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CAPITAL PARTNERS

Income Computation and Disclosure Standards (ICDS)

-Impact Analysis

Income Computation and Disclosure Standards (ICDS)

Background

- Section 145(1) of the Income-tax Act, 1961 (Act) stipulates that the method of accounting for computation of income under the heads “Profits and gains of business or profession” and “Income from other sources” can either be cash or mercantile system of accounting.

- Section 145(2) of the Act states that the Central Government may notify the accounting standards to be followed by any class of assesses or in respect of any class of income.

- Accordingly, two tax accounting standards were notified in **1996**:
  1. Disclosure of accounting policies (AS 1)
  2. Disclosure of prior period and extraordinary items and changes in accounting policies

Income Computation and Disclosure Standards (ICDS)

Background

- Finance Act, 2014 amended section 145(2) of the Act to substitute “accounting standards” with “income computation and disclosure standards” (ICDS).

- In December 2010, the CBDT constituted the Accounting Standards Committee which had earlier issued draft 14 Tax Accounting Standards in 2012. On the basis of the suggestions and comments received from the stakeholders, CBDT had revised and issued 12 draft ICDS for public comments.

- On 31st March, 2015, the Central Government has notified 10 out of the 12 draft ICDS which shall be effective from 1st April, 2015.

- The introduction of ICDS would alter the way companies compute their taxable income.

Income Computation and Disclosure Standards (ICDS)

Introduction

- Ten - Income Computation and Disclosure Standards have been introduced by CBDT on 31-March 2015 by Notification No. 33/2015 dated 31/03/2015 under the provisions of Section 145(2) of The Income Tax , 1961.

- ICDS are applicable to all taxpayers, following mercantile system of accounting, for computation of income chargeable under the head ***“Profits and gains of business or profession” and “Income from other sources”.***

- Does ICDS apply in the case of MAT?

- In case of conflict between the provisions/ of the Act and ICDS, ***the provisions of the Act shall prevail to that extent – Issue on construction contract (ICDS 3)***

Income Computation and Disclosure Standards (ICDS)

Applicability

- Applicable to all assesses following Mercantile system of accounting and chargeable to tax under the head "Profits and Gains of Business or Profession" or "Income from Other Sources".

- Applicable to all assesses:
  - Irrespective of applicability of Tax audit.
  - Irrespective of Turnover.
  - Irrespective of Status of Assessee vis-à-vis (Individual, AOP , firm and Resident , Non Resident).
  - Applicable from Assessment year 2016-17

Income Computation and Disclosure Standards (ICDS)

Applicability for FY 2015-16

- ICDS is applicable from financial 2015-16, which would make following impacts with immediate effect :
  - Computation of advance tax for assessment year.
  - Tax Expenses on quarterly results of the Company.

Non Compliance

- Non Compliance with ICDS can be ground for an assessing officer to complete the Assessment under "Best Judgment Assessment" under Section 144.

Income Computation and Disclosure Standards (ICDS)

- Ten notified ICDS are:
  1. Accounting Policies.
  2. Valuation of Inventory.
  3. Construction Contracts.
  4. Revenue Recognition.
  5. Tangible Fixed assets.
  6. Effects of Changes in Foreign Exchange Rates.
  7. Governments Grants.
  8. Securities.
  9. Borrowing Cost.
  10. Provisions, Contingent Liabilities and Contingent Assets.

ICDS I – Accounting policies

Accounting Policies (ICDS-I)

- In accordance with AS 1, the major considerations governing the selection and application of accounting policies should be:
  - Prudence;
  - Substance over form;
  - Materiality

- ICDS recognizes substance over form – Issue over MTM losses?

