Income Computation and Disclosure Standards – I to X

August 10, 2018

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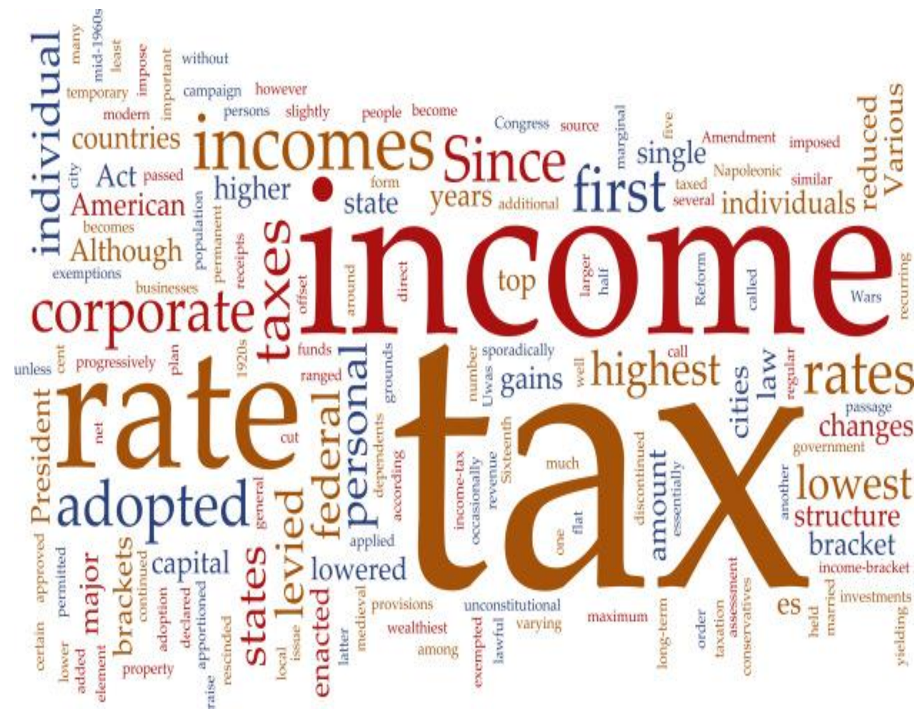
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ICDS Implementation in India – The story so far

ICDS implementation in India

September 2016/ March 2017

- The CBDT vide Notification No 87/ 2016 dated September 29, 2016 notified revised ICDS and repealed its earlier Notification No 32/ 2015
- Later, FAQs/ clarifications were released by the CBDT on March 23, 2017

July 2016

- Ministry of Finance ('MoF') announced the revision of ICDS and tax audit report to ensure compliance with the provisions of ICDS
- MoF also announced deferment of ICDS by one year and made it applicable from April 1, 2016 instead of April 1, 2015

March 2015

- 10 ICDS notified on March 31, 2015
- Draft ICDS on Leases and Intangibles not notified
- Applicable from AY 2016-17 (PY 2015-16)

January 2015

- CBDT issued draft of 12 ICDS, after incorporating suggestions from various stakeholders and providing transitional provisions for these ICDS
- Draft ICDS were open for comments and suggestions up to February 8, 2015

July 2014

- Finance Bill 2014 amended Section 145(2) of the Act. ICDS applicable from the previous year April 2015
- ICDS to be notified separately

October 2012

- Final report of the Committee and 14 ICDS published
- Comments invited from public on draft ICDS

December 2010

The CBDT constituted AS Committee to suggest the below:

- AS to be notified under the Act
- Amendments to the Act
- Method to determine book profit for MAT purposes on transition to Ind AS

1996

The Central Government had notified 2 Accounting Standards under Section 145(2) of the Income Tax Act, 1961 ('the Act')

ICDS Implementation in India

- Constitutional validity of ICDS was challenged before the Delhi High Court in the case of **Chamber of Tax Consultants vs Union of India [WP(C) 5595/2017]**

- The Delhi High Court held that the powers conferred in Section 145(2) of the Act have to be read down to restrict the power of the Central Government to notify ICDS that sought to override binding judicial precedents or the provisions of the Act [*excess of the scope of delegated legislation*]

- The Agra Bench of ITAT also relied upon the judgment delivered by Delhi High Court in the case of Chamber of Tax Consultants (supra) while deciding upon the issue of allowability of MTM Losses. It has held that Instruction No 3/2010 for disallowing MTM losses is not valid

- With a view to bring certainty and provide legal recognition to ICDS, the Finance Act 2018 has now introduced various provisions under the Act itself with **retrospective effect from AY 2017-18**

  - Amendments apply with retrospective effect ie wef FY 2016-17: Taxpayers who have filed their tax return for FY 2016-17 relying on the Delhi High Court ruling may now need to file a revised tax return in line with the proposed amendments the judgment of the Court came [Delhi HC was passed on November 7, 2017 and return of income pertaining to AY 2017-18 were due on November 30, 2017 (TP cases)]

  - In few cases, technical position prior to the order of the Delhi High Court has been retained with the only difference that now there is an effective and binding legislation which has to be adhered to in preference over the judgments

Draft ICDS on real estate transactions issued in May 2017 – Not yet notified

Other items not amended by Finance Act 2018

- The legislature has introduced amendment in the Finance Act 2018, only *qua* the issues dealt with by the Delhi High Court in the ruling of *Chamber of Tax Consultants*. Thus, in those cases, where no amendments are introduced vide the Finance Act 2018, the position should be that the judgments would prevail over the ICDS

- To the extent the Finance Act 2018 gives legitimacy, ICDS struck down would come back to life. In order to remove the confusion, it would be better if the Government issues new ICDS under Section 145(2) in place of the existing one after taking into account the amendments introduced vide the Finance Act 2018 and judgment of the Delhi High Court, to the extent not proposed to be overruled

Setting the context

- Companies generally compute their taxable income with reference to the below:
  - Accounting principles and policies for preparation of financial statements
  - Specific provision of the Act/ Rules
  - Various judicial pronouncements
- **Effective AY 2017-18**, income computation as well as disclosures to be based on notified ICDS
  - One point of check while reviewing the returns of income/ computation of income for companies undergoing due diligence (Vendor or Buyer due diligence etc) or health checks
  - Any deviations from the principles of ICDS should be brought out in the diligence/ health check report and tax liability (Tax + Interest + Penalty under Section 271 of the Act) on account of such deviations should be specifically computed and highlighted
  - In case where the amendment is made retrospectively as a result of which the tax liability is arising, the assessee would not be required to pay interest under Section 234A and 234B of the Act [*CIT vs Glenmark Pharmaceuticals Ltd - 398 ITR 439 (Bom) and CIT vs National Dairy Development Board - 397 ITR 543(Guj)]* – May not be a strong argument on merit as ICDS was applicable from AY 2017-18
  - Section 145(3) of the Act - Risk of Best judgement assessment
  - Also, to check if advance tax and deferred tax were computed keeping in mind the provisions of ICDS during FY 2016-17 and later

Basics

- **Source**: Section 145(2) of the Act
- **Effective Date**: AY 2017-18 (quarterly tax provision and advance tax as per ICDS to avoid interest)
- **Heads of Income**: Only for Profits and Gains from Business or Profession (PGBP) and Income from Other Sources (IOS)
- ICDS not applicable for computing book profit under Minimum Alternative Tax (MAT) provisions of the Act
- ICDS applicable for computation of Alternate Minimum Tax (AMT) under Section 115JC of the Act
- No of Standards: 10 - Notified
- **Disclosures**: Clause 13 and 14 of Form 3CD and in Income tax return (Schedule ICDS/ Part A - OI)
- Applicable to all taxpayers (Corporate & non-corporate) following mercantile method of accounting
- Individuals and HUF - ICDS applicable only if covered under tax audit provisions under Section 44AB of the Act
- Section 145(3) of the Act - Non-compliance could result in Best Judgment assessment, making ICDS an authoritative set of guidance
- Transitional provisions built-in all ICDS (except ICDS VIII on securities) - to avoid any double taxation/ non-taxation in pre and post ICDS periods

Highlights of ICDS - The Ground Rules

- No net worth or turnover criteria prescribed for applicability
- Entity need not maintain separate books of accounts for ICDS. Provision for tax, advance tax, payment of self assessment tax under normal provisions of the Act and deferred tax would get impacted
- Additional disclosures mandated by ICDS to be disclosed in Tax Audit Report and Return of income
- Should apply to non-residents (foreign companies) if mercantile system of accounting is followed
- Undefined words/ expression take their meaning from the Act
- Revenue/ expense on which there is no corresponding ICDS would continue to be governed by AS – *could this be extended to items not included in the Act by Finance Act 2018 (such as POCM approach etc)?*
- In the case of conflict, provisions of the Act shall prevail
- Clarity awaited in case of conflict between judicial precedents and ICDS (would Delhi High Court ruling continue to apply?)
- Sequence of prevalence should be: Act > Rules > ICDS > Judicial Precedents (clarified by FAQs dated March 23, 2017) – Not expressly provided that ICDS are subordinate to the law represented by judicial rulings (including rulings by the Apex Court)
- Would apply to persons computing income under presumptive taxation schemes (Sections 44AD, 44AE, 44ADA, 44B, 44BB, 44BBA, etc of the Act) [clarified by FAQs dated March 23, 2017] – Turnover based schemes, may not apply where the requirement of maintaining books of accounts does not exist (as per Section 44AA of the Act)

Purpose and Structure

Preamble and Introduction

Scope

Contents

Transitional Provisions

Disclosures

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 accounts.

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

***Purpose**:*

Standardization of computation of income so as stabilize tax treatments of various items to prevent avoidance of taxes

ICDS vs Accounting Standards/ Ind-AS

ICDS	Title	Corresponding AS	Corresponding Ind-AS
ICDS-I	Accounting Policies	AS 1	Ind-AS 1/8
ICDS-II	Valuation of Inventories	AS 2	Ind-AS 2
ICDS-III	Construction Contracts	AS 7	Ind-AS 11
ICDS-IV	Revenue Recognition	AS 9	Ind-AS 18
ICDS-V	Tangible Fixed Assets	AS 10	Ind-AS 16
ICDS-VI	Effects of Changes in Foreign Exchange Rates	AS 11	Ind-AS 21
ICDS-VII	Government Grants	AS 12	Ind-AS 20
ICDS-VIII	Securities	AS 13	Ind-AS 32/109
ICDS-IX	Borrowing Costs	AS 16	Ind-AS 23
ICDS-X	Provisions, Contingent Liabilities and Assets	AS 29	Ind-AS 37

No corresponding ICDS for AS covering cash flow statements, accounting for amalgamations, employee benefits, segment reporting, related party transactions, Earnings per share, consolidated financial statements, discounting operations, interim financial reporting, financial instruments (recognition, measurement and presentation), impairment of assets etc

