



Income Computation And Disclosure Standards (ICDS)

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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 had been notified until now:
 1. Disclosure of accounting policies
 2. Disclosure of prior period and extraordinary items and changes in accounting policies

Background

- ❖ Finance Act, 2014 amended section 145(2) of the Act to substitute “accounting standards” with “income computation and disclosure standards” (ICDS).
- ❖ 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 notified 10 ICDS which were to be effective from 1st April, 2015. The Government of India rescinded the notification issued on 31st March, 2015 and issued a notification dated 29th September, 2016 revising the provisions of ICDS and which are applicable from AY 2017-18
- ❖ The introduction of ICDS may significantly alter the way companies compute their taxable income.

General principles

- ❖ ICDS are applicable for computation of income chargeable under the head “profits and gains of business or profession” and “income from other sources” and not for maintaining books of accounts.
- ❖ ICDS applies to all taxpayers except individual and HUF who are not covered under the tax audit provisions.
- ❖ In case of conflict between the provisions of the Act and ICDS, the provisions of the Act shall prevail to that extent.
 - The risk of best judgment assessment u/s 144 if positions adopted as per ICDS which is contrary to rulings.
- ❖ ICDS applies only to taxpayers following mercantile system of accounting.

Circular No. 10/2017 dated 23rd March, 2017

❖ Clarifications-

✓ **Interplay between ICDS I and Maintenance of Books of Account**

It is clarified that ICDS are not applicable to maintenance of books of account. The Accounting Policies in ICDS I are applicable for computation of income.

✓ **Inconsistency between judicial precedents and ICDS**

The ICDSs have been notified after examination of judicial views for bringing certainty on issues covered by it. As the CBDT has now provided certainty by notifying ICDS, the provisions of ICDS shall be applicable to the transactional issues dealt therein from AY 2017-18 and onwards.

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❖ Clarifications-

✓ **Applicability of ICDS in certain cases**

The clarifications have been issued by the CBDT on the applicability of ICDS to persons covered under presumptive taxation scheme, companies following Ind-AS, computation under Minimum Alternate Tax ('MAT') and Alternate Minimum Tax ('AMT'), banks, etc. as under:

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Persons covered by presumptive scheme of taxation (eg. Sec 44AD, 44AE, 44ADA, 44B, 44BB, 44BBA of the Income-tax Act, 1961).

It has been clarified that ICDS is applicable to persons having income chargeable under the head 'Profits or gains of business or profession' or 'Income from other sources'. Therefore the relevant ICDS shall also apply to persons computing income under the relevant presumptive taxation scheme.

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❖ Clarifications-

✓ **Applicability to companies which adopted Ind-AS**

- ICDS is applicable for computation of taxable income under the Income-tax Act, 1961 ('Act') irrespective of the accounting standards adopted by the companies i.e., either Accounting standards or IND-AS.

✓ **Whether applicable to computation under MAT and AMT**

- As the provisions of ICDS are applicable for computation of income under the regular provisions of the Act, the provisions of ICDS shall not apply for computation of book profit under section 115JB of the Act. However, as AMT is computed on adjusted total income derived by making specified adjustment to total income computed under regular provisions of the Act, the provisions of ICDS will apply for computation of AMT.

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- ✓ **Applicability to Banks, Non-banking financial institutions, Insurance companies, Power sector etc.**
- The general provisions of ICDS shall apply to all persons unless there are sector specific provisions contained in the ICDS or the Act. (Example: ICDS VIII contains specific provisions for Banks or certain financial institutions and Schedule I of the Act contains specific provisions for Insurance business). Applicability of ICDS III and IV by real estate developers and Build-
- ✓ Operate-Transfer ('BOT') projects and applicability of ICDS for leases As currently there is no specific ICDS notified for real estate developers, BOT projects and leases, the relevant provisions of the Act and ICDS shall apply to these transactions as may be applicable.

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✓ Applicability of ICDS to income liable to tax on gross basis

The provisions of ICDS shall also be applicable for computation of income on gross basis (e.g. interest, royalty, fees for technical services under section 115A of the Act) for arriving at the amount chargeable to tax.

✓ Conflict between the provisions of ICDS and Income Tax Rules, 1962

As ICDS provides for general principles for computation of income, in case of conflict between the provisions of the Rules and ICDS, the provisions of Rules which deal with specific circumstances, shall prevail (e.g. 9A, 9B etc.).

