ICDS III, IV and V

WIRC
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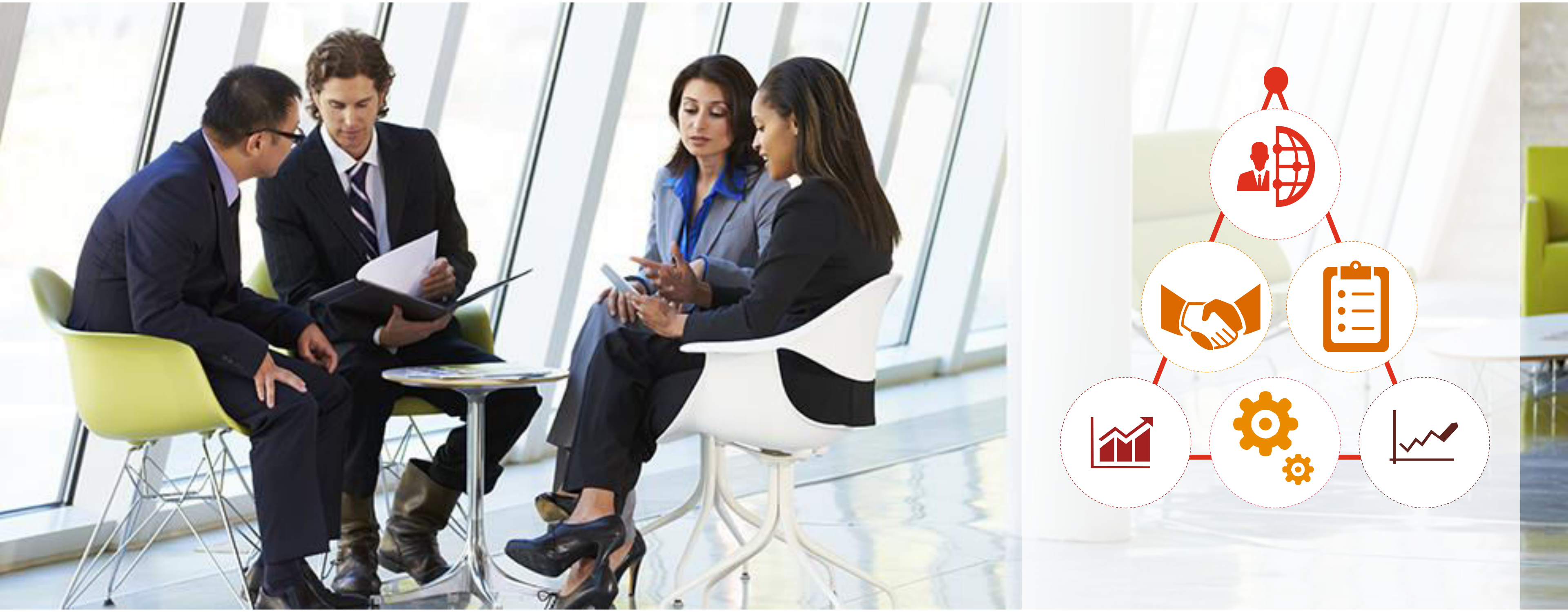

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Section

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ICDS – A Perspective

ICDS – Journey thus far

August 2012

14 August 2012
Accounting Standard Committee – Final Report – 14 draft Tax Accounting Standards

July 2014
Amendment to section 145(2) by Finance Bill 2014 – CG given powers to notify ICDS

9 January 2015
12 draft ICDS issued for public comments

31 March 2015
10 ICDS notified – applicable from AY 2016-17

29 September 2016
CBDT rescinds notification of March 2015
Revised 10 ICDS notified w.e.f. AY 2017-18

March 2017

23 March 2017
CBDT Cir.No. 10 – 25 FAQs on ICDS

Recently a writ petition filed before the HC challenging the validity

Basic points to remember

- Applicable to all assessees except individuals and HUFs not required to get accounts audited under section 44AB
- MAT working not impacted – also clarified by FAQs
- Cash basis accounting – ICDS not applicable
- Applicable only to Profits and Gains from Business or Profession and Income from other sources
- Provisions of Act prevail over ICDS

Additional adjustments for ICDS in the Computation of Income and additional disclosures in the Tax Audit Report

Macro issues and concerns

- Judicial precedents vs. ICDS – As per FAQs – ICDS prevail
- Real income theory vs. ICDS
- ICDS results in timing difference in offering income to tax – impact on MAT liability
- Whether practical to implement without maintaining separate books of account?

