INCOME COMPUTATION AND DISCLOSURE STANDARDS - ('ICDS')

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What is ICDS?

- Section 145(1) – Income chargeable under the heads "Profits and Gains from Business or Profession" or "Income from other Sources" – subject to 145(2) - as per method of accounting regularly followed

- Section 145(2) – the Central Government has power to notify "ICDS"

- CBDT vide Notification dated March 31, 2015 introduced 10 ICDS to be effective from April 1, 2015 and thus, the same was applicable from AY 2016-17 onwards

- However, in January 2016, Income-tax Simplification Committee recommended deferment of ICDS

What is ICDS?

- On July 6, 2016 via press release application of ICDS postponed by one year – to apply from AY 2017-18 and onwards.
- On September 29, 2016:, Revised ICDS notified effective from AY 2017-18 and Form 3CD was amended
- Recently, on March 23, 2017, CBDT has issued certain clarifications by way of FAQs.

What is ICDS?

- ICDS to be applicable only for computation of **‘Profits and Gains from Business & Profession’ (‘PGBP’)** and **‘Income from other sources’** in case of taxpayers following mercantile system of accounting

- • **No separate books of account** to be maintained for application of ICDS

- • ICDS shall also apply to persons computing income under **presumptive taxation scheme** (e.g. section 44AD, 44AE, 44B, 44BB, 44BBA etc.) in relation to ‘PGBP’ and ‘Income from other sources’ and also for computation of **income on gross basis** (e.g. section **115A** of the Act)

- • ICDS shall **apply irrespective of accounting standards** adopted by the companies i.e. AS or Ind-AS, and it shall not apply for computation of MAT but shall apply for computation of AMT

- • ICDS shall **apply to all persons** (including Banks, NBFCs, Insurance Co., Power Sector) unless there are sector specific provisions in ICDS or the Act

What is ICDS?

- Disclosure requirements provided in all ICDS (except ICDS 6 and ICDS 8) and shall be made in the Tax Audit Report (TAR) i.e. Form 3CD

- • Items not specifically covered by any ICDS (e.g.: leases, intangible assets, etc.) will continue to be governed by relevant AS/Ind-AS and existing provisions of the Act

- • ICDS shall prevail over the Judicial Precedents and be applicable to transactional issues dealt therein in relation to FY 2016-17 and subsequent FYs

What is ICDS?

- **Non-compliance with ICDS will give power to tax officer for Best Judgement assessment**

What is ICDS?

ICDS Disclosure in Return of Income

Part A- OI	Other Information *(optional in a case not liable for audit under section 44AB)*		
1	Method of accounting employed in the previous year *(Tick)* ☑	☐ mercantile ☐ cash	
2	Is there any change in method of accounting *(Tick)* ☑	☐ Yes ☐ No	
3	Effect on the profit because of deviation, if any, as per Income Computation Disclosure Standards notified under section 145(2) [column 11(iii) of Schedule ICDS]	3	
4	Method of valuation of closing stock employed in the previous year		

Schedule ICDS	Effect of Income Computation Disclosure Standards on profit	
Sl. No. (i)	ICDS (ii)	Amount (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)**	

What is ICDS?

ICDS – Relevant extract of tax audit report (1/2)

2. In the Income tax Rules, 1962, in Appendix II , in Form No. 3CD, in Part-B, in clause 13, for sub-clause (d), the following shall be substituted ,namely, —

"(d) Whether any adjustment is required to be made to the profits or loss for complying with the provisions of income computation and disclosure standards notified under section 145(2)

(e) If answer to (d) above is in the affirmative, give details of such adjustments:

		Increase in profit (Rs.)	Decrease in profit(Rs.)	Net effect (Rs.)
ICDS I	Accounting			

ICDS

ICDS – Relevant extract of tax audit report (2/2)

	Policies			
ICDS II	Valuation of Inventories			
ICDS III	Construction Contracts			
ICDS IV	Revenue Recognition			
ICDS V	Tangible Fixed Assets			
ICDS VI	Changes in Foreign Exchange Rates			
ICDS VII	Government Grants			
ICDS VIII	Securities			
ICDS IX	Borrowing Costs			
ICDS X	Provisions, Contingent Liabilities and Contingent Assets			
	Total			

(f) Disclosure as per ICDS:

(i)	ICDS I-Accounting Policies
(ii)	ICDS II-Valuation of Inventories
(iii)	ICDS III-Construction Contracts
(iv)	ICDS IV-Revenue Recognition
(v)	ICDS V-Tangible Fixed Assets
(vi)	ICDS VII-Governments Grants
(vii)	ICDS IX Borrowing Costs
(viii)	ICDS X-Provisions, Contingent Liabilities and Contingent Assets".

