Income Computation and Disclosure Standards (*erstwhile Tax Accounting Standards*)—Transforming the Way of Computing Income under Tax Laws

Section 145(2) of the Income-tax Act, 1961 has empowered the Central Government to notify Accounting Standards that should be followed by any class of person or in respect of any class of income. However, it has notified only two Accounting Standards, i.e., those on Disclosure of Accounting Policies and Disclosure of Prior Period Items and Extraordinary Items and Changes in Accounting Policies till date. Because of the absence of notifications on desired Accounting Standards, uncertainty continues to haunt with regard to various accounting issues, especially where the views of income tax authorities are not consistent with the guidance on Accounting Standards issued by The Institute of Chartered Accountants of India (ICAI)/the Ministry of Corporate Affairs (MCA) of the Government of India. In this article, the authors discuss the Disclosure Accounting Standards that have transformed the way of computing income under the tax laws. Read on…

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Background

It is generally accepted that income tax should be levied on profits determined as per GAAP with specific provisions under the Income-tax Act, 1961 providing for exemptions/additions to be adjusted for computation of taxable income. The Central Government is also empowered under Section 145(2)

of the Income-tax Act, 1961 to notify Accounting Standards that should be followed by any class of person or in respect of any class of income. However, only two Accounting Standards, on '*Disclosure of Accounting Policies*' and '*Disclosure of Prior Period Items and Extraordinary Items and Changes in Accounting Policies*' have been notified till date.

In the absence of notification of Accounting Standards under the Income-tax Act, 1961, uncertainty and litigation continues on various accounting related issues, where the views of the income-tax authorities may not be consistent with the guidance in Accounting Standards (AS) issued by ICAI/MCA. With the impending convergence with IFRS in India (Ind AS) this issue assumes greater importance.

In order to address some of these issues and bring greater clarity around computation of taxable income, the CBDT constituted the Accounting Standard Committee in December 2010, with the following terms of reference:

- To study the harmonisation of AS issued by ICAI with the direct tax laws in India, and suggest AS which need to be adopted under the Section 145(2) of Income-tax Act, 1961 along with the relevant modifications
- To suggest a method for determination of tax base (book profit) for the purpose of *minimum alternate tax* (MAT) in case of companies migrating to Ind AS
- To suggest appropriate amendments to the Income-tax Act, 1961 in view of the transition to Ind AS regime

Accounting Standards not covered	Rationale
AS 6, AS 14 and AS 15	Covered by specific provisions of Income-tax Act, 1961
AS 3, AS 17, AS 18, AS 20 and AS 24	For disclosures only; no impact on income tax computation
AS 21, AS 23 and AS 27	Deal with consolidated financial statements; not relevant for Income-tax Act, 1961
AS 22, AS 25 and AS 28	Not relevant for tax computation
AS 30, AS 31 and 32	Presently voluntary in nature with limited applicability due to conflicts with notified Standards

The Committee has finalised 14 Standards on topics considered immediately relevant after considering the public comments on the drafts issued by it earlier.

Final Recommendations

Key recommendations of the Committee are summarised as:

- Draft Income Computation and Disclosure Standards (referred as 'ICDS') would need to be in harmony with the provisions of the Income-tax Act, 1961. Further, ICDS would need to lay down specific rules which would enable computation of taxable income with certainty and clarity. Similarly, to ensure horizontal equity and uniformity, ICDS should eliminate alternatives, to the extent possible. Based on these objectives, it was concluded that AS issued by ICAI could not be notified under the Act without modification. Accordingly, ICDS modifies the AS to achieve the above objectives.
- ICDS should be applicable only to computation of taxable income and taxpayers will not be required to maintain separate books of accounts on the basis of ICDS. Profits as per the financial statements would be adjusted for specific requirements of ICDS for determining the taxable income.
- ICDS should apply to all taxpayers following mercantile system having profits/gains from business/profession or income from other sources without specifying any thresholds relating to turnover/income in order to bring certainty and uniformity in computation of taxable income.
- In case of a conflict between the Income-tax Act, 1961 and ICDS, provisions of the Act will prevail.
- Transition provisions will be notified with each ICDS as relevant, in order to prevent any tax leakage or any double taxation.