ICDS version 2018

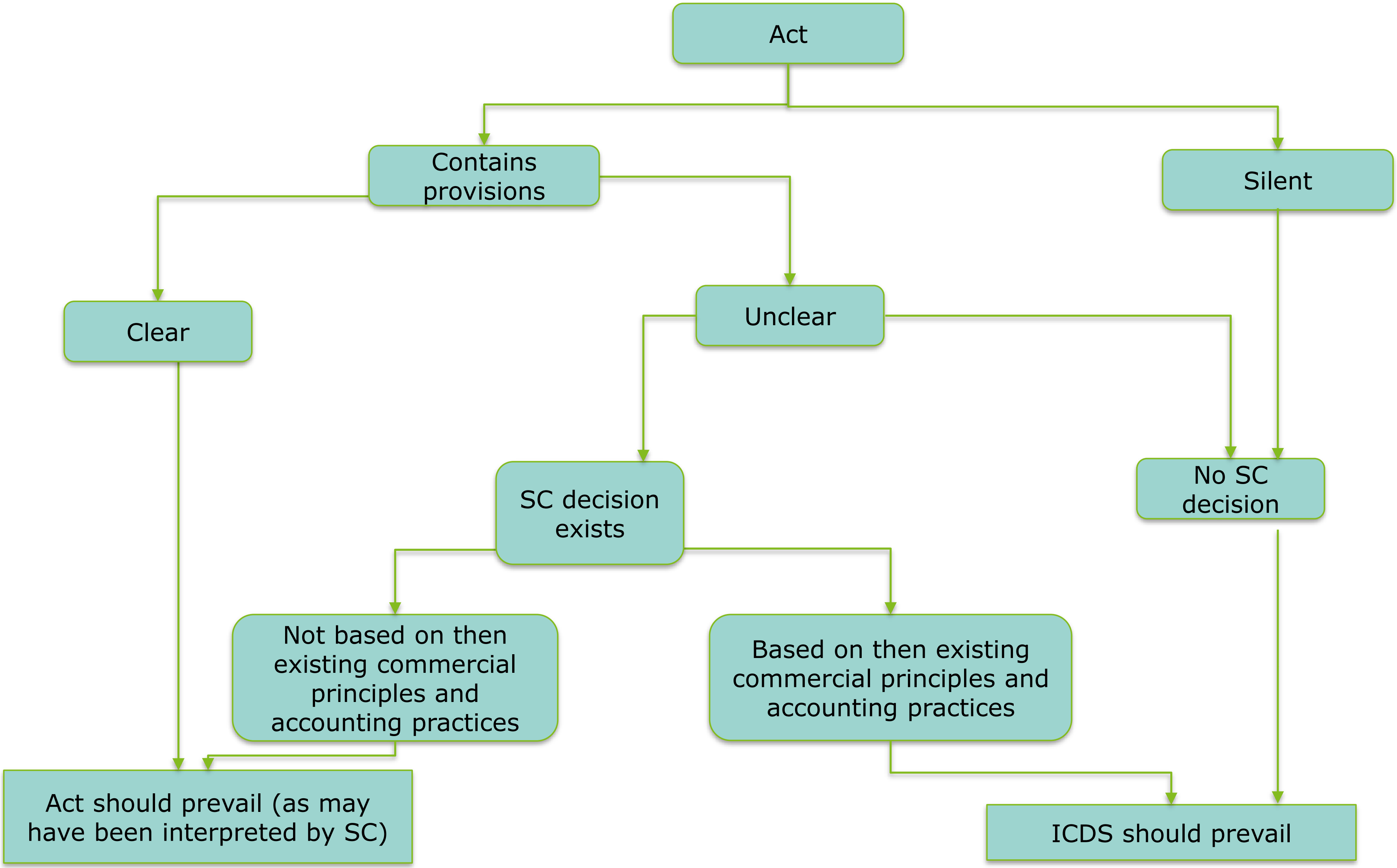
ICDS	Topic Covered	Delhi HC Ruling of Nov 8, 2017	Corresponding sections under Income tax Act
ICDS-I	Accounting Policies	Fully struck down [as it does away with the concept of prudence]	**36(1)(xviii), 40A(13)**
ICDS-II	Valuation of Inventories	Fully struck down [as it fails to recognise the distinction on valuation of inventory in case of continuing business vis-à-vis discontinuing one]	**145A**
ICDS-III	Construction Contracts	Para 10(a)- Retention money and Para 12 - Incidental income struck [as it goes against the settled principles of accrual of income]	44AD, 50C, 43CA, **43CB**
ICDS-IV	Revenue Recognition	Para 5- Export Incentive and Para - 6 POCM on services [as it goes against Apex Court Ruling on these aspects]	145A, **43CB, 145B**
ICDS-V	Tangible Fixed Assets	Not adjudicated	2(11), 43(1), 43(6), 35D
ICDS-VI	Effects of Changes in Foreign Exchange Rates	Fully struck down [as it goes against Apex Court Ruling]	43A, **43AA**
ICDS-VII	Government Grants	Para 4(2) – Government Grant received cannot be postponed after receipt [as it goes against the settled principles of accrual of income]	Explanation 10 to Section 43(1), **145B**
ICDS-VIII	Securities	Part A Fully struck down [as it would require maintenance of separate records for income tax purposes]	**145A**
ICDS-IX	Borrowing Costs	Para 5 – Incidental income struck [deriving from HC observations on ICDS - III]	36 (1)(iii), 43(1), Rule 8D
ICDS-X	Provisions, Contingent Liabilities and Assets	-	43B, 40A(7)

* *Highlighted sections have been inserted by the Finance Act 2018*

Specimen for computing income under ICDS

Particulars	Amount (INR)	Amount (INR)
Profits and Gains from Business or Profession (as per Profit and Loss Account)	XXX	
Income from Other Sources (as per Profit and Loss Account)	XXX	
Total		XXX
Add/ Less: Adjustments as per the provisions of the Act		XXX
Adjusted Taxable Income as per the Act		XXX
Add/ Less: Adjustments as per ICDS		XXX
Total Taxable Income		**XXX**

General Approach for resolving conflicts



ICDS – Few legal aspects

- ICDS has been notified under Section 145 of the Act - Is Section 145 a "charging section"?
  - Section 145 – A computation mechanism and not a charging section – held by the Supreme Court in the case of *A Krishnaswai Mudaliar & Others (53 ITR 122)* and *Standard Triumph (67 Taxman 160)*
  - Under Section 145, the Assessee's regular method of accounting determines the mode of computing the taxable income, but it does not determine or even affect the range of taxable income or the ambit of taxation - *State Bank of Travancore (158 ITR 102)*
  - In the scheme of the Act, income is identified/ recognised/ determined as per Section 4, 5, 14 [Chapter IV] of the Act along with the definition of income
  - Settled law that a notification cannot override the statute - *CIT vs Sirpur Paper Mills [(1999) 237 ITR 41 (SC)], CIT vs Taj Mahal Hotels [(1971) 82 ITR 44 (SC)*
  - Revenue authorities may still contend that ICDS being in relation to income computation has been framed to give effect to the provisions of Section 29 of the Act (Income from profits and gains of business or profession, how computed)
  - To end the battle, certain provisions of ICDS now inserted in the statute itself [Finance Act 2018]
- Can ICDS override the Act?
  - If Act contains a provision and the same is clear, Act shall prevail over ICDS
  - What if Act is silent or unclear?

ICDS – Few legal aspects

- Supreme Court is the law of the land since Article 141 of the Constitution provides that the law declared by the Supreme Court is binding on all Courts within the territory of India

- Following SC cases lay down this principle - *UP Pollution Control Board vs Kanoria Industrial Ltd (259 ITR 321), Shenoy and Co vs The Commercial Tax Officer (1985 SCR (3) 659), Assistant Collector Of Central vs Dunlop India Ltd (1985 SCR (2) 190 SC)*

  – Based on above, Supreme court's judgments' declares the Act as it always stood

  – **FAQ 2: The ICDS have been notified after due deliberation and after examining judicial views for bringing certainty on the issues covered by it. Certain judicial pronouncements were pronounced in the absence of authoritative guidance on these issues under the Act for computing Income under the head "Profits and gains of business or profession" or "Income from other sources". Since certainty is now provided by notifying ICDS under Section 145(2), the provisions of ICDS shall be applicable to the transactional issues dealt therein in relation to Assessment Year 2017-18 and subsequent assessment years**

- ICDS notified by the Central Government is a piece of delegated legislation. Such delegated legislation cannot override the provisions of the Act - *Assam Co Ltd vs State of Assam and Others [248 ITR 567 (SC)]* - Limitations of delegated legislation

Impact of ICDS on MAT and Deferred Tax

MAT

- MAT is calculated on book profits
- Any adjustment relating to ICDS is required to be done under the normal provisions and not MAT
- Hence, ICDS would have no implication on MAT computation

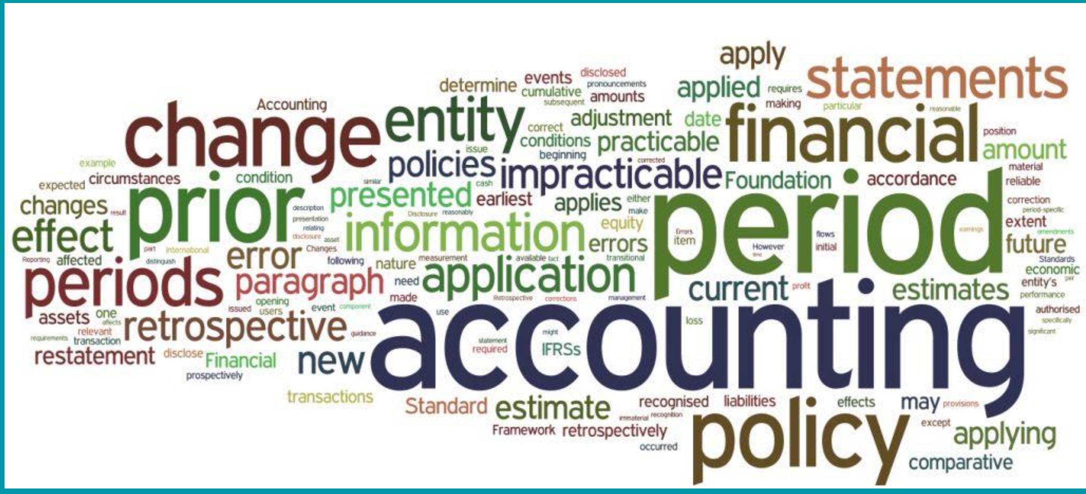
Deferred Tax

- Deferred tax is a result of temporary timing difference between the company's accounting and tax carrying values
- Adjustments relating to ICDS shall be made to normal profits computation – this could have an impact on temporary timing difference in the computation
- ICDS would have an implication on the same accordingly

ICDS – Significant Impact Areas

- Elimination of concepts of Prudence and Materiality
- Early taxation of Revenues
- Classification of a Qualifying Asset
- Higher capitalisation of Borrowing cost
- Recognition of Government Grants
- Accounting for Forward contracts
- Capitalisation of exchange differences
- Changes in accounting for provisions and contingent assets
- Many fact specific differences/ issues could arise

ICDS I – ACCOUNTING POLICIES



Scope and implications

- ICDS I deals with accounting policies and covers:
  - Fundamental Accounting Assumption - Going Concern, Consistency and Accrual
  - Accounting Policies
  - Considerations in the selection and change of Accounting policy; and
  - Disclosure of Accounting Policies
- No express principles of "Prudence" and "Materiality" as consideration in selection of Accounting policies
- **Mark to Market ('MTM') losses and expected losses not to be recognized unless specifically permitted by any other ICDS**:
  - MTM forex loss on monetary items covered under ICDS VI
  - Inventory valuation related loss covered under ICDS II and III
  - **Insertion of new Section 36(1)(xviii) in the Act to provide that marked to market loss or other expected loss computed *in accordance with the provisions of ICDS* to be allowed as deduction**
  - **Corresponding amendment is proposed through insertion of new Section 40A(13) which specifies that no deduction or allowance shall be allowed in respect of any marked to market loss or other expected loss, except as allowable under Section 36(1)(xviii)**
- ICDS I silent on treatment of MTM gains
- Question 8 of FAQ: Para 4(ii) of ICDS-I provides that MTM loss or an expected loss shall not he recognized unless the recognition is in accordance with the provisions of any other ICDS. Whether similar consideration applies to recognition of MTM gain or expected income?
  - Answer: Same principle as contained in ICDS-I relating to MTM losses or an expected loss shall apply *mutatis mutandis* to MTM gains or an expected profit.

Scope and implications

- As per ICDS I, accounting policy shall not be changed without "Reasonable Cause"
- Term "Reasonable Cause" has not been defined in ICDS-I or elsewhere
- "Reasonable Cause" would generally mean having sound judgment, fair and sensible, based on good sense, as much as is appropriate or fair, moderate.

Items affected	Impact on Tax position	
	Pre – ICDS	**Post ICDS**
Any change in accounting policy which will affect the profits of the business such as: • Change in valuation of inventories from FIFO to Weighted average or vice-versa; • Change in revenue recognition policy etc	• As per AS 2, notified under Section 145(2) of the Act, a change in accounting policy should me made only if: - Required by the statute; and - Result in more appropriate preparation and presentation of the financial statements	• Test of "Reasonable cause" needs to be satisfied • Following could be illustrative examples of reasonable cause: - To represent true and fair view - To meet statutory requirement - More appropriate preparation and presentation of financial statements - Reasonable person considers just and acceptable under normal circumstances - Commercial or business needs which will result into appropriate and fair presentation of transaction

Scope and implications

- ICDS I has impliedly eliminated the concept of Materiality:
  - Write off printing and stationery expenses, spares and materials, etc which are small value items cannot be ignored
  - Possible litigation to capitalize small value items, if tax authorities insist on strict application of ICDS I
  - Whether the taxpayer is expected to capitalize cost of petty items of stationery such as punching machines, calculators, etc merely because they do qualify as "Tangible Fixed Assets" under ICDS V
- Impact of absence of "Prudence" concept - Concept of prudence entails recognition of losses/ liabilities on best estimate basis. Absence of prudence concept could result in timing difference and creation of deferred tax asset
  - Provision for obsolete and slow moving inventory - *Molex Mafatlal Micron Ltd vs ITO*
  - Provision for warranty expenses - *CIT vs M/s Carrier Air-Conditioning and Refrigeration (Punjab & Haryana High Court), Rotork Controls India (P) Ltd vs CIT*
  - Provision for doubtful debts
  - Provision for statutory expenses (such as gratuity, leave benefits, etc)
- Will ICDS I overrule the judicial precedents which have held that expected losses are crystallized liability and hence should be allowed - *DCIT (International Taxation) vs Bank of Bahrain & Kuwait [2010] 41 SOT 290 (Mum) (SB), ABN Amro Securities India Pvt Ltd vs ITO [2011] 15 taxmann.com 177(Mum), DCIT vs Kotak Mahindra [2013] 35 taxmann.com 225 (Mum- Trib), CIT vs Woodward Governor India (P) Ltd [2009] 312 ITR 254 (SC), Oil & Natural Gas Corp Ltd vs CIT [2010] 327 ITR 272 (SC), EDAC Engineering Ltd vs DCIT [2013] 133 ITD 343 (Chennai)*
- Substance over Form - Backdoor entry for General Anti Avoidance Rules (GAAR)?

