Issues in Implementation of Income Computation and Disclosure Standard ("ICDS")

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List of ICDS

Notified

- I: Accounting policies
- II: Valuation of inventories
- III: Construction Contracts
- IV: Revenue Recognition
- V: Tangible Fixed Assets
- VI: Effects of Changes in Foreign Exchange Rates
- VII: Government Grants
- VIII: Securities
- IX: Borrowing Costs
- X: Provisions, contingent liabilities and contingent assets

Yet to be notified

- Events occurring after the end of previous year
- Prior Period Expense
- Lease
- Intangible Assets

ICDS - General principles

- ICDS applies only to taxpayers following mercantile method of accounting
  - Notification dated 31 March 2015 makes this clear
- Applicable to all taxpayers irrespective of turnover or quantum of income
  - Non resident taxpayers may also have concern on computation of income of PE/branch
- ICDS to be given effect in computation of taxable income
  - No two sets of books required to be maintained as clarified by Preamble of each ICDS
  - Additional disclosures mandated by ICDS may be in tax audit report or return of income

ICDS - General principles

- ICDS applies only to computation of income under following heads :
  - Profits and gains of business or profession
  - Income from other sources
- MAT will continue to be governed by books of account prepared as per AS
  - Mismatch between MAT and normal computation likely to be widened
  - Accelerated income recognition 'may' also result in duplicated levy of tax (i.e. Normal tax in year of recognition as per ICDS and MAT in year of recognition in books)[1] with no opportunity to offset MAT credit
  - Instances of mismatch between ICDS and book profit - Foreseeable loss on construction contract on POCM basis, bucket approach for valuation of securities

[1] Refer however Andhra Pradesh HC ruling in Nagarjuna Fertilizers & Chemicals Ltd. which upheld principle of no duplicated taxation under normal and MAT in different years

ICDS - General principles

- ICDS is based on currently applicable ICAI AS subject to deviations/carve outs as suggested by Committee
  - IFRS / Ind-AS are notified to become effective from F.Y. 2016-17 in phased manner
  - Differences of ICDS with Ind-AS will require independent evaluation (eg. BOT project, Revaluation of PPE, etc)
- Revenue / expense on which there is no ICDS will continue to be governed by AS
  - E.g. Leases, Prior period items
- Unlike ICAI AS, ICDS contains only main principles; ICDS has no Explanations or Illustrations
- Undefined words/expression take their meaning from ITA

ICDS - General principles - Canons of construction

- Modifications which now forms part of law may require strict construction based on language and may have impact on quantum of chargeable income.
- Non-compliance results in best judgement assessment
- Royalty, interest, FTS, etc., as per preponderant judicial view, may be taxed under DTAA when ‘paid’.

ICDS - General principles - Canons of construction

- Provisions of ITA to prevail in case of conflict with ICDS
  - Illustrative instances of likely conflict with provisions of ITA / Rules.
    - Disallowances under s. 43B , s.40(a)(ia), etc.
    - Presumptive taxation, tonnage tax, insurance companies, film producers/distributors, etc.
  - Would same position prevail in case of conflict between HC / SC rulings and ICDS?[1]
  - Illustrative instances of likely conflict with tenets of taxation settled by SC / HC w.r.t non-taxable capital receipts and/or non-accrual of income.
    - Export incentives recognized in books awaiting utilization[2]
    - Exchange fluctuation on capital account for domestic assets

1 Can one say, HC / SC ruling explains and interprets the law ?
2 Excel Industries Ltd. [TS-506-SC-2013]

ICDS - General principles - Canons of construction

- As per judicial precedents, business income to be computed as per principles of commercial accounting in consonance with accounting standards, subject to statutory provisions such as – say, S.36(1)(iii), S. 40(a)(ia), S. 43B, 43D, depreciation block, presumptive taxation, etc.
- With legislative sanction, principle of commercial accounting can be modified pursuant to notifications u/s. 145 (2) (Refer, Woodward Governor India (P) Ltd (312 ITR 254)

