INCOME COMPUTATION AND DISCLOSURE STANDARDS (ICDS)

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16 JULY 2016

Overview of ICDS

ICDS implementation in India – Story so far

1996

The Central Government notified two accounting standards under section 145(2) of the Income Tax Act, 1961 (the IT Act).

December 2010

The CBDT constituted AS Committee to suggest the following :

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

October 2012

- Final report of the Committee with 14 draft ICDS
- Comments invited from public on the Draft ICDS

July 2014

- Finance Bill 2014 amended section 145(2) of the IT Act. ICDS applicable from FY 1 April 2015
- ICDS to be notified separately

January 2015

- CBDT issued 12 draft ICDS, after incorporating suggestions by stakeholders and providing transitional provisions
- The draft ICDS were open for comments and suggestions till 8 February 2015

March 2015

- 10 Final ICDS notified on 31 March 2015
- Draft ICDS on leases and Intangible not notified
- Applicable from AY 2016-17

All legal entities in India would be required to comply with ICDS from 1 April 2015

Notified ICDS

- Accounting Policies
- Inventories
- Construction contract
- Revenue Recognition
- Tangible Fixed Assets
- Effects of changes in Foreign Exchange Rates
- Government Grants
- Securities
- Borrowing costs
- Provisions, Contingent Liabilities and Contingent Assets

ICDS- An Overview

- ✓ **Applicable to 'All' assesses following mercantile basis of accounting - no threshold of turnover/income**
- ✓ **Applicable for computation of income chargeable to income-tax under the head 'Profits and gains from business or profession' or 'Income from other sources'**
- ✓ **Applicable from AY 2017-18 – quarterly tax provision and advance tax as per ICDS to avoid interest**
- ✓ **Lay down certain rules to ensure certainty and clarity - eliminate alternatives to the extent possible**
- ✓ **Current Accounting Standards are taken as a base - however the objective was to provide an independent framework for tax computation**
- ✓ **Separate books of account not required to be maintained**
- ✓ **Various disclosure requirements – silent about the placement of various disclosures e.g. financial statements (separately), computation of income or return of income, etc.**

In case of conflict between the provisions of the Act and ICDS, the provisions of the Act shall prevail to that extent

ICDS- Press Release by CBDT for deferral

Relevant Extract of the Press Release dated 6 July 2016

1. Vide Notification No. SO 892 (E) dated 31st March, 2015, Central Government notified 10 Income Computation and Disclosure Standards (ICDS). These ICDS are applicable from 1.4.2015 i.e. previous year 2015-16 (Assessment Year 2016-17). Subsequent to notification of the ICDS, **a number of representations were received which were examined by an Expert Committee. The Committee has recommended amendments to the notified ICDS and also issuance of clarification in respect of certain points raised by the stakeholders.**

2. **The revision of ICDS/issue of clarifications as recommended by the Committee, is under consideration. The revision of the Tax Audit Report is also being made for ensuring the compliance with the provisions of ICDS and for capturing the disclosures mandated by the ICDS**.

3. Some of the tax payers might have filed their return of income and obtained Tax Audit Report without incorporating the compliance with the ICDS and related disclosures in the absence of the revised Tax Audit Report. Considering these facts, it has been decided that the ICDS **shall be applicable from 1.4.2016 i.e. previous year 2016-17 (Assessment Year 2017-18)**. The notification to this effect will be issued shortly.

ICDS - Key Impact Areas

Can ICDS go beyond the meaning of ‘income’, as defined and understood?

✓ In the scheme of the Act, income is identified or recognized or determined as per the provisions of S. 4, 5, 14 and Chapter IV as well as definition of ‘income’

✓ The recording of income and the method to be adopted in the books of account are provided in S. 145, a procedural provision

- The method of accounting, inter-alia, involves quantification
- ICDS deals only with quantification and disclosure
- Its scope and ambit is limited and not as wide as AS & GAAP
- ICDS recognize the above in its nomenclature, preamble and otherwise

✓ Revenue authorities may contend that ICDS being in relation to ‘income computation’, it is framed to give effect to the provisions of S. 29

- Possible to contend that ICDS is a child of S. 145 and not Chapter IV

✓ ICDS can be said to override at least quantification of income or expenditure, where a specific provision is made for determination of amount thereof

Identification & recognition as income ought to be decided by the provisions of the Act and not ICDS

ICDS - Key Impact Areas

Whether SC decisions are affected by ICDS?

✓ Article 141 of the Constitution of India provides that the law declared by SC shall be binding on all Courts in India

- The SC explains the provision of the Act

✓ All SC decisions dealing with identification, recognition, determining the nature of receipt, etc. should continue to govern the computation of total income

- ICDS may apply in respect of quantification of income

✓ ICDS may have impact on those decisions which relied on commercial principles and accounting practices then followed e.g.:

- Woodward Governor India Private Limited [(2009)(312 ITR 254)(SC)]

ICDS should not affect the principles laid down by SC decisions – except those decisions which relied on commercial principles and accounting practices then followed

ICDS I – Accounting Policies

Scope of ICDS I – Accounting Policies

- **ICDS I deals with accounting policies and covers the following areas :**

Fundamental Accounting Assumptions

- Going Concern;
- Consistency; and
- Accrual

Also covers

- Accounting Policies;
- Considerations in selecting Accounting Policy; and
- Disclosure of Accounting Policies

Comparison of AS – 1 with ICDS I

Particulars	As per Act	As per ICDS I
Fundamental Accounting Assumptions	• As per AS – 1 following are the fundamental accounting assumptions that underlie the preparation and presentation of financial statement: o Going concern o Consistency o Accrual	• No change in ICDS I - it also recognize the following fundamental accounting assumptions: o Going concern o Consistency o Accrual
Consideration in selection of Accounting Policy	• Selection of accounting policy should represent a true and fair view of the state of the affairs of the enterprise. • Following are the major consideration governing the selection and application of accounting policy: o Prudence o Substance over form; o Materiality	• ICDS-I also states that accounting policies adopted by a person shall be such as to represent a true and fair view of the state of affairs ***and income of the business, profession or vocation*** • Following aspects also mentioned : o Treatment for transactions and events shall be governed by substance and not form o ***Mark to Market loss and Expected Loss shall not be recognized*** unless it is in accordance with the provisions of any other ICDS • ***Impliedly, the principle of Materiality and Prudence removed from ICDS I***

