Implementation of IND AS - Impact on Corporate Tax

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Agenda

Introduction, Features and Roadmap

Components of Financial Statements

Impact on income-tax

Liability and Assets

Inventories

Provisions, Contingent Liabilities and Contingent Assets

Key take-aways

Introduction, Features and Roadmap

Indian Accounting Standards (Ind AS)

IFRS Adoption

Implementing in exact form as issued by International Accounting Standards Board (IASB)

Vs

IFRS Covergence

Implementing IFRS with certain departures to suit the country

Ind AS – India perspective

Companies (Indian Accounting Standard Rules), 2015

IFRS + Carve-outs = IND-AS

Has carve outs and carve ins as compared to IFRS

New standard on revenue recognition incorporated

Salient features of IFRS converged Ind AS

- Principle-based Standards
- More importance to concept of <u>'substance over form'</u>
- Reliance on <u>fair valuation</u>, and measurements on <u>time</u> value of money
- Require <u>more disclosures</u> of all relevant information and assumptions
- Require higher degree of <u>judgment and estimates</u>
- <u>Restatement</u> of previously issued Financial statements

Roadmap of implementation of Ind AS in India

MANDATORY IMPLEMENTATION OF IND-AS

PHASE I

- Listed Companies or Companies in the process of Listing and having net worth of INR 500 Crores or more (debt or equity, In or outside India listing)
- All other unlisted Companies having net worth of INR 500 Crores or more
- Holding, Subsidiary, Joint venture or Associates of companies covered above

Accounting period beginning from 1 April 2016 with comparatives for March 2016

PHASE II

- Listed Companies or Companies in the process of Listing and having net worth of less than INR 500 Crores or more (debt or equity, In or outside India listing)
- All other unlisted Companies having net worth of INR 250 Crores or more but less than INR 500 Crores
- Holding, Subsidiary, Joint venture or Associates of companies covered above

Accounting period beginning from 1 April 2017 with comparatives for March 2017

VOLUNTARY IMPLEMENTATION

Any company can voluntarily adopt Ind AS from year beginning 1 April 2015 with comparative for 2014-15

KEY MATTERS

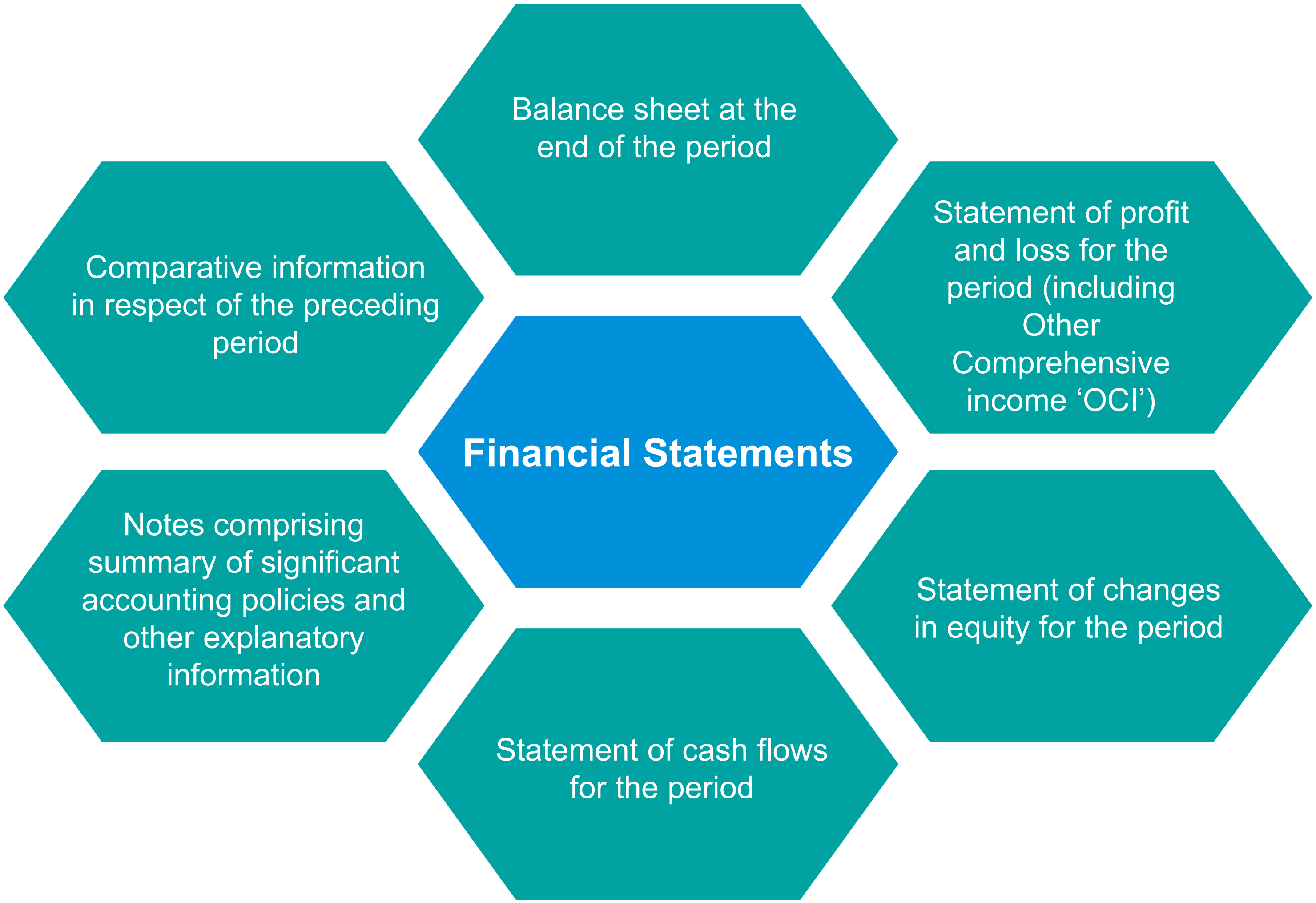
Companies listed in SMEs need not follow Ind AS