Draft Income Computation and Disclosure Standards (referred as 'ICDS') would need to be in harmony with the provisions of the Income-tax Act, 1961. Further, ICDS would need to lay down specific rules which would enable computation of taxable income with certainty and clarity.

ICDS does not recognise the concept of materiality for the purpose of computation of taxable income. This would lead to various interpretation issues such as whether the company's accounting policies would be applicable even to an immaterial item of income/expenditure/asset/liability.

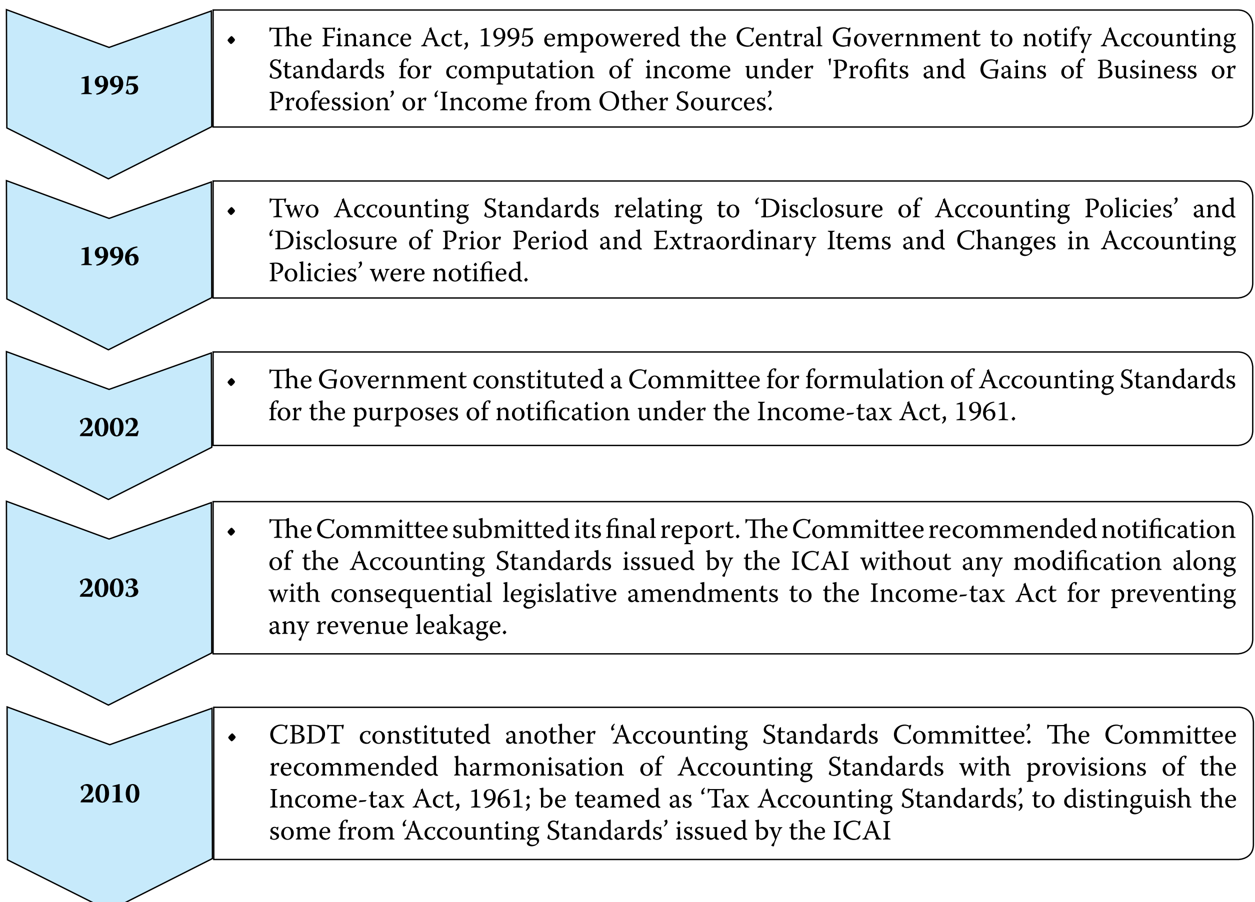
- To monitor the compliance with ICDS, appropriate modifications should be made to the return of income. For entities subject to tax audit, form 3CD should be modified so that a tax auditor is required to certify that computation of taxable income is in accordance with ICDS.
- Suitable amendments will be made to the Income-tax Act, 1961 to provide certainty on the following issues:
  - Allowability of depreciation on goodwill arising on amalgamation
  - Allowability of the provision made for the payment of pension on retirement or termination of an employee