What is ICDS?

ICDS – Step to harmonize Accounting & tax

Particulars	Amount
Profit or loss as per P&L Account	XXX
<u>Add/Less:</u> Adjustments to neutralize specific accounting treatment not aligned with ICDS	XXX
Eg. (1) Capital vs Revenue Expenditure	XXX
(2) Provision for expected losses	XXX
(3) Foreign Exchange Fluctuations	XXX
<u>Add/Less:</u> Specific adjustments under IT Act	
Eg (1) Depreciation/Investment allowance, Tax holiday, etc.	XXX
Taxable Income	XXX

ICDS – A step to harmonize Accounting Standards with IT Act

List of Notified ICDS

ICDS	Income Computation and Disclosure Standards	Equivalent AS	Equivalent IND AS
ICDS I	Accounting Policies	AS-1/5	IND AS-1 and 8
ICDS II	Valuation of Inventories	AS-2	IND AS-2
ICDS III	Construction contracts	AS-7	IND AS-11
ICDS IV	Revenue Recognition	AS-9	IND AS-18
ICDS V	Tangible Fixed Assets	AS-10	IND AS-16
ICDS VI	Effects of Changes in Foreign Exchange Rates	AS-11	IND AS-21
ICDS VII	Government Grants	AS-12	IND AS-20
ICDS VIII	Securities	AS-13	IND AS-32
ICDS IX	Borrowing Costs	AS-16	IND AS-23
ICDS X	Provisions, Contingent Liabilities and Contingent Assets	AS-29	IND AS-37

Applicability of ICDS

- ICDS will apply to:
  - An assessee
  - Following mercantile system of accounting
  - Computing taxable income under the following heads of income:
    - Profit and gains of business or profession
    - Income from other sources
- No Net worth or Turnover Criteria prescribed for applicability
- However, Individuals and HUFs not subject to tax audit u/s. 44AB exempted
- ICDS are mandatory in nature
- Not for the purpose of maintenance of books of account
- In case of conflict between ICDS and Act, the Act shall prevail

Fundamental Assumptions
ICDS I – Accounting Policies

ICDS 1 Relating to Accounting Policies

Particulars	As per ICDS 1	As per AS-1
Changes in Accounting Policy#	• Permitted for any "reasonable cause"	• No specific mention in AS -1 Principles laid down by AS-5: • If required by Statute, or • Compliance with AS, or • For more appropriate presentation

Observations:

- As per ICDS 1, Accounting policy can be changed for any "reasonable cause",
  - As per clarifications on ICDS issued by CBDT dated March 23, 2017, reasonable cause is an existing concept and has evolved well over a period of time conferring desired flexibility to the taxpayer in deserving cases.

Fundamental Assumptions
ICDS I – Accounting Policies

ICDS 1 Relating to Accounting Policies

Particulars	As per ICDS 1	As per AS-1
Disclosure in case of changes in Accounting Policies having no material effect in the current year but may have in future years	Disclosure is required in the previous year in which the change is adopted and also in the previous year in which such change has material effect for the first time	• Disclosure is required only in the year in which the change is adopted •

Observations:

- Upon change in accounting policy, disclosure required in the year of change if it has material effect
  - If no material effect in current year, **disclosure also required in first year** of material effect
  - Enhanced disclosure requirement and compliance burden
  - Material effect has not been defined

ICDS 3 – Construction Contracts

ICDS 3 – Construction Contracts

Contract Revenue

- Contract revenue includes initial amount agreed in contract including retentions and
- Variations in contract work, **claims and incentive** payments are included in contract revenue:

  (i) to the extent it is possible that they will result in revenue; and

  (ii) they are capable of being reliably measured.
- Uncertain collections to be booked as Bad debts – **No adjustment to revenue**
- Changes in estimate in revenue and cost – To be used in determination of amount in the period of change and subsequent periods