Separate roadmap for Banks, Insurance Companies and NBFCs

Once Ind AS is followed, it <u>should be followed for all subsequent years</u>

Components of Financial Statements

Components of IND-AS Financial Statements



Format of Statement of Profit & Loss Account

Statement of Profit and Loss account	Current Period	Previous period
Revenue		
Revenue from Operations		
Other income		
Total Income from operations		
Expenses		
Cost of Materials consumed		
Excise duty		
Purchase of stock-in-trade		
Changes in inventories of finished goods, stock-in-trade and work-in-progress		
Employee Benefit expenses		
Finance cost		
Depreciation and Amortization expenses		
Other expenses		
Total Expenses		

Format of Statement of Profit & Loss Account

Statement of Profit and Loss account	Current Period	Previous period
Profit before tax		
Tax expense (i) Current tax (ii) Deferred tax		
Profit (Loss) for the period from continuing operations		
Profit/(loss) from discontinued operations		
Tax expense of discontinued operations		
Profit/(loss) from Discontinued operations(after tax)		
Profit/(loss) for the period		
Other comprehensive Income		
A. (i) Items that will not be reclassified to profit or loss (revaluation, re-measurement of defined benefit plan etc.) (ii) Income tax relating to items that will not be reclassified to profit or loss		
B. (i) Items that will be reclassified to profit or loss (exchange difference in translation of financial statement of foreign operations) (ii) Income tax relating to items that will be reclassified to profit or loss		
Total comprehensive income for the period		

Impact on income-tax

International view on impact of IFRS on tax computation

UK

- Separate tax legislation that deals with IFRS conversion
- Computation of income is prepared based on domestic tax laws and IFRS adjustments are ignored

Brazil

- Tax rules are largely based on GAAP. As the number of differences between IFRS and GAAP increase, the number of adjustments required increases

Korea

- IFRS adjustments are to be ignored
- Tax computation governed by local tax laws

Nether-lands

- Annual accounts is prepared on the basis of Dutch GAAP, tax return is based on these financials and taking into account business principles

Taxable profit is principally based on the legal entity’s statutory accounts, with adjustments in local tax law

Tax impact calculations - reliance on books of accounts

Forms basis of book profits for MAT taxation

Determination of 'accumulated profits' for the purpose of deemed dividends

Transfer pricing - determination of ALP, comparability, etc.