Impact of Standards

Significant divergences exist between ICDS and Accounting Standards issued by ICAI/MCA. Objective of the Committee was to adhere to the principles of *'reduction of litigation', 'minimisation of alternatives'* and *'giving certainty to issues'*. However, the net effect of the Standards as compared to the position obtaining now would be:

- In many cases, timing of taxable income would be preponed
- In some cases, there would be an increase in taxable income
- Quite a few judicial decisions favouring assessee would become non-operative
- Penalties under tax laws would clearly be leviable even if amounts involved are not material from accounting perspective

Timeline showing various stages of formulation of ICDS (earlier known as *TAS*):



Year	
2011	• The Committee submitted drafts of two Standards namely 'Construction Contracts' and 'Government Grants'.
2012	• The Committee submitted drafts of remaining 12 Standards.
2014	• Shri Arun Jaitley, Minister of Finance, in his budget speech for 2014-15 mentioned that standards for computation of tax would be notified separately. Subsequently, *vide* the Finance (No. 2) Bill, 2014, suitable amendments have been made to Section 145 of the Income-tax Act including change of team 'Accounting Standards' to 'Income Computation and Disclosure Standards'. These amendments will take effect from 1st April, 2015, *i.e.*, assessment year 2016-17.

Significant Impact Areas of ICDS

Some of the areas where ICDS makes a significant divergence from the existing GAAP are:

No concept of 'materiality' and 'prudence' in selection and application of accounting policies

ICDS does not recognise the concept of materiality for the purpose of computation of taxable income. This would lead to various interpretation issues such as whether the company's accounting policies would be applicable even to an immaterial item of income/expenditure/asset/liability, *e.g.* in a company with, say, ₹10,000 crore of fixed assets, would it be necessary to depreciate even an asset of, say, ₹3,000 which meets the definition of fixed asset?

ICDS has also not considered the '*prudence*' principle for computing the taxable income. This is also evident in various ICDSs:

ICDS	Manner of Computation of Taxable Income
Accounting Policies	ICDS prohibits recognition of MTM loss/expected loss except required by any other Standard
Construction Contracts	ICDS requires contract revenue to be recognised even if there is uncertainty in collection (unlike AS 7). As per the ICDS, debtor may be later claimed as a deduction as bad debt expense. However, many experts have represented that under ICDS also, contract revenue should be recognised only when there is reasonable certainty of collection.
	Under ICDS, expected losses on construction contract should not be recognised as an expense.
Revenue Recognition	In case of uncertainty regarding collection, revenue recognition is postponed under the ICDS only in case of claim for escalation of price and export incentives. Subsequently, amounts not collected may be claimed as bad debt expense. However, a large number of experts have represented that the position as per the AS 9 should not be disturbed and revenue should be recognised only when there is reasonable certainty of its ultimate collection.
	Completed service contract method is not permitted for revenue recognition in case of services.
Government Grants	Under the ICDS, recognition of government grant is not postponed beyond the date of actual receipt even though the conditions attached to the grant are not fulfilled.

ICDS	Manner of Computation of Taxable Income
Securities	Under the ICDS, securities, which are held as stock-in-trade and not listed on a recognised stock exchange or listed but not quoted on a recognised stock exchange with regularity, are valued at actual cost initially recognised.
Provisions, Contingent Liabilities and Contingent Assets	ICDS does not deal with accounting for onerous contracts, thus, provision for loss on onerous contract is not permitted.