Comparison of AS – 1 with ICDS I

Particulars	As per Act	As per ICDS I
Change in Accounting Policy	• As per AS - 2, notified under section 145(2) of the Act, a change in accounting policy should me made only if: o Required by statute; and o Result in more appropriate preparation and presentation of the financial statement	• Shall not be changed without a reasonable cause
Disclosure of Accounting Policies	• All significant accounting policies shall be disclosed. However disclosure cannot remedy a wrong or in inappropriate treatment • Change in accounting policy having a material effect shall be disclosed along with impact of the change. If change is not ascertainable then that fact shall be indicated • If change in accounting policies does not have material impact in the current period but in later year then it shall be appropriately disclosed in the period in which change is adopted	• There is no change in ICDS – I except the following: o If change in accounting policies does not have material impact in the current period but in later year then it shall be appropriately disclosed in the period in which change is adopted ***and in which change has material impact for the first time.***

Concept of Prudence

- ICDS I does not allow ***Mark to Market ('MTM') losses*** and ***Expected Losses*** to be recognized unless specifically permitted by any other ICDS (e.g. MTM forex loss on monetary items covered under ICDS VI, inventory valuation loss covered under ICDS II and III.)
- As per Accounting Standard ('AS') 1 – 'Disclosure of Accounting Policies', the concept of 'Prudence' means
  - income to be recognized on realization and not anticipation
  - All known liabilities and losses to be recognized on estimation even though the amount cannot be determined with certainty
- ICDS I is silent on treatment of MTM gain

Items affected	Impact on Tax position	
	Pre –ICDS	Post ICDS
MTM Loss / Gain	Please refer case study for impact analysis	
Expected Loss	• ***Allowed*** where there is a reasonable certainty of its incurrence • Treated as ***crystallized liability*** when outflow of economic resource in settlement of present obligation is anticipated with reasonable accuracy • Examples of crystallized liability are loss on onerous contracts	• ***Specifically not allowed*** • Will ICDS overrule the judicial precedents which have held that expected losses are crystallized liability and hence should be allowed?

Concept of Materiality

Concept of Materiality

- ICDS I has impliedly eliminated the concept of Materiality
- Erstwhile, Tax Accounting Standard I notified u/s.145(2) was aligned to ICAI AS –I and permitted 'Materiality' as a consideration for selecting and applying accounting policy
- Write off of 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 Authority insists on strict application of ICDS

Change in Accounting Policy

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

<table>
<tr><th rowspan="2">Items affected</th><th colspan="2">Impact on Tax position</th></tr>
<tr><th>Pre – ICDS</th><th>Post ICDS</th></tr>
<tr><td>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 especially for real estate developers</td><td>• As per AS 2, notified under section 145(2) of the Act, a change in accounting policy should me made only if:

o Required by statute; and

o Result in more appropriate preparation and presentation of the financial statement</td><td>• Test of reasonable needs to be satisfied.
• Following are the illustrative examples of reasonable cause :
o To represent true and fair view
o To meet statutory requirement
o More appropriate preparation and presentation of financial statements
o Reasonable person considers just and acceptable under normal circumstances
o Commercial or business need which will result into appropriate and fair presentation of transaction</td></tr>
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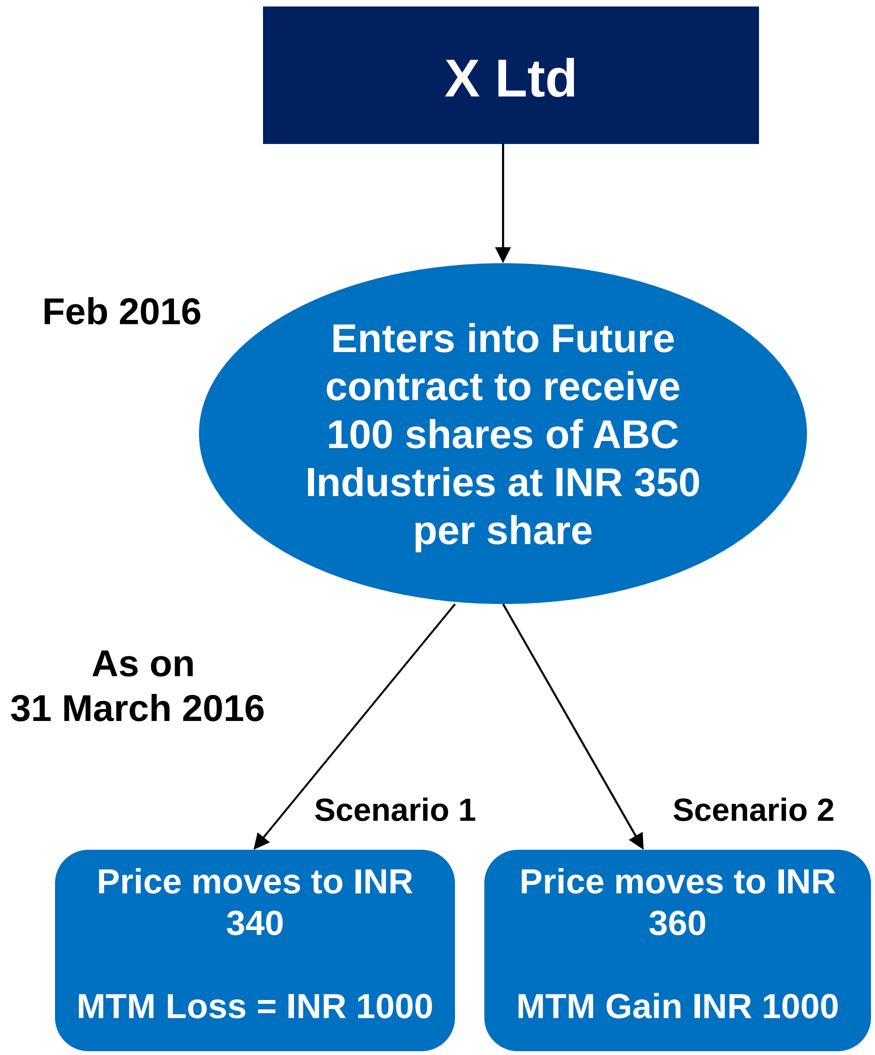
Case Study – Prudence