Transitional provisions

- ICDS apply with effect from F.Y. 2015-16 (A.Y. 2016-17)
- All ICDS (except ‘Securities) have transitional provisions to deal with open contracts/transactions as on 1 April 2015.
- Committee had recommended transitional provisions which ensure that there is neither double taxation nor escapement of taxation
- Accordingly, there is no ‘grandfathering’ for contracts/transactions entered prior to 1 April 2015. They are to be dealt with as per ICDS after taking into account income, expense or loss, if any, recognised in earlier years.

Reporting requirement

- Vide **Notification No. 24/2016 dated 30 March 2016**, ITR forms have been amended to provide detail of effect on the profit because of deviation, if any, as per Income Computation Disclosure Standards notified under section 145(2) under new schedule **“ICDS-Effect of Income Computation Disclosure Standards on profit”.**
- Tax payer is required to provide detail of amount that affects taxable profit under each ICDS. It is, however not clear whether such disclosure is optional for taxpayers not liable for tax audit – even though ICDS is applicable to them.
- New ITR forms does not specify any reporting requirement of necessary disclosures to be made in accordance with each ICDS. Presently tax audit form also does not provide to make such disclosures.
- It is therefore unclear as to where necessary disclosures, as required under each ICDS, is to be made. It is, however, advisable to make such disclosure in notes to computation of income

ICDS I - Accounting Policies

Fundamental accounting assumptions & Materiality

- Going concern, consistency and accrual are fundamental accounting assumptions. Disclosure required if any of the assumptions are not followed
- Accrual of income takes place when there emerges a debt in favour of taxpayer which is enforceable in law [E.D. Sassoon & Co. Ltd. (26 ITR 27) (SC)]
- Concept of 'materiality' which was relevant in selecting and applying accounting policy has been omitted.
  - While no likely significant tax impact, there could be litigation on small value items if Tax Authority insists on strict application of ICDS

Prudence

Concept of 'prudence' is modified by ICDS

- Prior to ICDS, prudence understood to mean non-recognition of anticipated profits but recognition of known liabilities and losses on best estimate basis (e.g. ICAI's guidance on derivatives in March 2008)
- As per Committee, prudence led to differential treatment of income and loss
- ICDS prohibits recognition of marked to market or expected loss unless permitted by any other ICDS (but silent on MTM gain)
  - Instances of losses permitted under other ICDS are:
    - Inventory valuation loss; subject to, Bucket approach for 'Securities'
    - MTM forex loss on monetary items (including forwards & options for hedging purposes)
    - Provisions for liabilities on 'reasonable certainty' basis

Change in accounting policy

- Accounting policy can be changed for any ‘reasonable cause’.
- Earlier, change permitted if required by statute; or for compliance with AS; or considered as resulting in more appropriate presentation.
- 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 required in first year of material impact.
  - Enhanced disclosure requirement and compliance burden

ICDS - Valuation of inventory

Valuation of inventory

- In case of assets:
  - Valuation at lower of cost or NRV
  - Permits FIFO, specific identification, weighted average, or retail method.
    - Standard cost method unacceptable for ICDS but Cos Act 2013 permits under Cost Records rules.
- In case of services, valuation to be the lower of cost or NRV.
  - Challenge of determining NRV in case of service provider who is on success fee model.
  - Cost to include direct cost of labour, supervision, personnel and attributable overheads (including depreciation?).
  - Once revenue is recognised on POCM as per ICDS on revenue recognition, attributable inventory need not be carried forward
  - Machinery spares which can be used only in connection with tangible asset and their use is expected to be irregular, shall be treated as tangible fixed assets.

