By:
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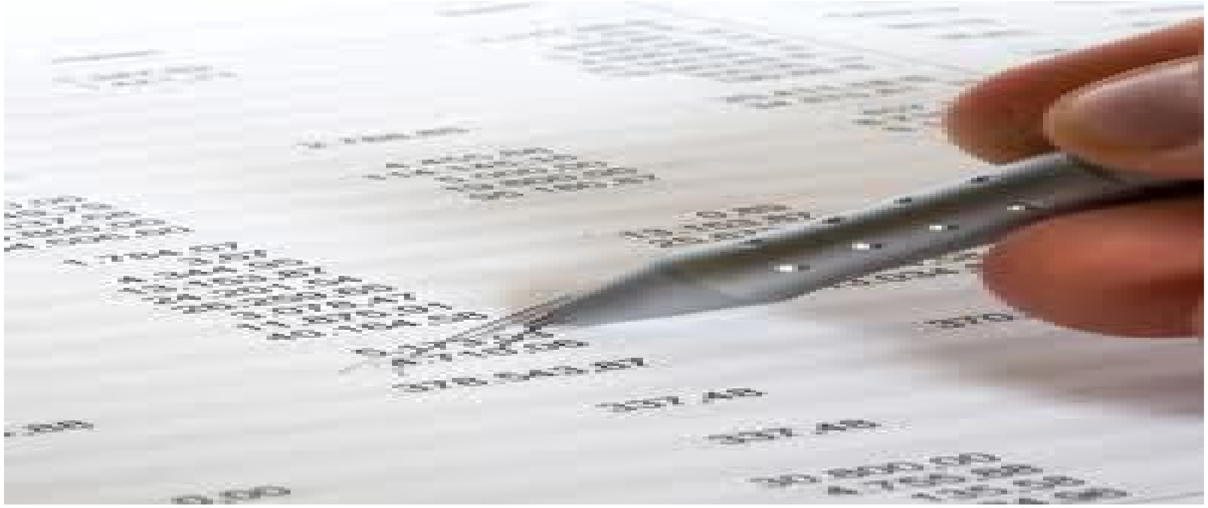
BORIVALI KANDIVAL EAST
STUDY CIRCLE

TAX ACCOUNTING STANDARD as recommended by CBDT

A new way to compute "TAXABLE INCOME"

23rd December, 2012.



Accounting Standards Committee

CONSTITUTION OF THE COMMITTEE

VIDE AN ORDER DATED 20/12/2010

- **Convenor**
- Shri H. Srinivasulu, IRS
- Commissioner of Income-tax-IV
- Hyderabad
- **Members**
- Shri Pravin Kumar, IRS
- Commissioner of Income-tax, Mumbai
- Shri Ankur Garg, IRS
- Commissioner of Income-tax, Rajkot
- Shri J. Krishna Kishore, IRS
- Commissioner of Income-tax, Vijayawada
- Shri Pawan Kumar, IRS
- Director (TPL), CBDT
- Shri Rajesh Kumar Bhoot, IRS
- Director (TPL), CBDT and Secretary of the Committee
- Shri M.P. Lohia, IRS(Retd.), FCA
- Chartered Accountant, Mumbai
- Shri Kamlesh Vikamsey, FCA
- Chartered Accountant, Mumbai
- Shri Milin Mehta, FCA
- Chartered Accountant, Vadodara
- Shri Jamil Khatri, FCA
- Chartered Accountant, Mumbai

OBJECTIVES OF THE COMMITTEE

The objective to form this committee were:

- To study the **harmonization** of ICAI AS with the ITL and to suggest accounting standards for tax compliance under the ITL, with relevant modifications.
- To suggest a **method for determination of tax base (book profit) for the purpose of MAT** in case of companies migrating to IND AS in the initial year of adoption and thereafter.
- To suggest appropriate **amendments to the ITL** in view of transition to IND AS regime.