Facts

- X Ltd buys a three month futures contract on the stock exchange in February 2016 which entitles him to receive 100 shares of ABC Industries at a price of INR 350 per share.
- Contract will expire in April 2016. As on 31 March 2016 there could be following two scenario :
- **Scenario 1**
  - o Price of shares is INR 340
  - o X Ltd incurs a notional loss of INR 1,000 [100 shares multiplied by difference of INR 10 (i.e. INR 350 less INR 340) per share]
- **Scenario 2**
  - o Price of shares is INR 360.
  - o X Ltd earns a notional gain of INR 1,000 [100 shares multiplied by difference of INR 10 (INR 360 less INR 350) per share]

Case Study – Prudence

Tax Treatment under both the Scenarios

Scenario	Treatment in Books	Tax Treatment	
		Pre -ICDS	Post ICDS
Scenario I MTM Loss of INR 1,000	• ***Recognized in the books*** by applying the concept of prudence	• ***MTM Loss is allowed*** • SC in the decision of Woodward Governor allowed the MTM Loss by relying on the principles of commercial accounting (i.e. prudence) unless superseded or modified by legislature	• ***Not allowed*** as per ICDS I. • Whether ratio of Woodward Governor is superseded by ICDS I? • ***Taxable income is higher by INR 1,000 than book profit***
Scenario II MTM Gain of INR 1,000	• ***Not recognized in books*** by applying concept of prudence	• ***Not taxable*** as it is only notional profit • Income is taxable only when right to receive that income arises • The above view is supported by various judicial precedents	• ***ICDS is silent on it*** • Whether reliance could be placed on various judicial precedents wherein Courts have held that MTM Gain is notional income and hence should not be taxable? • ***Taxable income will be same as per book profit***

ICDS II – Valuation of Inventories

Scope of ICDS II – Valuation of Inventories

Inventories defined as assets

- Held for sale in ordinary course of business
- In the process of production for such sale
- In the form of materials or supplies to be consumed in production process or rendering of services

Exclusions

- WIP under construction contract / other ICDS,
- Shares, debentures and Financial instrument held as stock-in-trade
- Producer's Inventories of livestock, agriculture, etc to the extent measured at NRV
- Machinery spares which can be used in connection with Tangible Assets – irregular in use

Permitted valuation methods

- FIFO, weighted average, retail method or specific identification method
- Dispensation of standard costing method

Scope of ICDS II – Valuation of Inventories

Other key points

- Lower of cost or NRV – goods as well as services
- Method of valuation once adopted cannot be changed without reasonable cause
- Distribution cost excluded
- Cost of services in case of service provider to include cost of labour, supervision, personnel and attributable overheads
- In case of newly commenced business, cost of inventory on the date of commencement of business shall be the opening inventory
- Value of Opening inventory to be same as the value of closing inventory of the immediate preceding year

Prospective from the date of transition
Transition provision only to the extent of borrowing cost

Position Pre and Post ICDS

Pre ICDS

- No concept of valuation for services
- Judicial precedents – both sides - opening stock could / could not be adjusted in case of change in method of valuation of closing stock
- Judicial precedents permitted *bonafide* change of method if it is as per AS and regularly followed

Post ICDS

- Services to be valued at lower of Cost or NRV
- Distribution cost excluded
- Value of Opening stock to be same as the value of closing stock of the immediate preceding year - *Tax impact in the year of change of inventory valuation*
- No change permitted without reasonable cause –

  Reasonable cause not defined - could create ambiguity

Issues

Issue 1

- Valuation of inventory for service industry – No clarity?

Issue 2

- Section 145A of the Act overrides Section 145 (ICDS) of the Act
- Section 145A states that stock valuation to be done as per method of accounting regularly followed
- Taxpayers regularly following Standard Cost method / including Distribution cost in inventory – Can this be continued post ICDS relying on Section 145A?

Section 145A

Method of accounting in certain cases.

145A. Notwithstanding anything to the contrary contained in section 145,—

- (a) **the valuation of purchase and sale of goods and inventory for the purposes of determining the income chargeable under the head "Profits and gains of business or profession" shall be—**

  (i) in accordance with the method of accounting regularly employed by the assessee; and

  (ii) further adjusted to include the amount of any tax, duty, cess or fee (by whatever name called) actually paid or incurred by the assessee to bring the goods to the place of its location and condition as on the date of valuation.

- Explanation.—For the purposes of this section*, any tax, duty, cess or fee (by whatever name called) under any law for the time being in force, shall include all such payment notwithstanding any right arising as a consequence to such payment;

- (b) interest received by an assessee on compensation or on enhanced compensation, as the case may be, shall be deemed to be the income of the year in which it is received.

Valuation of Inventories in case of service providers

AS- 2	ICDS
• AS-2 does not include Work in Progress ('WIP') arising in the ordinary course of business ***of service providers.***	• Specifies that it does not apply to WIP which is dealt with by other ICDS.

- Valuation of service inventory to be the lower of cost or NRV.
- Cost to include labor and other costs of personnel directly engaged in providing services including supervisory personnel and attributable overheads.
- Difficulty would arise in case of services whose chargeability depends on the success of the service.

Valuation of Inventories in case of Dissolution of Firm/AOP/BOI

- According to ICDS II, in case of dissolution of a partnership firm or association of person or body of individuals, ***notwithstanding whether business is discontinued or not***, the inventory on the date of dissolution shall be valued at the ***Net Realizable Value***.

- This is unfair particularly as there is no specific provision for allowing such NRV as the cost to the successor of the business.

- Also this is contrary to law settled by Apex court in the case of ***Sakthi Trading Co. v. CIT***

Case Laws discussed

A.L.A. Firm v. CIT [1991] 55 Taxman 497 (SC) / 189 ITR 285

- In cases of dissolution of firm, the stock-in-trade will have to be valued at the prevailing market price while preparing the accounts if the business of the firm is discontinued.

Sakthi Trading Co. v. CIT [2001] 118 Taxman 301 (SC) / 250 ITR 871

- If on dissolution of the firm the business is not discontinued, then, the ordinary principle of commercial accounting permitting valuation of stock-in-trade at Cost or Net Realizable value whichever is lower will apply.