Case Study 1

Issue

- Oil prices are fluctuating significantly
- Company A, engaged in oil exploration and production, proposes to change inventory valuation from weighted average to FIFO. Other companies in the industry follow FIFO
- Can it change its method of inventory valuation?

ICDS I

- **Accounting policy can be changed** if there is **reasonable cause** to do so
- ICDS II **prescribes FIFO and weighted average cost** methods for inventory valuation

Case Study 1

Analysis

- Negative case laws
  - *Ajanta Raj Proteins Ltd (Delhi ITAT) [32 SOT 517]* - Accounting Standards notified under Section 145 are irrelevant for Section 145A, Act is inflexible regarding valuation of purchase/ sale of goods and inventory once a method has been regularly employed
  - *Luxor Writing Instruments (Delhi ITAT) [22 taxmann.com 26]*
  - *Annamalaiar Mill Pvt Ltd (Madras Tribunal) [22 TTJ 204]* – the Assessee was not allowed to claim deduction which it was justly entitled to, on account of change in accounting policy
- Positive case laws
  - *Uniflex Industries (Lucknow ITAT) [15 SOT 246] and Discount & Finance House of India (Mumbai ITAT) [14 SOT 334]* - Post erstwhile Section 145A
  - *Atul Products Ltd (Gujarat HC) [125 taxmann.com 727]*
  - *Mopeds (Andhra Pradesh HC) [38 taxmann.com 123]*
- Not required to change opening stock – also supported by ICDS

Actual facts of case must be seen - Industry Practice, Statutory requirements, etc

Case Study 2

Issue

- Company X incurred marked to market (MTM) losses in future transactions:
  - Currency future : Rs 1 crore
  - Interest rate future : Rs 10 lakhs
- Can it claim the aforesaid losses as deduction under the Act

Case Study 2

MTM/ expected losses recognised in other ICDS

- Inventory valuation
- Securities valuation
- Foreign exchange differences
- Creation of provisions based on "reasonable certainty"

MTM losses NOT permitted?

- Derivatives – futures
- Interest swap
- Local commodity hedges/ derivatives

ICDS I

- MTM loss or an expected loss shall not be recognized **unless the recognition of such loss is in accordance with the provisions of any other ICDS**
- Given that ICDS VIII forbids the recognition of MTM on derivatives being futures, the same would not be allowed as a deduction
- *Woodward Governor (SC) 2009 [312 ITR 254]*
- *Kotak Mahindra Investment Ltd (Mumbai ITAT) 2013 [35 taxmann.com 225]* - MTM loss on derivatives ie equity/ index futures held as stock-in-trade was allowed while MTM gain is ignored

ICDS II – VALUATION OF INVENTORIES

Scope and Definitions

Scope

- Applies to valuation of inventories except:
  - WIP arising under "construction contracts" and dealt with other ICDS
  - Shares, debentures and other financial instruments held as stock-in-trade
  - Inventories of livestock, agriculture and forest products, mineral oils and gases to the extent that they are measured at Net Realizable Value ('NRV')
  - Machinery spares used in connection with tangible fixed assets and having irregular use

Definitions

- Inventories are assets:
  - Held for sale in the ordinary course of business
  - In the process of production for such sale
  - In the form of materials or supplies to be consumed in the production process or in the rendering of service
- NRV
  - Estimated selling price in the ordinary course of business *less* estimated costs of completion and estimated costs necessary to make the sale

Measurement

Inventories shall be valued at cost or NRV, whichever is lower

Cost of inventories

1 Cost of inventories

Particulars	Amount
Cost of purchase	xx
Cost of services	xx
Cost of conversion	xx
Other costs*	xx
Cost of Inventories	**xx**

2 Cost of purchase

Particulars	Amount
Purchase price	xx
Duties and taxes	xx
Freight inward and other expenses directly attributable to acquisition	xx
Less: Trade discounts, rebates and similar items	(xx)
Cost of Purchase	**xx**

3 Cost of services

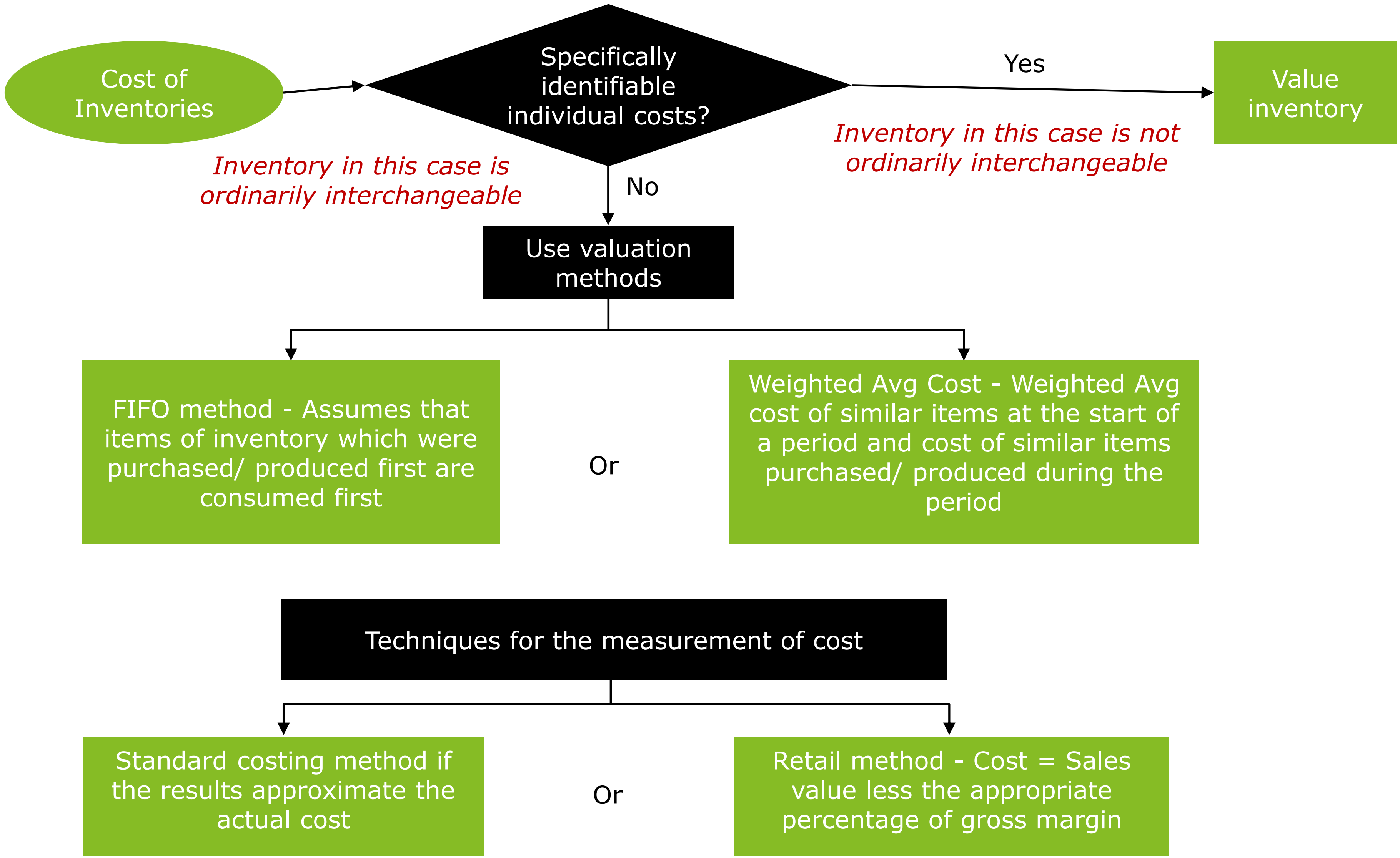
Particulars	Amount
Labour cost	xx
Supervisory personnel cost	xx
Attributable overheads	xx
Other costs of personnel directly engaged	xx
Cost of Services	**xx**

4 Cost of conversion

Particulars	Amount
Cost directly related to units of production	xx
Systematic allocation of:	
Fixed production overheads	xx
Variable production overheads	xx
Cost of Conversion	**xx**

**** Exclusions from costs are abnormal amounts of wasted materials, storages costs, administrative overheads and selling costs. Other costs shall be included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition***

Other valuation methodology



Miscellaneous provisions

NRV

- Based on the most reliable evidence available at the time of valuation
- Take into consideration
  - Purpose of holding the inventory
  - Fluctuations of price or cost directly related to events occurring after the end of the PY
- Material and other supplies held for use in production of inventories:
  - Cost: If finished product be sold at or above cost
  - NRV = Replacement cost - If cost of finished product will exceed NRV and decline in price of materials

Value of opening inventory

- Value at the start of the year shall be:
  - Cost of inventory available, if any, on the day of the commencement of the business when the business has commenced during the PY; and
  - Value of the inventory as on the close of the immediately preceding PY, in any other case

Change of method of valuation

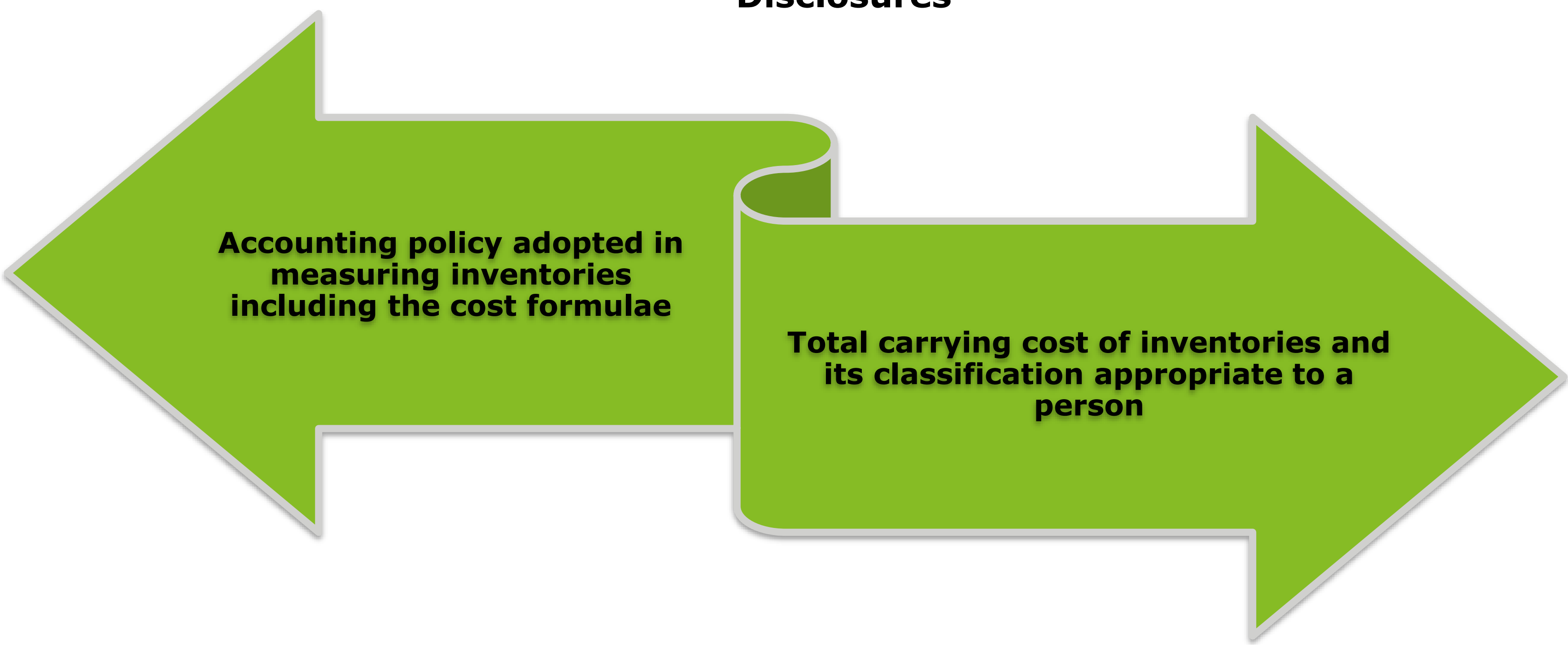
- No change permitted without reasonable cause

Section 145A of the Act amended by the Finance Act 2018 to incorporate the provisions of ICDS II dealing with valuation of inventories. Prima facie, the non-obstante part of the erstwhile section 145A has been now removed. Therefore, now Section 145A would not prevail over Section 145.

