

October 10, 2016

Revised Income Computation and Disclosure Standards

Section 145 of the Income tax Act, 1961 (**"the Act"**), as amended by the Finance Act, 1995, empowered the Central Government to notify the Accounting Standards to be followed for computing income under the head "Profits and Gains of Business or Profession" and "Income from Other Sources". In pursuance thereof, in 1996, two Accounting Standards relating to "Disclosure of Accounting Policies" and "Disclosure of prior period and extraordinary items and Change in accounting policies" were notified.

Several committees were formed by the Central Government for drafting and notifying Accounting Standards for the purpose of the aforesaid section. Finally, the Central Board of Direct Taxes (**"CBDT"**) vide Notification No. 33/2015 on March 31st 2015, i.e., after almost two decades, notified 10 Income Computation & Disclosure Standards (**"ICDS"**), to be effective from Assessment Year 2016-17 onwards.

Subsequent to notification of the ICDS, a number of representations were received from the stakeholders which were examined by an Expert Committee. Since the Committee recommended amendments to the notified ICDS and revision of ICDS/ issue of clarifications as recommended by the Committee was under consideration, the Government decided to defer the applicability of ICDS and made the same applicable, w.e.f., April 1st 2016, i.e., from previous year 2016-17 (Assessment Year 2017-18).

The Central Government has vide Notification dated 29 September 2016 released new set of ICDS. The revised ICDS are applicable from assessment year 2017 -18 and would have bearing on the taxable income of the current financial year and subsequent financial years.

The revised ICDS are applicable to all taxpayers following mercantile system of accounting, except individual and Hindu Undivided Family not required to get his accounts of the previous year audited in accordance with the provisions of section 44AB of the Act.

The key changes that have been brought about by the revised ICDS issued on 29th September, 2016 are as under -

(a) ICDS –II – Inventories

- ICDS defined cost of inventories to, inter alia, include cost of services. ICDS provided that in case of service providers, cost of services shall consist of labour and other costs of personnel directly engaged in providing the service including supervisory personnel and attributable overheads.

- It was unclear whether the aforesaid requirement of inclusion of cost of services in cost of inventories applied only to services providers. The words “in case of a service provider” have been deleted in the revised ICDS. In other words, the aforesaid requirement of including cost of services in inventory valuation applies to all entities who fall within the ambit of ICDS.
- Further, standard costing has also been permitted for valuation of inventories in addition to the retail method of valuation.

(b) ICDS-III –Construction contracts

- In terms of original ICDS, income from construction contract was required to be recognized by following percentage of completion method (“POCM”).
- The revised ICDS provides that in relation to construction contracts under progress as on 31.3.2016, the method of accounting being regularly followed by an entity in respect of the same, even if different from POCM, may continue to be followed.

(c) ICDS-IV- Revenue recognition

- The revised ICDS now additionally provides that revenue is required to be recognised on a straight line basis over the specific period where the services are provided by an indeterminate number of acts over a specific period of time
- However, revenue from service contracts with duration of not more than 90 days may be recognised when the rendering of services under that contract is completed or substantially completed.
- The interest on refund of any tax, duty or cess shall be recognised as income on receipt basis.

(d) ICDS-V - Tangible Fixed Assets

- The requirement of maintaining the details of jointly owned fixed assets in the fixed asset register separately has been done away with.

(e) ICDS –VI- Effects of changes in foreign exchange rates

- It is now provided that on the last day of each previous year, non-monetary item being inventory which is carried at net realisable value denominated in foreign currency shall be reported using the exchange rate that existed when such value was determined.
- The requirement of classification of foreign operations into integral and non-integral foreign operations has been done away with.

(f) ICDS- VIII- Securities

- This ICDS has now been bifurcated into two parts – Part A, relating to securities held as stock in trade, and

Part B, relating to securities held by a scheduled bank or public financial institutions formed under a Central or a State Act or so declared under the Companies Act, 1956 or the Companies Act, 2013.

- In relation to entities covered under Part B, it has been provided that the securities shall be classified, recognised and measured in accordance with the extant guidelines issued by Reserve Bank of India in this regard.
- Option of applying weighted average cost formula is now provided for determining cost of security, where the actual cost initially recognised cannot be ascertained by reference to specific identification. Earlier only option of first-in-first-out method was provided.

(g) ICDS-IX- Borrowing Cost

- The revised formula for general borrowing seeks for capitalisation of interest cost, irrespective whether such borrowing has been utilized for acquisition of asset, whereas the erstwhile ICDS provided for capitalisation of *“funds borrowed generally and utilised for the purpose of acquisition..... of a qualifying asset”*.
- For the purpose of computing the borrowing cost eligible for capitalisation in relation to general borrowing, only the amount of qualifying asset, to the extent, it is funded out of specific borrowing is to be reduced, as against the full value of such asset as per the erstwhile ICDS.
- In connection with the borrowing costs eligible for capitalisation, it has now been provided that such cost shall only be capitalised till the date when the asset is first put to use and in case of inventory, when substantially all the activities necessary to prepare such inventory for its intended sale are complete.

Vaish Comments

ICDS will bring about a paradigm shift in the manner of computation of taxable income chargeable under the head “Profit and Gains of Business or Profession” and “Income from Other Sources” from assessment year 2017-18, which is the first year of its implementation. While the revised ICDS do address some of the concerns of the stakeholders, significant issues / doubts arising out of ICDS originally notified have, unfortunately, not been addressed. For example, the revised ICDS fails to consider, inter alia, the following important issues highlighted by the stakeholders:

- Whether judicial precedents interpreting provisions of the Act would be regarded as law and, therefore, override ICDS if inconsistent with provisions of ICDS?
- No relief granted in case of mismatch between MAT and ICDS which may result in double taxation?
- ICDS is silent on the treatment of unrealised gains in respect of transactions required to be marked to market – whether prudence concept can be followed?
- Whether interest would be considered for inventory valuation if there is delay on account of lockouts/ business suspension / non-availability of raw material and the final products gets delayed beyond 12 months?

- Whether ICDS-III applies to Real Estate Developers?
- Where adjustment were to be made by the Revenue in assessment to the closing stock, whether such adjustment will be considered in the opening stock of next year?
- Whether interest incurred during a particular year on loan borrowed for purchase of securities would be added to the cost of security where such interest is payable in the subsequent year?
- Whether suo moto allocation of interest on amount borrowed generally and utilized for purpose of acquisition, construction or production of a qualifying asset made on any other basis would be acceptable?

Unless the aforesaid issues are adequately addressed/ clarified, the objective of the Government to ease the carrying on of business in India and reduce litigation would not be achieved.

Further, the Government needs to seriously consider as to whether MAT provisions are anymore required, considering that with the introduction of ICDS, which as per the Government has the effect of bringing the accounting treatment in harmony and as close as possible to the provisions of the Act, it would not be possible for companies to reduce taxable income by resorting to so called accounting jugglery, which was the *raison d'etre* provided for introduction of MAT provisions. By abolition of MAT provisions, there would at least be some reduction in compliance burden on companies.

We will keep you updated on further developments on the subject matter.

For any further details and clarifications, please feel free to write to:

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