ICDS III – Construction Contracts

Scope of ICDS III – Construction Contracts

- ICDS III applies to a ‘contractor’ for a construction contract
- ICDS III defines the term construction contract to mean a “contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use and includes:
  - (a) contract for the ***rendering of services*** which are directly related to the construction of the asset, for example, those for the services of project managers and architects;
  - (b) contract for ***destruction or restoration of assets***, and the restoration of the environment following the demolition of assets. ”
- ICDS III applies to fixed price contracts, cost plus contracts or hybrid contracts (i.e. mix of fixed and cost plus contract)
- ICDS III provides guidelines vis-à-vis application to each construction contract, application to group of contracts and to identifiable components of a single contract.

Whether ICDS III – Construction Contracts applicable to Real Estate Developers and Service Concessioners?

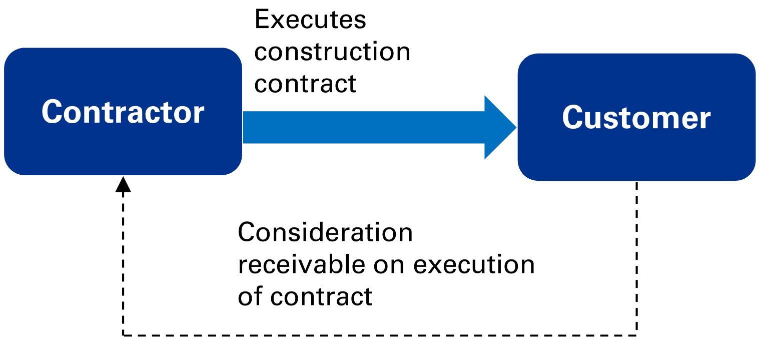
Tax Treatment under Pre-ICDS vis-à-vis Post-ICDS

Sr. No.	Particulars	Tax Treatment under Pre-ICDS	Tax Treatment under Post-ICDS
1	Contract Revenue	• As per AS-7, contract revenue shall comprise of: o initial amount of revenue agreed in the contract; and o 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* • AS-7 does not prescribe inclusion of retention money in contract revenue. • Further, based on various judicial precedents, retention money is taxable on its accrual i.e. on completion of contract or satisfaction of conditions	• As per ICDS III, contract revenue shall comprise of: o initial amount of revenue agreed in the contract ***including retentions;*** and o variations in contract work, claims and incentive payments to the extent *probable* that *they will result in revenue and they are capable of being reliably measured* • Contract Revenue shall be recognized when there is ***reasonable certainty of its collection*** • **Will ICDS override principle laid down by judicial precedents on Accrual?**
2	Contract Costs	• As per AS-7, contract cost shall comprise of: o costs that relate directly to the specific contract; o costs that are attributable to contract activity in general and can be allocated to the contract; and o such other costs as are specifically chargeable to the customer under the terms of the contract.	• As per ICDS III, contract cost shall comprise of: o costs that relate directly to the specific contract; o costs that are attributable to contract activity in general and can be allocated to the contract; o such other costs as are specifically chargeable to the customer under the terms of the contract; and o allocated borrowing costs in accordance with the ***ICDS on Borrowing Costs***

Tax Treatment under Pre-ICDS vis-à-vis Post-ICDS

Sr. No.	Particulars	Tax Treatment under Pre-ICDS	Tax Treatment under Post-ICDS
2	Contract Costs	• As per AS-7, any incidental income shall be reduced from the contract cost. • As per Act, debatable area	• Any incidental income being interest, dividend, capital gains are specifically **not allowed to be reduced** from contract costs.
3	Revenue recognition	• As per AS-7, provides for recognition of revenue basis Percentage of Completion Method ('POCM'). • Where outcome of a construction contract cannot be estimated reliably, the revenue to be recognized to the extent of contract costs incurred • Stage of completion of contract for recognizing contract revenue and contract cost **not prescribed under AS-7**.	• ICDS III provides for recognition of revenue basis Percentage of Completion Method ('POCM'). • During early stages of a contract, where the outcome of the contract cannot be estimated reliably, contract revenue is recognized only to the extent of costs incurred • Early stage of contract **shall not extend beyond 25%** of stage of completion
4	Contract cost relating to future activity	As per AS-7, contract costs relating to future activity on the contract is recognized as an asset **provided that recovery of the contract costs is probable**.	Contract cost relating to future activity are recognized as an asset **irrespective of probability of recovery of contract costs.**
5	Provision for Future/ anticipated losses	• As per AS-7, the provision for future/ anticipated losses are recognized as expenses immediately • Various judicial precedents have held that the provision for future/ anticipated losses should be allowed on prudent basis	• ICDS III is silent on provision for future/ anticipated losses. However, as per ICDS I, an expected loss is not allowed unless it is specifically allowed by other ICDS. Since ICDS III does not contain any specific provision for recognition of expected loss, it should not be allowed.

Case Study 1 – Retention Money



Consideration receivable from customer	
Total Consideration (From Year 1 – Year 4)	INR 100
Retention money receivable at the end of Year 4 on completion of contract	INR 100
Total	**INR 200**

** CIT vs. Simplex Concrete Tiles Pvt. Ltd. [1989] 179 ITR 8 (Cal), CIT vs. East Coast Constructions & Industries Ltd. [2007] 283 ITR 596 (Mad), CIT vs. Associated Cables Pvt. Ltd. [2006] 286 ITR 596 (Bom) and CIT vs. P&C Constructions Pvt. Ltd. [2009] 318 ITR 113 (Mad)*

Facts

- Contractor obtains and executes a construction contract with customer for a total consideration of INR 200
- Contractor to receive INR 100 during the period of construction i.e. Year 1 to Year 4
- Balance consideration of INR 100 i.e. retention money to be received by the Contractor on completion of the construction contract i.e. at the end of Year 4 subject to satisfaction of conditions under the contract.

Position under Pre-ICDS

- Various judicial precedents* have laid down the principle that retention money accrues to the contractor only when there is right to receive such income.
- Basis the above principles, contractor to offer retention money to tax on completion of contract i.e. in Year 4

Position under Post-ICDS

- Under ICDS III, contract revenue to include retention money. Hence, retention money will be taxable on POCM basis if its receipt is probable and the amount of retention money can be reliably measured

Does ICDS override judicial precedents?