INTERIM REPORT OF THE COMMITTEE

- The Committee submitted its interim reports in August 2011 and May 2012.
- The first interim report of August 2011 and drafts of Tax AS on Construction Contracts and Government Grants
- These were published for public comments in October 2011

FINAL REPORT OF THE COMMITTEE

- The Committee submitted its final report in August 2012 along with drafts of 14 Tax AS.
- After examining the existing set of 31 ICAI AS, the Committee has recommended an approach of notifying independent set of Tax AS with the object of bringing **certainty** and **clarity, eliminating alternatives** (to the extent possible) as also to ensure horizontal equity and uniformity.
- The 3 basic principles are:

a. REDUCTION OF LITIGATION
b. MINIMIZATION OF ALTERNATIVES
c. GIVING CERTAINITY TO ISSUES

Issues & Recommendations

The Committee during its meetings deliberated at length various issues which may arise in notifying Accounting Standards under the Act.

The issues pertinent to notification of Accounting Standards under the Act and the recommendations of the Committee on the same are as under:

Issue I

Two Sets of Books of Accounts

Issue

In accordance with the AS issued by the ICAI & another in accordance with the Accounting Standards notified under the Act?

Recommendations

- TAS should be made applicable only to the computation of taxable income (**Profits and Gains of Business & Profession ; Income from Other Sources**)

and

- a taxpayer **need not maintain** separate sets of books of account on the basis of TAS.
- To set at rest any future controversy in this regard, appropriate amendments should be made to the Income Tax Law.

Issue II

Applicability of TAS

Issue

- Whether the TAS should be made applicable to all taxpayers or to a class of taxpayers having turnover / income above a certain threshold limit?

Recommendations

- Tax AS should be made applicable to:
- All classes of taxpayers, irrespective of
- quantum of turnover/income,
- with a view to bring certainty on the issues covered by Tax AS.

Issue III

Conflict between the provisions of TAS & AS

Issue

In case of conflict between the express provisions of the Act and the TAS – which shall prevail?

Recommendations

The provisions of Income Tax Act, 1961 shall prevail over TAS

Issue IV

Transitions to TAS

Issue

The notification of TAS from a specific date may lead to a situation where income arising from a particular transaction may neither be taxable in the pre-TAS period nor in the post-TAS period or may be taxable in both the periods.

Recommendations

Transitional provisions, wherever required, should also be notified along with TAS.

To ensure that there is no double taxation or non-taxation of any income in pre and post TAS period

Issue V

Ensuring Compliance with TAS

Issues

How will the Government ensure that a taxpayer has computed taxable income in accordance with the provisions of TAS?

Recommendation

- For ensuring compliance with the provisions of TAS by the taxpayer, the Committee recommends
- Appropriate modification in the return of income.
- For tax audit cases, the Form 3CD should also be modified so that a tax auditor is required to certify that the computation of taxable income is made in accordance with the provisions of TAS.

Round 1

AS which were discarded to be modified for notification u/s 145(2) of the act as they did not affect the computation of taxable income.

- Following 7 Acc. Std need not be reviewed for harmonization:
- AS 6 - Depreciation Accounting
- AS 20- Earning Per Share
- AS 21 - Consolidated Financial Statements
- AS 22- Accounting for Taxes on Income
- AS 23- Accounting for Investments in Associates in Consolidated Financial Statements
- AS 25- Interim Financial Reporting
- AS 28- Impairment of Assets

Round 2

AS which were discarded to be modified for notification u/s 145(2) of the act as they were mere disclosure requirements or specific provisions were already there in Income Tax Act

- **AS-3 Cash Flow Statements**
- **AS- 14 Accounting for Amalgamations** (Sec 43(1) expl 1, Sec 43(6) Expl 2, Sec 47 (vi), Sec 47 (viaa), Sec 47 (vica), Sec 72A, Sec 72 AA, Sec 72 AB
- **AS- 15 Employee Benefits**