Valuation of Inventories



ICDS II - Valuation of inventory

ICDS definition

- a "Inventories" are assets:
- i held for sale in the ordinary course of business;
 - ii in the process of production for such sale;
 - iii in the form of materials or supplies to be consumed in the production process or in the rendering of services.

AS 2 definition

- 3.1. Inventories are assets:
- (a) held for sale in the ordinary course of business;
 - (b) in the process of production for such sale; or
 - (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

Most clauses in ICDS 2 and AS 2 are similarly worded.

ICDS II - Valuation of inventory

- Exclusions from application of ICDS
 - WIP arising under 'construction contract' including directly related service contract
 - Shares, debentures and other financial instruments held as stock-in-trade
 - Producers' inventories of livestock, agriculture and forest products, mineral oils, ores & gases to the extent that they are measured at net realisable value;
 - Machinery spares

ICDS II - Valuation of inventory

- ICDS II permits **FIFO and Weighted Average Cost formula** for inventory valuation
 - Retail method permitted in specified situations
- New ICDS now permits **standard cost method** for the purpose of inventory valuation
- Method of valuation once adopted shall not be changed without reasonable cause
- Inventory cost exclusions :
 - Abnormal wastages
 - Storage costs
 - Administrative overheads
 - Selling Costs

ICDS II – Service contracts

AS- 2	ICDS
<ul style="list-style-type: none">AS-2 does not include work in progress (WIP) arising in the ordinary course of business <i>of service providers.</i>	<ul style="list-style-type: none">Specifies that it does not apply to WIP which is dealt with by other ICDS.

- Definition of inventory – does not include services ?
- Valuation of service inventory to be the lower of **cost or NRV.**
- **The costs of services in the case of a service provider** shall consist of labour and other costs of personnel directly engaged in providing the service including supervisory personnel and attributable overheads.

Value of opening inventory

- Value of opening inventory should be same as preceding year's closing inventory.
- In case of a newly commenced business, the value of the opening inventory shall be the cost of the inventory.
- Cases of conversion of capital asset into stock-in-trade with intent to commence business may remain unaffected due to overriding provisions of Section 45(2) of the Act.
- If business is commenced with acquisition of running business on slump sale, price paid will be 'cost' of opening inventory.
- If partner takes over running business of firm/LLP, value agreed with other partners for inter-se settlement shall be 'cost' for the partner.

Method of Valuation

- Revised ICDS permits **standard cost method** for the purpose of inventory valuation.
- Companies Act, 2013 also permits Standard cost method under Cost Records rules.
- Further, as per ICDS, method of valuation once adopted shall not be changed without reasonable cause. It would not have a significant impact since bonafide change may constitute reasonable cause

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

- According to ICDS, 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.

Disclosures

- The Accounting Policies adopted in measuring inventories including the cost formulae used. Where Standard Costing has been used as a measurement of cost, details of such inventories and a confirmation of the fact that standard cost approximates the actual cost and
- The total carrying amount of inventories and its classification appropriate to a person.

Construction Contract



Construction Contracts

AS - 7	ICDS III
❖ <u>Real Estate Developers</u>	
It does not deal with recognition of revenue by Real Estate Developers and there is separate Guidance Note on the same issued by the ICAI.	ICDS is silent whether the same is applicable to Real Estate Developers or not.
❖ <u>Contract Cost</u>	
Contract Cost includes: <ul style="list-style-type: none">- Direct cost- Cost allocated to the contract- Cost specially charged to the customer under the terms of the contract	The scope of the Contract Cost has been widened to include “Allocated Borrowing Cost” in accordance with ICDS on Borrowing Cost.