Section

2

ICDS III – Construction Contracts

ICDS III - Applicability

Applicable to Contractor for construction contract commenced on or after 1 April, 2016

Not Applicable to Real Estate Developers – draft ICDS issued

ICDS III – An Overview…

Contract Revenue

- The initial amount of revenue, including retentions
- Variations in contract work, claims and incentive payments:
  - to the extent that it is probable that will result in revenue
  - they are capable of being reliably measured

Contract Cost

- Costs that relate directly to the specific contract
- Costs attributable to contract activity in general and can be allocated to the contract
- Such other costs as are specifically chargeable to the customer under the terms of the contract
- Allocated borrowing costs in accordance with the ICDS on Borrowing Costs

To be reduced by - incidental income, not being in the nature of interest, dividends or capital gains, that is not included in contract revenue.

…ICDS III – An Overview

Recognition of Contract revenue and expenses

- Contract Revenue – as revenue
  Contract Costs – as expense
  with reference to the stage of completion of the contract
- Percentage of Completion Method ('POCM') basis only
- Stage of completion to be determined based on:
  - Expenditure approach
  - Work survey approach
  - Physical work completion approach
- Early stage of contract – when outcome cannot be reliably estimated – contract revenue = contract costs incurred
- Early stage not to go beyond 25% of stage of completion

Principally in lines with AS-7 except a few deviations

Contract Accounting (AS-7) – a perspective

- Contract account to be maintained for each separate contract
- Contract accounts to be prepared on POCM basis
- Contractor to determine the stage of completion at each reporting date (based on the approaches in AS-7)
- Profit and Loss Account to be hit by the contract revenue and contract expenses not recognised earlier for each contract

Key deviations from AS – 7 – Revenue Recognition – Timing

AS-7	ICDS-III
• Contract revenue to be recognized if it is possible to reliably estimate the outcome of a contract. Provides guidance on how to determine if it is possible to reliably estimate the outcome.	• The criteria "if it is possible to reliably estimate the outcome of a contract" omitted. • Contract revenue to be recognized when there is reasonable certainty of its ultimate collection.

'Reasonable certainty' meaning? Conditional clauses in the contract could have bearing

Should not result in adjustment in most of the cases as the guidance in AS-7 logically leads to determination of 'reasonable certainty of its ultimate collection'

Key deviations from AS – 7 – Revenue Recognition – early stage and stage of completion

AS-7	ICDS-III
• Where outcome of a construction contract cannot be estimated reliably, the revenue to be recognized = contract costs incurred.	• Early stages of a contract, where the outcome of the contract cannot be estimated reliably, contract revenue = contract costs incurred
• No threshold for stage of completion specified, beyond which to recognise revenue mandatorily	• Postponing revenue recognition beyond 25% of stage of completion not permitted (even if not possible to reliably estimate the outcome)

Issue – what if there is no reasonable certainty of ultimate collection even after contract reaches 25% completion?

Where no recognition in books made beyond 25% of contract completion – ICDS will result in preponing the tax liability – resulting in MAT for subsequent years

Case Study 1 – Preponement of revenue recognition

- Total Contract Revenue (-) Contract Costs = Rs. 100 Crs.

Rs. In crores

Year	% of project completed in the year	As per books (also as per tax in pre-ICDS scenario)	Income for Normal tax computation as per ICDS	Tax payable – Normal tax provisions (30%) / MAT (20%) pre-ICDS	Tax payable – Normal tax provisions (30%) / MAT (20%) post-ICDS
1	30%	NIL	30	NIL	9 (30 x 30%)
2	70%	70	40	21 (70 x 30%)	14 (70 x 20%)
3	100%	30	30	9 (30 x 30%)	9 (30 x 30%)
Total				**30**	**32**

Higher overall tax outflow

Key deviations from AS – 7 – Revenue Recognition – Retention Money

AS-7	ICDS-III
• No specific mention of retention money in the definition of contract revenue (however, revenue agreed in the contract should include retention money in most cases)	• Retention money specifically included in contract revenue.