Section 36 (1)(ib), Section 36 (1)(ii) read with Section 43B(c) , Section 36 (1)(iv) read with Section 43B(b), Section 36 (1)(iva), Section 36 (1)(v) read with Section 40A(7) and Section 43B(b), Section 36 (1)(va) read 2 (24)(x), Section 40A(9) , Section 43B(f) , Section 35DDA

- **AS-17 Segment Reporting**
- **AS- 18 Related Party Disclosures**
- **AS-24 Discontinuing Operations**
- **AS -27 Financial Reporting of Interests in Joint Ventures.**
- **AS – 30, 31, 32 Financial Instruments (Recognition and Measurement, Presentation and Disclosure)**

AS 1

Accounting Policies.

- Expected losses or mark-to-market losses shall not be recognized unless permitted by any other TAS.
- Concept of materiality for selection of accounting policies is omitted as it is not recognized by the ITL for the purpose of computation of taxable income.
- Accounting policies shall not be changed without a reasonable cause.

AS 2

Valuation of Inventories.

- Since ICAI AS-2 does not specifically prescribe the method of valuation of inventories of a service provider, the same should be incorporated in TAS based on international best practices.
- Use of standard cost method as a technique for measurement of cost is not recommended.
- To reduce litigation, TAS specifically incorporates the well-established principle that the value of inventory of a business as on the beginning of a tax year shall be the same as the value of inventory at the end of the immediately preceding tax year.
- Method of valuation of inventory once adopted by a taxpayer in any tax year shall not be changed without a reasonable cause.
- Inventory on the date of dissolution of a partnership firm, association of persons and body of individuals shall be valued at net realizable value.

AS 4

Events occurring after end of Previous Year.

- Disclosures relating to events occurring after the end of the tax year do not directly impact the computation of income. Hence, these provisions have been removed in TAS

AS 5

Prior Period Expense.

- The TAS deals with prior period expenses, but does not provide guidance on prior period income. This seems to be in line with current practice whereby prior period income is subjected to tax in the current year.

- Prior Period Expense shall not be considered as an allowable deduction in the tax year in which it is recorded unless the taxpayer proves that such expense accrued during the said tax year

AS 7

Construction Contracts.

- Retention money shall be recognized for computing revenue based on percentage of completion method.
- Before reversal of revenue already recognized as income on account of uncertainty arising on realizability of contract revenue, the sum shall be written off in the books of account in line with the provisions of the ITL relating to bad debts.
- Pre-construction income in the nature of interest, dividend and capital gains shall not be reduced from the cost of construction but shall be taxed as income in accordance with the applicable provisions of the ITL.

AS 7

Construction Contracts (Contd)

- Contract costs relating to future activity shall be recognized as an asset and if such costs are not realizable then the same may be allowed under the provisions of the ITL.
- Losses incurred on a contract shall be allowed only in proportion to the stage of completion.
- Future or anticipated losses shall not be allowed unless such losses are actually incurred.
- Once a contract crosses 25% of the completion stage, the revenue in respect of such contract shall be required to be recognized.

AS 9

Revenue Recognition.

- Revenue from service transactions shall be recognised by following only ”percentage completion method”.
- In view of specific provisions in the ITL for bad debts, the postponement of revenue recognition due to uncertainty in ultimate collection shall be restricted to claims for price escalation and export incentives.

AS 10

Tangible Fixed Assets

- In case of acquisition of an asset in exchange for another asset, shares or other securities, lower of the fair value of the asset/securities given up or the asset acquired shall be recorded as actual cost of the asset.
- Revaluation of assets is not incorporated in TAS as the ITL does not recognize the concept of revaluation of assets
- The ITL contains specific provisions relating to retirement and disposal of tangible fixed assets. Hence, same are not incorporated in TAS.

AS 11

Effects of Change in Foreign Exchange Rates.

- All foreign currency transactions would be required to be recognised at the exchange rate prevalent on the date of the transactions.

- The TAS requires exchange differences on translation of non-integral foreign operations to be recognised as income or expense, instead of their recognition in the foreign currency translation reserve account as currently required by AS 11.