Ascertaining fair market value for the purpose of taxability under section 56(2)(x) / 50CA

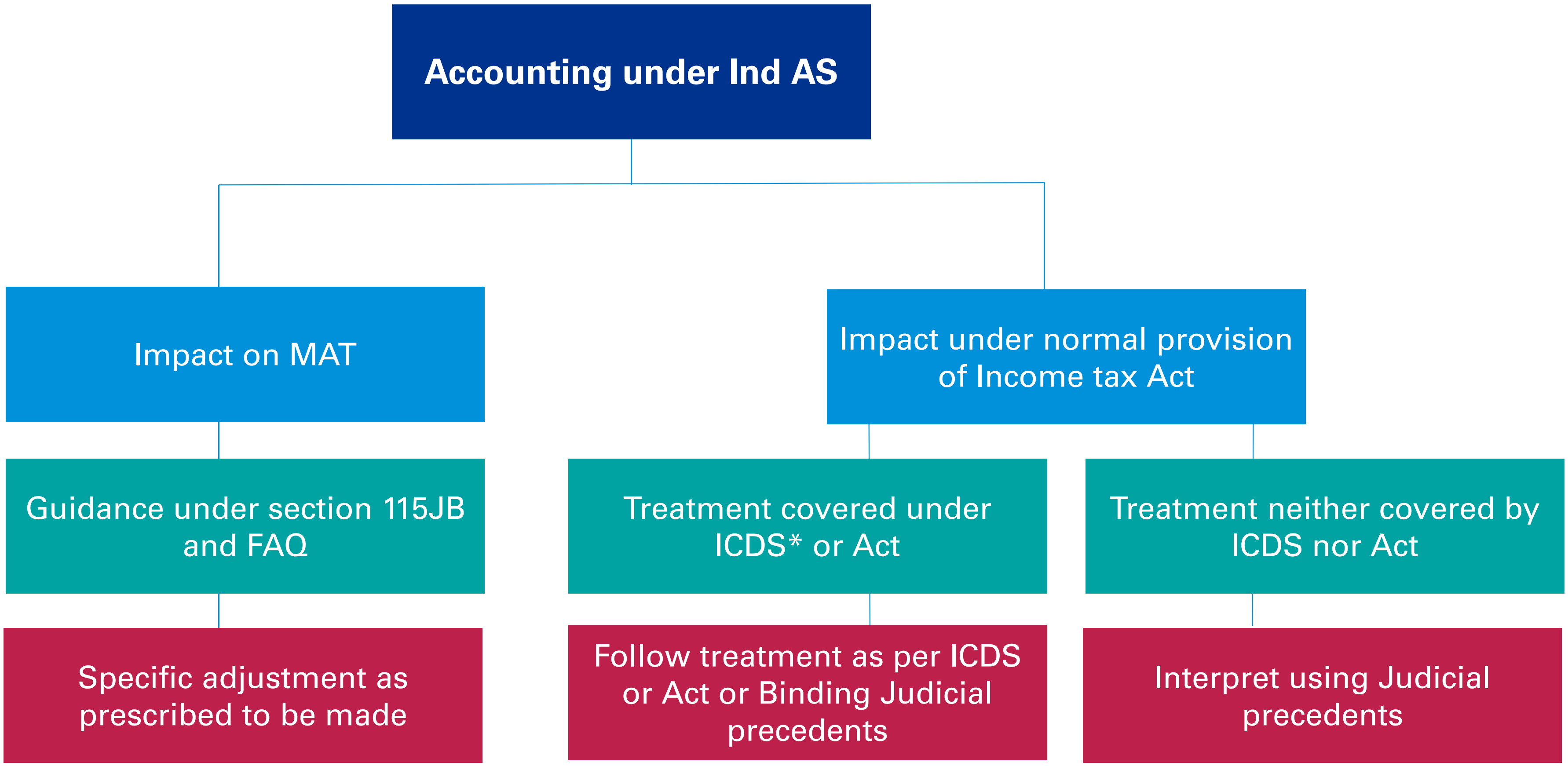
Limits on interest deduction paid or payable to AE

Computation of cost of undertaking under slump sale

Impact on disallowance under section 14A

Properties/ Liabilities are transferred at books values in case of demerger

Interplay between Ind AS and Income Tax



Given statutory recognition from AY 2017-18

Interplay between Ind AS and Income Tax

Key Principles for computing taxable income :