Initial amount agreed in the contract + Retention money + Variations, claims and incentive = Contract Revenue

ICDS 3 – Construction Contracts

ICDS 3 – Construction Contracts

Particulars	As per ICDS 3	As per AS 7
Revenue Recognition	Reasonable Certainty	Reliably estimated – a) Fixed Price – Revenue is measurable , costs are identifiable and economic benefit is probable b) Cost Plus - costs are identifiable and economic benefit is probable
Observations: • Accounting principles are more substantive and recognize income once it is actually accrued. "Reasonable certainty" provided under ICDS is subject term and therefore could invite litigation.		

ICDS 3 – Construction Contracts

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Particulars	As per ICDS 3	As per AS 7
Retention Money	Recognised on POCM basis. Judicial precedents pre-ICDS in favour of taxpayer*	AS 7 silent; Recognised only when right to receive established
Observations: • Q No 11 of FAQ provides that the retention money should be recognized only when there is certainty of its ultimate collection. Also the concept of *real income* would come into picture !		
Revenue recognition during early stages of contract	Profits to be recognised once contract crosses 25% stage of completion	No profit to be recognized if outcome of project cannot be ascertained However, any expected loss to be recognized immediately
Observations: • If outcome can not be estimated and the 25% threshold is exceeded, there would be mismatch in revenue recognition in books of accounts and tax computation.		

**CIT vs Simplex Concrete Tiles India Pvt Ltd (179 ITR 8) (Cal HC), CIT vs East Coast Constructions & Industries (283 ITR 297)*

ICDS 3 – Construction Contracts

ICDS 3 – Construction Contracts

Particulars	As per ICDS 3	As per AS 7
Contract costs relating to future activity	Recognized as an **asset** irrespective of recovery probability	Recognized as asset if it is probable that such costs are recoverable
Observations: • Costs which are not recognized as assets and recongized in the profit and loss account due probability of their recovery as per the principles laid down by AS 7 will get disallowed as per the provisions of ICDS 3		

ICDS 3 – Construction Contracts

Case study I– Expected Loss in contract

I Co → Enter into construction contract → Customer

Contact parameters at the end of	Year 1	Year 4
Total Revenue	100 cr	133 cr
Total Estimated cost	120 cr	120 cr
Stage of completion	30%	100%

Facts:

- I Co entered into construction contract at beginning of year 1 for Rs. 100 Cr. estimating profit margin of 10%
- Prices of construction material suddenly shoot up towards the end of year 1
- Contract had reached 30% completion stage at end of year 1 and is expected to be completed in year 4
- I Co is negotiating for escalation in contract price with customer but negotiations are not likely to be concluded up to year 4. Outcome is not estimable
- I Co proposes to book foreseeable loss of Rs. 20 Cr. on the contract in year 1
- Also evaluate if customer accepts escalation of Rs. 33 cr. in year 4 which wipes-off the impact of rise in price and project ends in profit

Scope of delegated legislation

- Settled law that a notification cannot override the statute. This view is supported based on following decisions :
  - CIT v. Sirpur Paper Mills [(1999)(237 ITR 41)(SC)]
  - CIT v. Taj Mahal Hotels [(1971)(82 ITR 44)(SC)]

- Durga Dass Devki Nandan Vs. ITO (200 Taxman 318)(HP) :
  - "It is settled law that the CBDT cannot issue a circular, which goes against the provisions of the Act. The CBDT can only clarify issues but cannot insert terms and conditions which are not part of the main statute; A delegate or person authorized to issue delegated legislation cannot virtually set at naught the provisions of the main statute."

- Preamble to every ICDS clearly states that in case of conflict between the provisions of the Act and the ICDS - the provisions of the Act shall prevail.

ICDS III - CONSTRUCTION CONTRACTS

Retention Money

- Retentions -
  - "amounts of progress billing which are not paid until satisfaction of conditions specified in the contract for the payment of such amounts or until defects have been rectified"

- AS/Ind AS –
  - Silent on treatment of retention money.
  - It requires separate disclosure of retention money.
  - **Recognition of revenue is based on PCM method, subject to ultimate recovery**.