- Prudence and materiality - Not recognized by ICDS – **A gruesome impact**

- Provision for expected losses is not recognized by ICDS – **Could result in unnecessary litigation**

ICDS 2 – Valuation of inventories

Valuation of inventories (ICDS-II)

- The principal rule for measurement is identical with AS 2 – Cost or Net Realizable Value, whichever is lower

- The inclusion of element in which CENVAT credit is available has been an area of litigation – Has ICDS resolved this issue – **Mumbai ITAT** in the case of **Petro Specialties Private Limited (34 Taxmann.com 76)**

- ICDS also includes services within its scope – A bubble in the making

- Departure from the dictum in the case of **Supreme Court** in the case of **British Paints Limited (188 ITR 44)**, which held that each year's profit to be determined on an independent basis

Valuation of inventories (ICDS-II)

- Valuation of inventory in the case of dissolution – **Delhi High Court** in the case of **Madhu Rani Mehra (10 Taxmann.com 126)** held that stock should be valued at net realizable value

- The above impact in the case of ICDS?

ICDS 3 – Construction contracts

Construction contracts (ICDS-III)

- Contract revenues and costs to be recognized having regard to Percentage of Completion Method – Once a contract cross 25 percent, the profit is to be recognized

- Retention money is considered as part of contract revenues - Conflict with the concept of real income – SC in the case of ED Sasson & Co Limited (26 ITR 27)

- Retention money – Issue in the case of non-recovery?

- Anticipated losses allowable as a deduction ONLY when actually incurred – In conflict with established principles – **Delhi High Court** in the case of **Triveni Engineering & Industries Limited (336 ITR 374)**

Construction contracts (ICDS-III)

- Pre-construction income in the nature of interest, dividend or capital gains not to be reduced from the cost of construction

- The above-mentioned changes could have a serious impact on MAT

- The impact of ICDS in the context of Ind AS (IFRS), which recognizes Completed Contract Method in certain situations depending inter-alia on when control in the property is transferred

ICDS IV – Revenue Recognition

Revenue Recognition (ICDS-IV)

- ICDS IV deals with the bases for recognition of revenue arising in the course of the ordinary activities of a person from:
  - sale of goods;
  - rendering of services;
  - use by others of the person's resources yielding interest, royalties or dividends.

- Does not deal with the aspects of revenue recognition which are dealt with by other ICDS.

- With respect to sale of gods revenue shall be recognized when ***significant risks and rewards of ownership have been transferred*** to the buyer and the seller retains ***no effective control*** of the goods.

Revenue Recognition (ICDS-IV)

- Revenue from service transactions shall be recognized by percentage of completion method. The requirements of this standard shall stand mutandis apply to the recognition of revenue and the associated expenses for a service transaction.

- Interest shall accrue on the time basis determined by the amount outstanding and th e rate applicable - Issue on broken period interest in respect of interest recognized as income but the related asset is sold before receipt of interest

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

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

Revenue Recognition (ICDS-IV)

Significant Deviations

- Revenue from service contract only to be recognized on percentage completion method as against AS-9 (Revenue Recognition) where both ***'completed service contract method' and 'percentage completion method'*** is permitted for recognition of revenue from service contract.

- Disclosure requirements similar to construction contract have been prescribed for service contracts.

Transitional Provisions

- Any contracts running as on 01.04.2015 shall be in line with ICDS 9

Revenue Recognition (ICDS-IV)

Related Judicial Pronouncements

- The assesse couldn't be said to be following wrong accounting policy if it didn't recognize the interest accrued on loan given to certain companies which eventually became sick - ***Kerala State Industrial Products Trading Corporation Ltd. v. Asst. CIT [2012] 22 taxmann.com 78 (Cochin).***

- Treatment in the case of sticky loans – An exposure

Revenue Recognition (ICDS-IV)

Impact on business and way forward

- Many companies recognize revenue from service contract as per completed contract method. Non inclusion of said method in ICDS will cause undue hardship to such companies as they have to separately compute revenue from service contract as per percentage completion method for Income Tax purpose.

- Treatment of finance lease transactions – Where transfer of property in goods do not coincide with transfer of risks and rewards associated with ownership?