- Since mark-to-market gains or losses are unrealized in nature, all gains or losses on forward exchange or similar contracts entered into for trading or speculation contracts shall be recognized only on settlement.

AS 12

Government Grant

- Government grants should either be treated as revenue receipt or should be reduced from the cost of fixed assets based on the purpose for which such grant or subsidy is given.
- Recognition of Government grants shall not be postponed beyond the date of actual receipt

AS 13

Securities.

- Unlike AS 13, the TAS covers securities held as stock–in- trade, but does not cover other securities.

- Securities should be valued at lower of cost or net realizable value (NRV). Comparison of cost and NRV shall be done category-wise (and not for each individual security) for which securities shall be classified into the following categories: (a) Shares (b) Debt securities (c) Convertible securities (d) Any other securities not covered above.

- Unlisted or thinly traded securities shall be valued at cost.

- Cost which cannot be ascertained by specific identification shall be determined on the basis of first-in-first out (FIFO) method.

AS 16

Borrowing Costs.

- Borrowing cost will not include exchange differences arising from foreign currency borrowings.
- TAS requires capitalisation of borrowing costs for all covered assets irrespective of the period of construction. The only exception to this rule is for inventories, where the TAS requires capitalisation of borrowing costs only for inventories that than 12 months to complete.
- Specific pro-ration formula is provided for capitalizing borrowing costs relating to general borrowings.
- Income on temporary investments of borrowed funds cannot be reduced from borrowing costs eligible for capitalization.
- Condition of suspension of capitalization during interruption of active development is removed in TAS.

AS 19

Leases.

- In the case of finance leases, depreciation will be allowed to the lessee even though the asset is owned by the lessor. The Committee has recommended amendment in the provisions of the ITL relating to depreciation, ownership, block of assets, transfer etc., to align with this requirement.

- AS 19 provides several indicators for finance lease classification that have to be considered in totality along with an understanding of the substance of the arrangement. TAS considers the existence of any one of the specified indicators as sufficient evidence for finance lease classification

AS 26

Intangible assets.

- In case of acquisition of an intangible asset in exchange for another asset, shares or other securities, lower of fair value of the asset/securities given up or the asset acquired shall be recorded as actual cost of the asset.
- As the ITL contains specific provisions relating to amortization, retirement and disposal of intangible assets (including those acquired on amalgamation), same are not incorporated in TAS

AS 29

Provisions, Contingent Liabilities and Contingent Assets.

- A provision can be recognized when it is "reasonably certain" that an outflow of economic resources will be required to settle an obligation.
- A contingent asset can be recognized when the realization of related income is "reasonably certain"
- AS 29 provides for recognising losses on onerous executory contracts when the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. The TAS excludes all executory contracts including onerous contracts from its scope. Accordingly, such unavoidable future losses cannot be currently recognised under the TAS. This is consistent with the general provisions under the TAS, which preclude recognition of unrealised gains and losses.

FEW EXAMPLES

IMPACT ASSESSMENT

Construction Contracts (Example 1)

- ABC Limited furnishes the following information about its revenue from its construction contract under POC Method and CC Method:

Year	**POC Basis (Rs.)**	**CC Basis (Rs.)**
Year 1	16,00,000	10,00,000
Year 2	26,00,000	18,00,000
Year 3	8,00,000	22,00,000
Total	**50,00,000**	**50,00,000**

Tax Rate is 30%. Compute Pre TAS and Post TAS Tax outflows?