Construction Contracts

AS - 7	ICDS III
❖ <u>Recognition of Contract Revenue</u>	
Contract revenue to be recognized if it is possible to reliably estimate the outcome of a contract.	The criteria “if it is possible to reliably measure the outcome of a contract” has been omitted. Contract revenue to be recognized when there is reasonable certainty of its ultimate collection.
<u>Impact:</u> The recognition of contract revenue may be preponed under ICDS.	
❖ It lays down the conditions to estimate the outcome of construction contract in case of :- - Fixed Price Contract - Cost plus Contract	❖ ICDS is silent on the same

Construction Contract

AS-7	ICDS III
❖ <u>Situation when outcome of contract cannot be reliably estimated</u>	
<p>Contract revenue and contract costs to be recognized as revenue or expenses by reference to the POCM if the outcome of the contract can be estimated reliably; else, revenue should be recognized only to the extent of contract costs incurred.</p> <p>No quantitative threshold laid down for determining the stage of completion, until when, the outcome of a contract cannot be reliably measured.</p>	<p>ICDS provides that early stage of a contract shall not exceed 25% of the stage of completion.</p> <p>In other words, upto 25% of the stage of completion, if the outcome of construction contract cannot be reliably measured, contract revenue is recognized only to the extent of cost incurred.</p>
<u>Impact:</u> Under ICDS, profit recognition has to start compulsorily once 25% stage is completed but the same is not the case currently under AS – 7.	

Construction Contract

AS-7	ICDS III
❖ <u>Retention Money</u>	
Contract revenue shall comprise: The initial amount of revenue agreed in the contract	Contract revenue shall comprise: The initial amount of revenue agreed in the contract, <u>including retentions.</u>
Impact Analysis: There are various judicial precedents like <u>Angelique International Ltd. vs Department of Income Tax [ITA No.4085/DEL/2011]</u> which does not recognize retention money as income for tax purpose if there is no enforceable debt. ICDS leads to deviation from the settled judicial position.	

- The CBDT clarified that Retention money, being part of overall contract revenue, shall be recognised as revenue subject to reasonable certainty of its ultimate collection condition contained in Para 9 of ICDS –III on Construction Contracts.

Construction Contract

AS-7	ICDS III
❖ <u>Incidental Income</u>	
Any incidental income, not included in the contract revenue, shall be deducted while computing construction cost.	Contract cost shall be reduced by any incidental income, not being in the nature of interest, dividends or capital gains, that is not included in the contract revenue. Therefore, those interest income, dividend income and capital gains shall be taxed as income in accordance with the applicable provisions of the Act.

Construction Contract

AS-7	ICDS III
❖ <u>Recognition of foreseeable losses</u>	
It permits to recognise immediately the foreseeable losses on a contract regardless of commencement or stage of completion of contract.	ICDS does not permit recognition of the foreseeable/expected losses on a contract. ICDS on accounting policies also does not permit recognition of foreseeable loss.
<u>Impact:</u> ICDS deviates from the present legal settled position in the case of <i>CIT V/s. Triveni Engineering & Industries Ltd (49 DTR 253) (Del)</i> & <i>CIT v. Advance Construction Co. (P) Ltd (275 ITR 30) (Guj)</i> in which foreseeable losses on construction contracts were allowed as a deduction for tax purpose.	

Example:

Year	Loss	Unrelated Income	Computation		Remarks
			Income Tax	Books of Accounts	
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	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.

Construction Contract

AS-7	ICDS III
❖ <u>Recognition of incentive payments</u>	
<p>Incentive payment to be recognised only when (i) probability exists that specified performance standards would be met or exceeded (Guidance para in ICAI AS, links probability to contract progress upto sufficiently advanced stage); (ii) incentive is reliably measurable.</p>	<p>Requires recognition under POCM if incentive reliably measurable and it is probable that it will result in revenue. In absence of further guidance, ambiguity may arise if the requirement of “sufficiently advanced stage of contract” is deleted/diluted.</p>
❖ <u>Recognition of claims</u>	
<p>Claims against customers to be recognised when (i) probability exists that the customer will accept the claim (Guidance para in ICAI AS, links probability to negotiation progress upto advanced stage); (ii) amount is reliably measurable.</p>	<p>Requires recognition under POCM if claims are reliably measurable and it is probable that it will result in revenue. In absence of further guidance, ambiguity may arise if the requirement of “advanced stage of negotiation” is deleted/diluted.</p>

Construction Contract

- Contract Revenue and Contract Costs associated with the construction contract which commenced on or after 1 April 2016 shall be recognized as per provision of ICDS – III
- Contract Revenue and Contract Costs associated with the construction contract which commenced on or before 31 March 2016 but not completed by the said date, shall be recognized based on method regularly followed by the person prior to 1 April 2016

Disclosures

- 1. The amount of contract revenue recognized as revenue in the period
- 2. the methods used to determine the stage of completion of contracts in progress

For contracts in progress/ service transactions * -

- 1. the amount of costs incurred and recognized profits less recognized losses upto the reporting date
- 2. the amount of advances received
- 3. the amount of retentions

*Disclosure requirement in case of service transactions is under ICDS on revenue recognition.