Case Study 1 – Retention Money

Position under Pre-ICDS

Particulars	Year 1	Year 2	Year 3	Year 4
Total Contract Revenue (excluding Retention Money)	100	100	100	100
Percentage of Completion (Cumulative)	25%	50%	75%	100%
Cumulative Contract Revenue to be recognised	25	50	75	100
Contract Revenue to be recognised in each year	25	25	25	25
Retention Money taxable in Year 4	0	0	0	100
Total Revenue	25	25	25	125
Taxable Profit earned on Contract @ 20%	5	5	5	25
Tax under Normal Provisions @ 30%	1.5	1.5	1.5	7.5
Tax under MAT Provisions @ 18.5%	0.925	0.925	0.925	4.625
MAT Applicable	**No**	**No**	**No**	**No**

Position under Post-ICDS

Particulars	Year 1	Year 2	Year 3	Year 4
Total Contract Revenue (including Retention Money)	100	100	100	100
Percentage of Completion (Cumulative)	25%	50%	75%	100%
Cumulative Contract Revenue to be recognised	25	50	75	100
Contract Revenue to be recognised in each year	25	25	25	25
Retention Money taxable in Year 1 on POCM basis	**25**	**25**	**25**	**25**
Total Revenue	50	50	50	50
Taxable profit earned on contract @ 20%	10	10	10	10
Tax under Normal Provisions @ 30%	3	3	3	3
Tax under MAT Provisions @ 18.5%	0.925	0.925	0.925	**4.625**
MAT Applicable	**No**	**No**	**No**	**Yes**

Tax Payable
under MAT
in Year 4

Case Study 2 – Revenue recognition not beyond 25% Stage of Completion

Position under Pre-ICDS

Recognition of Contract Revenue				
Particulars	Year 1	Year 2	Year 3	Year 4
Contract Revenue	100	100	100	100
Stage of Completion	25%	50%	75%	100%
Contract Revenue recognized	Nil*	50	25	25

*No revenue is recognized in Year 1 since contractor recognizes revenue only when stage of completion is 30%

Position under Post-ICDS

Recognition of Contract Revenue				
Particulars	Year 1	Year 2	Year 3	Year 4
Contract Revenue	100	100	100	100
Stage of Completion	25%	50%	75%	100%
Contract Revenue recognized	25	25	25	25

Facts

- In the instant case, it is assumed that construction contractor recognizes contract revenue only on completion of 30% of the contract in its books of account
- Under Pre-ICDS, the contractor follows similar policy for recognizing revenue for the tax purpose
- Under Post-ICDS, it is mandatory to recognize contract revenue on completion of 25% of the contract

Case Study 2 – Revenue recognition not beyond 25% Stage of Completion

Position under Pre-ICDS

Particulars	Year 1	Year 2	Year 3	Year 4
Total Contract Revenue	100	100	100	100
Percentage of Completion (Cumulative)	25%	50%	75%	100%
Cumulative Contract Revenue to be recognised	0	50	75	100
Contract Revenue to be recognised in each year	0	50	25	25
Total Revenue	0	50	25	25
Taxable Profit earned on Contract @ 20%	0	10	5	5
Total Book Profits	0	10	5	5
Tax under Normal Provisions @ 30%	0	3	1.5	1.5
Tax under MAT Provisions @ 18.5%	0	1.85	0.925	0.925
MAT Applicable	**No**	**No**	**No**	**No**

Position under Post-ICDS

Particulars	Year 1	Year 2	Year 3	Year 4
Total Contract Revenue	100	100	100	100
Percentage of Completion (Cumulative)	25%	50%	75%	100%
Cumulative Contract Revenue to be recognised	25	50	75	100
Contract Revenue to be recognised in each year	25	25	25	25
Total Revenue	25	25	25	25
Taxable Profit earned on Contract @ 20%	5	5	5	5
Total Book Profits	0	10	5	5
Tax under Normal Provisions @ 30%	**1.5**	1.5	1.5	1.5
Tax under MAT Provisions @ 18.5%	0	**1.85**	0.925	0.925
MAT Applicable	**No**	**Yes**	**No**	**No**

Tax Payable under MAT in Year 2

Case Study 3 – Recognition of Foreseeable Loss

Year	Loss	Unrelated Income	Computation		Comments
			Income Tax	Books of Account	
1	Expected loss = 5,000	4,000	4,000	(1,000)	Foreseeable loss of contract is not allowed as deduction in Year 1 as per ICDS and thus tax is required to be paid as per Normal Provisions.
2	Contract concludes on loss of 5,000	4,000	(1,000)	4,000	The foreseeable loss is recorded in year 1 as per AS 7 and as per ICDS the same will now be allowed in year 2. However, MAT will apply and tax is required to be paid as per the provisions of MAT.

Impact: ICDS deviates from the present legal settled position in the case of *CIT V/s. Triveni Engineering & Industries Ltd (49 DTR 253) (Del) & CIT v. Advance Construction Co. (P) Ltd (275 ITR 30) (Guj))* in which foreseeable losses on construction contracts were allowed as a deduction for tax purpose.

ICDS IV – Revenue Recognition

Scope of ICDS IV – Revenue Recognition

ICDS IV applicable to recognition of income arising in the course of the ordinary activities of a person from:

- **The sale of goods**
- **The rendering of services**
- **The use by others of the person's resources yielding interest, royalties or dividends**

Applicability of ICDS IV to Real Estate Sector and Lease Transactions?

Tax Treatment under Pre-ICDS vis-à-vis Post-ICDS

Sr. No	Relevant Aspect	Tax Treatment under Pre-ICDS	Tax Treatment under Post-ICDS
1	Sale of goods	• Revenue to be recognised on fulfillment of conditions: o Property in goods transferred or all significant risks and rewards of ownership transferred; and o No significant uncertainty regarding amount of consideration	• The conditions for revenue recognition remains the same as AS-9 • No illustrations as provided in AS -9 to determine when the conditions are fulfilled– o Whether illustrations in AS-9 be referred and relied? o Whether the conditions contained in various Acts (such as Sale of Goods Act) be referred and relied?
2	Rendering of Services	• As per AS-9, revenue from service transactions is recognized either by: o the proportionate completion method or o the completed service contract method	• Under ICDS, revenue from service transactions to be recognized mandatorily by the percentage completion method • The provisions of ICDS III relating to construction contracts vis-à-vis recognition of revenue shall apply mutatis mutandis