ICDS V –Tangible Fixed Assets

Tangible Fixed Asset (ICDS-V)

- ICDS V applies only to tangible fixed assets and not to goodwill.
- It has defined the term "***Actual Cost***" which is line with Income Tax Act, 1961.
- It provides that machinery spares which can be used only in connection with an item of tangible fixed asset and their use is expected to be irregular, ***shall be capitalized***.
- When a tangible fixed asset is acquired in exchange for shares or other securities, the ***fair value of the tangible fixed asset so acquired*** shall be its actual cost.
- When several assets are purchased for a consolidated price, the consideration shall be apportioned to the various assets on a ***fair basis*** whereas as per AS 10, the consideration is apportioned on fair basis as determined by ***competent valuers***.

Tangible Fixed Asset (ICDS-V)

- Expenses between the readiness of the project to commence its production and the commencement of actual production – AS allows the same to be expensed off or deferred over a period of time

Tangible Fixed Asset (ICDS-V)

Significant Deviations

- In case of acquisition of a tangible fixed asset in exchange for another asset, shares or other securities, the fair value of the tangible fixed asset so acquired shall be its actual cost – AS permits recognition based on book value of the asset proposed to be exchanged

- There is no concept of revaluation of asset in the ICDS. The same is in conformity with the provision of the Act wherein also the concept of revaluation of assets is not recognized.

- ICDS prescribes disclosure requirement similar to requirement of Tax Audit Report. Even the persons not subject to tax audit have to comply with such disclosure requirement.

Tangible Fixed Asset (ICDS-V)

Impact on business and way forward

- As per ICDS and AS-10, any expenditure incurred which increases the useful life of an asset is required to be capitalized with the cost of said asset. Hence it can be inferred that any expenditure incurred in relation to any asset which does not increase useful life of the said asset, for e.g. expenditure for the purpose of preserving or maintaining an existing tangible fixed asset may be claimed as ***revenue expenditure – Inspection costs?***

- In absence of determination by registered valuers in ICDS words "***fair basis***" becomes subjective and might be prone to litigation.

- ICDS permits exchange losses on monetary items to be recognized as expense – **Kerala High Court** in the case of **Cochin Refineries Limited** (173 ITR 461) which held that exchange difference on purchase of assets to be capitalized

ICDS VI – The Effects of Changes in Foreign Exchange Rates

The Effects of Changes in Foreign Exchange Rates (ICDS-VI)

- Initial recognition of foreign currency transaction shall be at the transaction rate.

- Conversion to reporting currency at the end of the financial year for
  - Non-monetary items are recorded at the transaction rate
  - Monetary items are recorded at the year end rate

- Exchange difference for
  - Non-monetary items will not be recognized in P&L
  - Monetary items is recognized in P&L

- Initial recognition, conversion and recognition of exchange difference shall be subject to provisions of section 43A of the Act or Rule 115 of Income-tax Rules, 1962

The Effects of Changes in Foreign Exchange Rates (ICDS-VI)

- Forward exchange contract not intended for trading or speculation
  - Any premium or discount arising at the inception shall be amortized as expense or income over the life of the contract.
  - Exchange differences on such a contract shall be recognized as income or as expense in the previous year in which the exchange rates change.
  - Any profit or loss arising on cancellation or renewal shall be recognized as income or as expense for the previous year.

- Forward exchange contract intended for trading or speculation
  - Premium, discount or exchange difference shall be recognized at the time of settlement.

The Effects of Changes in Foreign Exchange Rates (ICDS-VI)

Impact on business – A few aspects

- For conversion of non monetary items, no exchange difference would arise. Hence, foreign exchange gain/loss in the books will have to be reduced/added back respectively.

- Inventory value shall be unaffected from the exchange rate fluctuations till the time it is disposed off i.e. sold or used.

ICDS VII – Government Grants

Government Grants (ICDS-VII)

- Grant is recognized when there is a reasonable assurance that the terms of grant shall be complied.

- Recognition of grant shall not be postponed to a later date than on the date of receipt.

- Accounting treatment of grant in following cases
  - For depreciable fixed asset- grant shall be deducted from actual cost or WDV.
  - For non depreciable fixed asset requiring fulfillment of obligations- the grant shall be recognized as income over the same period over which the cost of meeting such obligation is charged to income.
  - For grants not directly related to asset acquired- pro rata reduction of the amount shall be charged to all the assets with reference to which the grant is received.