The Effects of Changes in Foreign Exchange Rates



Revenue monetary items (like trade receivables, payables, bank balance, etc.)

AS- 11	ICDS
<ul style="list-style-type: none">❖ Reported using the closing rate❖ Exchange difference recognised in P&L A/c❖ Allowed under the Act also.	<ul style="list-style-type: none">❖ Converted into reporting currency by applying the closing rate❖ Recognised as income or expense subject to provisions of Rule 115

Impact: No change in tax position

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 that existed when such rate was determined. .	No change in the position

Capital monetary items – Relating to Imported assets

AS- 11	ICDS
<ul style="list-style-type: none">❖ Requires recognition in P&L A/c.❖ Option of capitalization u/s 211(3C) of companies Act, 1956 as per which (Para 46 & 46A) exchange differences arising in case of long-term foreign currency monetary items shall be either adjusted to capital asset or accumulated in FCMITDA.	<ul style="list-style-type: none">❖ Requires recognition in P&L A/c subject to provisions of Section 43A.❖ No Para 46 & 46A exists.

Impact:

- ❖ Presently, Section 43A permits capitalization on payment basis of exchange differences relating to asset acquired from a country outside India.
- ❖ Hence, there would be no change in the tax position.

Capital monetary items – Not relating to Imported assets

AS- 11	ICDS
<ul style="list-style-type: none">❖ Requires recognition in P&L A/c.❖ Option of capitalization u/s 211(3C) of companies Act, 1956 as per which (Para 46 & 46A) exchange differences arising in case of long-term foreign currency monetary items shall be either adjusted to capital asset or accumulated in FCMITDA.	<ul style="list-style-type: none">❖ Requires recognition in P&L A/c subject to provisions of Section 43A.❖ No Para 46 & 46A exists.

Impact:

- ❖ Section 43A does not apply since it applies only if it relates to the imported assets.
- ❖ Presently, such FE differences are not recognized for tax purposes i.e. gain is not taxable, loss is not deductible/ allowable.

Capital monetary items – Not relating to Imported assets

Judicial precedents

- ❖ Section 43A of the Act was introduced by the Finance (No. 2) Act, 1967 with effect from 1st April, 1967.
- ❖ In the case Tata Iron & Steel [TISCO - (1998) 231 ITR 285 (SC)] for the case relating to AY 1960-61 and AY 1961-62 (When Section 43A was not introduced), Supreme Court had held that cost of an asset and cost of raising money for purchase of asset are two different and independent transactions and events subsequent to acquisition of assets cannot change price paid for it. Therefore, fluctuations in foreign exchange rate while repaying instalments of foreign loan raised to acquire asset cannot alter actual cost of assets for computing depreciation.

Capital monetary items – Not relating to Imported assets

Hence, **given that the provisions of Section 43A requiring foreign exchange gain/loss to be adjusted with the cost of the assets, apply only with respect to imported assets, the case of indigenous assets will continue to be governed by the ratio of the Tata Iron & Steel's decision.**

- ❖ Gains arising on deposits (in foreign currency) are capital receipt as the deposits were in essence loan/capital and not a trading receipt - Shell Company of China Ltd. [22 ITR 1 (CA)]
- ❖ If the foreign currency is held as a capital asset or as fixed capital, profit or loss to an assessee on account of appreciation or depreciation in the value of foreign currency held by it, on conversion into another currency, would be of capital nature. - Sulej Cotton Mills Ltd., [(1979) 116 ITR 1 (SC)]

Capital monetary items – Not relating to Imported assets

Conclusion

- ❖ Since ICDS requires recognition in P&L A/c subject to provisions of Section 43A and Section 43A applies only if it relates to imported assets, a controversy may arise, whether such exchange fluctuation gain or loss on capital monetary items (not relating to imported assets) would be allowable as an income or expense as per ICDS or not.
- ❖ May be considered as non-cognizable for tax purposes based on its Capital nature.
- ❖ It is also arguable that judicial settled position would remain unchanged as the Act shall prevail in case of conflicts with ICDS.