Valuation of inventory

- Valuation of opening inventory to be the same as closing inventory in preceding year – regardless of change in method of valuation of closing inventory.
- Method of valuation once adopted shall not be changed without reasonable cause.
  - Courts have permitted bonafide change where changed method is as per GAAP and followed regularly thereafter (e.g. from cost to lower of cost or NRV)
- On dissolution of firm, AOP or BOI, inventory to be valued at NRV regardless of whether business is discontinued.
  - Overrules SC ruling in Shakthi Trading's case (250 ITR 871) where SC upheld lower of cost or NRV considering that business was continued post dissolution
  - In ALA Firms (189 ITR 285)(SC), SC upheld valuation at NRV since business was discontinued on dissolution

ICDS - Construction Contracts

ICDS - Construction Contracts

- Like ICAI AS, not applicable to real estate developers
- Applies to a fixed price, cost plus, or to a hybrid of fixed & cost plus contract
- Mandates recognition of revenue under POCM
  - Mandatory to recognize profit/loss on POCM basis beyond 25%
- Components of revenue recognition on POCM basis
  - Contract revenue to be recognised if there is reasonable certainty of ultimate collection
    - Reconcilable with real income theory as per present position
  - Retention money to be included as part of contract revenue

ICDS - Construction Contracts

- Foreseeable losses
  - Future/anticipated losses are not allowed
  - Contract cost relatable to proportion of work completed are allowed
- Contract cost to be reduced by incidental income if not in the nature of interest, dividends or capital gains
  - ICDS on Borrowing Cost does not permit reduction of income from temporary investments of borrowed funds for capitalization

ICDS - Revenue recognition

Revenue recognition

- Revenue from sale of goods recognised upon transfer of property or upon transfer of significant risk/rewards of ownership to buyer.
- Revenue to be recognised only if there is reasonable certainty of its ultimate collection.
  - ICDS not materially different from AS-9
  - ICDS is in line with current judicial thinking which aligns also with real income theory!
- But ICDS is ambiguous whether condition of reasonable certainty of ultimate collection applies also to interest and royalty income
- When ability to assess condition of reasonable certainty of ultimate collection is lacking for escalation of price and export incentives, revenue should be postponed to the extent of uncertainty – No clarity on other items like overdue interest or compensation through arbitration etc.

Revenue recognition

- ICDS on revenue recognition will not cover revenues dealt by other ICDS; say, Construction contracts, Government grants, Foreign exchange fluctuation, Contingent Assets
  - ICDS on Revenue recognition may cover revenues on which presently no specific ICDS is notified (e.g. Leases, BOT projects, Real estate development)
- Mandatory for service sector following mercantile method of accounting to recognise revenue on POCM basis mutatis mutandis Construction Contracts
  - Inserted to reduce litigation and alternatives for accounting
  - No need to recognise profit if stage of completion < 25%
  - Foreseeable loss may also be on POCM basis.
  - Valuation of inventory of service covered by ICDS on valuation of inventory (direct labour cost and attributable overheads)

Revenue recognition

- Disclosures
  - Total amount of revenue not recognized due to lake of reasonable certainty of its ultimate collection along with nature of uncertainty for sale of goods.
  - Amount of revenue from service transactions.
  - Methods used to determined stage of completion of service transactions.
  - For service transactions in progress – cost incurred, profit recognized, advances received and retentions.
  - **Recent amendment:** Finance Act, 2015 has amended ITA to provide that debt taxed as per ICDS but not recognized in the books shall be allowed as bad debt in the tax year in which it becomes irrecoverable and it shall be deemed as if such debt has been written off as irrecoverable in the accounts for this purpose.