- Retention money – if not included in contract accounts – could result in pre-recognition by application of ICDS – MAT impact
- However, the criteria of 'reasonable certainty of ultimate collection' applies to retention money as well - CBDT FAQs state the same

Judicial precedents holding retention money taxable on accrual basis – would ICDS prevail?

Key deviations from AS – 7 – Incidental income

AS-7	ICDS-III
• As per AS-7, any incidental income shall be reduced from the contract cost	• Any incidental income other than interest, dividend, capital gains is only allowed to be reduced from contract costs

Such other income to be taxed under the respective heads of income

Interest income that is inextricably linked to the contract should ideally go on to reduce the contract costs – Bokaro Steel Ltd. [1999] 236 ITR 315 (SC)

Key deviations from AS – 7 – Losses

AS-7	ICDS-III
• Actual Losses – no specific mention – but will be recognized based on prudence • Expected losses – to be recognized immediately irrespective of the stage of completion of the contract	• Actual losses – since no specific mention – on POCM basis – no prudence principle applicable to ICDS • Expected losses – ICDS III silent – as per ICDS I not allowed to be recognised

- May result in timing difference of recognition of profits / losses in books and for tax purposes
- ICDS inconsistent with judicial precedents allowing forseeable losses – Advance Construction Co. (P) Ltd. 275 ITR 30 (Guj)

Could result in higher normal tax in earlier years and MAT in the later years of the contract

Case Study 2 – Actual Losses

- Total Contract Revenue (-) Contract Costs = Rs. 100 Crs.
- Loss due to fire in year 2 – Rs. 20 crs.

Rs. In crores

Year	% of project completed in the year	As per books (also as per tax in pre-ICDS scenario)	Income for Normal tax computation as per ICDS	Tax payable – Normal tax provisions (30%) / MAT (20%) pre-ICDS	Tax payable – Normal tax provisions (30%) / MAT (20%) post-ICDS
1	30%	NIL	30	NIL	9 (30 x 30%)
2	70%	50 (70 – 20)	26 (40 – 20x70%)	15 (50 x 30%)	10 (50 x 20%)
3	100%	30	26 (30-20x30%)	9 (30 x 30%)	7.8 (26 x 30%)
Total				**24**	**26.8**

Actual losses also on POCM basis!

Other Key Issues

- Non-corporate contractors like individuals, HUF, LLP ordinarily use Completed Contract Method (‘CCM’)
    - POCM would need to be mandatorily applied
- Bad Debts to be written off – was in conflict with provisions of section 36(1)(vii) where the revenue may not have been recorded in the books – amendment by Finance Act 2015 cleared the issue

Disclosure Requirements

- The amount of contract revenue recognized as revenue in the period
- The methods used to determine the stage of completion of contracts in progress
- For contract in progress at the reporting date:-
  - Amount of costs incurred and recognized profits (less recognized losses) upto the reporting date;
  - The amount of advances received; and
  - The amount of retentions

Section

3

ICDS IV – Revenue Recognition

ICDS IV – Revenue Recognition…

Revenue from sale of goods – When to be recognised

- Property in the goods is transferred

OR

- All significant risks and rewards of ownership have been transferred and the seller retains no effective control over the goods

Rendering of services

- POCM basis – same principles of recognition as in Construction Contract ICDS III (including latest revenue recognition upon 25% of project completion)
- If duration of service contract is not more than 90 days - revenue may be recognized when the rendering of services is completed or substantially completed – CCM basis

AS-9 recognizes revenue from services either by POCM or CCM – not much impact ordinarily
Higher overall tax outflow due to MAT where CCM used in books

…ICDS IV – Revenue Recognition…

Interest income recognition

- On time basis determined by the amount outstanding and the rate applicable
- Interest on refund of any tax, duty or cess – deemed to be income of the year in which it is received
- Discount or premium on debt securities shall be spread over the term of the security

- Principle laid down by SC in E.D.Sasoon 26 ITR 27 (SC) – income accrues only when there is a right to receive – terms of contract may sometimes shift the right to receive to ultimate maturity
- Interest on refund of taxes – No provision as regards reversal of such refund at subsequent appellate level

Whether ICDS would override 'real income' theory?