Forex derivatives – Forward exchange contracts

Purpose	AS - 11	ICDS	Impact
Hedging – Capital account	<ul style="list-style-type: none"> ❖ Premium/discount is amortized over the life of contract. ❖ Restated on MTM basis at year end and difference is recognized in P&L. ❖ Profit/loss on cancellation or renewal is also recognized in P&L. 	Same as AS – 11	<p><u>Impact:</u> As per the Act, FE difference is capitalized to imported asset on actual settlement, if it is related to imported asset. If not related to imported assets, exchange difference may give rise to capital gains but only on actual settlement and not on MTM basis. However, ICDS requires FE differences to be recognized as revenue income/ expense which is contrary to the judicial settled position under the Act.</p>
Hedging – Revenue account	Same as above	Same as above	No change in tax position in relation to contracts on revenue account

Impact of Hedging – Capital account Explained with the help of Following Illustration

On 01-01-16, XYZ Ltd. borrowed loan from USA to purchase asset from India, payment to be made \$ 100,000 on 30-06-16. On 01-01-16 itself it entered into a forward exchange contract to mitigate the risks associated with changes in exchange rates. The company follows Para 46A for the accounting purpose. The exchange rates (Rs. per US \$) are as below:

Period	01-01-16	31-03-16	30-06-16
Spot Rate	60	63	65
Forward rate (for six months)	62		
Forward rate (for three months)		64	

Rs. in Lakhs

Cont.

Particulars	F.Y. 2015-16			FY. 2016-17		
	Accounting Purpose	Income-tax purpose		Accounting Purpose	Income-tax purpose	
		Pre-ICDS	Post-ICDS		Pre-ICDS	Post-ICDS
Premium	1 [62-60]/2 (capitalized as per Para 46A over period of contract)	Nil (Non-cognizable for the tax purpose)	*(1) [62-60]/2 (deducted from Net Profit as per books to arrive at PGBP)	1 [62-60]/2 (capitalized as per Para 46A over period of contract)	Nil (Non-cognizable for the tax purpose)	*(1) [62-60]/2 (deducted from Net Profit as per books to arrive at PGBP)
Forward Exchange Gain	(3) [63-60] (reduced from value of asset as per Para 46A)	Nil (Non-cognizable for the tax purpose)	*3 [63-60] (Added to Net Profit as per books to arrive at PGBP)	(2) [65-63] (reduced from value of asset as per Para 46A)	Nil (Non-cognizable for the tax purpose)	*2 [65-63] (Added to Net Profit as per books to arrive at PGBP)
Loss due to increase in Liability	3 [63-60] (capitalized as per Para 46A)	Nil (Non-cognizable for the tax purpose)	*(3) [63-60] (deducted from Net Profit as per books to arrive at PGBP)	2 [65-63] (capitalized as per Para 46A)	Nil (Non-cognizable for the tax purpose)	*(2) [65-63] (deducted from Net Profit as per books to arrive at PGBP)

* To the extent, ICDS suggests revenue treatment of exchange fluctuations on capital account, it is in conflict with the provisions of the Act and settled position by the Supreme Court in the case of TISCO-(1998) 231 ITR 285 (SC). However, on a practical plank, the Tax Department may not challenge treatment as per ICDS.

Depreciated Value/ Written Down Value (WDV) of Asset

Cont.

F.Y.	Accounting Purpose	Income-tax purpose	
		Pre-ICDS	Post-ICDS
2015-16	Rs. 60,00,000	Rs. 60,00,000	Rs. 60,00,000
	Add: Rs. 3,00,000		
	Less: (Rs. 3,00,000)		
	Add: Rs. 1,00,000		
	Balance: Rs. 61,00,000	Balance: Rs. 60,00,000	Balance: Rs. 60,00,000
2016-17	Add: Rs. 2,00,000		
	Less: (Rs. 2,00,000)		
	Add: Rs. 1,00,000		
	Balance: Rs. 62,00,000	Balance: Rs. 60,00,000	Balance: Rs. 60,00,000

This would result into difference of amount of depreciation as per accounts and tax and thus creation of DTA/DTL as the case may be as per AS 22 “Accounting for Taxes on Income”



Thank You