Retention Money

- Judicial View –
  - More than 6 High Courts have held that retention money doesn't accrue during the performance of contract based on the principle of 'accrual'
  - For instance:
    - CIT vs. Simplex Concrete Piles India Pvt. Ltd. (179 ITR 8) (Cal HC);
    - CIT vs. East Coast Constructions & Industries Ltd. (283 ITR 297)(Mad HC);
    - CIT vs. Associated Cables Pvt. Ltd. (286 ITR 596)(Bom HC);
    - CIT vs. P&C Constructions Pvt Ltd (318 ITR 113)(Mad HC)].
  - To overcome unintended meaning given by judicial pronouncements.

Retention Money

- ICDS –
  - Contract revenue defined to include the initial amount of revenue agreed in the contract, <u>including retentions</u>.
  - Further, contract revenue is to be recognized by reference to the stage of completion of contract activity.

- FAQ of CBDT
  - Retention money, being part of overall contract revenue, shall be recognized as revenue subject to reasonable certainty of its ultimate collection condition contained in para 9 of ICDS – III. (Q 11)

Whether Retentions is taxable on PCM basis under ICDS

- Possible view –
  - ICDS cannot override the concept of accrual u/s. 5
    - 'Accrual' of income is dealt u/s. 4 and 5 of the IT Act.
    - ICDS is only a computational provision
    - A computational provision cannot bring to tax something which is not income accrued u/s 5.
    - Under ICDS I itself, 'accrual' is regarded as one of the fundamental accounting assumptions
  - ICDS only defines Contract Revenue to include "Retention Money". Recognition criteria is still the same i.e. when there is reasonable certainty of its ultimate collection.

Expected Loss

- Expected Loss:
  - Total contract costs exceed total contract revenue

- AS/Ind AS–
  - Expected loss is allowed – prudence
  - To remove differential treatment between income and losses - Steps

- ICDS III is silent on treatment of Expected Loss

Expected Loss

- ICDS I -
  - Principle of ‘prudence’ not regarded as one of the principles for selecting accounting policy
  - Expected loss shall not be recognised unless such recognition is in accordance with any other ICDS
- ICDS X-
  - Unlike AS 29, ICDS X does not allow creation of provision for ‘onerous contracts’

Recognition of revenue from Service Transactions

- AS 9 –
  - Permits both the methods of revenue recognition.

- Ind AS 18:
  - Permits on PCM basis for recognition of revenue from service transactions
  - To reduce litigation and alternatives, only PCM is recommended

- ICDS –
  - Permits only PCM, except where the duration of the contracts is $\leq$ 90 days.

Recognition of income from Service Transactions

- Judicial Pronouncements –
  - As both the methods are permitted in commercial accounting principle, hence any method can be followed.
  - Bilahari Investment (P.) Ltd. (299 ITR 1) (SC): Service provider - follow completed contract method

- Possible view –
  - The terms used in the standards are ‘revenue recognition’ not income recognition. However, in case of Lohia Machine (152 ITR 308), Supreme Court has upheld the power of rule making authority restrict the manner of computation to any one of the possible methods.

Implication of following CPM method in Books

- Possibility of MAT liability:
  - Say, service contract will take 3 years for execution and expected profit is Rs. 300.

Year	Income Tax	Books of Accounts	Tax @ 30%	MAT @ 18.5%
1	100	-	30	0
II	100	-	30	0
III	100	300	30	55.5

- TDS Mismatch:
  - ICDS does not require raising of a bill - if the transaction is covered by TDS then complication will increase, as the tax would be deducted in the year in which the bill is raised

Recognition of interest income from NPAs

- Judicial Pronouncements –
  - Real Income theory –
    - Shoorji Vallabhdas & Co. (46 TR 144) (SC):

      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. ;
    - Godhra Electricity (225 ITR 746) (SC),
    - State Bank of Travancore v. CIT (158 ITR 102) (SC)

Recognition of interest income from NPAs

- CIT v. Motor Credit Co. (P) Ltd. (127 ITR 572)(Mad)[SLP dismissed by SC in (149 ITR (Statutes) 93].

