ICDS— Salient Features, Major Deviations from settled Accounting Standards and Significant Implications

CBDT has on the last day of this financial year notified the much debated Income Computation and Disclosure Standards (ICDS) vide Notification No. 32/2015, dated 31st March 2015. The notified ICDS would apply to computation of income under the head "Profits and gains of business or profession" or "Income from other sources" and are not meant for the purpose of maintenance of books of accounts. The said standards need to be followed by all assessees, following the mercantile system of accounting from Assessment Year 2016-17 and subsequent assessment years. At the outset it is necessary to clarify that although the subject is new and giving rise to numerous issues and therefore should require elaborate analysis but due to space constraint here is only a very concise write up to provide overview of the subject matter.

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Relevant Provisions in the Income Tax Act, 1961

i. Under Section 145(1), income chargeable under the heads "Profits and gains of business or profession" or "Income from other sources" is to be computed in accordance with either the cash or mercantile system of accounting regularly employed by the assessee.

ii. Section 145(2) empowers the Central Government to notify in the Official Gazette from time to time, income computation and disclosure standards ("ICDSs") to be followed by any class of assessees or in respect of any class of income.

ICDSs Notified

i. Accordingly, the Central Government has, in exercise of the powers conferred under Section 145(2), notified *vide* Notification No. 32/2015 dated 31- 03- 2015, 10 income computation and disclosure standards (ICDSs) to be followed by all assessees, following the mercantile system of accounting, for the purposes of computation of income chargeable to income-tax under the head "Profit and gains of business or profession" or "Income from other sources". This notification has come into force with effect from 1st April, 2015, and shall accordingly apply from A.Y. 2016-17 onwards.

ii. All the notified ICDSs are applicable for computation of income chargeable under the head "Profits and gains of business or profession" or "Income from other sources" and not for the purpose of maintenance of books of account.

iii. Each of the ten notified ICDSs has a scope paragraph explaining what exactly the ICDS deals with. In some standards, the scope paragraph also specifies what the ICDS does not deal with.

iv. Nine out of the ten notified ICDSs contain transitional provisions to prevent any tax leakage or any double taxation.

Provisions of the Act prevail over the ICDSs

In the case of conflict between the provisions of the Income-tax Act, 1961 and the notified ICDSs, the provisions of the Act shall prevail to that extent.

Salient features, major deviations from Accounting Standards and significant implications :

1. ICDS I: Accounting Policies

1.1. ICDS on Accounting Policies deals with significant accounting policies. While it recognises the fundamental accounting assumptions of going concern, consistency and accrual, it does not recognise the concepts of "materiality" and "prudence" in selection of accounting policies.

Each of the ten notified ICDSs has a scope paragraph explaining what exactly the ICDS deals with. In some standards, the scope paragraph also specifies what the ICDS does not deal with. Nine out of the ten notified ICDSs contain transitional provisions to prevent any tax leakage or any double taxation.

1.2. ICDS does not recognise marked to market loss or an expected loss unless the recognition of such loss is in accordance with the provisions of any other ICDS.

1.3. Change in accounting policy based on "reasonable cause" allowed

The term "reasonable cause" has not been defined and would involve exercise of judgement by management and tax authorities. As compared to AS 5 and AS(IT) II, ICDS appears to provide greater flexibility since it is not confined to factors enumerated in AS 5 or AS(IT) II. The deviation may permit change in accounting policy when necessitated by other genuine circumstances like change in business model, availability of new technology to gather accounting information, etc. It is believed that 'reasonable cause' shall include factors of change in statute and change in accounting standard as specified in AS-5.

1.4. Age old principle of prudence omitted

It is unfortunate that the ICDSs omit specific reference to Prudence as a principle to be considered in selecting and applying an accounting policy. The age old canon of prudence which has been consistently deployed by commercial world as a fundamental accounting consideration and which hitherto has also been accepted by the Revenue in hitherto existing AS(IT) I.