- Business income is computed in accordance with the method of accounting regularly employed by the taxpayer – could be either cash or mercantile / accrual
- Business income as per method of accounting adopted to be adjusted by the specific deductions / allowances / disallowances specified in the Act
- Real income is taxable and not hypothetical income

  – unrealized gains / losses not recognized for tax computation
- Concept of time value of money not recognized
- Notional expenses not allowable. However, provisions are allowed if created on a scientific basis
- Adjustments to be made to accounting profits as per notified Income Computation and Disclosure Standards (ICDS) - effective from FY 2016-17

Profits as computed following Ind AS to be the starting point for computing taxable income and further adjusted in the light of principles stated above

Impact on Income tax - Specific Ind AS

Assets & Liabilities

- Financial Liability and Assets: Ind AS 32, Ind AS 109, Ind AS 107 & Ind AS 113
- Inventories – Ind-AS 2
- Provisions, Contingent Liabilities and Contingent Assets: Ind AS 37
- Property, Plant, Equipment's (IND AS 16)
- Intangible Assets (IND AS 38)

Income and expense

- Revenue recognition - IND AS 115
- The Effect of Changes in Foreign Exchange Rates – Ind-AS 21
- Borrowing cost – Ind-AS 23
- Government Grants (IND AS 20)

MAT Impact

Financial Liability and Assets: Ind AS 32, Ind AS 109, Ind AS 107 & Ind AS 113

Overview of the FI standards -Ind AS 32, 109, Ind AS 107 & Ind AS 113

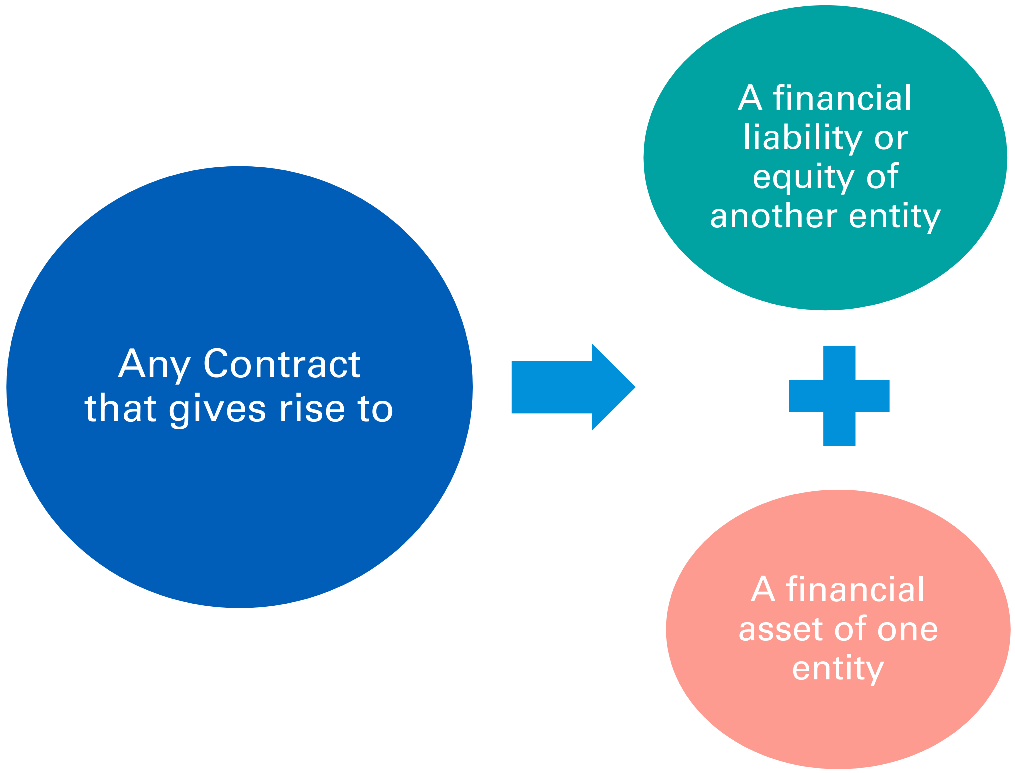
Liability and asset classification
Ind AS 32: FI: Presentation

Recognition and derecognition
Classification & Measurement
Derivatives
Hedge accounting
Ind AS 109- Financial Instruments

Disclosures
Ind AS 107: FI: Disclosures

Fair value measurements- Ind AS 113

Financial Instrument - Definition



Liability or equity: Classification per Ind AS 32

Contractual obligation to deliver cash or another financial asset or exchange financial assets/liabilities under potentially unfavourable conditions

Liability

Residual interest in the assets of the enterprise after deducting its liabilities

Equity

Substance over form

Preference shares – financial liability or equity?