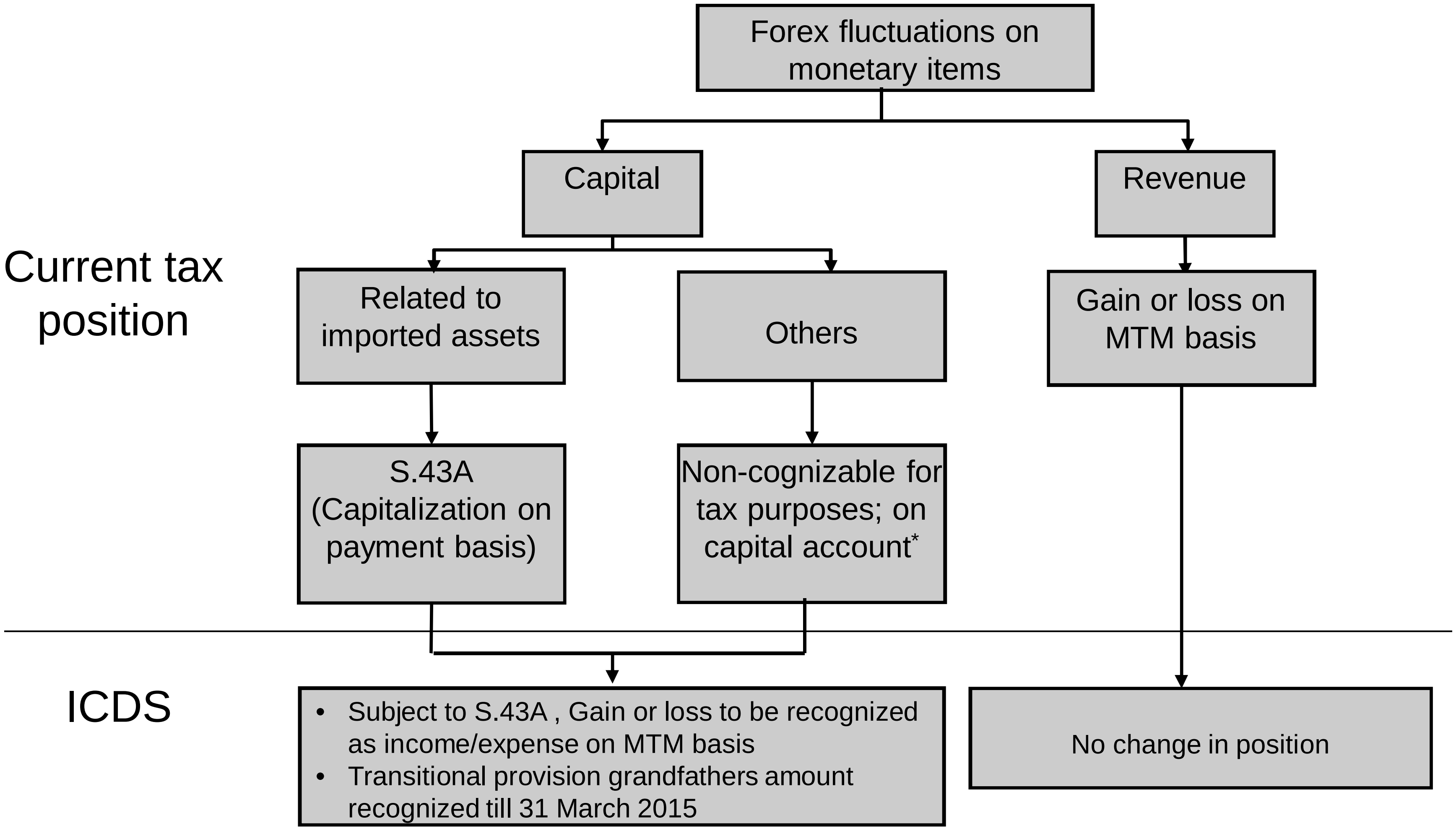
ICDS - Tangible fixed assets

Tangible fixed assets

- Components of cost align largely with commercial concept and definition of actual cost in S.43(1) of ITA.
- Fair value of a tangible fixed asset acquired in exchange constitutes cost of asset received
  - No option of adopting fair value of asset given up
- ICDS acknowledges that depreciation and income arising on transfer will be as per ITA.
- Requirement of maintaining ICDS specific fixed asset register as proposed earlier has been deleted

