR. JUSTICE BECHU KURIAN THOMAS

THURSDAY, THE 24TH DAY OF JUNE 2021 / 3RD ASHADHA, 1943

ITR NO. 264 OF 1997

AGAINST THE ORDER/JUDGMENT IN ITA 997/1989 OF

I.T.A.TRIBUNAL,COCHIN BENCH, ERNAKULAM

PETITIONER/S:

THE COMMISSIONER OF INCOME TAX,
COCHIN.

BY ADVS.
SRI.P.K.R.MENON,SR.COUNSEL, GOI(TAXES)
SRIJOSE JOSEPH, SC, FOR INCOME TAX
CHRISTOPHER ABRAHAM, INCOME TAX DEPARTMENT

RESPONDENT/S:

BHAGEERATHA ENGINEERING LTD.,
COCHIN.

BY ADVS.
SMT.P.ANITHA
SMT.P.ANITHA
SMT.R.S.GEETHA
SRI.V.B.UNNIRAJ
SRI.T.M.SREEDHARAN (SR.)

THIS INCOME TAX REFERENCE HAVING COME UP FOR HEARING, THE
COURT ON 24.06.2021 DELIVERED THE FOLLOWING:

ORDER

S.V. Bhatti, J.

The Commissioner of Income Tax, Cochin (for short 'Revenue') and M/s.Bhagheeratha Engineering Limited (for short 'the assessee') are the petitioner and the respondent respectively in the instant I.T.R. The reference is made by the Income Tax Appellate Tribunal (ITAT) on the application made by the Commissioner of Income Tax (Appeals), Cochin, under Section 256(1) of Income Tax Act, (for short 'Act'). The reference deals with the controversies and the consequent questions of law arising in the finalisation of assessment for the Assessment Year 1986-87.

2. The assessee, as a contractor, is engaged in the business of construction of dams, bridges, railway lines, canal embankment etc. The assessee, as part of its business, had

undertaken the construction of a branch railway line for a cement factory in Iraq. The standing of assessee in the execution of work is that of a sub-contractor and the principal contractor was Indian Railway Construction Company (for short 'Ircon Ltd.'). It is an admitted circumstance that the assessee had entered into back to back contract with Ircon Ltd. The assessee had completed a portion of the contract work during the previous year ending 1985-86. The completed portion of contract during the previous year ending on 31.03.1986, bills were submitted and the quantum of executed work was certified at Rs.13,14,66,919/-. The assessee, as against the said certified amount of Rs.13,14,66,919/-, received Rs.3,27,60,321/-. The expenses booked during the year against execution of the said work was Rs.6,21,90,197/-. The assessee was following the mercantile system of accounting and has been filing the returns accordingly. But, the assessee for the subject assessment year

adopted completed contract method of accounting standard and as per the adopted accounting standard did not reflect entries for recognition of revenue from the work executed by the assessee in the previous year 1985-86. The assessee had taken a stand that Iraq was at war with Iran and in these conditions the completion of contract work would either take long time, the time schedule are not certain, and the balance of work whether could be executed by the assessee/sub-contractor in the near future. The assessee, compelled by the circumstances, entered into supplementary agreement dated 05.09.1984 with Ircon Ltd for deferred payment of contract dues. The assessee, keeping in perspective these singular circumstances faced in the execution of sub-contract in Iraq, had chosen to adopt completed contract method of accounting for determination of income from the work executed by the assessee in Iraq. Due to deferred payment agreement between the contractor and the sub-contractor, no

part of the contract amount was receivable during the relevant previous year. Therefore, no income from the contract could be assessed for income tax purposes. The assessee places reliance on 'accountancy standards for accounting for construction contracts' (for short 'AS'). In the professional parlance of accountancy, the completed contract method is a standard accountancy method and not inconsistent with the provisions of the Act.