Transitional Provisions and Disclosures

- **Interest and other borrowing costs**, which do not qualify to be a part of inventory valuation as per the standard but is a part of the opening value of inventory, shall be taken into account for determining cost of closing inventory of period beginning on or after April 1, 2016 if it continues to remain part of inventory

Disclosures



Points for discussion

- Applicability of this standard to pure service industry (say, technology/ consultancy companies etc)
  - As opposed to AS 2, ICDS-II could be considered as applicable to service providers
  - Para 6: The costs of services in the case of a service provider shall consist of labour and other costs of personnel directly engaged in providing the service including supervisory personnel and attributable overheads
  - Service providers need to follow percentage completion method, hence valuation of work-in-progress (WIP) is implicit therein and ICDS-II should not apply
  - Considering the fact that WIP arising in the ordinary course of business of service providers are specifically not included in the definition of inventories itself, there is strong argument to state as of now that this ICDS may not be applicable to pure service industry, except to the extent of consumables
- Treatment of WIP arising in the ordinary course of business of service provider – Applicability of ICDS II?
- Concept of ‘reasonable cause’ for change in valuation methodology not defined
  - FAQs released by CBDT states that the term ‘reasonable cause’ is an existing concept and has evolved well over a period of time conferring flexibility to the tax payer in deserving cases

Points for discussion

- In case addition made by the Assessing Officer to the value of closing inventory, corresponding adjustment to the opening inventory whether possible?

- Para 24 of ICDS-II: Firm/ AOP/ BOI - Inventory valuation based on NRV on dissolution may give rise to deferred tax assets, if business continues and the NRV is more than actual inventory cost

  – Under AS, inventory valued at cost and as per ICDS, it is valued at NRV, leading to differential profit being subject to tax

  – Besides, no specific provision for allowing NRV as cost to successor of business

  – Contrary to Supreme Court decision in case of *Shakti Trading Co (250 ITR 871)* wherein it was held that if business continues after dissolution, inventory to be valued at NRV or cost, whichever is less

Major differences between ICDS II, AS 2 and Ind AS 2

Particulars	ICDS II	AS 2	Ind AS 2
Exclusions	Selling costs excluded in valuation	Selling and distribution costs excluded in valuation	Selling costs excluded in valuation
Dissolution of firm	Inventory valuation at NRV	Standard not applicable	Standard not applicable

Case Study 3

- ABC Ltd is engaged in the business of manufacture and sale of machines and has the following costs for the year ended March 31, 2017:

  A. Purchase Cost – INR 1,50,00,000

  B. Freight Inwards – INR 45,00,000

  C. Duties & Taxes – INR 30,00,000

  D. CENVAT credit recoverable – INR 15,00,000

- What would be the value of closing stock?

ICDS III - CONSTRUCTION CONTRACTS

Scope and Definitions

Scope of the Standard

- In determination of income for a construction contract of a contractor

Definitions

- Construction contract - 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:
  - Contract for rendering of services directly related to the construction of the asset (say, architects or project management services)
  - Contract for destruction or restoration of assets, and the restoration of the environment following the demolition of assets

Types of Construction Contracts

Construction Contracts

Fixed Price contract

- Contractor agrees to a fixed contract price or a fixed rate per unit of output
- Fixed price may be subject to escalations

Cost Plus contract

- Contractor is reimbursed for allowable or otherwise defined costs, plus a mark up on these costs or a fixed fee

Combining and Segmenting Construction Contracts

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

- Separate proposals submitted for each asset
- Each asset subjected to separate negotiation
- Costs and revenues of each asset can be identified

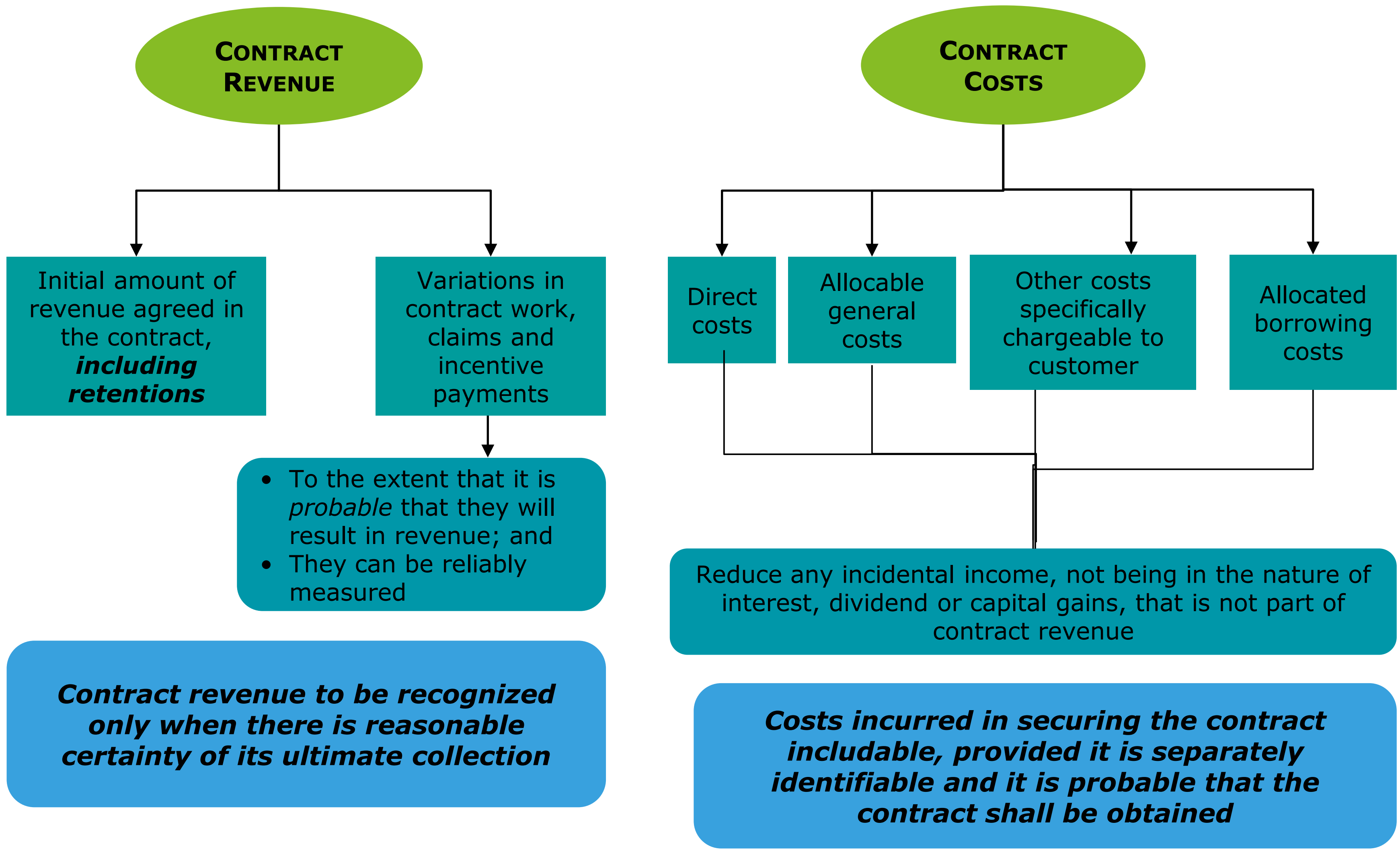
Group of contracts (with single or several customers) be treated as a single contract when:

- Group of contracts is negotiated as single package
- Contracts are so closely interrelated that they are, in effect, part of a single project with overall profit margin
- Contracts are performed concurrently or in a continuous sequence

Construction of an additional asset be treated as separate contract when:

- Assets differs significantly in design, technology or function from the original asset
- Price of additional asset is negotiated without having regard to original contract price

Contract Revenue and Contract Costs



Percentage of Completion Method ('POCM')

POCM

- 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

Stage of completion

- To be determined with reference to:
  - Proportion of contract costs incurred for work performed up to the reporting date and estimated total contract costs; or
  - Surveys of work performed; or
  - Completion of a physical proportion of the contract work
- Only those contract costs that reflect work performed are included in costs incurred up to the reporting date
- Progress payments and advances received from customers not determinative of stage of completion
- Contract revenue already recognised as income and subsequently written off in the books of accounts as uncollectible – to be recognised as expense and not as an adjustment to the contract revenue
- Contract cost related to future activity of the contract and advance payments to sub-contractors not be recognised as contract costs

Section 43CB has been inserted by the Finance Act 2018 to provide that profits and gains of a construction contract or a contract for providing service shall be determined on the basis of 'percentage of completion method' in accordance with ICDS

Percentage of Completion Method ('POCM')

Early stage of a contract

- If contract outcome cannot be reliably estimated during early stage, contract revenue to be recognized only to the extent of costs incurred
- Early stage of a contract not to extend beyond 25 percent of the stage of completion

Change in estimates

- If there is a change in estimates for the purpose of POCM, changed estimates to be used in the period of change and in subsequent period

New Section 43CB

- Section 43CB of the Act shall not be applicable in the following contracts for providing services:
  - With duration less than 90 days, income shall be determined on the basis of project completion method (when project is completed or substantially completed)
  - Involving indeterminate number of acts over a specific period of time, income shall be determined on the basis of a straight-line method
- For all the above methods, contract revenue shall include retention money and the contract costs shall not be reduced by any incidental income in the nature of interest, dividends or capital gains [contrary to the position laid out by the Supreme Court in the case of *CIT vs Bokaro Steel Ltd (236 ITR 315)] and Karnal Co-operative Sugar Mills Ltd [243 ITR 2(SC)]*
- Incidental income other than interest, dividends or capital gains could be reduced from contract cost (such as income in the nature of rentals from temporary leasing of premises to the contractor etc)

Percentage of Completion Method ('POCM')

New Section 43CB

- One has to note that ICDS-IV provided an option to the assessee in case where the service contracts took less than 90 days for completion to follow contract completion method
- However, proviso to Section 43CB(1) mandates the usage of project completion method. Thus, in case of all service contracts, irrespective of the method of accounting followed for maintaining books of account, one has to offer revenue to tax only on the basis of project completion method
- Similar is the case of contracts which involve indeterminate number of acts for completion, ICDS-IV provided for an option to follow either the percentage completion method or straight line basis method. However, the proviso to Section 43CB(1) mandates the usage of straight line basis method
- Also, where one follows project completion method while maintaining books of account and is required to follow POCM for computing taxable income, there may arise MAT implications, as a result of which same income could be taxed doubly, once under the normal provisions and again under MAT provisions (discussed on Slide No 50)
- Can retention money recognized under Section 43CB be written off as Bad debts under Section 36(1)(vii) if collection is not reasonably certain? *Revenue recognized for ICDS purposes but not in books of accounts - When such amounts are irrecoverable, bad debts should be allowed as deduction [2nd proviso to Section 36(1)(vii)]*

Transitional Provisions & Disclosure Requirements

Transitional Provisions

Contract revenue and contract costs associated with the construction contract, which commenced on or before March 31, 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 April 1, 2016

Disclosure Requirements

- Total amount not recognized as revenue from sale of goods due to lack of certainty of ultimate collection
- Amount recognized as revenue from services and method used to determine stage of completion
- Service transactions in progress:

  Amount of costs incurred and recognized profits up to previous year and Amount of advances received and retentions

ICDS III vs AS 7 and Ind AS 11

Particulars	AS 7	ICDS III	Ind AS 11
Applicability	Accounting for construction contracts in the financial statements of contractors	Applied in determination of income for a construction contract of a contractor	Accounting for construction contracts in the financial statements of contractors including the financial statements of real estate developers
Recognition of contract revenue and expense	Contract revenue and expense to be recognized when outcome of construction contract can be estimated reliably Outcome of construction contract can be estimated reliably when 4 specific conditions [Para 22] are satisfied	These conditions have not been incorporated into the ICDS, as they are subjective However, safe harbor during early stages of a contract, ie until the contract reaches 25 percent completion	Contract revenue and expense to be recognized when outcome of construction contract can be estimated reliably Outcome of construction contract can be estimated reliably when 4 specific conditions are satisfied
Treatment of incidental Income	Contract cost is to be reduced to that extent	Incidental income like dividends, interest and capital gain taxable as per normal provisions of the Act	Contract cost is to be reduced to that extent
Recognition of expected loss	Standard prescribes for recognition of expected loss	No such provisions prescribed under ICDS	Standard prescribes for recognition of expected loss