ICDS - Foreign exchange fluctuations

Foreign exchange fluctuations



* ICDS treatment is in conflict with SC decisions

Foreign exchange fluctuations

Forex derivatives covered by ICDS

Forward Contracts

Foreign Currency option

ICDS makes no distinction between capital and revenue

Hedging Contracts

- ICDS allows loss/gain on MTM basis
- Premium/discount to be amortised over contract life

(Same as ICAI)

- Trading
- Speculation
- Firm commitments*
- Highly probable forecast*

- ICDS recognises loss/gain on actual settlement basis (including premium/discount)
- ICAI permits MTM

- May have significant impact for banks!!
- May result in MAT mismatch
- Other taxpayers need to guard against characterization as ‘speculative’

* ICAI AS- 11 excludes these contracts. ICDS explains firm commitment to mean assets/liabilities which exists by end of previous year

Forex derivatives : Overview from ICDS perspective

Forex derivatives
(not covered by ICDS)

Forex derivatives like cross currency swaps, futures, interest rate swaps, exotic products

Committee had recommended formulation of separate ICDS[1]

ICDS is silent !

But, ICDS on accounting policies prohibits MTM or expected loss!!

[1] ICAI recommends recognition of MTM loss and ignoring of MTM gain

Integral vs non-integral foreign operations

Foreign Operations

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

- ICDS applies same principles as own assets and liabilities subject to S.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 translation on MTM to be recognized as income/expense (whereas ICAI AS-11 requires accumulation in reserve)
- No distinction between capital and revenue items
- MTM to be recognized even on tangible fixed asset??
- Transitional provision grandfathers amount ‘recognized’ till 31 Mar 2015.
  - Can Tax Authority seek upfront recognition in FY 2015-16 of amount lying in reserve on 31 Mar 2015?

ICDS - Government grants

ICDS on Government grants

- Consistent with S.43(1), grant relatable to depreciable fixed asset is to be reduced from cost.
- Grant relatable to non-depreciable fixed asset to be considered as income on upfront basis (or, over a period matching related cost)
  - Unlike AS-12, erroneously classifies a capital receipt into a revenue item?
- Recognition of grant cannot be postponed beyond date of actual receipt
  - Impact of non-grandfathering of past receipts
- Accelerated recognition on receipt basis and/or income recognition of grant credited to capital reserve may create MAT mismatch

ICDS on Government grants

- Any Government grant not dealt with specifically to be accounted as income
- ICDS limited to Government grant and may not have impact on parental subvention.
- ICDS also requires disclosure of all unrecognized grants
  - Perhaps, the intent is to require disclosure of grants which are not recognised due to absence of reasonable assurance of compliance of future conditions and/or receipt of grant.
- **Recent amendment: Finance Act, 2015** has amended S.2(24) of ITA to provide that any grant or subsidy which is related to non-depreciable asset shall be taxable as its income. **Finance Bill, 2016** further amended such provision to provide that in case grant or subsidy is given by the Central Government for the purpose of corpus of the trust/institution established by state or Central Government, it is not regarded as income of such trust/institution.

ICDS - Securities

ICDS - Securities

- Deals with securities held as stock-in-trade
  - Currently, ICAI AS-13 principles on “current investments” apply to securities held as stock-in-trade
- ‘Securities’ defined to have meaning assigned in S.2(h) of SCRA except derivatives referred in S.2(h)(1a)
- ICDS does not apply to securities held by
  - Insurance Companies; Mutual Funds; Venture Capital Funds; Banks; Public Financial Institutions
  - FIIs/FPIs, since securities are deemed to be capital assets in their hands
- Coverage of ICDS will illustratively affect
  - Stock-Brokers; NBFCs; Others engaged in securities trading
  - Computation of ‘deemed speculation’ loss under Explanation to s.73