3. The Deputy Commissioner of Income Tax/Assessing Officer issued notice under Section 143(3) of the Act and taking note of the quantum of work/bills certified by Ircon for the work executed in Iraq and the expenses incurred in this behalf for executing the work in the previous year 1985-86, added Rs.6,92,96,722/- being the difference between amount certified and expenses incurred. The reference deals with the questions of law arising out of completed contract accounting method

adopted by the assessee and whether the assessee has discretion to do so, and/or curtailed by the Act and finally the adoption of completed contract method fails the requirement of *bona fides* in selecting the completed contract method. On appeal, at the instance of assessee, the Commissioner of Income Tax (Appeals) rejected the addition of Rs.6,92,96,722/-. On the appeal filed by the Revenue, the Tribunal confirmed the view taken by the Commissioner of Income Tax (Appeals). Under these circumstances the following questions are referred for our opinion:

- 1) “Whether on the facts and in the circumstances of the case and also in view of the fact that the assessee was following mercantile system of accounting with regard to the expenditure with reference to the sub-contract with Ircon Ltd. should not the contract receipt or the right to contract receipt be considered under the mercantile system of accounting for assessment purpose?
- 2) Whether, on the facts and in the circumstances of the case and considering the method of accounting followed by the

assessee with regard to the expenditure incurred, should not be the bills certified as relating to the work completed during the year be brought to tax in the assessment year 1986-87?

3) Whether on the facts and circumstances of the case the Tribunal is right in law in holding that the mere fact that the work was executed or the progress bills were presented and approved does not create an enforceable right in the assessee to receive payment?

4. Learned Standing Counsel Mr.Christopher Abraham adverted to the undisputed circumstances in the case, namely that the assessee, prior to the subject previous year, was following mercantile system of accounting. The departure from mercantile system of accounting to completed contract accounting system for the works under execution in Iraq is rightly noted as an incidence to avoid or evade tax by the assessee. The Assessing Officer rightly added the difference between the amount for which works are certified and the expenses booked by the assessee against the works in Iraq, as

income derived from the contract under execution in Iraq, amounting to Rs.6,92,96,722/-. The assessee should have consistency in adopting accounting standard and departure from consistent practice is not *bona fide* adding of income, hence, is within the discretion and jurisdiction of the Assessing Officer under the Act, particularly having regard to the scope and purpose of Section 145 of the Act. According to argument, the mercantile system of accounting ought to be accepted as consistent to the business practice of the assessee and since no exception to the details of these entries is taken in the long spells of examination by the Department etc, the natural consequence is to add the difference amount to the total income of the assessee. Therefore, stated summarily, the adoption of completed contract is not acceptable. Thereby the recognition of revenue takes place as per mercantile system of accountancy and the certified work therefore is treated as enforceable right

and receipt in the books of account of the assessee and the inclusion of the amount is valid and correct.

5. *Per contra*, learned Senior Advocate Mr. T M Sreedharan prefaces the circumstances in which the assessee was positioned, are singular and could be limited to, by way of illustration to similarly situated unfortunate contractors who were executing contracts in Iraq, when Iraq went to war with Iran. He invites the attention of the Court to the deferred payment agreement dated 05.09.1984 and argues that the assessee, compelled by circumstances beyond its control, had realised the difficulty of completing the work at any time in the near future from the previous year ending 31.03.1986. The assessee shall not be compelled to opt for a system of accountancy which is not suitable or compatible to the circumstances of the case. While arguing, even in retrospect, it is stated that even today it cannot be said that Iraq is peaceful

and good atmosphere is present for execution of work by the foreign agencies. Therefore, the uncertainty was looming large and the option taken by the assessee conforms to the certified accounting standards followed and verified by the Institute of Chartered Accountants. According to him, the assessee has discretion to opt for a particular accounting system unless and until the system so adopted by the assessee is established as a ruse conceived to evade payment of tax and a finding to the said effect is recorded by the Assessing Officer. In the instant case, no such finding is recorded by the Assessing Officer. The reasons of Assessing Officer were independently examined by both CIT (Appeals) and the Appellate Tribunal, and have been disapproved. Therefore, for the sake of asking, the assessee shall not be compelled to revert to mercantile system and adopt the tax planning as per the wish of Revenue. Alternatively the mercantile system does not reflect the actual state of affairs of

assessee/Company, much less the taxable income of the assessee for the Assessment Year.