Points for discussion

- Recognition of foreseeable losses on a contracts regardless of commencement or stage of completion of contract – Doesn't seem to be permissible
  - ICDS does not permit – by implication, expected losses on a contract also to be recognised on POCM
  - Permitted under AS 7 and Ind AS 11
  - Potential mismatch between book and taxable profits thereby leading to mismatch in years between income chargeable to tax at normal rates and MAT
  - Contrary to the rulings in the cases of *Angelique International Ltd vs DCIT [ITA No 4085/Del/2011], CIT vs Triveni Engineering & Industries Ltd (49 DTR 253)[Del], CIT vs Advance Construction Co (P) Ltd (275 ITR 30)[Guj]*
- Effect of safe harbor provisions applicable under ICDS – Revenue may start combining and segmenting of contracts
- Whether retention money is to be recognized on billing? Answer is 'Yes' – Section 43CB of the Act
  - FAQs released by CBDT (FAQ No 11) states retention money, being part of overall contact revenue, shall be recognized as revenue subject to reasonable certainty of its ultimate collection condition prescribed in Para 9 – Accrual principle under the Act ignored
  - More than 6 High Courts have held that retention money doesn't accrue during the performance of contract based on the principle of 'accrual'
  - If the payment of retention money is delayed or is to be made on fulfilment of certain conditions, but there is reasonable certainty of its ultimate collection then the same has to be recognised
  - Committee Report says unintended meaning given by judicial precedents!
- Non recognition of upfront losses on "onerous" contracts

Illustration

How will expenses related to future activity and expected future losses, if any, on construction contracts be accounted for under the ICDS – Impact *Qua* MAT provisions

Year	Contract	Other business income	Total income		Remarks
			Normal Income (ICDS)	Book Profits	
1 (20 percent work)	Foreseeable loss (3,000)	4,000	4,000 (4,000 - Nil)	1,000 (4,000 - 3,000)	Foreseeable loss (3000) of contract is not allowed as deduction in Year 1 under ICDS provisions (absence of prudence and provision for expected loss unless provided by ICDS-III)
2 (100 percent work)	Contract concludes on loss of (3,300)	4,000	700 (4,000 - 3,300)	3,700 (4000 + 3,000 - 3,300)	Actual loss of (3,300) of contract will be allowed as a deduction in normal computation of income

In case tax payable as per normal provisions in Year 1 and tax payable under MAT in Year 2, taxpayer ends up paying tax in two years on income which is larger than his real commercial income (+MAT credit aspect)

Under ICDS-I, foreseeable/ future loss is not allowed. However, a possible view (litigative though) is that 20 percent of the loss ie INR 600 is crystallised in Year 1 and should be allowed in Year 1 itself

ICDS IV – REVENUE RECOGNITION

Definitions and Recognition

REVENUE

Gross inflow of

CASH, RECEIVABLES OR OTHER CONSIDERATIONS

Arising in the course of the ordinary activities of a person

SALE OF GOODS

Recognized when:

- Property in the goods transferred for a price; or
- All significant risks and rewards of ownership transferred; and
- Seller retains no effective control of the goods transferred
- **Reasonable certainty of its ultimate collection**

RENDERING OF SERVICES

POCM

- Revenue matched with service transactions costs incurred in reaching the completion stage, resulting in the determination of revenue, expenses and profit which can be attributed to the proportion of work completed

USE OF RESOURCES BY OTHERS YIELDING INTEREST, ROYALTIES OR DIVIDENDS

- Interest - Time basis
- Interest on refund of tax – deemed to be income in the year of receipt
- Discount or premium – accruing over the period of maturity
- Royalties – As per the terms of the agreement
  - ✓ If more appropriate – can be recognized on some other systematic and rationale basis
- Dividend – as per the Act

Transitional Provisions

Transitional Provisions

- In case of a service transaction – the transitional provision provided in construction contract would be applicable *mutatis mutandis*

- In case of other transaction:

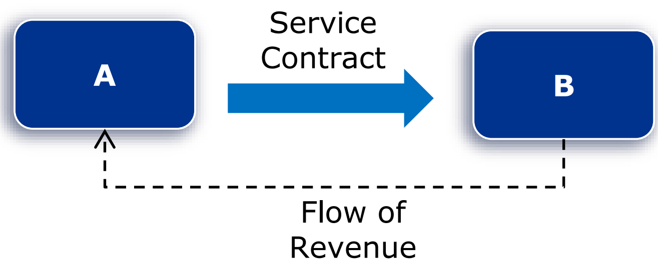
  - A transaction undertaken on or before March 31, 2016 but not completed by the said date shall be recognized in accordance with the provisions of this standard for the previous year commencing on the April 1, 2016 and subsequent previous year

  - The amount of revenue, if any, recognized for the said transaction for any previous year commencing on or before the April 1, 2015 shall be taken into account for recognizing revenue for the said transaction for the previous year commencing on the April 1, 2016 and subsequent previous years

ICDS IV vs AS 9 and Ind AS 18

Particulars	AS 9	ICDS IV	Ind AS 18
Method to recognize revenue for service transactions	AS-9 recognizes two methods for revenue recognition for service transactions: ▪ Completed Service Contract Method ▪ Proportionate Completion Method	ICDS has prescribed a single method of POCM (completed service contract method for only for service contracts spanning less than 90 days)	Ind AS prescribes single method ie POCM
Measurement of revenue	Measurement of revenue based on the consideration received or receivable	Measurement of revenue based on the consideration received or receivable	Measurement of revenue is based on fair value of consideration received
Recognition of interest income	Recognized on accrual basis	Recognized on accrual basis	Recognized on accrual using effective interest method

Illustration



Contract Value – INR 1000

- "A" obtains and executes a service contract with 'B'
- Billing milestone at completion of 60 percent of work
- At the end of Year 1, 'A' has completed 50 percent of work
- By the end of Year 2, 'A' has completed all the work and recognized revenue earned from the contract in its books

Table 1: Pre-ICDS (Project Completion Method)

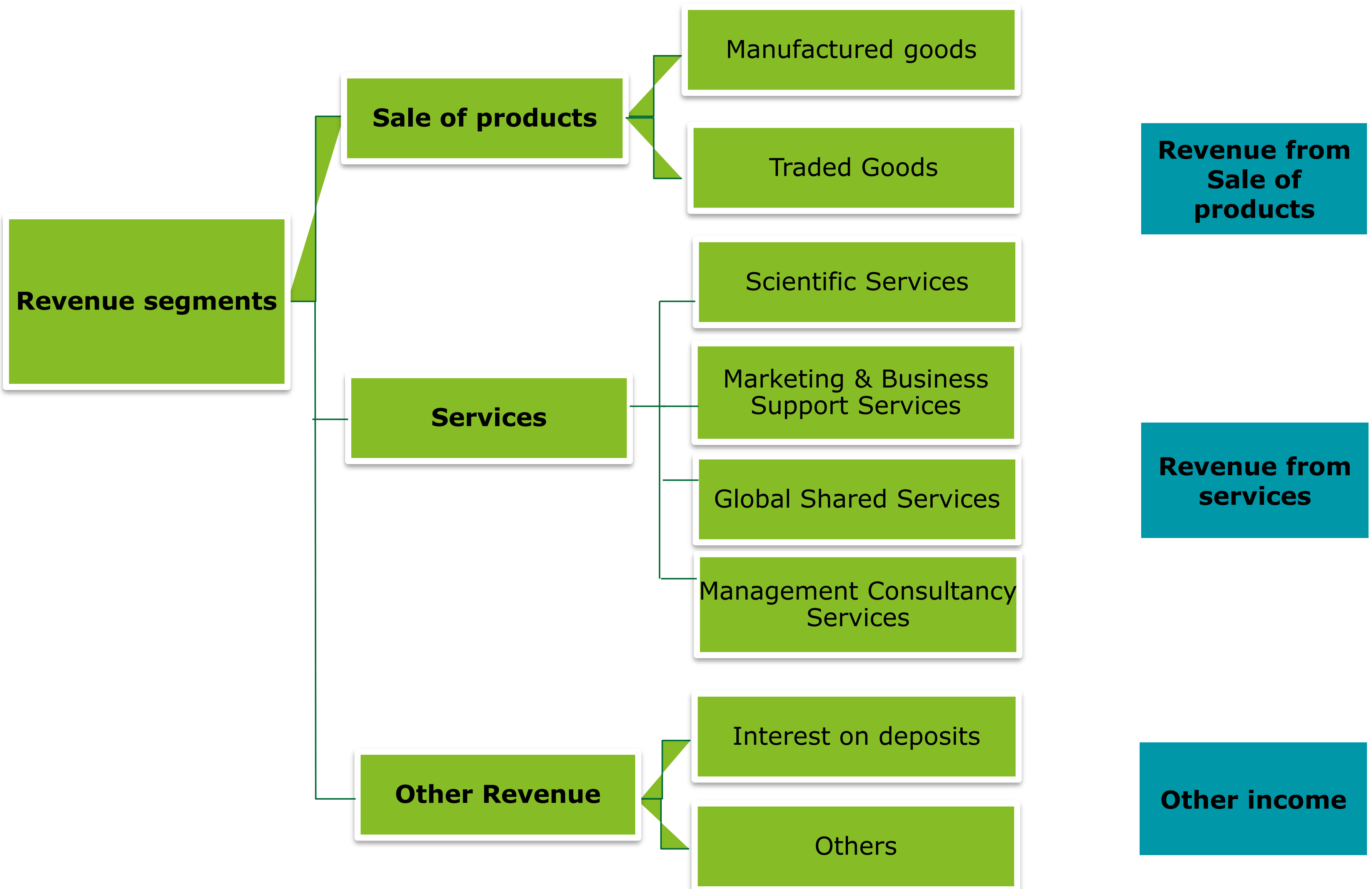
Particulars	Year 1	Year 2
Net Profit as per Books	-	1000
Tax Payable @ 30 percent	-	**300**
Tax Payable as per MAT @ 18.5 percent	-	185
Total Tax Liability	**300**	

Table 2: Post-ICDS (Percentage Completion Method)

Particulars	Year 1	Year 2
Net Profit as per Books	-	1000
Net Profit Under ICDS	500	500
Tax Payable @ 30 percent	**150**	150
Tax Payable as per MAT @ 18.5 percent	-	**185**
Total Tax Liability	**335**	

In this regard, one could refer to the judgment of the Hon'ble Andhra Pradesh High Court in case of CIT vs Nagarjuna Fertilizers & Chemicals Ltd.(373 ITR 252), wherein the Court has held that once an income has been taxed under normal provisions of the Act, the same cannot be taxed under MAT provisions

Illustration



Points for discussion

- While it is provided that revenue from sale of goods shall be recognized only if there is 'reasonable certainty of ultimate collection', similar condition is absent for services, interest, royalty and dividend revenue streams - *There should be no compulsion to such income which is doubtful of recovery (Real income theory)*

- FAQ No 13: The condition of reasonable certainty of ultimate collection is not laid down for taxation of interest, royalty and dividend. Whether the taxpayer is obliged to account for such income even when the collection thereof is uncertain?

  - As a principle, interest accrues on time basis and royalty accrues on the basis of contractual terms. Subsequent non-recovery in either cases can be claimed as deduction in view of amendment to Section 36(1)(vii)

- Revenue recognition from Professional Service Arrangement (“PSAs”) – Customer acceptance based recognition - requires to be examined light of this ICDS and the terms of agreement

- Integrated Arrangements – Following aspects of recognition under these arrangements to be examined:

  – Installation or go live based revenue recognition

  – Recognition of revenue from sale of hardware - where deliver of hardware is linked to subsequent performance of the contracts

  – Professional or outsourcing services - Time and material based or Fixed fee arrangements

  – Post contract customer support – determination of fair value and recognition

- Recognition of revenue where servicing fees included in the price of the product

- Fees that are earned on the execution of a significant act

Points for discussion

- FAQs No 14: Section 115A of the Act provides for rate of taxation for non-resident assesse - for interest/ dividend income, no return of income is required to be filed [Section 115A(5)].

  - Therefore, Section 145(2) should not be applicable (though FAQs mentions that its applicable)

  - Royalty/ FTS chargeable under the treaty when "paid". Hence, ICDS should not be applicable.

  - For such non-resident service providers, charging provisions are synchronized with withholding provisions for payers and the whole of income gets covered by TDS

- **Insertion of new Section 145B to provide** as below:

  - In line with ICDS IV, claim for escalation of price in a contract or export incentives shall be deemed to be income of the previous year in which reasonable certainty of its realization is achieved [overrules the judgement of the Hon’ble Supreme Court in *CIT vs Excel Industries Limited (2015) 358 ITR 295 (SC)]*

  - Interest received on compensation or on enhanced compensation which was not expressly dealt in ICDS IV, shall be deemed to be income of the year in which it is received

  - In line with ICDS VII, income from assistance in the form of subsidy or grant or cash incentive or duty drawback or waiver shall be taxable on receipt basis, if not offered to tax earlier

- FAQs No 12: Since there is no specific scope exclusion for real estate developers and Build- Operate Transfer (BOT) projects from ICDS IV on Revenue Recognition, whether ICDS-III and ICDS-IV should be applied by Real Estate developers and BOT operators. Also, whether ICDS is applicable for leases

  - At present there is no specific ICDS notified for real estate developers, BOT projects and leases. Therefore, relevant provisions of the Act and ICDS shall apply to these transactions as may be applicable.