Preference shares to be classified as a financial liability if all the following conditions are met:

- they are redeemable on a specific date
- they are redeemable at the option of the holder
- Issuer obligated to make payments in form of interest or dividend

Related dividend will appear above the line in the profit and loss account

Substance over form or legal structure?

Substance over Form

Accounts and the accounting method followed by an assessee continuously for a given period of time needs to be presumed to be correct till the AO comes to the conclusion for reasons to be given that the system does not reflect true and correct profits;

CIT vs. Woodward Governor (Supreme Court)

Legal Form

The true effect of accretion made pursuant to the contract has to be judged not by artificial rules but from the intention of the parties to the contract….

State of Andhra Pradesh v. Kone Elevators India PVt. Ltd (Supreme Court)

Two exceptions are noted for recharacterisation for transaction where (i) where the economic substance of a transaction differs from its form and (ii) where the form and substance of the transaction are the same but arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner.

EKL Appliances Ltd (Delhi High Court)

Convertible loans - expense dividend or interest?

Finnish Supreme Court

- The taxpayer was a Finnish company (FI Co) which was 95.7% owned by a company resident in Luxembourg (LU Co).
- In 2009, FI Co received a loan of EUR 15 million from LU Co and wanted to deduct EUR 1,337,500 as interest expenses paid to LU Co.
- The loan was given without any collateral and did not have any provisions for repayment by a definite date. The interest rate was fixed at 30% and the interest was added to the principal. The loan could be paid back only upon FI Co's request and was under IFRS accounting rules treated as equity (hybrid loan).
- The Finnish tax authorities recharacterized the loan as equity investment and consequently, disallowed the interest deduction.

Issue

Whether the loan could be re-characterized as equity investment and, consequently, the interest paid for such loan could be disallowed.

Amortised cost and effective interest method

Amortised cost	=	Initial recognition amount	-	Cash received	-/+	Interest income / expense	-	Impairment

Amortised cost is calculated using the **effective interest rate** method

Example

1. Loan of Rs. 1000 received after reducing upfront fees of Rs. 100.
2. The loan is repayable after 2 years, without payment of interest.
3. Assuming interest discounting rate of 10% p.a., the amortised cost of Rs. 900 (Rs. 1000 – Rs. 100) would be at Rs. 744.
4. Balance amount i.e. Rs. 156 (900-744) would be considered as interest.

Financial liabilities treatment

Instrument	Indian GAAP	Ind AS	Tax/ MAT
Non-convertible debentures Term loans / CC /OD Trade payables	• No specific accounting standard • Fees / costs paid on origination recognized as expense upfront	• Classified at amortised cost • Interest expense recognized based on effective interest rate resulting into amortization of upfront fees / costs	• Actual interest expense deductible on accrual basis subject to the provision of section 36(1)(iii) of the Act • Notional interest expense to be disallowed. • The deductibility of issue expenses (i.e. fees etc.) should be dealt with basis the basic principle of taxation (i.e. accrual) and the prevailing judicial precedents • No adjustment to be made in MAT computation (including for notional interest).
Convertible Preference shares	• No specific accounting standard • Fees / costs paid on origination recognized as expense upfront	• May be treated as a compound instrument- requirement to split between equity and liability component • Interest expense recognized based on effective interest rate resulting into amortization of upfront fees / costs	• Any amount debited to profit and loss account towards interest or dividend to be disallowed. • Issues expenses, such as fees/ costs, etc. to be disallowed under normal tax computation. • Under MAT - Dividend/ interest debited to be added back to the Book profit (FAQ-8).