5.1 To convince the Court with an illustration he has drawn our attention to the outflow from the books of account, certified bills, actual receipt from the principal contractor, if are treated as receivable and after deducting expenses income tax is levied, the assessee would be paying tax on amount which is not certain in any manner as on the date of filing of income tax return but further outflow of cash reserves would occasion. According to him, the circumstances leading to the supplemental agreement and limited options in which the assessee had accepted the proposal of Ircon and Union of India are independently considered both by the Commissioner of Income Tax (Appeals) and the Income Tax Appellate Tribunal. The findings of fact are pure and simple, recorded by the authorities having jurisdiction in this behalf. The questions of

law are to be answered in favour of the assessee in the facts and circumstances and no exception to the findings recorded in this behalf would be taken. The learned Senior Counsel finally argues that the questions substantially compel the assessee to follow mercantile system of accounting, in spite of such accounting system being impracticable and unworkable in the circumstances of the case. He prays for dismissing the appeal.

6. The learned counsel on both sides have made the above submissions by drawing our attention to various findings recorded by the authorities in Annexures A to C, judicial or binding precedent on the questions for decision are not placed before us. According to them, the questions are substantially formulated in the facts and circumstances of the case on hand and are decided.

6.1 Stated succinctly, question no.1, taking note of the accounting standard practiced by the assessee for the previous

assessment years, whether the contract receipt or the right to contract receipt, be considered under mercantile system of accounting for assessment purpose. Question no.2 deals with bills certified as amounting to work completed for the previous year ending 31.03.1986 and revenue recognition should have been carried out. Question no.3 deals with the enforceability of certified bills and entitlement of assessee to receive payment. The questions, though are stated in three dimensions, we would like to deal with the questions referred to us as two parts. Question nos.1 and 2 as forming the first part and question no.3 as the second part and the questions substantially depend on assessee's discretion in choosing accounting standard.

6.2 It is useful to preface a few circumstances admitted by the parties and the findings recorded by the three authorities. Annexure D is agreement dated 27.08.1981 entered into between Ircon and the assessee. Under the said agreement

Ircon has sub-contracted a portion of the work for execution in favour of assessee. On 05.09.1984 the assessee entered into supplementary agreement for defferment of payment. The assessee, for the subject year recorded work completed as amounting to Rs.13,14,66,919/-, expenses incurred as Rs.6,21,90,197/- and actual receipts amounting to Rs.3,27,60,321/-. The assessee by resorting to completed contract accounting standard, did not include the details of Iraq contract in the subject return.

6.3 The Assessing Officer accepts that an assessee may follow different kinds of accounting system, according to assessee's convenience. The Revenue is concerned with the reflection of fair and reasonable declaration of income as arising out of business carried on during subject year by the assessee. The assessee has completed a part of the work. The contractor has approved the work executed by the assessee.

The assessee received a portion of the payment as well. Therefore, the completed contract method would not reflect fair and reasonable picture of the profit earned by the assessee from year to year or for the subject assessment year. The supplementary agreement for deferred payment postpones receipt of payment and not otherwise. The circumstances in Iraq may not take away the right of assessee to receive contract amount for the completed work. The assessee since has been following mercantile system of accounting, should have followed the same accounting standard for the subject assessment year as well. Therefore, the difference between certified work and the expenses incurred in this behalf has been treated as income assessable to tax in the assessment year and added accordingly.

6.4 The Commissioner of Income Tax (Appeals) in detail referred to the contentions, totality of circumstances and has

concluded that the assessee will finalise the profit or loss on account of this particular contract when the entire payment is received and it will be offered to taxation in the year of completion of contract. Therefore, as stated above, there will not be revenue loss on account of this completed contract method of accounting system adopted by the appellant. Stated differently, the CIT (Appeals) records a finding that by resort to completed contract method, the revenue is not adversely affected. The CIT(Appeals), thereafter examined whether the income has accrued to the appellant during the accounting year relevant to the assessment year. By referring to a few decisions it is noted that “even if there is a change in the methods of accounting in respect of the source of income and it is in good faith changed the method of accounting and it has to be accepted”. It has been decided by the Kerala High Court in the case reported in *Forest Industries Travancore Ltd v. Commissioner of*