  <u>Where no income has resulted, it cannot be said that the income has accrued merely on the ground that the assessee has been following the mercantile system of accounting</u>

- Principle of accrual –
  - CIT vs. Vasisth Chay Vyapar Ltd. (196 Taxman169)(Delhi),
  - CIT vs. India Equipment Leasing Ltd (293 ITR 350)(Mad), etc.
  - DIT vs. Brahamputra Capital Financial Services Ltd. (12 taxmann.com 387)(Delhi).
  - CIT vs. Elgi Finance Ltd (293 ITR 357)(Mad).

Recognition of interest income from NPAs

- Possible view –
  - ICDS is a delegated legislation, cannot bring to tax something which has been held to be not 'income';
  - Besides it cannot override the concept of 'accrual' u/s. 5;
  - The explanation of CBDT does not hold good in case of 'IOS';
  - Recognition of interest on NPAs for NBFCs is governed by section 45Q of the RBI Act, which override any other law in India. Therefore, arguable that it overrides section 145 of the Act.

Impact of ICDS IV on recognition of export incentive

- Ind AS –
  - Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g., for escalation of price, export incentives, interest etc., revenue recognition is postponed to the extent of uncertainty involved.

- ICDS –
  - Para 5 – where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim for export incentives, revenue recognition in respect of such claim shall be postponed to the extent of uncertainty involved.

Impact of ICDS IV on recognition of export incentive

- Judicial Pronouncement –
  - Income to be recognised when there is corresponding third party liability to pay
  - See CIT v. Excel Industries Ltd. (358 ITR 295) (SC)
- Possible view –
  - ICDS cannot override the concept of accrual as explained by the courts.
  - Additional argument can be taken that export incentive is outside the scope of the ICDS - EAC Vol 26, Q 32.

Impact of ICDS IV on treatment of Finance Lease

- AS/Ind AS –
  - A separate AS is prescribed for accounting of leases
  - Recommended a separate ICDS on leases, which has not been notified yet.
- ICDS IV –
  - Excludes revenue recognition of items specifically dealt by other ICDS.

Impact on current treatment of Contingent Asset

- Accounting Standard –
  - Requires recognition when there is virtual certainty of inflow of economic benefits.

-
  - To remove differential treatment between recognition of income and expense.

- Judicial Pronouncements –
  - Basic concept of accrual & real income theory applicable for taxation of income

Impact on current treatment of Contingent Asset

- ICDS –
  - Requires recognition of contingent asset if it becomes ‘**reasonably certain’** that inflow of economic benefit will arise.

- Our view –
  - ICDS being a computational provision cannot override the concept of accrual u/s 5, as explained by the courts.

Treatment of loss on Onerous contract

- Accounting Standard –
  - If an enterprise has a contract that is onerous, the present obligation under the contract is recognised and measured as a provision. Onerous Contract means a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

- ICDS X -
  - Does not deal with recognition of loss arising out of onerous contract.

- <u>Observations</u>–
  - *Prima facie*, such loss won't be allowed. However, if it is concluded that ICDS – I is a legislative misfire, then relying on commercial accounting principle the loss should be allowed.

Clarifications issued by CBDT

- Impact of transitional provisions of ICDS X:
  - Para 20 requires that the provision/assets for FY 2016-17 shall be recognised after taking into account the amount, if any recognised in earlier years in respect of the same item;
  - It is clarified that the intent behind the said para is to avoid any ‘double taxation’ or ‘double deduction’ of same income/expense, due to applicable of ICDS.

- Post-retirement expenditure dealt with in AS-15 not covered by ICDS X:
  - There is no specific exclusion for employee benefits such as provident fund, gratuity, etc. in ICDS X;
  - Hence, there was an ambiguity whether ICDS X can apply to such benefits and whether provision for such liabilities (without discounting for present value) will be allowable under ICDS X.
  - It is clarified that ICDS X would not apply to such benefits.

Consequence of non-compliance with ICDS

- Section 145(3)-
  - AO has the power to make best judgement assessment u/s. 144 if he is not satisfied about the :-
    - correctness or completeness of the accounts of the assessee ; or
    - method of accounting is not regularly followed ;or
    - Income not computed as per ICDS.

- Hence, on not complying with ICDS, the AO can ignore the books of the assessee and do a best judgement assessment.

- Therefore, in case of any deviation from the ICDS, there should be a proper disclosure giving the reasoning for such deviation in the computation.

THANK YOU!