1.5. It is logically apprehended that if the authorities literally implement the ICDSs then it may have the effect of altering the settled legal concept of "income" without legislative change. It may accelerate norms of accrual of chargeable income. Such literal implementation may not withstand the test of law on real commercial income and therefore is likely to increase only the litigations.

1.6. Further, postponing deductibility of losses may result in companies becoming liable to MAT in a later year on account of income which is already taxed in an earlier year due to the provisions of ICDS. This would result in double taxation of the same income.

1.7. Non-recognition of concept of "materiality" As prescribed in AS 1 and as was also hitherto recognised in Tax Accounting Standard notified under Section 145(2), ICDS I, however, does not recognise the concept of "materiality".

2. ICDS II :Valuation of Inventories

2.1. Term "Inventories" has been defined to mean assets held for sale in the ordinary course of business; in the process of production for such sale; in the form of materials or supplies to be consumed in the production process or in rendering of services.

2.2. This ICDS requires inventory to be valued at cost or net realisable value, whichever is lower.

2.3. The cost of items that are not ordinarily interchangeable; and goods or services produced and segregated for specific projects shall be assigned by specific identification of their individual costs. In other cases cost shall be assigned by using the First-in First-out FIFO or weighted average cost formula.

2.4. It also requires inventory to be valued at net realisable value on the date of dissolution of a firm, AOP or BOI, whether the business is discontinued or not. This is a deviation from the settled judicial precedent that inventory should be valued at lower or cost or market price, if the firm is dissolved due to death of a partner and the surviving partners reconstitute the firm and continue the business as before.

2.5. It provides that in case of a service provider, the cost of services shall consist of labour and other cost of personnel directly engaged in providing the service including supervisory personnel and attributable overheads. The scope of AS-2 does not include work in progress arising in the ordinary course of business of service providers.

2.6. As the expression "service" has not been defined or explained, it may lead to different interpretations by different assessees.

2.7. Para 18 of AS 2 recognises standard cost method as one of the Techniques for the measurement of the cost of inventories, for convenience if the results approximate the actual cost. However, ICDS does not permit Standard Cost as a method of valuation of inventory. Standard Cost is an internationally known and accepted method of valuation of inventories.

As prescribed in AS 1 and as was also hitherto recognised in Tax Accounting Standard notified under Section 145(2), ICDS I, however, does not recognise the concept of "materiality".

3. ICDS III: Construction Contracts

3.1. This ICDS is required to be applied in determination of income for a construction contract of a contractor.

3.2. It recognises only percentage of completion method (POCM) for recognising contract revenue and contract costs associated with a construction contract.

3.3. Disclosure requirements include amount of contract revenue recognised as revenue in the period, the methods used to determine the stage of completion of contracts in progress etc.

3.4. There is no provision to recognise expected losses on construction contracts as an expense immediately like in AS 7.

3.5. It does not permit recognition of foreseeable loss on a contract at any stage of a contract. By implication, expected losses on a contract also need to be recognised on POCM basis. In *CIT vs. Triveni Engineering & Industries Ltd 49 DTR 253 (Del), CIT vs. Advance Construction Co. (P) Ltd 275 ITR 30 (Guj))*, the provision for foreseeable losses on construction contracts has been judicially upheld to be allowable for tax purposes as long as such provision is in accordance with accounting standard or is justified by the principle of prudence or by the nature and circumstances of the contract. Paras 33 to 36 of AS 7 permit recognition of foreseeable losses on a contract regardless of commencement or stage of completion of contract.

3.6. The bar on recognition of foreseeable loss will also result in mismatch with MAT liability.

Para 18 of AS 2 recognises standard cost method as one of the Techniques for the measurement of the cost of inventories, for convenience if the results approximate the actual cost. However, ICDS does not permit Standard Cost as a method of valuation of inventory. Standard Cost is an internationally known and accepted method of valuation of inventories.

3.7. **There is no provision to decrease contract revenue where damages are imposed by customer for delayed execution of contract**. Perusal of Para 11(c) of AS-7 *vis-a-vis* Para 11 of ICDS would enable one to grasp complete deviation.