Bucket Approach

- In contrast with ICAI AS, ICDS mandates ‘bucket’ approach for valuation of security at lower of cost or NRV
- Securities to be classified into following buckets
  - Shares; Debt Securities; Convertible Securities; Any Other Securities
- Fair value of security acquired in exchange for other securities or assets to be regarded as actual cost of security acquired.
  - Fair value of securities or assets given up is not relevant
- Opening Value to be
  - Cost of securities available, if any, on commencement of business if business commenced during the previous year
  - Closing value of immediately preceding previous year in any other case

Bucket approach for lower of cost or NRV

Illustrative impact

Sr.	Cost	Movement of share price	Year end NRV	Year end conventional valuation
1.	200	(-160)	40	40
2.	200	(-160)	40	40
3.	200	(-160)	40	40
4.	200	(-160)	40	40
Subtotal (A)	800	640	160	160
5. (B)	200	+600	800	200
Total (A+B)	1000	(-40)	960	360

Stock value on Bucket valuation

Itemised valuation

Impact analysis

- Bucket approach virtually results in accelerated taxation with reference to the security (at item (5) above) which appreciates in value
- May also create mismatch with MAT

Valuation of unlisted/ thinly traded securities at cost

- Unlisted securities and thinly traded securities to be valued at cost only regardless of NRV
  - Difficulty where securities are delisted or become thinly traded during a particular year.
  - Opening stock of such securities may be valued at NRV (being lower than cost) whereas closing stock may be valued at cost resulting in artificial income as also mismatch with MAT

Reduction of Pre-acquisition Interest from Cost

- SC in Vijaya Bank's case (187 ITR 541) had ruled that pre-acquisition interest paid is part of purchase cost of security
- Above ruling was distinguished by Bombay HC in American Express Bank's case (258 ITR 601) which held that SC ruling does not apply to business head of income, if securities are held as stock in trade.
- As per prevalent practice in finance sector, purchase price is split up into two components at inception of deal. Broken period interest cost is netted against interest income.
- ICDS recognizes prevalent practice and provides for reduction of pre-acquisition interest from cost of security.

ICDS - Borrowing Cost

ICDS on Borrowing Cost

- Propositions governed by statutory provisions
  - In computing business income, S.36(1)(iii) overrides all accounting principles except when there is interest cost for extension of business.
  - Hence, arguable that ICDS limited to cases where there is extension of business.
  - SC in case of Taparia Tools Ltd.[1] upheld deduction for upfront interest by holding that ITA does not recognize concept of Differed Revenue Expenditure.
  - Inclusion of interest cost in inventory of real estate developer may not conflict with deduction u/s. 36(1)(iii).
- In a case involving extension of business, interest cost is still deductible if considered as revenue expense under ICDS.
  - Interest attributable to inventory which matures to the level of saleable condition within 12 months is revenue expense.
  - Interest attributable to any tangible or intangible asset post date of first put to use.

[1] TS-134-SC-2015

ICDS on Borrowing Cost

- In case of specific borrowing, capitalization to commence from date of borrowing upto date when asset is put to use [as against ICAI AS-16 condition of incurrence of cost upto readiness to use]
- In case of general purpose borrowing:
  - Capitalisation to commence from date of utilization
  - Capitalisation as per, ambiguously worded, normative pro-rata formula
- ICDS is silent on reduction of income from temporary deployment of unutilized funds from specific loans
  - ICAI AS requires the same to be reduced from borrowing cost
  - As per Committee, condition removed to align with judicial precedents
- Unlike ICAI AS-16, requirement to suspend capitalization during interruption of active development of asset/inventory is removed in ICDS

ICDS on Borrowing Cost

- Qualifying Asset under ICDS means
  - Tangible Asset like Land, Building, Plant, Machinery etc.
  - Intangible Asset like Knowhow, Patterns, Copy rights, licenses and other business and commercial rights.
  - Inventories that require a period of 12 months or more to bring them to a saleable condition.
- Qualifying Asset under AS-16 refers to substantial period of time i.e. 12 months or more for all the assets.