(This is not an exhaustive list)

***Not a strict application of* ‘accrual concept’**

Even though the ICDS on *‘Accounting Policies’* mentions *accrual* as one of the fundamental accounting assumptions, unrealised foreign exchange gain or losses (even though accrued in accounts) are not recognised as an allowable expense under the ICDS.

No change in accounting policy without a reasonable cause

Under the ICDS, an accounting policy cannot be changed without a reasonable cause, *e.g.*, change in method of valuation of inventory would require a reasonable cause. This position is different from the Indian GAAP wherein an accounting policy can change, *inter alia*, on account of a more appropriate presentation of the financial statements of the enterprise. The term *reasonable cause* has been not been defined and would involve exercise of judgement by management and tax authorities. However, it seems that the condition of *reasonable cause* is stricter as compared to the condition of ‘more appropriate presentation of financial statements’ under Indian GAAP.

Inventory valuation in case of service provider

AS 2 on *‘Valuation of Inventories’* is silent on valuation of inventories of a service provider. General practice indicates that inventory is valued by service provider on the basis of principles under AS 2. The ICDS specifically requires inventory to be valued in case of service provider. However, unlike the principles of AS 2, it requires inventory to be valued at cost. Many experts have represented that such inventory should also be valued at lower of cost or net realisable value (as in the case of AS 2).

ICDS requires exchange differences on translation of non-integral foreign operations to be recognised as income or expense, instead of their recognition in foreign currency translation reserve (FCTR) as required under the AS 11. This seems to be based on the analysis that the Income-tax Act, 1961 does not distinguish between the tax treatment incorporating the results of branches that may qualify as non-integral from those that qualify as integral.

Basis for valuation of opening stock

As per the ICDS on *‘Valuation of Inventories,’* opening inventory is valued at amount of closing inventory of immediately preceding previous year. This requirement nullifies the impact of judicial decisions as per which the opening stock is valued on the *same basis* as closing stock, in cases where there is a change in the accounting policy for inventory valuation during the year.

Allowability of prior period expense

As per the ICDS, prior period expense would be allowed as deduction only in the year to which it pertains, thus, revised return needs to be filed in such cases, wherever permissible. However, many experts have represented that prior period expense should be allowed in the year of recognition, i.e. the current year.

Specific revenue transactions

AS 9 contains certain illustrations that provide more clarity on application of revenue recognition principles to specific types of transactions, *e.g.,* a sale and repurchase agreement may be in substance a financing arrangement, or an upfront membership fee may be consideration for future discounted products or services. Since similar illustrations are not included in the ICDS, the position around such specific transactions requires guidance.

Reporting of foreign currency transactions at transaction date

As per the ICDS on *‘The Effects of Changes in Foreign Exchange Rates’,* foreign currency transactions

are recorded by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the transaction. The option given under the AS 11 for using the weekly or the monthly exchange rate has not been considered under the ICDS which may cause a lot of practical difficulties with no significant benefits in reporting especially in case of enterprises having high volume of foreign currency transactions. The application of the requirement under the ICDS does not seem viable and, thus, a large number of experts have represented that the option to use average rates as per the AS 11 should be retained, since it would otherwise lead to undue compliance burden.

Though efforts have been done to harmonise AS with the direct tax laws, various significant differences exists between AS and ICDS. Some of the provisions of the ICDS also represent a significant change or clarification in the tax position as compared to currently prevailing practices.

Accounting for foreign currency option contracts akin to forward exchange contracts

Accounting prescribed by the ICDS for foreign currency option contracts is similar to that for forward exchange contracts. This may have accounting implications, *e.g.,* computation of discount/premium in case of option contracts, when there is no obligation under an option contract to buy/sell foreign currency unlike a forward exchange contract.