3.8. No specific permission for downward revision in revenue due to downward variation in contract

Unlike Para 12 of AS-7, ICDS III does not specifically permit decrease in contract revenue due to downward variation in contract. It only permits recognition of upward variation to the extent there is probability of resulting in revenue.

3.9. No specific condition to consider outcome of a contract

While AS 7 lays down specific conditions to be satisfied for considering when the outcome of a construction contract can be estimated reliably, ICDS III does not specify any such conditions. It simply makes reference to early stages of a contract and states that such stage shall not extend beyond 25% of the stage of the completion.

3.10. **On retention money**, the ICDS III provides that retention money is to be considered as part of contract revenue for recognition on POCM basis. This is a significant deviation from settled AS 7 as well as settled legal position and would lead to acceleration of chargeability of revenue in a year where income has not been earned.

4. ICDS IV: Revenue Recognition

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

It does not, however, deal with the aspects of revenue recognition which are dealt with by other ICDSs.

4.2. This ICDS contains a provision wherein the revenue from sale of goods could be recognised when there is reasonable certainty of its ultimate collection. However, it does not contain a similar provision for recognition of revenue from rendering of services or use by others of person's resources yielding interest, royalties and dividends.

4.3. Disclosure requirements include the amount of revenue from service transactions recognised as revenue during the previous year, information relating to service transactions in progress at the end of the previous year etc.

4.4. This ICDS conflicts with judicially settled position of taxation based on real income.

4.5. Even if the recognition in books is sought to be neutralised by making corresponding provision on the debit side, the taxpayer will still be exposed to MAT liability since provision for bad & doubtful debts is not an allowable deduction for MAT purposes.

4.6. Rendering of services: recognition of only percentage of completion method

AS-9 provides that revenue from service transactions is usually recognised as the service is performed, either by the proportionate completion method or by the completed service contract method, whichever relates the revenue to the work accomplished. However, ICDS provides only for percentage completion method for recognition of service transactions.

5. ICDS V: Tangible Fixed Assets

5.1. This ICDS deals with the treatment of tangible fixed assets.

5.2. It contains the definition of tangible fixed assets which also provides the criteria for determining whether an item is to be classified as a tangible fixed asset.

5.3. It provides the components of actual cost of such assets and valuation of such assets in special cases.

5.4. It also provides that depreciation on such assets and income arising on transfer of such assets shall be computed in accordance with the provisions of the Act.

5.5. The disclosure requirements in respect of such assets, include description of asset or block of assets, rate of depreciation, *etc*.

6. ICDS VI: The Effects of changes in foreign exchange rates

6.1. This ICDS deals with treatment of transactions in foreign currencies, translating the financial statements of foreign operations and treatment of foreign currency transactions in the nature of forward exchange contracts.

6.2. This ICDS requires exchange differences arising on settlement of monetary items or conversion thereof at last day of the previous year to be recognised as income or as expense in that previous year.

6.3. In respect of non-monetary items, exchange differences arising on conversion thereof as at the last day of the previous year shall not be recognised as income or as expense in that previous year.

6.4. The ICDS provides that initial recognition, conversion and recognition of exchange difference shall be subject to the provisions of Section 43A and Rule 115.

6.5. The ICDS requires classification of a foreign operation as an integral foreign operation or a non-integral foreign operation.

6.6. The ICDS does not make distinction between capital v revenue nature of foreign exchange fluctuations. ICDS overlooks the fact that fluctuation on capital account is not part of income base.

Currently, it is judicially well settled under the Act that there is a distinction between foreign exchange fluctuation difference on revenue account and on capital account. What is chargeable as income is fluctuation on revenue account. Exchange fluctuation relating to a revenue item is considered as income receipt. Fluctuation on capital account, if it represents a loss, is not deductible in computation of income, likewise, gain is not taxable. The only exception to this rule is an adjustment which may be required to the cost of an imported asset in terms of Section 43A of the Act.