Financial Asset is

Cash

An equity instrument of another entity

A contractual right to

Receive cash or other financial asset or	Exchange financial assets or financial liabilities with another entity **under conditions that are potentially favourable to the entity**

Certain contracts that may be settled in the entity's own equity instruments

Initial Measurement

Financial Asset

Financial Liability

Fair value on initial recognition

Transaction Costs : For any asset that is not measured at FVTPL, the initial value will include transaction costs.

FVTPL
Immediate expense

FVTOCI
Transfer to OCI
and
Disposal or impairment

Financial Assets
At amortized cost

Using effective interest rate

Financial Liabilities
at amortized cost

Using effective interest rate

"Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

Case study - Loan to Subsidiaries at less than market rate

Ind AS

Accounting of loan to Subsidiaries

- A two year interest free loan of INR 1,000 to a subsidiary is re-casted in books of accounts to recognize INR 900 as principal and INR 100 as interest

In the books of Parent

Accounting of loan to subsidiaries as per Ind AS		
Loan to Subsidiary account Dr	900	
Investment in Subsidiary account Dr	100	
To Bank account Cr		1000

Accounting of interest income (yearly)		
Loan to Subsidiary account Dr	50	
To Interest income account (Interest income recognized every year for 2 years)		50

In the books of Subsidiary

Accounting of loan from holding company as per Ind AS		
Bank account Dr	1000	
To Loan from Parent Dr		900
To Equity account Cr		100

Accounting of interest expense (yearly)		
Interest expense Dr	50	
To Loan from parent account Cr (Interest expense recognized every year for 2 years)		50

Income & Expenses - Factors to be tested

Income

- Whether defined under the Act – Section 2 (24)?
- Whether covered by deeming provisions?
- Whether represents accrual in wealth or increase in profits?
- Whether represents real profits?

Expenses

- Whether represents actual outgo?
- Whether can be categorized as losses?
- Whether allowable on deemed basis?
- Whether merely an accounting entry?

Interplay between Ind AS and Income Tax - Certain issues

Issue 1:

If Ind AS results in notional income or expenses to be recognized in the P&L Account and there is no specific guidance under the Act / ICDS, what treatment to be adopted?

Solution:

The SC vindicated this position in the case of **C.I.T. v. Shoorji Vallabhdas & Co.** holding as under –

"Income-tax is a levy on income. No doubt, the Income-tax Act takes into account two points of time at which the liability to tax is attracted, viz. the accrual of the income or its receipt; ***but the substance of the matter is the income. If income does not result at all, there cannot be a tax, even though in book-keeping, an entry is made about a hypothetical income, which does not materialise****. Where income has, in fact, been received and is subsequently given up, in such circumstances that it remains the income of the recipient, even though given up, the tax may be payable.* ***Where, however, the income can be said not to have resulted at all, there is obviously neither accrual nor receipt of income, even though an entry to that effect might, in certain circumstances, have been made in the books of account.****"*

Thus, based on above argument it is clear that <u>Notional Income or notional expenses cannot be taxed or allowed under Income Tax</u>

Real expenditure or Notional expenditure

What is material for the purpose of section 145 is, the method to be such that the real income, profit and gain can be properly deduced therefrom. If the method adopted does not afford true picture of profit, it would be rejected, but then such rejection should be based on cogent evidence and would be done with caution.

Sanjeev Woollen Mills (Supreme Court)

Real income

Expenditure relates to something paid out or spent which indicates a sort of volition, something which comes out of the pocket and spent.

CIT v. S.C. Kothari, (1971) 82 ITR 794, 801-2 (SC)

Paid or spent

Neither a debit for a notional amount

K. Sankaranarayana Iyer & Sons v. CIT, (1980) 14 CTR (Mad) 219, 220

No notional amounts

Interplay between Ind AS and Income Tax - Certain issues

Issue 2:
Can assessee choose one method for accounting and a different method for tax purposes?