No provision similar to Para 46/ 46A of AS 11

There is no provision under the ICDS on *'The Effects of Changes in Foreign Exchange Rates'* corresponding to the Para 46/46A of AS 11. This will have significant differences in way the exchange differences are recognised in the books of accounts and those recognised for taxation purposes.

Let us analyse the impact on long-term foreign currency monetary item under the ICDS by taking an example of an asset which is not a qualifying asset under the AS 16. Following table indicates the impact:

Exchange differences	Relating to	Under AS 11 *(not a qualifying asset)*		Under ICDS
		Companies not opting for Para 46/ 46A of AS 11	**Companies opting for Para 46/ 46A of AS 11**	
Unrealised exchange differences	Depreciable capital assets	Recognise in P&L	Capitalise & depreciate over useful life of asset	Disallowed
	Others	Recognise in P&L	FCMITDA; amortise over period of loan	Allowed
Realised exchange differences	Depreciable capital assets	Recognise in P&L	Capitalise & depreciate over useful life of asset	Capitalise if fixed asset acquired from outside India
	Others	Recognise in P&L	FCMITDA; amortise over period of loan	Allowed

Exchange differences on translation of non-integral foreign operation

ICDS requires exchange differences on translation of non-integral foreign operations to be recognised as income or expense, instead of their recognition in foreign currency translation reserve (FCTR) as required under the AS 11. This seems to be based on the analysis that the Income-tax Act, 1961 does not distinguish between the tax treatment incorporating the results of branches that may qualify as non-integral from those that qualify as integral. However, it may be noted that there does exist a measurement difference in quantification of impact of exchange differences between integral and non-integral foreign operation per ICDS, *e.g.,* fixed assets and other non-monetary assets of non-integral foreign operation are restated using the exchange rates on each balance sheet date whereas in case of an integral operation, these are not restated at subsequent balance sheet date.

Use of FIFO method for securities

Under the ICDS on *'Securities',* cost of security (held as stock-in-trade) would be determined on the basis of FIFO method, where application of specific identification method is not feasible. This is unlike the AS 13 where, ordinarily, the appropriate cost formula would be based on average costs.

Formula for capitalisation of borrowing costs in case of general borrowings

ICDS on *'Borrowing Costs'* gives a specific formula for capitalisation of borrowing costs in case of general borrowings, which is:

** as appears in the balance sheet of a person on the first day and the last day of the previous year*

It is not clear whether the term *qualifying asset* as mentioned in the formula should include all qualifying assets, even though they were put to use in the past years, or should it be construed to mean only those qualifying assets which are under process, i.e. not yet put to use. This issue becomes more complex with definition of *qualifying asset* wherein no minimum period has been prescribed for classification as a qualifying asset, other than in case of inventories, *e.g.,* qualifying assets include tangible assets and intangible assets which are ready to use at the time of acquisition. Consider for example a case where a company has started construction of a fixed asset on 2nd April, 2014, using general borrowings and the asset is completed on 30th March, 2015. Capitalisation of borrowing costs in such cases may result in significant practical challenges.

Also, as per the formula, assets funded out of equity would not be excluded from the computation of capitalisation of borrowing costs, which will lead to absurd results in cases where equity is utilised for the purpose of funding qualifying assets/other assets.

Lessee to be entitled to depreciation in case of finance lease

Income-tax Act, 1961 currently allows depreciation only on those assets that are owned by the assessee. As such, for a finance lease arrangement, it is the lessor that is entitled to the depreciation deduction and the lease rentals are taxed as its income. Now, ICDS provides that assets covered by a finance lease would be capitalised and depreciated by the lessee. Accordingly, the lessor would not be entitled to depreciation on assets that are given on finance lease. However, since the Income-tax Act, 1961 overrides the ICDS, suitable amendments may be required to the Act to facilitate this provision of ICDS.

Also, under the ICDS, lease payments under an operating lease would be recognised as an expense on straight line basis over the lease term. Similar is the case with lessor for lease income under an operating lease. These provisions of ICDS would also have a consequential impact on various other provisions, *e.g.* TDS and benefits under the *Double Taxation Avoidance Agreements* (DTAA) would need to be considered prior to implementation of these requirements under ICDS.