Solution

Year	CC Basis (Rs.) [Pre TAS Scenario]	POC Basis (Rs.) [Post TAS Scenario]
Year 1	3,00,000 (10,00,000 x 30%)	4,80,000 (16,00,000 x 30%)
Year 2	5,40,000 (18,00,000 x 30%)	7,80,000 (26,00,000 x 30%)
Year 3	6,60,000 (22,00,000 x 30%)	2,40,000 (8,00,000 x 30%)
Total	**15,00,000**	**15,00,000**

Construction Contracts (Example 2)

- A firm of contractors obtained a contract for construction of bridges across river Yamuna. The following details are available in the records kept for the year ended 31st March, 2012 (Rs. in lakhs):

1. Total Contract Price	Rs.1,000
2. Work Certified	Rs. 500
3. Work not Certified	Rs. 105
4. Estimated further Cost to Completion	Rs. 495
5. Progress Payment Received	Rs. 400
6. To be Received	Rs. 140

Compute Income/ Loss under AS 7 and Proposed TAS

Solution as per AS 7

COMPUTATION AS PER AS 7

(i) Computation of amount of foreseeable loss	**Rs. lakhs**
Total costs of construction (500 + 105 + 495)	1,100
Less: Contract Price	1,000
Amount of foreseeable loss	100

(ii) Computation of contract work in progress	**Rs. lakhs**
Cost of work certified	500
Cost of work uncertified	105
	605

Thus, contract work in progress amount to 55% of the total costs of construction.

(iii) Computation of contract revenue to be recognised	**Rs. lakhs**
Cost incurred to date (Representing 55% of the total costs of construction)	605
55% of contract revenue	550
Loss to be recognised in the P/L	55

Solution ………

- Further, having regard to Para 35 of AS 7 (Revised),
- a foreseeable loss on the entire contract need to be recognised immediately;
- Since the total foreseeable loss is Rs. 100 lakhs, an additional amount of Rs. 45 lakhs need to be recognised as provision for the period ending 31-3-2012
- (This provision of Rs. 45 Lakhs disallowed under PGBP as TAS does not require creation of such provision)

Construction Contracts (Example 3)

The company undertook a contract for building a crane for Rs. 10 lakhs. As on 31-3-2012, it incurred a cost of Rs. 1.5 lakhs and expects that there will be Rs. 9 lakhs more for completing the crane. It has received so far Rs. 1 lakh as progress payment;

The management is not in a position to reliably estimate the outcome of this contract;

- Compute Income/ Loss under AS 7 and Proposed TAS

- Computation under AS 7 and Proposed TAS
- Para 32 of AS 7 states that: “during the early stages of a contract it is often the case that the outcome of the contract cannot be estimated reliably. Nevertheless, it may be probable that the enterprise will recover the contract costs incurred” ;

- Therefore, contract revenue is recognised only to the extent of costs incurred that are expected to be recovered;

- As the outcome of the contract cannot be estimated reliably, no profit is recognised;

- Para 25 of AS 7 requires that:“when it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognised as an expense immediately”

Solution

- **Percentage of Completion** = 14.28% (i.e. Rs. 1.5 Lakhs/ Rs. 10.5 Lakhs);

- **Foreseeable loss** = Rs. 50,000 (as the expected cost of Rs. 10.50 lakhs exceeds the contract revenue by Rs. 50,000) should be recognised as an expense in the current year itself;

- **Provision** = Rs. 50,000 not allowed under Proposed TAS

Construction Contract Example 3.1

The company undertook a contract for building a crane for Rs. 10 lakhs. As on 31-3-2012, it incurred a cost of Rs. 3.5 lakhs and expects that there will be Rs. 9 lakhs more for completing the crane.

It has received so far Rs. 1 lakh as progress payment;

The management is not in a position to reliably estimate the outcome of this contract;

Compute Income/ Loss under AS 7 and Proposed TAS

Solution

- Computation under AS 7 and Proposed TAS
- Para 32 of AS 7 states that: "during the early stages of a contract it is often the case that the outcome of the contract cannot be estimated reliably. Nevertheless, it may be probable that the enterprise will recover the contract costs incurred" ;
- Therefore, contract revenue is recognised only to the extent of costs incurred that are expected to be recovered;
- As the outcome of the contract cannot be estimated reliably, no profit is recognised;
- Para 25 of AS 7 requires that: "when it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognised as an expense immediately"