*Income Tax*¹: which reads “*that the assessee was entitled to change his method of valuation of stock in this manner even though the revenue may be affected adversely by such change*”. Finally held that:

“16. It may be noted that the agreement in respect of the contract in the appellant's case is similar to that of the case of Recondo Ltd. (Bombay). The important factor which necessitated the change of method of accounting in the case of Recondo Ltd. was the war between Iran and Iraq and as a result, all the receipts were postponed at the Government's intervention to a later year. Therefore, the dictum that an income is taxable only when it has become due, applies to both the cases. After analysing various case laws mentioned above, I have come to a conclusion that the amount of Rs.6,92,96,722/- included by the Assessing Officer is the income of the appellant had not accrued to the appellant during the accounting year relevant to the assessment year. Hence, this addition has to be deleted.”

7 The Income Tax Appellate Tribunal in appeal filed by the Revenue held that:

1 1964 51 ITR 329 Ker

“The learned CIT (Appeals) saw merit in the contention of the assessee that having regard to the special features of this contract and the difficulties faced by the assessee in executing the work in a war-torn country facing financial and economic crisis, the assessee was well advised to follow the completed contract method. He also noticed the contention of the assessee that no part of the income has accrued during the accounting year relevant to the assessment year under appeal on account of the specific provision contained in clause 19 of the agreement which related to the payment. As per that clause payment was to be made by IRCON Ltd. to the assessee only when the money was received by IRCON Ltd., from the Iraqi authorities. Further, it was noticed that such payments were deferred upto July, 1989 by an agreement entered into with the Iraqi Government. He also noticed the decisions relied on by the assessee viz., 46 ITR 144(SC), 56 ITR 42(SC); 57 ITR 624(SC), 89 ITR 266(SC) and also 105 ITR 627 (Ker.). He also noticed the contention of the assessee that amounts thus far expended on the contract in a total of Rs.6,21,90,197 were to be treated as work-in-progress as the assessee had adopted completed contract method of accounting for arriving at the profit in respect of this contract.

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As the receipts were postponed to later years at the intervention of the Iraqi Government in respect of the contract, the learned CIT(Appeals) held that the amount of Rs.6,29,96,722/- included by the assessing officer as the income of the assessee had not accrued to the assessee during the accounting year relevant to the assessment year 1986-87. Thus, he deleted the addition.”

In the aforementioned conclusion recorded by the CIT (Appeals) and ITAT, let us examine the questions referred for our opinion:

Questions 1 and 2

7.1 The conspectus of judicial precedence suggests to an axiomatic view, however, subject to a few exceptions, that the assessee has discretion to follow a particular accounting system, namely mercantile system, completed contract etc for maintenance of accounts. The books of account are maintained in the format of accounting system adopted by the assessee. The Act does not stipulate adherence to one particular

accounting standard to be followed by a particular set of assessees, depending upon the nature of business the assessees do. There is no prohibition under the Act to change from one particular accounting standard to another accounting standard by the assessee. The object of the Act is the recognition/identification of income liable to tax under the Act and is definitely attained by several methods of accounting.

7.2. The same results in recognition/identification of income are attained by following any one of the accepted accounting methods. From accounting parlance, completed contract method is one of such methods adopted to recognise the revenue and profit associated with the project only after the project has been completed. The completed contract method is resorted to when there is uncertainty about the collection of funds due from a customer under the terms of a contract. In accounting parlance, this method yields same results as the

percentage of completion method, but only after the project has been completed. The completed contract method, prior to completion, does not yield any useful information and the delay in income recognition allows the business to defer the recognition of related income tax issues. In the said accountancy pattern, the revenue and accounts recognition defer till the end of the project, consequently the timing of revenue recognition is delayed.