Classification as a finance lease

Under the ICDS on *'Leases'*, though the indicators for classification of leases are similar to that under the AS 19, the Standard provides that meeting even a single indicator would classify the lease as a finance lease, whereas, under the AS 19, a single indicator may not necessarily classify the lease as a finance lease. Thus, in certain cases, this may lead to different classification of leases for accounting and taxation purposes.

Joint confirmation for same lease classification

ICDS requires that the lessor and the lessee should have the same lease classification for a lease transaction and a joint confirmation needs to be

The first step towards establishing a robust control environment is to ensure that organisational goals and objectives are well established and broken into periodic milestones. Also important is that these goals are communicated to each member of the organisation.

documented in this regard. Further, in case a joint confirmation is not available, the lessee would not be entitled to a depreciation deduction on such assets.

Reasonable certainty for creation of provision

AS 29 requires recognition of a provision if its existence is considered *probable*. However, under the ICDS, the recognition of a provision is mandated when the existence is *reasonably certain*. This change from *probable* to *reasonably certain* for recognition of provision would result in higher profit for taxation.

Next Steps

Impact assessment

Companies should also compare the provisions of the ICDS with their current tax positions and practices and also identify gaps between current tax and accounting practices and requirements of the ICDS. This will enable companies to better evaluate the future impact of the ICDS on their taxable income, tax liabilities, tax policies and positions, tax planning strategies, cash flows optimisation opportunities, reporting and information processes and GAAP alignment. Companies may also decide to review the terms of their business contracts and practices to determine whether any changes may be required to minimise adverse implications.

Implementation plan

Companies should prepare a *pro-forma* template for the computation of income based on the ICDS requirements including preparation of list of relevant information required for disclosure purposes.

Changes to information systems and processes

Finally, companies should evaluate their information, documentation and contracting systems and processes to ensure that they are sufficient to meet the new requirements of the ICDS. There may arise a need for designing and implementing certain changes to IT systems including the chart of accounts. This will be essential to obtain the information required for computation of income under the ICDS without maintaining two separate books of account.

Trainings

Training needs of personnel in the tax and finance departments should also be considered. Customised training sessions should be provided to help tax and financial reporting teams to gain an in-depth understanding of requirements of the ICDS and evaluate the practical issues that the team will face in implementation of ICDS.

Conclusion

ICDS represents a significant move towards providing a uniform basis for computation of taxable income. Though efforts have been done to harmonise AS with the direct tax laws, various significant differences exists between AS and ICDS. Some of the provisions of the ICDS also represent a significant change or clarification in the tax position as compared to currently prevailing practices. These are broadly intended to cover aspects that have historically been a subject matter of litigation and diversity. Depending on the practices currently followed, a company may be affected significantly by these changes.

On transition to ICDS from a specific date, a situation may arise where income arising from a particular transaction may neither be taxable in the pre-ICDS period nor in post-ICDS period or may be taxable in both the periods. In order to mitigate such situations, transitional provisions, wherever required, should be prescribed on an immediate basis for effective implementation of ICDS from assessment year 2015-16. Additional guidance is expected to be provided through separate ICDS on specific areas such as accounting for real estate, service concession arrangements, financial instruments, share based payments and exploration activities. This will further strengthen the ICDS framework.

The ICDS has also removed one of the significant impediments to adoption of Ind AS since the ICDS provide an independent framework for computation of taxable income regardless of the accounting framework adopted by companies, *i.e.*, whether the companies follow AS or Ind AS. However, there is a need to consider the impact on computation of MAT when Ind AS comes into force since MAT is based on the accounting profits. Transition to Ind AS should be closely monitored and appropriate amendments relating to MAT should be considered in the future based on these developments.

The real benefit of providing a uniform framework for computing taxable income will only be achieved through a uniform and impartial implementation of ICDS by the tax authorities and the judiciary. The tax authorities may consider issuance of internal implementation guidelines and training to ensure that the ICDS are correctly applied and implemented at the field level. ■