Solution

- Computation under AS 7 and Proposed TAS
  Percentage of Completion = 28% (i.e. Rs. 3.5 Lakhs/ Rs.12.5 Lakhs);

- • Foreseeable loss = Rs. 2,50,000 (Rs. 12,50,0000 less Rs.10,00,000)

Particulars	AS – 7	TAS
Foreseeable Loss	250000	250000
Contract Cost to Date	350000	350000
Contract Revenue	350000	280000
Loss to be recognized in P/L Account	0	70000
Provision to be made	250000	180000

Construction Contract Example 4

- A Contractor engaged in the business of civil construction work does not maintain regular books of account;
- The bills submitted in respect of contracts for the period 1.4.2011 to 31.3.2012 are as follows:

1. Value of Work carried out Rs. 35.00 L
2. Value of Materials supplied (F.C.) Rs. 18.00 L
3. Gross Billing Rs. 53.00 L
4. Amount retained @ 10% (Rs. 5.30 L)
5. Net Billing Rs. 47.70 L

How will the profit of the contractor be assessed by the AO post TAS

Solution

- Retentions are amounts of progress billings which are not paid until the satisfaction of conditions specified in the contract for the payment of such amounts or until defects have been rectified;
- Para 9 of TAS states that Contract revenue shall comprise of the initial amount of revenue agreed in the contract, including retentions

Particulars	Pre Tax AS-7	Post TAS
Gross Billing	53,00,000	53,00,000
Value of Material supplied	(18,00,000)	(18,00,000)
Retention Money	(5,30,000)	N.A
Turnover	29,70,000	35,00,000
8% of above u/s 44AD	2,73,600	2,80,000

Government Grants (Example 1)

- ABC Limited has set up its business in a designated backward area which entitles the company to receive from the Government of India a subsidy of 20% of the cost of investment;

  Having fulfilled all the conditions under the scheme, the company on its investment of Rs. 50 crores in capital assets, received Rs. 10 crores from the Government in January, 2012;

- Show the treatment under AS 12 and Post TAS for the year ended 31st March, 2012.

Solution

Particulars	AS-12(Option 1)	AS-12(Option 2)	TAS
Cost of Asset	50.00 Crores	50.00 Crores	50.00 Crores
Govt. Grant	10.00 Crores	10.00 Crores	10.00 Crores
Deferred Income	NIL	10.00 Crores	NIL
Cost after Govt.Grant	40.00 Crores	50.00 Crores	40.00 Crores
Depreciable Value Dep Rate @ 10%p.a	40.00 Crores 4.00 Crores	50.00 Crores 5.00 Crores	40.00 Crores 6.00 Crores(Tax Rate @ 15%)
Govt.Grant to be recognized as Income yr by yr basis	NIL	1.00 Crore for 10 yrs	NIL

Government Grants Example 2

- ABC Limited received a grant of Rs. 800 lakhs during the year 2011-2012 for various welfare activities to be carried out for its employees;

  The grant was received on 31.08.2011 but the conditions to be fulfilled for its utilisation have the 31.08.2013 as the last date;
- The management is of the **<u>skeptical view</u>** that the conditions would be fulfilled by that date. However, as on 31.03.2011, no such condition has been fulfilled.

- Show AS 12 and Proposed TAS treatment

Solution

- As per AS 12, only receipt of a govt. grant is not a conclusive evidence that conditions attaching thereto have been fulfilled or will be fulfilled;
- AS 12 Treatment: Govt. Grant shall not be recognised;
- TAS Treatment: Govt. Grant shall be taken as Income for taxation purposes

Government Grant (Example 3)

- ABC Limited received a grant of Rs. 800 lakhs during the year 2011-2012 for various welfare activities to be carried out for its employees;

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  The management is of the **Skeptical view** that the conditions would be fulfilled by that date. However, as on 31.03.2012, no such condition has been fulfilled.

  Show AS 12 and Proposed TAS treatment assuming that no such conditions were in fact fulfilled and the grant was required to be refunded.