6.7. While both AS 11 and ICDS VI provide the same treatment for conversion of Assets and Liabilities (both monetary and non-monetary) of non-integral foreign operations at the closing rate as well as the income and expense items on exchange rates at the dates of the transactions, but the exchange differences arising on such conversion is treated differently in AS 11 *vis-a-vis* ICDS VI. AS 11 capitalises such exchange difference by transferring the same in a special reserve namely 'foreign currency translation reserve' till the time such net investment is finally disposed of. On the other hand, ICDS VI provides for treatment of such exchange differences to be recognised as income or as expense thereby impacting computation of income and tax outgo. *The recognition of exchange difference as income or expense on conversion of items in financial statements of non-integral foreign operations would directly impact the computation of income and the resultant tax liability.*

7. ICDS VII: Government Grants

7.1. This ICDS deals with the treatment of government grants.

7.2. This ICDS does not deal with Government assistance other than in the form of Government grants and Government participation in the ownership of the enterprise.

7.3. It requires recognition of Government Grants only when there is a reasonable assurance that the person shall comply with the conditions attached to them and the grants shall be received. However, it also states that recognition of Government grant shall not be postponed beyond the date of actual receipt.

7.4. This ICDS requires Government grants relatable to depreciable fixed assets to be reduced from actual cost/WDV.

7.5. The standard requires grants relating to non-depreciable fixed assets to be recognised as deferred income over a period matching with costs to be incurred for meeting the related obligations.

7.6. Grant receivable as compensation for

Disclosure requirements include the amount of revenue from service transactions recognised as revenue during the previous year, information relating to service transactions in progress at the end of the previous year *etc.*

expenses or losses or for the purpose of giving immediate financial support to be recognised as income of the period in which it is receivable.

7.7. All other Government grants shall be recognised as income over the periods necessary to match them with the related costs which they are intended to compensate.

7.8. This ICDS, thus, does not distinguish between capital and revenue nature of a Government Grant. There is no express clarification that the requirement to recognise Government grants as upfront or deferred income will not apply to grants in the nature of promoters' contribution and other capital grants.

7.9. The standard contains certain disclosure requirements, like nature and extent of Government grants recognised during the previous year as income, nature and extent of Government grants not recognised during the previous year as income and reasons thereof.

8. ICDS VIII: Securities

8.1. This ICDS deals with securities held as stock-in-trade.

8.2. It requires securities to be recognised at actual cost on acquisition.

8.3. Subsequently, at the end of any previous year, securities held as stock-in-trade have to be valued at actual cost initially recognised or net realisable value at the end of that previous year, whichever is lower.

8.4. It goes on to provide that such comparison of actual cost initially recognised and net realisable value has to be done category-wise and not for each individual security.

8.5. This provision is not in line with the settled judicial position that anticipated profit should not be taken into consideration for valuation of stock-in-trade. Requirement of category-wise comparison in ICDS virtually leads to recognition of anticipated profits contrary to settled judicial position, since appreciated value of certain securities will absorb fall in value of other securities.

8.6. Currently there is no AS which directly deals with valuation of securities held as stock-in-trade. However, footnote 3 to AS-13 clarifies that since the manner in which such securities are accounted for and disclosed in the financial statements is quite similar to that applicable in respect of current investments under AS-13, the provisions of AS-13, to the extent that they relate to current investments, are also applicable to securities held as stock-in-trade, with suitable modifications. ICDS further provides that securities which are unlisted or which are thinly quoted on a recognised stock exchange shall be valued at actual cost irrespective of the NRV.

The ICDS VII, thus, does not distinguish between capital and revenue nature of a Government Grant. There is no express clarification that the requirement to recognise Government grants as upfront or deferred income will not apply to grants in the nature of promoters' contribution and other capital grants.

8.7 This deviation is not in line with the settled judicial position more particularly in the case of *UCO Bank Ltd vs. CIT 240 ITR 355 (SC) as well as in Chainrup Sampatram vs. CIT 24 ITR 481 (SC)* that anticipated profit should not be taken into consideration for valuation of stock-in-trade.