Government Grants (ICDS-VII)

- For grants receivable as compensation for expense/loss or for the purpose of giving immediate financial support- recognized as income of the period in which it is receivable.
- Grants in the form of non-monetary asset given at concessional cost- shall be accounted at acquisition cost or at a nominal cost

➢ Refund of Grant

  - Any refund shall be first adjusted against any unamortised deferred credit remaining in respect of such grant and the balance shall be charged to P&L.
  - For depreciable fixed asset refund shall be adjusted by increasing the cost or WDV by the amount refundable.

➢ Grants in Capital form if received in lieu promoter contribution are to be offered as income.

Government Grants (ICDS-VII)

Deviation from Accounting Standard

- ICDS does not allow recording government grant (in lieu of promoters contribution) as "Capital reserve"

- Initial recognition cannot be postponed beyond actual receipt date even if recognition criteria as per Accounting Standard is not fulfilled.

- As per ICDS, all grants are recorded either by reducing from cost or recognized as income either immediately or over a period of time, depending on the nature of grants.

- Disclosure requirement has been widened in ICDS to include grants recognized as well as grants not recognized by way of deduction from cost / WDV or as income.

ICDS IX – Borrowing Costs

Borrowing Costs (ICDS-IX)

- The borrowing cost that are directly attributable to the acquisition, construction or production of a qualifying asset, shall be capitalized as part of the cost of that asset.

- Amount of borrowing cost to be capitalized:

- For ‘specific’ borrowings, it shall be the actual borrowing costs incurred during the period on the funds so borrowed.
- For ‘general’ borrowings, it shall be computed by applying following formula.

A * B/C

A= Total general borrowing costs

B= Average of costs of qualifying asset as appearing in the balance sheet on the first day and the last day of the previous year

C= The average of the amount of total assets as appearing in the balance sheet on the first day and the last day of the previous year (except assets which have specific borrowings).

Borrowing Costs (ICDS-IX)

- Commencement of capitalization of

- Specific borrowing cost shall be from the date on which funds were <u>borrowed.</u>
- General borrowing cost shall be from the date on which funds were <u>utilized.</u>

- Cessation of capitalization of borrowing cost in case of

- Qualifying asset shall be when such asset is first put to use (and not ready to use)
- Inventory asset shall be when substantially all the activities necessary to prepare such inventory for its intended sale are complete.

- Temporary suspension of business- Should costs be capitalized?

Borrowing Costs (ICDS-IX)

Deviation from Judicial Pronouncements

- SC ruling in ***Tuticorin Alkali Chemicals (227 ITR 172)*** requires that interest income earned from temporary deployments of funds has to be offered to tax immediately as IFOS, which was subsequently distinguished in ***Bokaro Steel Limited (236 ITR 315)[SC]***
- AS-16 requires income from temporary deployment of unutilised funds to be reduced from borrowing cost.
- ICDS does not provide for the same and it shall be taxable as Income from other sources.

Borrowing Costs (ICDS-IX)

Impact on business and way forward

- Borrowing cost eligible for the capitalisation under ICDS shall be lesser than under AS 16 since exchange difference is excluded as per ICDS. Also , ICDS provides for the recognition of exchange differences due to principal amount in P&L a/c subject to section 43A.

- The Income-tax Act has been amended to be in line with the ICDS, which provides for capitalization of borrowing costs without any exception.

- Specified tangible & intangible assets are qualifying assets regardless of substantial period condition.

Borrowing Costs (ICDS-IX)

Impact on business and way forward

- ICDS includes ‘land’ in the definition of qualifying assets, unlike AS-16. As per ICDS, borrowing cost in respect of land shall be capitalized. The depreciation shall not be allowed on the same since the land is a non-depreciable asset. However, the capitalized cost shall form part of a cost of asset while calculating Income from Capital Gain in respect of that land.