Solution …..

- As per AS 12, only receipt of a govt. grant is not a conclusive evidence that conditions attaching thereto have been fulfilled or will be fulfilled;

  AS 12 Treatment (31.03.2012): Govt. Grant shall not be recognised;

  TAS Treatment (31.03.2012): Govt. Grant shall be taken as Income for taxation purposes.

  TAS Treatment (31.03.2013): Govt. Grant Refund shall be taken as Expense for taxation purposes

Government Grant (Example 4)

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  The grant was received on 31.08.2011 but the

  conditions to be fulfilled for its utilisation have the 31.08.2013 as the last date;

  The management is **reasonably assured** that the conditions would be fulfilled by that date. However, as on 31.03.2012, no such condition has been fulfilled.

  Show AS 12 and Proposed TAS treatment assuming that no such conditions were in fact fulfilled and the grant was required to be refunded.

Solution …..

- As per AS 12, only receipt of a govt. grant is not a conclusive evidence that conditions attaching thereto have been fulfilled or will be fulfilled;

  AS 12 Treatment: Govt. Grant shall be recognised as income in P/L A/c.

  TAS Treatment: Govt. Grant shall be taken as Income for taxation purposes.

  TAS Treatment (31.03.2013): Govt. Grant Refund shall be taken as Expense for taxation purposes

Points of Discussion

- The impact of these recommendations and proposals on deferred tax, are to watch out for and the consequent impact on book profits for the purposes of MAT
- The proposals regarding expense items in TAS are understandable however, where revenue recognition criteria are undergoing a change, readers of financial statements are likely to scratch their heads over the Government's rationale for a different approach for tax purposes
- Coming to other specifics of the recommendations, ASC recommends providing for method of valuing inventory for service industry, though no proposals have been incorporated yet in the draft TAS for valuation of inventories.
- TAS does provide for provisions for allowability of prior period expenses but makes no mention for treatment of prior period income
- Further, treatment of fixed assets exchanged with another asset has also been envisaged in the TAS.

Points of Discussion.....

- Such a fixed asset is to be recorded at its fair market value or the fair value of the asset given up, whichever is lower. "Fair value", for this purpose, is the amount for which that asset could be exchanged between knowledgeable, willing parties in an arm's length transaction. How to compute fair value and interpret arm's length transaction continues to remain subjective and open to further interpretation!

- The major change which industry will encounter is in relation to treatment of unrealised foreign exchange fluctuation losses provided for in accordance with AS – 11, on year-end outstanding balances.

- the industry, taxpayers while computing taxable income have claimed deduction of such exchange fluctuation losses, a position duly validated by the Supreme Court; however, the draft TAS proposes to disallow such a loss until actual settlement.

- While tax payers will struggle to adhere to two sets of AS running in different directions. In times to come, perhaps, AS issued by the ICAI may lose their relevance for tax purposes in some cases where options provided by AS are done away with in TAS for instance – revenue from service transaction is to be recognised as per 'percentage completion method' only.

Points of Discussion…..

- It is noticeable that many issues are left untouched, such as treatment of lease rent equalization created under AS – 19, provisions such as provision for warranty, sales return, special discounts etc.
- Harmonisation of AS and TAS will widen the gap between accounting profits and tax profits
- From a taxpayer's standpoint, there will be the rigours of following AS issued by the ICAI for accounting purposes and then separately following the 14 TAS for tax purpose

Points of Discussion…..

- Indeed, tax payers are not required to maintain separate tax books as clarified in the ASC's final report, yet it is difficult to imagine reconciliation of two different positions without maintaining copious documentation, a job close to maintaining separate books of accounts!!
- Taxpayers will also be forced to maintain records to keep a track of differences every year, specially where income recognition criteria and other accounting aspects are significantly different such as cases of construction contracts, unarguably, leading to additional time spent on compliance.

- Thank You!!!!

- CA Aankit Kumar Jain

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