Possible Views subject to ICDS specific adjustments:

View 1 : Assessee has option to choose ICAI AS for tax purpose

View 2 : Assessee has to mandatorily follow Ind AS for tax purpose

Analysis:

Under Income-tax Act, Sec. 44AA & 44AB takes care of requirement to maintain books of accounts & tax Audit

Landmark Judgment of Hon'ble SC in United Commercial Bank vs. CIT held that

- Books of accounts prepared in statutory form may not be decisive and conclusive in determining real income;
- Preparation of Balance Sheet in accordance with statutory provision would not disentitle assessee in submitting income tax return on the real taxable income

- Further, Cos. Act cannot override taxability based on accounting
- Thus, if real income can be obtained from ICAI AS, one may opt for the same

Practical points for consideration :

- Separate set of ICAI AS needs to be prepared
- Without audited figures, it would be difficult to prove authenticity of accounts prepared as per ICAI AS when asked by tax authorities
- Also, if tax authorities accept the books as per ICAI AS, reconciliation may be asked by tax authorities
- Thus, better view is to follow Ind AS treatment in practical scenario

Financial Assets- Measurement (1/2)

<table>
<tr><th>Instrument</th><th>Indian GAAP</th><th>Ind AS</th><th>Tax / MAT</th></tr>
<tr><td>Equity shares (excluding subsidiaries, associates and JV)</td><td rowspan="5">• Current investments at lower of cost and fair value and long term investments at cost less other than temporary diminution</td><td>• FVTPL
• Irrevocable choice to classify as FVOCI</td><td rowspan="5"><u>Income Tax-</u>
<u>Stock in Trade/ Current investment (i.e. FVTPL)</u>
• FV loss computed category wise allowed as deduction (part A of ICDS VIII) under the head business income
• FV gain to be disregarded. Subsequent FV loss (to the extent of FV gain disregarded in the past) to be ignored
<u>Securities held as capital assets/ non-current investments (i.e. FVOCI or amortized cost)</u>
• FV through OCI should be disregarded for computing the income under the head 'Business Income'
• Any cost incurred for acquiring capital asset/ investment be added to the cost of capital asset/ investment. Amortised cost, if any, to be added back in the computation.
• Actual gain/ loss taxable as LTCG / STCG on transfer of securities/ assets depending upon the period of holding
<u>MAT-</u>
• No adjustment required for MTM gain/ loss recognized through profit and loss account (FVTPL) (FAQ-1)
• Any amount credited/ debited towards FV through OCI under 'Items that will not be re- classified to P/L (except for gains/ losses from investments in <u>equity instruments designated at fair value through OCI)</u> to be added/ reduced for computing MAT liability
• Impact of gains/ losses from investments in equity instruments to be considered for MAT in the year of disposal/ retiring, etc. of such equity instruments</td></tr>
<tr><td>Preference shares</td><td>• Amortised cost; or
• FVTPL
Based on the terms e.g. redemption, conversion</td></tr>
<tr><td>Non convertible bonds / Government securities</td><td>• Amortised cost; or
• FVTPL; or
• FVOCI
Based on the terms e.g. redemption, conversion</td></tr>
<tr><td>Convertible debentures</td><td>• FVTPL</td></tr>
<tr><td>Mutual funds, VC Funds</td><td>• FVTPL</td></tr>
</table>

Financial Assets- Measurement (2/2)

Instrument	Indian GAAP	Ind AS	Tax / MAT
Others, e.g. Trade receivables, loans and advances, deposits	No specific requirement, generally at cost less any impairment	Generally amortised cost	The deductibility/ taxability of the cost/ amortised cost should be dealt with basis the basic principle of taxation (i.e. accrual).

Expected Credit Losses ('ECL') - Taxation

Banks, NBFCs, Financial Institution/ Corporation

Deduction allowable in accordance with the provision of section 36(1)(vii) and (viia) of the Act.

Other Companies

Provision towards ECL to be disallowed

Write-off, if any, should be deductible under section 36(1)(vii) r.w.s 36(2) of the Act.

MAT – to be added back to the book profit under clause (i) of Explanation 1 to section 115JB(2)

Inventories: Ind AS 2

Measurement

Initial Measurement

At

Cost

Subsequent Measurement

At Lower of

Cost | **Net realisable value**

Include:

- All costs of purchase
- Costs of conversion / production
- Other costs incurred in bringing the inventories to their present location and condition

Exclude:

- Trade discounts, rebates and similar items
- **Financing element of deferred settlement beyond normal credit terms**

Key differences between IGAAP, Ind AS & ICDS

Particulars	Indian GAAP	Ind AS	ICDS
Deffered Settlement basis (Credit facility)	• No guidance	• Excess over normal price is to be accounted as interest over the period of financing	• ICDS is also silent on deferred settlement basis. • Definition of interest under Section2(28A) of the Income Tax Act, 1961, inter alia, includes interest payable in respect of credit facility which has not been utilized. • Interest expense to be separately claimed as an deduction?