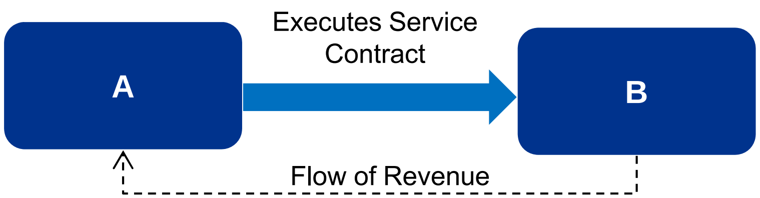
Tax Treatment under Pre-ICDS vis-à-vis Post-ICDS

Sr. No.	Relevant Aspect	Tax Treatment under Pre-ICDS	Tax Treatment under Post-ICDS
3	Recognition of Interest Income	• As per AS-9 interest income is recognized on time basis • As per Act, interest income is taxable basis the accrual concept	• Similar to AS-9, interest income to be recognized on time basis • Test of accrual not relevant? • Impact on interest on sticky loans o Time basis Vs Real income theory
4	Recognition of Royalty Income	• Recognized as per the terms of the agreement	• No change in ICDS
5	Recognition of Dividend	• Dividend to be recognised in accordance with the provisions of the Act – o In the previous year in which it is declared, distributed or paid; o Interim dividend – when the dividend is unconditionally made available	• Dividend to be recognised in accordance with the provisions of the Act – o In the previous year in which it is declared, distributed or paid; o Interim dividend – when the dividend is unconditionally made available

Tax Treatment under Pre-ICDS vis-à-vis Post-ICDS

Sr. No.	Relevant Aspect	Tax Treatment under Pre-ICDS	Tax Treatment under Post-ICDS
6	Uncertainty in collection of Interest and Royalties	• As per AS-9, the revenue recognition of interest could be postponed ***if it would be unreasonable to expect ultimate collection***	• Silent on such condition o Prudence / Real Income Theory still applicable?
7	Disclosures	• No disclosures apart from circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties	• Additional disclosures are required to be made (such as method used to determine stage of completion, amount of revenue recognized from service transactions, details of service transactions in progress at the year end etc.)

Case Study – Percentage Completion Method



Facts

- ‘A’ obtains and executes a service contract with ‘B’
- Billing milestone at completion of 60% of work
- At the end of Year 1, ‘A’ has completed 50% of the 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 (Contract Completion Method)

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

Table 2: Post-ICDS (Percentage Completion Method)

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

ICDS V – Tangible Fixed Assets

Scope of ICDS V – Tangible Fixed Assets

Assets included

- Land, building, machinery, plant or furniture;
- 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 valuation is needed*
- 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*

Prospective from date of transition

Tax Impact of ICDS V – Tangible Fixed Assets

Taxation Impact in line with the provisions of the Act

- Cost of assets largely aligned with Section 43(1) of the Act
- Capitalisation of exchange differences relating to fixed assets shall be in accordance with section 43A and other similar provisions of the Act.

Prospective from the date of transition

Issues

- In absence of valuation for assets purchased for consolidated price, AO may allocate more cost to non-depreciable assets?
- Can exchange difference arising on External Commercial Borrowings be capitalized even if used for acquiring domestic assets – Para 5 and 6 of ICDS VI?


ICDS VI – Effects of Changes in
Foreign Exchange Rates

ICDS VI – Effects of changes in foreign exchange rates Scope & significant impact areas

Scope

- Foreign currency monetary items to be reinstated at year end. Conversely, non-monetary items to be carried at exchange rate as on date of transaction
- Premium, discount and exchange differences on forward contracts (including foreign currency options) entered for trading, speculation & hedging of firm commitment or a highly probable forecast transaction to be recognised only on settlement
- Exchange differences on forward contracts other than aforesaid to be allowed on year end, premium and discount to be amortized over life of the contract
- Integral foreign operations – financial statements to be translated following the same principles as followed by an Indian company

Significant tax impact areas

- Exchange differences on forward contracts entered for-
  - ✓ trading / speculation / hedging of firm commitment or
  - ✓ a highly probable forecast transaction

  to be allowed **only on settlement**

Pre-ICDS MTM losses / gains on derivatives were generally claimed / offered relying on settled judicial precedents

ICDS VI – Effects of changes in foreign exchange rates Revenue non-monetary items (like inventory)

AS- 11	ICDS	Impact
❖ Which are carried in terms of historical cost denominated in a FC - Reported using the exchange rate at the date of the transaction	Converted into reporting currency using the exchange rate at the date of the transaction.	No exchange difference would arise under both No change in the position
❖ Which are carried at fair value or other similar valuation denominated in a FC - Reported using the exchange rates that existed when the values were determined i.e. closing rate.	Converted into reporting currency using the exchange rate at the date of the transaction.	No exchange difference would arise as per ICDS. Hence, the FE gain/loss as per the books of accounts will have to be reduced/ added back respectively while computing the taxable income.

ICDS VI – Effects of changes in foreign exchange rates
Case Study – Revenue non-monetary items

Particulars	Amount in Forex	Exchange Rate	Value
Cost	$10,000	55 as on date of acquisition	Rs.5,50,000
NRV	$5,000	60 closing rate i.e. at B/S date	Rs.3,00,000
Valuation at lower of cost or NRV ($10,000 or $5,000) i.e. $5,000			
As per AS 11			**Rs.3,00,000 (5,000*60)**
As per ICDS			**Rs.2,75,000 (5,000*55)**