Case Study 4

Issue

- Aisha has provided interior decoration services during FY 2017-18 to Mr Shah [contract period exceeding 90 days]
- On completion of first milestone, Aisha has raised an invoice amounting to Rs 1,00,000
- As per terms of contract, it has been agreed that retention money would be 5 percent of the invoice value and the same would be remitted after 1 year
- Accordingly, Aisha would be entitled to receive Rs 95,000 during FY 2018-19
- What would be the revenue to be recognized by Aisha during FY 2017-18?

Case Study 5

ICDS

ICDS III

- Contract revenue shall comprise of:
  - the initial amount of revenue agreed in the contract, including retentions; and
  - variations in contract work, claims and incentive payments:
    - to the extent that it is probable that they will result in revenue; and
    - they are capable of being reliably measured.

Analysis

- Accordingly, revenue to be recognized during FY 2017-18 would amount to Rs 1,00,000, ie including retention money

ICDS V – TANGIBLE FIXED ASSETS

Scope

Assets included – Tangible Fixed Assets

- Land, Building, Machinery, Plant or Furniture *[Definition consistent with "Block of Assets" as per Section 2(11) of the Act, the only exception being Land]*
- Held with the intention of using for producing/ providing goods or services; and
- Not held for sale in the normal course of business

Other points

- Where several assets are purchased for a consolidated price, consideration shall be apportioned to various assets on a "fair" basis - **does not specifically indicate whether valuation is needed**
  - "Fair" basis – approach not defined; may be ambiguous and could be litigative as well
  - In absence of valuation for assets purchased for consolidated price, tax officer may want to allocate more cost to non-depreciable assets [this aspect could be relevant to slump purchase transactions etc]
- Fair value of a tangible fixed asset acquired in exchange constitutes **cost of asset received**
  - No option of adopting fair value of assets given up
- Components of cost **align largely** with definition of Actual cost in Section 43(1) of the Act
  - Cost of tangible fixed asset to include purchase price, import duties and other taxes (excluding those subsequently recoverable), directly attributable expenses incurred to make the asset ready for intended use
  - Administration and general overheads not specifically attributable to be excluded
  - Trade discounts and rebates to be deducted in arriving at actual cost

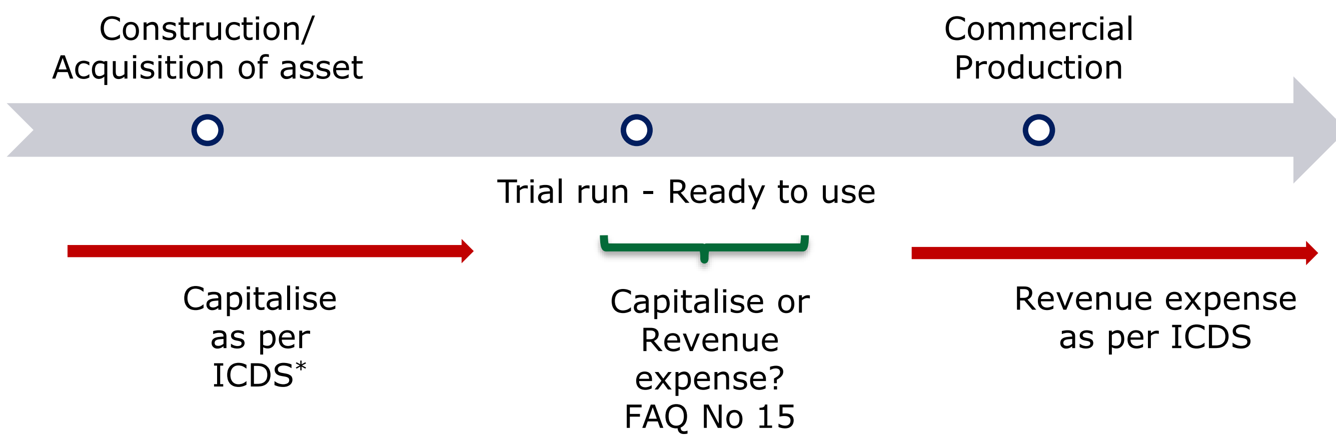
Relevant Points

- **Costs to be capitalized**
  - Expenditure incurred on start up and commissioning of the project
  - Expenditure incurred on test runs and experimental production
  - Expenditure that increases future benefits from existing asset beyond its previously assessed standard of performance
  - Stand-by equipment and service equipments
- Machinery spares to be charged to revenue as and when consumed
  - Exception: Spares used only with tangible fixed asset and use is expected to be irregular - to be capitalized
- Capitalization of exchange differences relating to fixed assets shall be in accordance with Section 43A and other similar provisions of the Act
- FAQs No 15: Expenses incurred till plant has begun commercial production ie production intended for sale or captive production is to be capitalised
  - Clarification contrary to judicial precedents such as Delhi ITAT ruling in case of *NTPC Ltd 357 ITR 253*, wherein it has been held that post trial run expenditure shall be allowed as revenue expenditure

Relevant Points

- Cost of improvement (which increases the previously assessed level of performance) to be capitalized, otherwise to be expensed-off
  - Whether minor improvement or repairs (such as replacement of computer RAM or hard disk) needs to be capitalized? *ICDS X - Provision made shall be the best entitlement of expense recorded to settle present obligation at the end of that year (without discounting)*
  - What about major inspection costs (such as aircraft interiors)? Under Ind-AS such inspection costs to be capitalized if recognition criteria is met
- Whether ICDS-V is a legislative misfire?
  - "Actual cost" defined under Section 43(1) of the Act [and supplemented by various Explanations and rulings such as *Challapali Sugar Case (98 ITR 167)(SC)* postulating recording of actual cost basis commercial accounting principles]
  - Section 32 deals with claim of depreciation
  - As regards gain/ loss on transfer of fixed assets, the same to be computed as per provisions for computing "Capital gains"
  - Overall ICDS-V becomes inconsequential and serves limited purpose

Expenditure to be capitalised



ICDS V recognizes that expenditure on startup and commissioning of a project needs to be capitalized, whereas expenditure post commercial production needs to be claimed as revenue. Accordingly, expenditure incurred during test runs and experimental production (also referred to as "stabilization periods" in certain industries) may have to be capitalized

Also, stands clarified vide Ques No 15 of the FAQs issued by CBDT on March 23, 2017

Also held by the Gujarat HC in the case of *Saurashtra Cement (127 ITR 47),* Delhi HC in the case of *Food Specialties (136 ITR 203),* Bombay HC in the case *of GT Industries (203 ITR 538)

Disclosures (Clause 18 of Form 3CD)

- Depreciation of asset or block of assets
- Rate of depreciation
- Actual cost or written down value
- Additions or deductions during the year with dates put to use
- Adjustments on account of CENVAT credit claimed and allowed
- Adjustments on account of change in rate of exchange of currency and subsidy/ grant/ reimbursement etc

Transitional Provisions

- Actual cost of tangible fixed assets, acquisition or construction of which commenced on or before March 31, 2016 but not completed by the said date, shall be recognised in accordance with the provisions of this standard.

- Amount of actual cost, if any, recognised for the said assets for any previous year commencing on or before April 1, 2015 shall be taken into account for recognising actual cost of the said assets for the previous year commencing on April 1, 2016 and subsequent previous years

ICDS VI – Effects of changes in foreign exchange rates

Key Provisions

ICDS VI deals with

- Treatment of transactions in Foreign Currencies ("FC")
- Translating the financial statements of Foreign Operations ("FO")
- Treatment of FC transactions in the nature of forward exchange contracts

Definitions

- FC transaction – transaction denominated in or requiring settlement in FC, including transactions arising when a person –
  - Buys/ sells goods/ services priced in FC
  - Borrows/ lends funds in FC
  - Participates to an unperformed forward exchange contract
  - Acquires/ disposes assets or, incurs/ settles liabilities in FC
- Monetary items – money held, assets to be received, liabilities to be paid in fixed/ determinable amounts of money (eg Cash, Receivables, Payables, etc)
- Non-monetary items - other than monetary (eg Fixed assets, Inventories, Investment in equity shares etc)
- ICDS refers 'foreign operations of a person' as a Branch (or any other name called), the activities of which are based or conducted in a country other than India

Key Provisions

Monetary items

Particulars	ICDS VI	AS 11/ Ind AS 21
Initial recognition	At the exchange rate as on the date of transaction or average rate for a week or month (if approximates to actual) [Para 3(1) and 3(2)]	Similar to ICDS, except that Ind AS 21 refers to use of 'Spot exchange rate'. [any variance requires to be considered for total income computation]
Conversion at the last date	Converted using closing rate, except if closing rate appears to be unrealistic – rate/ amount at which likely to be realized [Para 4(a) and Para 4(b)]	AS 11 is similar to ICDS. Ind AS 21 provides only for closing rate [any variance requires to be considered for total income computation]
Exchange difference arising on settlement or conversion	Recognized in profit and loss account [para 5(1)]	Similar to ICDS, except that AS 11 provides for accumulation in 'foreign currency translation reserve' in respect of non-integral operations

Key Provisions

Non-Monetary items

Particulars	ICDS VI	AS 11/ Ind AS 21
Initial recognition	Same as monetary items	Same as monetary items
Conversion at the last date	All non-monetary items (except inventory carried at NRV) – rate as on the date of the transaction Inventory carried at NRV – rate existed on the date of determination of NRV [Para 4(c) and 4(d)]	Carried at Historical cost – rate as on the date of the transaction Carried at Fair Value – rate as on the date on which fair value is determined (includes Inventory and other assets)
Exchange difference arising on settlement or conversion	Not be recognized in profit and loss account [Para 5(ii)]	Recognized in the profit and loss account (subject to option of capitalization exercised as per AS 11)

- Para 7 of ICDS VII provides for an overriding impact of Section 43A of the Act and Rule 115
- Section 43A provides for capitalization exchange differences relating to an asset acquired from a country outside India, arising on settlement
- Rule 115 providers the rate of exchange for conversion of income expressed in foreign currency

Illustration

Particulars	Category	Rate on Transaction date	Closing rate as of March 31	Rate at which realized/ disbursed	Conversion rate applied	Remarks
Trade receivable – Debtor X	Monetary	65	66	NA	66	Para 4(a)
Trade receivable Debtor Y	Monetary	65	Unrealistic to closing rate	55	55	Para 4(b)
Investment in shares of A	Non-Monetary	60	62	-	60	Historic rate – Para 4(c)
Inventory (valued at NRV)	Non-Monetary	65	60	-	60	Para 4(d) – date of NRV [non claim for exchange loss allowed in PL]

Illustration

Particulars	Category	Cost	Exchange loss on liability outstanding	Remarks
Assets acquired outside India	Covered under Section 43A	USD 2,000	USD 10	If loss is on settlement – allowed for capitalization under Section 43A
Indigenous assets in Foreign currency (from a SEZ, EOU or FTZ)	Not covered under Section 43A	USD 5,000	USD 75	Not allowed for capitalization under Section 43A– Whether claim could be made under Para 5(1)?

Forward Contracts

Particulars	ICDS VI	AS 11/ Ind AS 21
Trade/ speculation contract or hedging foreign risk contract (firm commitment or highly probable forecast)	Premium/ discount or exchange difference to be recognized only on settlement basis	Provides for recording Mark to Market losses/gains [any Mark to Market losses/gains requires to be considered for the purpose of total income

- With ICDS being introduced, claim of mark to market losses/ gains are deductible only on settlement basis even on trade or speculation contracts
- Forward contract (other than covered above) – premium or discount is allowed to be claimed over the period of the contract and exchanges gains/loss in the year of change in the rates
- ICDS I on accounting policies provides that marked to market loss or an expected loss shall not be recognized unless the recognition of such loss is in accordance with the provisions of any other ICDS

Key points and Practical issues

- Non-monetary items (in respect of inventory valued at NRV) – no gain or loss is considered for tax purpose

- No claim is allowed for mark-to-market loss on forward contract, covered in ICDS VI

- ICDS and Ind AS does not distinction between integral and non integral foreign business operations (unlike in AS 11). Accordingly -

  - All assets and liabilities of foreign operations would be needs to be classified as monetary and non-monetary items and treatment provided in ICDS is required to be given effect

  - Any balance in Foreign currency Translation Reserve shall be recognized in FY 2016-17, to the extant not recognized in the income computation (FAQs No 16)

- Para 7 (overriding impact of Rule 115) – Rule 115 provides applying TT buying rate on the specified date expect if such income is received or brought to India during the year. Impact of the same in respect of unrealized income/ accruals requires to considered for the purpose of tax computation

- Significance of SC rulings - *Sutlej Cotton Mills Limited vs [CIT (1979) 116 ITR 1 (SC)], CIT vs Woodward Governor India P Ltd [312 ITR 254(SC)]*, post ICDS (monetary liabilities for fixed assets purchase)

Insertion of new Section 43AA to provide for treatment of specified foreign currency transactions as per ICDS VI
Specified foreign currency transactions include: (a) Monetary items and non-monetary items (b) Translation of financial statements of foreign operations (c) Forward exchange contracts (d) Foreign currency translation reserves
Section 43AA is subject to the provisions of Section 43A of the Act, which deals with treatment of foreign exchange fluctuations for imported capital assets

Section 43A vis-à-vis Section 43AA

- Treatment provided in Section 43A and Section 43AA are contrary to each other

- Section 43A is a non-obstante clause

- Section 43A deals with a case, where the assessee has acquired any asset from outside India and there is increase or reduction in liability to pay as a result of fluctuation in foreign exchange rate

- In such a case, any increase or decrease in liability at the time of making payment has to be adjusted to the actual cost of the asset under Section 43(1) or other sections as provided therein. Thus, Section 43A applies to any asset purchased from outside India and it recognises the fluctuation which arises at the time of making payment. In all other cases Section 43AA would apply.