8.8. Para 13 of ICDS VIII prescribes FIFO method for valuation of securities instead of average cost as prescribed in Para 22 of AS 13. This difference in method of valuation of inventories would have an impact on the total income.

9. ICDS IX: Borrowing Costs

9.1. This ICDS deals with the treatment of borrowing costs. It does not deal with the actual or imputed cost of owners' equity and preference share capital.

9.2. It requires borrowing costs which are directly attributable to the acquisition, construction or production of a qualifying asset to be capitalised as part of the cost of that asset. Other borrowing costs have to be recognised in accordance with the provisions of the Act.

9.3. Qualifying asset has been defined to mean–
land, building, machinery, plant or furniture, being tangible assets;
know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature, being intangible assets;

inventories that require a period of twelve months or more to bring them to a saleable condition.

9.4. This ICDS provides the formula for capitalisation of borrowing costs when funds are borrowed generally and used for the purpose of acquisition, construction or production of a qualifying asset.

9.5. It also provides when capitalisation of borrowing costs would commence and cease.

9.6. It requires disclosure of the accounting policy adopted for borrowing costs and the amount of borrowing costs capitalised during the year.

9.7. Treatment of interest cost as per ICDS would be subject to the provisions of Section 36(1)(iii).

9.8. ICDS provides for capitalisation of entire borrowing costs relatable to specific borrowings as against Para 10 of AS 16 provides that the amount of borrowing costs relatable to specific borrowings for a qualifying asset eligible for capitalisation should be reduced by any income on the temporary investment of those borrowings. To that extent, the ICDS deviates from the settled judicial precedent and would impact computation of income.

10. ICDS X: Provisions, Contingent Liabilities and Contingent Assets.

10.1. This ICDS deals with Provisions, Contingent Liabilities and Contingent Assets. However, it does not deal with provisions, contingent liabilities and contingent assets –
resulting from financial instruments,
resulting from executory contracts,
arising in insurance business from contracts with policyholders and covered by another ICDS.

10.2. It also does not deal with recognition of revenue dealt with by ICDS on Revenue Recognition.

10.3. The ICDS specifies the conditions for recognition of a provision.

10.4. It provides that a person shall not recognise a contingent liability or a contingent asset. However, it requires contingent assets to be assessed continually. When it becomes reasonably certain that inflow of economic benefit will arise, the asset and related income have to be recognised in the previous year in which the change occurs.

Para 13 of ICDS VIII prescribes FIFO method for valuation of securities instead of average cost as prescribed in Para 22 of AS 13. This difference in method of valuation of inventories would have an impact on the total income.

ICDS-X provides that provisions should be recognised if they meet the criteria of reasonably certainty. The deviation prescribed by ICDS *viz.* 'reasonably certain' criterion without defining its scope is likely to unsettle the settled legal position and create confusion for taxpayers leading to litigation.

10.5. It contains provisions for measurement and review of a provision and asset and related income.

10.6. It also provides that a provision shall be used only for expenditure for which the provision was originally recognised.

10.7. The ICDS also contains disclosure requirements in respect of each class of provision, asset and related income recognised.

10.8. AS-29 recognises that, apart from legal/contractual obligations, obligations may arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner.

10.9. ICDS-X provides that provisions should be recognised if they meet the criteria of reasonably certainty. The deviation prescribed by ICDS *viz.* 'reasonably certain' criterion without defining its scope is likely to unsettle the settled legal position and create confusion for taxpayers leading to litigation.

10.10. Proposal to tax value of Contingent Assets on 'reasonable certainty' basis

Under AS-29, contingent assets are recognised if inflow of economic benefits or reimbursement is considered virtually certain. ICDS provides that contingent assets should be recognised if they meet the criteria of reasonably certain. The ICDS is in conflict with the concept of "accrual" under the Act, according to which, unless there is an enforceable debt due, there is no income which can be said to accrue. ■