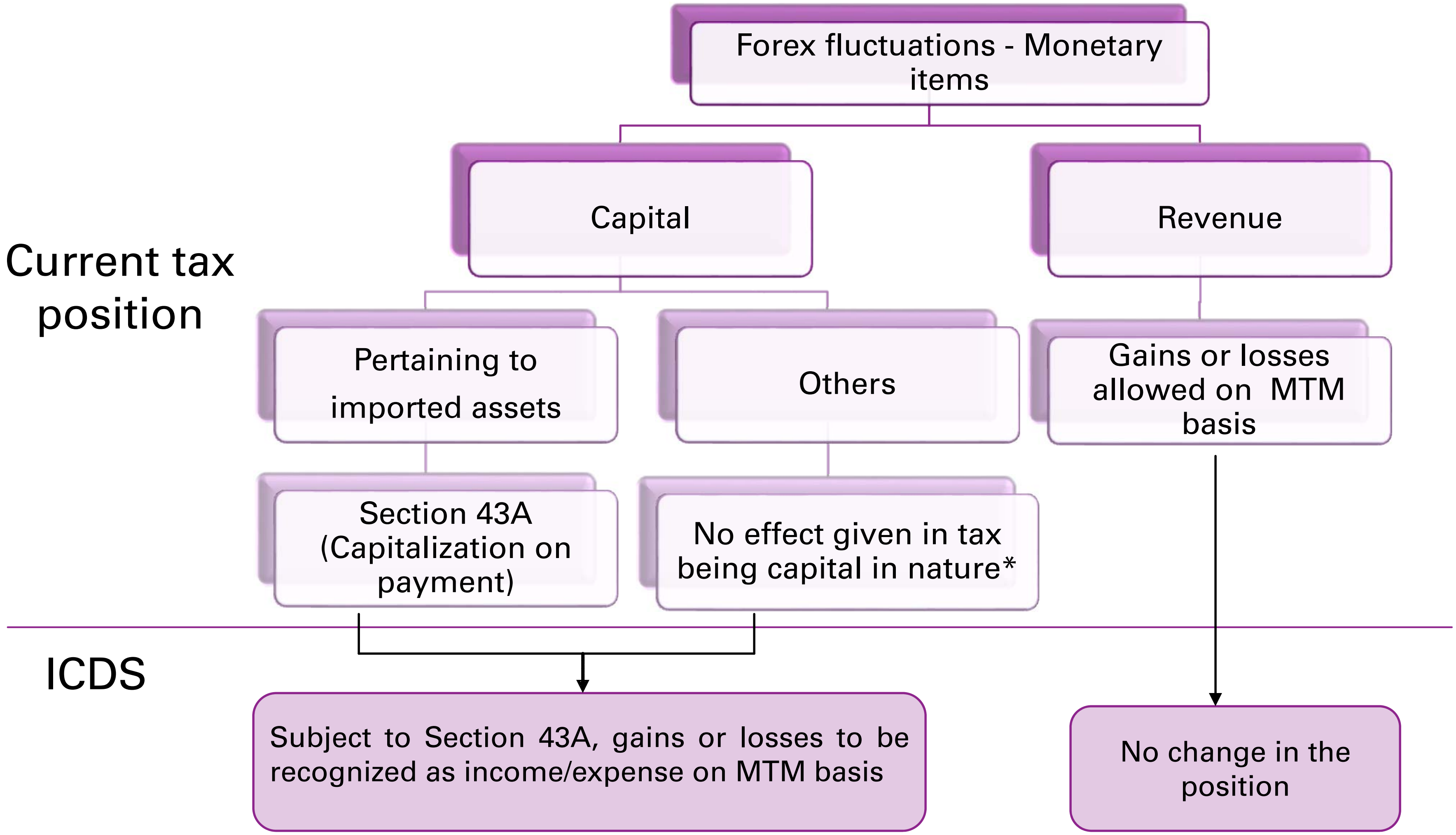
ICDS VI – Effects of changes in foreign exchange rates
Case Study – Revenue non-monetary items

Applicability of AS 22- Deferred Tax

- This will result into creation of Deferred Tax Liability ('DTL') as per AS 22 "Accounting for Taxes on Income"
- DTL will be created on difference of valuation of Inventory as per Taxation and as per Books of accounts

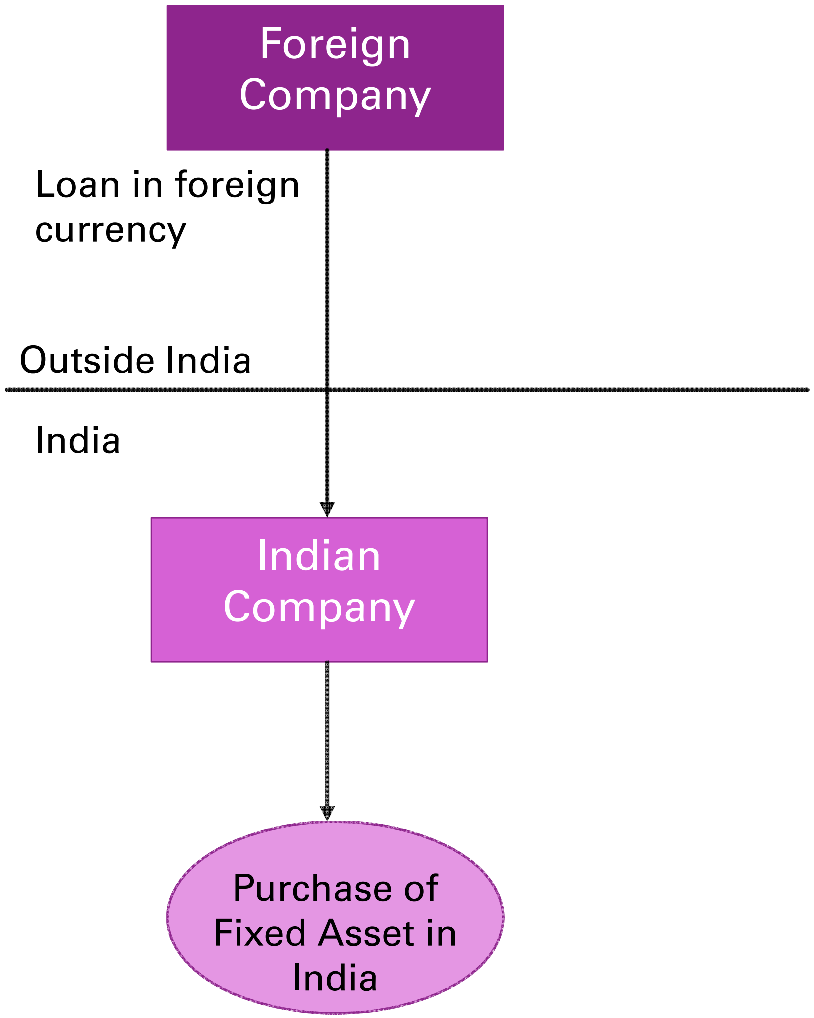
  = Rs. 3,00,000 – Rs. 2,75,000 = Rs. 25,000 * Applicable Tax Rate
- When stock will be sold, in that year it will result into reversal of DTL.