Points for consideration

- Legal form of the transaction – The Sale of Goods Act
- Withholding tax on interest
- Multiple reconciliations – Income Tax Act, GST, Ind AS books

Provisions, Contingent Liabilities and Contingent Assets: Ind AS 37

Scope

Applies to all entities in accounting for provisions, contingent liabilities and contingent assets

Excludes

- Resulting from executory contracts, unless they are onerous; or
- Covered by another standard, e.g.:
  - Financial instruments (Ind AS 109)
  - Employee benefits (Ind AS 19)
  - Income taxes (Ind AS 12)
  - Leases (Ind AS 17)
  - Business combinations (Ind AS 103)

Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent

Key differences between IGAAP, Ind AS & ICDS - Provisions

Particulars	AS 29	Ind AS	ICDS/ Tax impact
Recognition of provisions	• A provision is recognised only when a past event has created a legal or constructive obligation, an outflow of resources is probable, and the amount of the obligation can be estimated reliably.	• A provision shall be recognised when all of the following conditions are met: a) an enterprise has a present obligation as a result of a past event; b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and c) a reliable estimate can be made of the amount of the obligation.	• As per ICDS, Provisions shall be recognised if it is reasonably certain that outflow of economic resources will be required. • Provision is not discounted to NPV • The criteria for recognition of provisions on the basis of the test of 'probable' (i.e. more likely than not criteria) replaced with the requirement of 'reasonably certain'. • In the absence of definition and scope of 'reasonably certain' criteria, an ambiguity would arise on assessment of 'reasonably certain' criteria. • In the Act, there is no specific provision for recognition of provisions. However, provisions are allowed based on accrued liabilities as per ordinary principles of commercial accounting.

Provision for Warranty is allowed as an expenditure upholding the test of 'probable' warranty obligation in the following judgments.

- Rotork Controls India P. Ltd. (2009) 314 ITR 62 (SC)
- Himalaya Machinery (P) Limited v DCIT 334 ITR 64
- CIT vs. Luk India P. Ltd. 52 DTR 117.
- Siemens Public communication Networks Limited v CIT
- CIT v Indian Transformer Limited. 270 ITR 259

Constructive Obligation

Meaning

An obligation derived by an established '***pattern of past practice***' or a '***sufficiently specific current statement***' or an obligation created by a ***'valid expectation'***

Cases	IGAAP	IND AS
Announcement of Voluntary Retirement Scheme ('VRS')	Provision will be created when agreement is in place	Provision will be created when it is announced to the public
Publishing clean up policy	Provision to be created only when contractual obligation is created	Provision to be created when a policy has been communicated to the concerned parties

Deduction of Constructive Obligation

Provision shall be deductible only if it is created scientifically. Whether such provision is created out of an obligating event or constructive obligation, it shall be deductible only if it is scientifically made.

Case study - Discounting of provisions

- Ind AS 37 mandates creation of provision considering time value of money.
- Discounting of provisions is required in such a scenario.

Accounting under IGAAP		
Expense account Dr	100	
To Provision account Cr		100

Accounting under Ind AS for creation of provision		
Expense account Dr	90	
To Provision account Cr		90

Accounting under Ind AS for interest charge YoY		
Interest account Dr	4	
To Provision account Cr		4

?

Whether for tax computation, provision to be considered at discounted value or at the original value (i.e. Without considering the discounted factor)

Key take-aways

Key take-aways

Real Income

- Difference in “accounting accrual” and “tax accrual”
- Only real income taxable as per section 4/ 5 of the Act

Evaluate

- Every amount debited/ credited to profit and loss account to be evaluated to determine the tax impact

Reconcile

- Reconcile the stand for the tax purpose vis-a-vis the disclosures made in the financial statements

Parallel Records

- The tax treatment relating to financial instruments will require companies to maintain memorandum accounts for control purpose

Any Questions?

Questions

&

Answers

Thank You

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