- Section 43AA would apply to any asset purchased from within India, but for the purchase of which a loan has been taken in foreign currency from outside India. Also, Section 43A would apply only at the time of making payment, whereas Section 43AA would apply for year-end valuations as well

- Section 43A provides adjustment in the cost whereas, Section 43AA provides that any exchange fluctuation has to be recognised at loss or gain as the case may be.

- There is no intelligible difference between assets acquired from within India and from outside India if the payment has to be ultimately made in foreign currency. Also, now one can argue that gain or loss arising as at the year end on account of foreign exchange fluctuation has to be recognised as gain/ loss as per Section 43AA, even when the asset is purchased from outside India, as Section 43A apply only at the time of payment. In such a case, an unusual situation would arise ie, exchange fluctuation at the time of making payment would be required to be capitalised whereas the fluctuation arising on year end valuation would be required to be taken as income/ loss

Transitional Provisions

- ICDS to be applicable for:
  - All foreign currency transaction undertaken on or after April 1, 2016
  - Exchange differences arising in respect of monetary items or non-monetary items, on the settlement thereof during the previous year commencing on the April 1, 2016 or on conversion thereof at the last day of the previous year commencing on the April 1, 2016 , shall be recognized in accordance with the provisions of this ICDS after taking into account the amount recognized on the last day of the previous year ending on the March 31, 2016 for an item, if any, which is carried forward from said previous year
  - Forward exchange contracts existing on April 1, 2016 or entered on or after April 1, 2016
  - Translation of financial statements of foreign operations for previous year commencing on April 1, 2016
- Other forex derivatives like, futures, interest rate swaps, etc are not covered by ICDS VI [ICDS I would still apply in such cases]

ICDS VII – Government Grants

Key Provisions

- Government grants are assistance in cash or kind to an enterprise for past or future compliance of conditions and are called by other names such as, subsidies, cash incentive, duty drawback, waiver, concessions, reimbursements

- ICDS VII does not deal with:

  – Government assistance other than in the form of Government Grants (say, infrastructure facility to public/ backward areas or imposition of trade restriction for competition)

  – Government participation in ownership of enterprise (say, Equity participation in Public sector company/ back or financial institution)

  – Government assistance which cannot have a value upon them (say, free technical advice or medical assistance, guarantee)

  – Transaction with Government which cannot be distinguished from normal trading transaction of the person (say, payments for purchase/ sale of goods or services to Government)

  – Any Government grants which does not have any conditions associated or attached

- LPG subsidy or any other welfare subsidy received by individual is excluded (MOF Press release May 5, 2015), Sales tax deferral payment, loan or debt simplicitor – may not qualify

- ‘Government’ is defined to incudes bodies formed under foreign law (grants from Foreign Government also covered)

Key Provisions

Particulars	ICDS VII	AS 12/Ind AS 20
Recognition criteria	Grants should not be recognized until there is 'reasonable assurance' that (i) the person shall comply with the conditions attached to them, and (i) the grants shall be received	Similar to ICDS
Variance in recognition	Recognition shall not be postponed beyond the date of actual receipt <u>Judicial reference under the Act</u> *CIT Vs Ashoka Lungi Company (120 ITR 413) (Madras High Court), CIT Vs Punjab Bone Mills (Punjab and Haryana Court) – recognize grant on filing application*	Mere receipt of a grant is not necessarily conclusive evidence that the conditions attached have been or will be fulfilled [This could lead to timing issue - Double taxation on account of MAT or capitalization issues for asset related grants]

- Reasonable assurance – Not defined under the ICDS, but can be understood to mean having significance degree of certainty of satisfying the conditions

Key Provisions

Particulars	ICDS VII	AS 12/Ind AS 20
Grants related to depreciable asset	Deduction from: - Actual cost of assets; or - WDV of block of assets	▪ Recognize outside profit and loss account (Ind AS)/ Reduction from gross value of asset (AS 12); or ▪ Treated as deferred income and recognize to profit and loss account over the useful life of asset [ICDS does not provides alternatives – this could lead to variances in computation of income]
Grants related to non-depreciable assets	Should be treated as income and recognized over the period of fulfillment of conditions [may dilute the mandatory recognition provided under Section 2(24)(xviii) of the Act – which provides for recognition on actual receipt]	Similar to ICDS [Additionally AS 12 provides for credit to capital reserve – Para 8.4]

Key Provisions

Particulars	ICDS VII	AS 12/Ind AS 20
Grants not directly identifiable to asset (grants based on total expenditure incurred including revenue)	Provides for identification of grants related to assets on proportionate basis and (i) Reduced from the actual cost or WDV (depreciable assets) (i) Recognized over the period of fulfilling the condition (non-depreciable asset)	No such specific treatment (capital approach or income approach followed)
Grants in the nature of revenue – requiring incurring expenses	Recognized in profit and loss account over the period over the necessary cost incurred	Similar to ICDS
Grants in the nature of compensation for expenses or loss	Recognized in profit and loss account in the year/ period in which it is receivable	Similar to ICDS

Key Provisions

Particulars	ICDS VII	AS 12/Ind AS 20
Repayment of grants	First reduced from the unamortized deferred credit (in case of non depreciable assets or grant which are subject to condition) and balance charged to profit and loss account In case of depreciable assets, actual cost is adjusted and depreciation is provided prospectively	Similar to ICDS

Others

Transitional Provisions

- All the Government grants which meet the recognition criteria after April 1, 2016 shall be recognized for the previous year commencing on or after April 1, 2016 in accordance with the provisions of this ICDS after taking into account the amount, if any, of the said Government grant recognized for any previous year ending on or before March 31, 2016

Clarifications issued by CBDT vide Circular dated March 23, 2017

- FAQs No 17
  - CBDT has issued clarification on the treatment of recognizing Government grants where the partial amount was recognized prior to March 31, 2016 – grants received prior to March 31, 2016 – requires to be recognized under the earlier law

Disclosure requirements

- The disclosures under this ICDS are fairly extensive, and need to be made for different types of Government grants received and recognized during the year - Disclosure of duty drawback on import assets? Practical challenge!

- ICDS also requires disclosure of Government grants not recognized during the year

ICDS VIII – Securities

Key Provisions

Scope of the Standard – Part A

- ICDS deals with securities held as stock-in-trade and does not deal with:
  - Recognition of interest and dividends on securities which are covered by other ICDS;
  - Securities held by person engaged in insurance business;
  - Securities held by mutual funds, venture capital funds, bank and public financial institutions

Definitions

- Fair value – an amount for which an asset could be exchanged between knowledgeable, willing buyer and a knowledgeable, willing seller in an arms' length transaction
- Securities - meaning assigned to it in clause (h) of Section 2 of the SCRA (other than derivatives referred to in sub-clause (1a) of that clause) and includes share of a company in which public are not substantially interest

Key Provisions

Particulars	ICDS VIII	AS 13/ Ind AS 109
Initial recognition	• Purchase price plus brokerage, fees, tax, duty or cess • Purchase price includes interest (for debt securities) the same requires to be reduced on receipt of interest income	• Valued at purchase cost • Ind AS 109 also provides for fair value cost plus transaction cost (in case securities other than those classified as fair value through P&L)
Securities received in exchange of other securities/ asset	• Recorded at fair value of securities/ asset so acquired	• Recorded at fair value of securities given up (AS 13) [Any variance in value requires to be considered for tax computation]
Subsequent measurement	• Valued at cost or NRV, which ever is less • Cost or NRV shall be determined at security category-wise (shares, debt securities, convertible securities and others) • Cost is referred to value determined at the beginning of the year, subject to exception • FIFO or weighted average used in absence of specific cost	• Same as ICDS • Cost or NRV is compared at each security-wise (AS 13) • Cost is actual cost (AS 13) [Any variance in value requires to be considered for tax computation. There could be challenges in tracking the cost and NRV details, specifically if shares are acquired throughout the year]

Illustration

Security	Category	Cost	NRV	Lower	Remarks
A	Shares	100	75	75	345 to be considered as inventory
B	Shares	120	150	120	
C	Shares	140	120	120	
Total		**360**	**345**	**345**	

Part B

Scope of the Standard – Part B

- ICDS deals with securities held as stock-in-trade by scheduled bank or public financial institution

Classification, Recognition and Measurement

- As per guidelines issued by the Reserve Bank of India (RBI) from time to time

ICDS IX – Borrowing Costs

Scope & Definitions

- Deals with treatment of Borrowing Cost
- Does not deal with actual or imputed cost of owner’s equity and preference share capital

Definitions

- Borrowing costs are interests and other costs incurred by a person for borrowing funds and include
- Commitment charges on borrowings
- Amortized amount of discounts or premiums
- Amortized amount of ancillary costs incurred in connection with arrangement of borrowings
- Finance charges in respect of assets acquired under finance leases or similar arrangements

Recognition

Definitions [continued]

- Qualifying Asset ('QA') means
  - Land, building, machinery, plant or furniture, being tangible assets
  - Know-how, patents, copyrights, trade marks, licenses, franchises or any other business or commercial rights of similar nature, being intangible assets
- Inventories that require a period of 12 months or more to bring them to a saleable condition

Recognition

- Borrowing costs directly attributable to the acquisition, construction or production of a QA shall be capitalized
- Other costs shall be treated in accordance with the provisions of the Act

Key Provisions

Amount of Borrowing Costs eligible for capitalization

- Specific borrowings: Actual borrowing costs incurred during the period on the funds so borrowed
- General borrowings: A ^{X} B $^{/}$ C

A	Borrowing cost during the year other than relating to specific purpose
B	i. Average of opening and closing cost of the qualifying asset; or
	ii. Half of the cost of qualifying asset (where the qualifying asset does not appear on the first day); or
	iii. Average of opening cost of asset and cost on date of completion / sale
C	Average of total assets as on last date of the previous year

- For general borrowing - Qualifying asset shall be such asset that necessarily require a period of twelve months or more for its acquisition, construction or production