ICDS VI – Effects of changes in foreign exchange rates
Monetary Items



* Treatment is in conflict with SC decision in case of Tata Iron & Steel (98 Taxman 459)

ICDS VI – Effects of changes in foreign exchange rates
Case Study – Monetary items of capital nature



Facts

- Indian Company borrows foreign currency loan (ECB) from Foreign Company repayable after 5 years
- Indian Company utilizes ECB proceeds to acquire assets in India
- At the end of year 1, due to reinstatement of principal amount of loan, Indian Company incurs MTM loss of INR 50 lacs

ICDS VI – Effects of changes in foreign exchange rates
Case Study – Monetary items of capital nature

Tax Treatment - Pre ICDS	Tax Treatment - Post ICDS
➢ Distinction between capital and revenue nature of exchange fluctuation is well settled ➢ Exchange fluctuation of capital nature ignored under tax (gain not taxable, loss not deductible) ➢ Sec 43A permits capitalization in case of imported assets only ➢ MTM loss of INR 50 lacs is a sunk loss	➢ In contrast to settled judicial position, ICDS requires recognition of MTM gain/loss as income/expense (subject to Sec 43A) ➢ Can the Indian Company claim deduction of MTM loss of INR 50 lacs • Applicability of section 37(1)? ➢ Will revenue authorities tax gains relying on ICDS?

ICDS VI – Effects of changes in foreign exchange rates
Case Study – Forward Contract

- Indian Company has entered into a contract with foreign enterprise for export of services worth USD 1,00,000
- On 1 March 2016, the contract was partly executed to the extent of USD 50,000 and therefore debtors were recorded and is outstanding in the books as on 31 Mar 2016
- Balance USD 50,000 is firm commitment to be exported before 31 July 2016
- Indian Company enters into forward contract with bank to hedge its currency exposure of USD 1,00,000 on 1 March 2016
- What will be the amount of MTM to be allowed for tax purposes?

Date	Spot rate	Forward rate
1 Mar 2016	1 USD = Rs. 60	1 USD = Rs. 58
31 Mar 2016	1 USD = Rs. 55	1 USD = Rs. 57

ICDS VI – Effects of changes in foreign exchange rates
Case Study – Forward Contract

Item	Treatment in books	ICDS Treatment
<u>On-Balance Sheet items</u>		
Discount on forward contract	INR 1,00,000 (60-58*50,000)	To be amortized over life of the forward contract
Exchange differences on monetary item i.e. debtors	Losses of INR 2,50,000 (60-55*50,000)	Gain and loss would offset each other and have **no impact** on the P&L
Exchange differences on forward contract	Gain of INR 2,50,000 (60-55*50,000)	
<u>Off-Balance Sheet items</u> MTM	MTM losses of INR 50,000 (58-57*50,000)	Not to be allowed

ICDS VI – Effects of changes in foreign exchange rates Treatment for Derivatives

Treatment for Derivatives

Derivatives

Forward Exchange Contracts – For trading/ speculation

- Premium or discount on contracts and exchange difference shall be recognized at the time of settlement
- (AS 11 permits MTM on year end)

Forward Exchange Contracts – To hedge foreign currency risk of a firm commitment or a highly probable forecast transaction

- Premium or discount on contracts and exchange difference shall be recognized at the time of settlement
- (AS 11 excludes these contracts)

Other Forward Exchange Contracts (such as hedging for on-Balance Sheet items)

- Premium or discount arising at inception shall be amortised over the life of the contract
- Spot exchange difference shall be recognized on year end basis
- (Same as AS 11)

Other Derivative contracts (Covered in ICDS on Accounting policies)

- MTM shall not be recognized unless permitted by other ICDS. MTM deferred till settlement

"Forward Exchange Contract" means an agreement to exchange different currencies at a forward rate, and includes a foreign currency option contract or another financial instrument of a similar nature;

ICDS VI – Effects of changes in foreign exchange rates
Foreign Operations

Foreign Operations

Integral operations
(e.g. Warehouse, liaison office)

- ICDS applies same principles as own assets and liabilities subject to Sec 43A and Rule 115

- But no distinction between capital vs. revenue
(Largely aligns with ICAI AS-11)

Non-integral operations
(e.g. Branch functioning on independent basis)

- ICDS requires recognition of gains / losses on translation of assets and liabilities, both monetary and non-monetary at year end (whereas AS-11 requires accumulation in reserve)

- Effect on accumulated reserve - not clarified

- No distinction between capital and revenue items

Relevant Definitions

- **Exchange difference** is the difference resulting from reporting the same number of units of a foreign currency in the reporting currency of a person at different exchange rates.
- **Foreign currency** is a currency other than the reporting currency of a person.
- **Forward rate** is the specified exchange rate for exchange of two Currencies at a specified future date
- **Forward exchange contract** means an agreement to exchange different currencies at a forward rate, and includes a foreign currency option contract or another financial instrument of a similar nature.
- **Integral foreign operation** is a foreign operation, the activities of which are an integral part of the operation of the person.
- **Monetary items** are money held and assets to be received or liabilities to be paid in fixed or determinable amounts of money. Cash, receivables, and payables are examples of monetary items.
- **Non-integral foreign operation** is a foreign operation that is not an integral foreign operation.
- **Non-monetary items** are assets and liabilities other than monetary items. Fixed assets, inventories, and investments in equity shares are examples of non-monetary items.
- **Fair value** is the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm’s length transaction.
- **Securities** shall have the meaning assigned to it in clause (h) of Section 2 of the Securities Contract (Regulation) Act, 1956 (42 of 1956), other than Derivatives referred to in sub-clause (1a) of that clause.

Premium or discount on foreign exchange rate

The premium or discount that arises on the contract is measured by the difference between the exchange rate at the date of the inception of the contract and the forward rate specified in the contract.

Exchange difference on the contract is the difference between:

(a) the foreign currency amount of the contract translated at the exchange rate at the last day of the previous year, or the settlement date where the transaction is settled during the previous year; and

(b) the same foreign currency amount translated at the date of inception of the contract or the last day of the immediately preceding previous year, whichever is later.

Thank You

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Schedule ICDS in Form ITR 6

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)**	