- Income from temporary deployment of unutilised funds from specific loans shall be taxable as Income from other sources under the ICDS.

- Borrowing cost incurred during the periods in which active development of the asset is interrupted can also be capitalised under the ICDS since there is no provision for suspension.

ICDS X – Provisions, Contingent Liabilities and Contingent Assets

Provisions, Contingent Liabilities and Contingent Assets(ICDS-X)

- The ICDS deals with provisions, contingent liabilities and contingent asset, except those:
  - resulting from financial instruments;
  - resulting from executory contracts;
  - arising in insurance business from contracts with policyholders; and
  - covered by another Income Computation and Disclosure Standard.

- Provisions shall be recognized if it is ***"reasonably certain"*** that outflow of economic resources would be required whereas in AS 29 provisions shall be recognized if it is "probable" that outflow of economic resources will be required.

- ICDS doesn't provide any specific guidance on meaning of '***obligation***' whereas as per AS obligations may be legally enforceable and may also arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner

Provisions, Contingent Liabilities and Contingent Assets(ICDS-X)

- ICDS also requires recognition of ***contingent assets*** when the inflow of economic benefits is ***reasonable certain*** whereas as per AS 29 Contingent assets/ reimbursement claims are recognized only if inflow of economic benefits/ reimbursement is “virtually certain”.

Provisions, Contingent Liabilities and Contingent Assets(ICDS-X)

Deviation from Judicial Pronouncements

- Provision for Warranty is allowed as an expenditure upholding the test of ***'probable'*** warranty obligation in the following judgments. However, ICDS recognizes provision only if the outflow is reasonably certain.

  - Rotork Controls India P. Ltd. (2009) 314 ITR 62 (SC) (extract on next slide)
  - 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

Provisions, Contingent Liabilities and Contingent Assets(ICDS-X)

***Rotork Controls India (P.) Ltd. v.* CIT [2009] 180 TAXMAN 422 (SC)**

- A provision to qualify for recognition, there must be a present obligation arising from past events, settlement of which is expected to result in an outflow of resources and in respect of which a reliable estimate of amount of obligation is possible.

- If historical trend indicates that in past large number of sophisticated goods were being manufactured and defects existed in some of items manufactured and sold, then provision made for warranty in respect of army of such sophisticated goods would be entitled to deduction from gross receipts under section 37(1), provided data is systematically maintained by assessee.

Provisions, Contingent Liabilities and Contingent Assets(ICDS-X)

Impact

- 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.

- Provisions made on obligations recognized out of customary business practices or voluntary obligations ***may not be allowed***. (e.g. informal refunds policy to dissatisfied customers, employee welfare, etc.)

- Revenue authorities may contest that ‘reasonably certain’ is a lower threshold than ***‘virtually certain’.***

Conclusion

Income Computation and Disclosure Standards (ICDS)

Conclusion

- The introduction of ICDS may significantly alter the way the companies compute their taxable income, irrespective of whether the company reports its financial results as per Ind AS or existing AS.

- Even though there is no requirement under the act to maintain separate books of accounts for income tax purposes, the effect of implementation of ICDS will put additional compliance burden on the tax payer.

- ICDS is meant to supplement the present income Tax Act and the rationale behind issuing ICDS is to lessen the uncertainty of alternative accounting treatment due to flexibility offered by Accounting Standard.

Income Computation and Disclosure Standards (ICDS)

Conclusion

- ICDS shall not be applicable to computation of book profit u/s 115JB of the Act.

- The ICDS are applicable w.e.f 01-04-2015 & hence advance tax for current financial year & thereafter needs to be computed based on ICDS.

Thank You..

About Nash Capital Partners

We are an emerging leader in tax, corporate finance, corporate restructuring, corporate law and accounting advisory. Our global approach to service delivery helps provide value added services to our clients. Clients recognise us as a differentiator due to our entrepreneurial vision, industry tailored solutions, which is delivered by some of the leading talented professionals in the country. We believe that client satisfaction is the right of all our clients and we are committed to exceeding these expectations.