Other Provisions

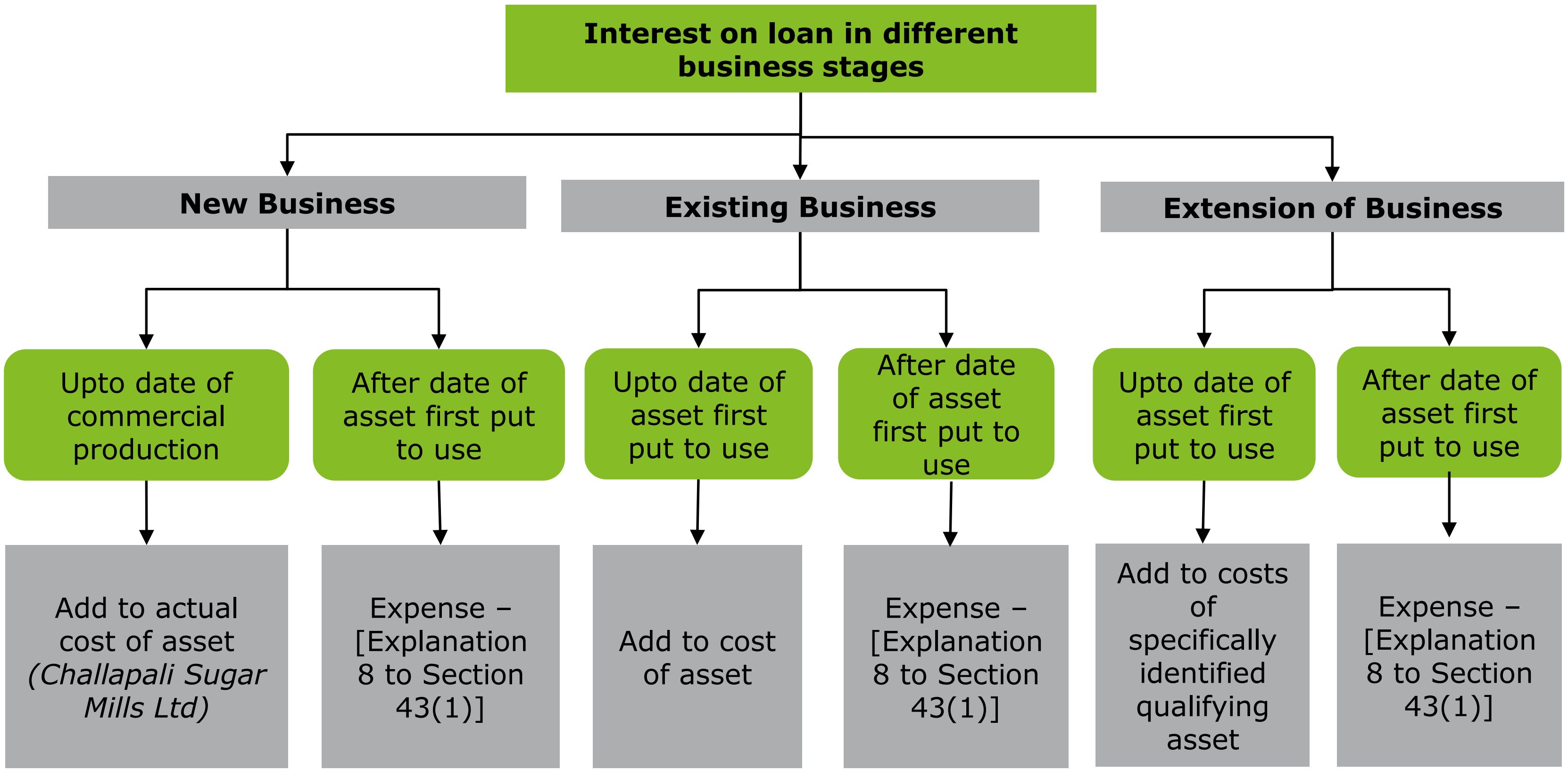
Commencement of Capitalization

- Specific borrowings – from the date on which funds are borrowed
- General borrowings – from the date on which funds were utilized

Cessation of Capitalization

- Tangible/ intangible QAs – when asset is first put to use
- Inventories – when substantially all activities necessary to prepare such inventory for its intended sale are completed
- Part completion of QA when such part is capable of being used while construction continues
  - Part of tangible/ intangible QA - when such part of an asset is first put to use
  - Part of inventories - when substantially all activities necessary to prepare such part of inventory for its intended sale are completed

Interplay between Section 36(i)(iii), 43(1) and ICDS



Other Aspects

- Formula for capitalisation in case of general borrowing - Impact on total income

- No clarity on whether income on temporary investment to be reduced from cost of asset or should be treated as Income from other sources

- Inventory cost - Interplay between Section 36(1)(iii) of the Act and borrowing cost capitalization under ICDS [Act would prevail – reference to ‘asset’ meaning capital assets – *CIT vs Lokhandwala Construction Industries (260 ITR 579)*

Clarifications issued by CBDT

- FAQs No 20
  - Exclusion of borrowing cost from capitalization which gets disallowed under specific provisions of the Act
  - CBDT has clarified that specific provisions of the Act overrides the ICDS. Accordingly, borrowing costs eligible for capitalization under ICDS IX shall exclude those costs which are disallowed under the specific provisions of the Act [this could create timing issue on capitalization]
- FAQs No 21
  - CBDT has clarified that bill discounting charges and other similar charges would fall under the definition of borrowing costs as per ICDS IX
- FAQs No 22
  - Allocation of borrowing costs of general borrowing
  - CBDT has clarified that the capitalization of general borrowing cost under ICDS IX shall be done on asset-by-asset basis

Comparison of ICDS IX vis-à-vis AS 16 and Ind AS 23

ICDS IX	AS 16	Ind AS 23
Specific exclusion of actual or imputed cost of owners equity or preference share capital	Same as ICDS	Same as ICDS
Does not deal with exchange differences arising from foreign currency borrowings	Deals with exchange differences arising from foreign currency borrowings to the extent they are classified as interest	Deals with exchange differences arising from foreign currency borrowings to the extent they are classified as interest
Does not considers substantial period of time taken by QA to get ready for intended use or sale other than inventories *But provides specific exclusion for general borrowing*	Capitalization of borrowing costs shall be done if the QA takes substantial period to get ready for intended use or sale	Same as AS
ICDS does not specifically provide for reduction of interest earned on temporary investment of borrowed funds	Provides for reduction	Same as AS

Other Provisions

Transitional Provisions

- Borrowing costs incurred on or after April 1, 2016 shall be capitalized in accordance with the provisions of this ICDS after taking into account the amount of borrowing costs capitalized, if any, for the same borrowing for any previous year ending on or before March 31, 2016

- Transition provision inserted to ensure that there is no double taxation or double non-taxation

Disclosures Requirements

- Accounting policy adopted

  – Accounting policy required to be disclosed in respect of borrowing costs would be the policy followed as per ICDS I

- Amount of Borrowing cost capitalized during the year

  – ICDS requirement on disclosure of the amount of borrowing costs capitalized during the previous year does not state whether such details are required to be given block -wise or whether such disclosure has to be given in aggregate.

  – Disclosure of the aggregate amount should suffice [Technical guidance on ICDS issued by the Institute of Chartered Accountants of India (ICAI)]

Case Study

Issue

- Can borrowing cost pertaining to ‘land’ which has not been put to use be capitalized?

ICDS

- ICDS IX includes land in its definition of ‘qualifying asset’

Analysis

- Unlike AS 1 and Ind AS 23, ICDS on borrowing cost includes ‘land’ in its definition of a qualifying asset
- Borrowing cost pertaining to land, which is not put to use will be capitalized for tax purposes. ‘Land’ is a non-depreciable asset. Hence, the depreciation on capitalized borrowing cost would not be available.
- However, when land is sold, deduction for cost of land and borrowing cost capitalized should be allowed as a deduction (cost of acquisition)

ICDS X – Provisions, Contingent liabilities and Contingent Assets

Key Provisions

Scope

- Deals with provisions, Contingent Liabilities and Contingent assets, except those -
  - Resulting from financial instruments
  - Resulting from Executory Contracts
  - Arising in insurance business from contracts with policy holders
  - Covered by another ICDS

Definitions

Provision
- Liability which can be measured only by using a substantial degree of estimation

Liability
- Present obligation of the person arising from past events, result in an outflow of resources embodying economic benefits

Obligating event
- An event that creates an obligation that results in a person having no realistic alternative to settling that obligation

Key Provisions

Definitions [continued]

- Contingent liability -
  - **Possible obligation** arising from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the person
  - **Present obligation** arising from past events but is not recognized because:
    - it is not reasonably certain that an outflow of resources embodying economic benefits will be required to settle the obligation; or
    - a reliable estimate of the amount of the obligation cannot be made
- Contingent asset –
  - **Possible asset** that arises from past events the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the person

Key Provisions

Recognition of a Provision

A provision shall be recognized when:

A person has a present obligation as a result of a past event;

It is **reasonably certain** that an outflow of resources embodying economic benefits will be required to settle the obligation; and

A reliable estimate can be made of the amount of the obligation

- If these conditions are not met, no provision shall be recognized
- No provision shall be recognized for costs that need to be incurred to operate in the future
- Contingent Assets and Contingent liabilities are not to be recognised

Key Provisions

Measurement of a Provision

- Amount recognized as a provision shall be the best estimate of the expenditure required to settle the present obligation at the end of the previous year

- Amount of a provision shall not be discounted to its present value

- Provisions to be reviewed at the end of each previous year and adjusted to reflect the current best estimate

Recognition and Measurement of a asset and income

- A person shall not recognize a contingent asset

- However, contingent assets are assessed continually and when it becomes reasonably certain that inflow of economic benefit will arise, the asset and related income are recognized in the previous year in which the change occurs

- Amount recognized as asset and related income shall be the best estimate of the value of economic benefit arising at the end of the previous year

- Amount and related income shall not be discounted to its present value

Other Provisions

Transitional Provision

- All the provisions or assets and related income shall be recognized for the previous year commencing on or after April 1, 2016 in accordance with the provisions of this standard after taking into account the amount recognized, if any, for the same for any previous year ending on or before March 31, 2016

Disclosures

- Disclosures under this ICDS are fairly extensive, and need to be made for each class of provision and asset. They are however similar to the disclosures required under AS 29 and under Ind AS 37

- Reference in relation to assets and related income should be considered only in relation to recognition of contingent assets as assets, and not to all assets, since the ICDS deals only with contingent assets

Difference between AS 29 and ICDS X

ICDS X	AS 29
• Provisions shall be recognised if it is **reasonably certain** that outflow of economic resources will be required	• Provisions shall be recognised if it is **probable** that outflow of economic resources will be required
• It is not applicable to “executory contracts”. • However, "onerous contracts" are not specifically excluded from executory contracts	• Since "onerous contracts" are excluded from executory contracts, AS 29 is applicable to onerous contracts • Requires upfront recognition of liabilities under onerous contracts
• Contingent assets/ reimbursement claims to be recognized if inflow of economic benefits / reimbursements is **reasonably certain**	• Contingent assets / reimbursement claims are recognized if inflow of economic benefits/ reimbursement is **virtually certain**

- Guidelines prescribed in ICDS X and AS 29 differs significantly from the guidelines laid down in Ind AS 37 (in respect of definition of provision and includes legal and constructive obligation) though the disclosure aspects related to provisions and contingent liabilities are similar

Items covered

Possible items	Possible items
Provision for warranties - subjected to fair valuation	Provision in respect items covered under Section 43B
Provision for expected losses from contract – for further performance	Provision for ESOP expenses – provided as per IND AS
Provision for year-end expense - Ascertained liabilities, gratuity/ leave encashment	Interest on income tax refund - covered in ICDS IV
Provision for litigation expense (recognized in the books)	Sales tax/service tax refund claim – whether contingent asset
Provision for estimated credit loss	FV adjustment entries under IND AS

Case Study

Issue

- Company Y creates provision for asset retirement obligation, ie it provides for contractual/ statutory liability of decommissioning of an asset

- Since the liability is created in the current year, being revenue in nature, can it be claimed as deduction?

ICDS

- A provision shall be recognized when:

  – a person has a present obligation as a result of a past event

  – it is reasonably certain that an outflow of resources embodying economic benefits will be required to settle the obligation; and

  – a reliable estimate can be made of the amount the obligation

Analysis

- Above conditions would be satisfied for decommissioning liability. Though an actual outflow of cash could not be determined at the time of provisioning, a reliable estimate can be made and hence, it should be possible to claim a deduction

- Various courts have also held that provision for decommissioning liability is deductible under Section 37(1) of the Act

Thank you

Annexures

ICDS specific changes notified in ITR (1/2)

Schedule ICDS	Effect of Income Computation Disclosure Standards on profit	
Sl. No.	ICDS	Amount
(i)	(ii)	(iii)
I	Accounting Policies	
II	Valuation of Inventories	
III	Construction Contracts	
IV	Revenue Recognition	
V	Tangible Fixed Assets	
VI	Changes in Foreign Exchange Rates	
VII	Government Grants	
VIII	Securities	
IX	Borrowing Costs	
X	Provisions, Contingent Liabilities and Contingent Assets	
11.	**Total Net effect (I+II+III+IV+V+VI+VII+VIII+IX+X)**	

ICDS specific changes notified in ITR (1/2)

Part A- OI **Other Information** *(optional in a case not liable for audit under section 44AB)*

1	Method of accounting employed in the previous year *(Tick)* ☑	☐ mercantile ☐ cash		
2	Is there any change in method of accounting *(Tick)* ☑	☐ Yes ☐ No		
3	Effect on the profit because of deviation, if any, as per Income Computation Disclosure Standards notified under section 145(2) [column 11(iii) of Schedule ICDS]		3	
4	Method of valuation of closing stock employed in the previous year			
	a	Raw Material (if at cost or market rates whichever is less write 1, if at cost write 2, if at market rate write 3)		☐
	b	Finished goods (if at cost or market rates whichever is less write 1, if at cost write 2, if at market rate write 3)		☐
	c	Is there any change in stock valuation method *(Tick)* ☑ ☐ Yes ☐ No		
	d	Effect on the profit or loss because of deviation, if any, from the method of valuation prescribed under section 145A	4d	

Tax Audit Report and Computation of income

ICDS Impact by
ndeep Jhunjhunwa

ICDS comments in Tax Audit Report

Draft tax comp by
ndeep Jhunjhunwa

Draft tax computation