...ICDS IV – Revenue Recognition...

Royalties

- Shall accrue and be recognised in accordance with the terms of the relevant agreement, unless, having regard to the substance of the transaction, it is more appropriate to recognize revenue on some other systematic and rational basis.

Dividends

- Dividends are recognized in accordance with the provisions of the Act.

Transitional provisions

- Applicable to all service transactions undertaken on or before 31 March, 2016 and not completed by that date
- Other than above, revenue for all transactions in accordance with the provisions of ICDS IV – any revenue recognised earlier needs to be adjusted

Disclosure Requirements

- In a transaction involving sale of good, total amount not recognized as revenue during the previous year due to lack of reasonably certainty of its ultimate collection along with nature of uncertainty
- The amount of revenue from service transactions recognized as revenue during the previous year
- The method used to determine the stage of completion of service transactions in progress
- For service transactions in progress at the end of the previous year:-
  - Amount of costs incurred and recognized profits (less recognized losses) upto end of previous year
  - The amount of advance received
  - The amount of retentions

Certain disclosure requirements could be practically onerous

Section

4

ICDS V – Tangible Fixed Assets

ICDS V – Tangible Fixed Assets – Actual Cost…

Tangible Fixed Assets

- Land
- Building
- Machinery
- Plant
- Furniture

held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business. (AS-10 deals with goodwill also)

Components of Actual Cost

- Purchase price + import duties and other taxes (excluding those subsequently recoverable)
- any directly attributable expenditure on making the asset ready for its intended use
- any trade discounts and rebates shall be deducted
- Admin and other general overhead expenses not relating to a specific tangible fixed asset to be excluded.
- Expenditure on start-up, commissioning of project, test runs to be capitalised.

...ICDS V – Tangible Fixed Assets – Actual Cost...

Subsequent adjustments

- Cost of a tangible fixed asset may undergo changes subsequent to its acquisition or construction on account of price adjustment, changes in duties or similar factors, or exchange fluctuation as specified in ICDS VI.

Improvements and Repairs

- Expenditure that increases the future benefits from the existing asset beyond its previously assessed standard of performance is added to the actual cost.
- Cost of an addition or extension to an existing tangible fixed asset of a capital nature and which becomes an integral part of the existing tangible fixed asset is to be added to is actual cost.
- Any addition or extension, which has a separate identity and is capable of being used after the existing tangible fixed asset is disposed of, shall be treated as separate asset.

Definition of WDV in section 43(6) does not specifically allow addition after the previous year in which the asset is acquired

...ICDS V – Tangible Fixed Asset – Actual Cost

Self Constructed Tangible Fixed Assets

- Same principles mentioned before
- Cost of construction that relate directly to specific tangible fixed asset + costs that are attributable to the construction activity in general and can be allocated to the specific tangible fixed asset
- Any internal profits shall be eliminated in arriving at such costs.

Asset acquired in exchange for other asset or for shares or other securities

- Fair Value of the tangible fixed asset acquired

Several assets purchased for a consolidated price

- Consideration to be apportioned to various assets on a fair basis

ICDS V – Transitional Provisions

- Actual cost of tangible fixed assets, acquisition or construction of which commenced on or before 31 March 2015, but not completed by the said date, shall be recognized in accordance with ICDS V – adjustments to be made if any amount is already recognised as actual cost

Disclosure Requirements

- Description of asset or block of assets
- Rate of Depreciation
- Actual cost or written Down Value ('WDV'), as the case may be
- Additions or deductions during the year with dates; in the case of any addition of an asset, date put to use; including adjustments on account of –
  - CENVAT Credit claimed and allowed under the CENVAT Credit Rules, 2004
  - Change in rate of exchange of currency
  - Subsidy or grant or reimbursement, by whatever name called
  - Actual cost or Written Down Value, as the case may be
- Depreciation Allowable
- WDV at the end of the year

Thank You

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