ICDS on Borrowing Cost

- General Interest cost to be capitalized as per ICDS = A x B / C
- A = Total borrowing cost Less specific borrowing cost
- B = Average of various qualifying assets (other than directly funded from specific borrowings)
- C = Average of total assets as per Balance Sheet1 (excluding assets directly funded from specific borrowings)
- Disclosure
- **Recent amendment:** Finance Act, 2015 has amended S.36(1)(iii) to omit the condition of asset acquisition ‘for extension of existing business or profession’ for disallowance of borrowing cost to align the Act with ICDS.

ICDS – Provisions, Contingent liabilities and Contingent assets

ICDS – Provisions, Contingent liabilities and Contingent assets

- Provision for liability can be made if, as per yardstick of *'reasonable certainty'*, there is present obligation likely to involve outflow of economic resources
  - ICAI AS -29 requires provisions to be made as per yardstick of probability on MLTNTS basis
  - Reasonable certainty criteria is used in other ICAI AS/ICDS also (eg. AS-9/ICDS on recognition of revenue or AS-22 on recognition of DTA).
  - Provision not to be discounted to NPV
  - ICDS silent on present obligation which arises out of business custom/practice or such equitable consideration, even in absence of contractual obligation
- Provision for restructuring costs will continue to be governed by specific provisions of ITA
- ICDS silent on 'onerous executory contracts'

ICDS – Provisions, Contingent liabilities and contingent assets

- Contingent asset to be recognized as income if inflow of economic benefit or reimbursement is *‘reasonably certain’*
  - Substantial deviation compared to the threshold of ‘virtual certainty’ as per ICAI AS-29
  - Conflicts directly with concept of accrual of income as per ITA?
  - Ambiguity on whether transitional provision requires recognition of all past accumulated contingent assets in F.Y. 2015-16!!
  - As per dictionary/judicial exposition, reasonably certain means fair and reasonable; being free from reasonable doubt, what reasonable person may believe as certain
- Yardstick of *‘reasonable certainty’* needs to be uniform in case of provision for liability as also asset, but, is prone to subjective considerations by different assessees in identically placed situation
- In either case, opinion of experts and events after balance sheet date may be relied upon by Tax Authority

Contingent Asset recognition

- Evaluate impact of requirement of recognition based on ‘reasonable certainty’
- Transitional provisions require recognition of assets and related income as on 1 April 2015 in accordance with ICDS
- Consider following chronicle related to insurance claim under loss of profit policy

Event	Year
Incurrence of loss	2005
Claim accepted by lower court	2008
Claim accepted by High Court	2013
Year of transition to ICDS	2016
Claim accepted by SC	2020

- Will taxpayer need to recognize claim receivable and related amount as income of FY 2015-16?
- If claim related to loss of stock-in-trade, S.41(1) may lead to tax in year in which amount of claim is ‘obtained’?
- **Recent amendment:** Finance Act, 2015 has amended ITA to provide that debt taxed as per ICDS but not recognized in the books shall be allowed as bad debt in the tax year in which it becomes irrecoverable and it shall be deemed as if such debt has been written off as irrecoverable in the accounts for this purpose.

Concluding thoughts

Some high impact areas of ICDS

- Conflict with settled judicial principles on capital receipts being called ‘income’ (e.g. Forex fluctuation, Retention money)
- ‘Real income’ theory whether overridden? (e.g. Retention money, Contingent assets, Bucket approach)
- Potential retrospective catch up taxation due to transitional provisions (Service revenue recognition on POCM, contingent assets, non-integral foreign operations)
- Mismatch with MAT due to timing differences between books and tax
- Deferment of foreseeable loss on onerous contracts
- Forex derivative loss on actual settlement basis (other than forwards and options)

Thank you