7.3 The completed contract method is resorted to when it is not possible to derive dependable estimates about the percentage of completion of the project or when there are inherent hazards that may interfere with completion of a project or when contracts are of such a short-term nature that the results reported under the completed contract method and the percentage of completion method would not vary materially. In completed contract accounting method,

recognition of revenue is avoided during the execution of the contract. The adoption of this accounting system, in effect, facilitates the drawing of profit or loss at the end of completion of project. There is no prohibition under the Act against changing the account method by an assessee. The change in accountancy method, as long as, held not to be *bona fide* or intended to avoid/evade payment of tax of income received by the assessee, the assessee is free in its discretion to change the accounting procedure in a year. Section 145 of the Act enables the Assessing Officer to determine whether or not the income deduced by the accounts maintained by the assessee is correct, a computation is proffered, and conform to the circumstances of the case. In this case, we are proposing to examine the discretion available to the assessee and the legal obligations read with functions conferred on the Assessing Officer under Section 145 of the Act. We would like to conclude that normally

the choice of the method of accounting remains with the assessee. It is open to the assessee to follow one system of accounting in respect of one source and another system in respect of another source. Likewise, it is also open to the assessee to change its method of accounting regularly employed by it, in any assessment year. However, we hasten to add that the change should be *bona fide* and the change is not a casual departure from the regular method which has hitherto been adopted by the assessee with a view to avoiding or evading income tax. Now reverting to the case on hand, we notice that it is not the case of Revenue, much less the consideration by the Assessing Officer, that the case on hand attracts any of the exceptions by referring to which the accounting system now adopted by the assessee warrants to be disregarded and the accounts should have been finalised as per mercantile system of accounting.

8. The first question deals with the obligation to follow mercantile system of accounting, record expenditure, contract receipt etc. For the view in the particular facts and circumstances of this case and upon considering the findings recorded by CIT(Appeals) and Tribunal, we are of the view that the argument of Revenue that mercantile system of accounting should have been adopted for the work executed in Iraq, does not arise and the assessee had rightly adopted completed contract system for the work under execution in Iraq in the contemporary period. The answer to second question is dependent on the findings we have recorded in the first question. Once this Court holds that the completed contract method adopted by the assessee in the current facts and circumstances is right, the bills certified as relating to work completed cannot be recognised as receipts and brought to tax in the Assessment Year 1986-87. The question that mercantile

system of accounting should be directed would curtail the discretion available to the assessee.

For the above reasons and consideration, we answer the points in favour of assessee and against the Revenue.

Question No.3

9. The question deals with a finding of fact recorded by the Tribunal. From the findings recorded, it is not brought to our notice that the bills certified are gone that far in getting approval from the Iraq Government and an enforceable right in the Assessment Year. The bills are stated as certified. It is definitely an enforceable right in the realm of contract. The assessee since is subjected to vagaries and uncertainties of fluctuation, preferred to have completed contract method for the entire project. The effect of these transaction, recognition of revenue etc would arise either upon completion of the contract and/or rescission of contract, other foreseen and

unseen eventualities, that means, arising in the course of the execution of the contract. By keeping in view the finding of fact recorded by the Tribunal, we answer the issue by holding that the bills certified in the case on hand having regard to the deferred payment agreement entered by the assessee did not create an enforceable right even in the subsequent Assessment Year.

The point is answered in favour of the assessee and against the Revenue.

ITR No.264/1997 is answered as indicated above. Registry shall send the certified copy of this judgment to the Income Tax Appellate Tribunal, Cochin.

Sd/-

S.V.BHATTI

JUDGE

Sd/-

BECHU KURIAN THOMAS

JUDGE

APPENDIX OF ITR 264/1997

PETITIONER ANNEXURE

ANNEXURE D	COPY OF THE AGREEMENT BETWEEN INDIAN RAILWAY CONSTRUCTING COMPANY LTD. AND BHAGEERATHA ENGINEERING LTD.
ANNEXURE E	COPY OF THE AGREEMENT BETWEEN INDIAN RAILWAY CONSTRUCTING COMPANY LTD. AND BHAGEERATHA ENGINEERING LTD.
ANNEXURE A	COPY OF THE ASSESSMENT ORDER DATED 31/03/1988.
ANNEXURE B	COPY OF THE ORDER OF THE COMMISSIONER OF INCOME TAX (APPEALS) DATED 14/09/1989.
ANNEXURE C	COPY OF THE ORDER OF THE TRIBUNAL DATED 30/09/1994.