Deloitte
Haskins & Sells LLP

Deloitte's recommendations on Income Computation & Disclosure Standards

In response to CBDT press release dated 26th November, 2015

December 2015

Contents

1. Background ..... **Error! Bookmark not defined.**
2. General Recommendations 2
3. ICDS I : Accounting Policies 4
4. ICDS II : Valuation of inventory ..... Error! Bookmark not defined.
5. ICDS III : Construction Contracts ..... **Error! Bookmark not defined.**
6. ICDS IV : Revenue Recognition 9
7. ICDS V : Tangibile Fixed Assets 11
8. ICDs VI : Effects of Changes in Foreign Exchange Rates 13
9. ICDS VII : Government Grants 14
10. ICDS VIII : Valuation of Securities 15
11. ICDS IX: Borrowing Costs 17
12. ICDS X : Provisions, Contingent Liabilities and Contingent Assets 18

1. Background

On 26th November 2015, the Central Board of Direct Taxes (CBDT) invited the stake holders and general public to bring out issues which in their opinion would require further clarification/guidance for proper implementation of the provisions of the ICDS. In response to this press release, we submit below our recommendations on ICDS for consideration by CBDT.

2. General Recommendations

1. Issue: Need for Income Computation and Disclosure Standards (ICDS)

1.1. The objective of ICDS was to bring greater consistency in the application of accounting principles in computation of taxable income, to simplify the implementation of provisions of the Income Tax Act, 1961 (Act) and to reduce tax disputes.

1.2. However, in the current form, the ICDS increase ambiguity in many areas and also increase the burden on taxpayers in the form of maintenance of extensive documentation. For example,

- ICDS does not recognise the universally-accepted accounting principle of ‘prudence’ even though the same has been accepted by courts for tax purposes. Non-recognition of the principle of prudence will lead to taxable profits being overstated – to the detriment of taxpayers. Also, such a deviation adopted by ICDS is bound to lead to renewed litigation.
- ICDS introduces new concepts which have been left undefined - ‘reasonable cause’ for change in accounting policy or ‘reasonable certainty’ for recognition of provisions and contingent assets. Taxpayers are at a loss to understand how such provisions are to be implemented on account of no clarity.
- Moreover, even though the preamble to ICDS states that the ICDS are not for the purpose of maintenance of books of account, the deviations from accepted accounting principles (such as different formula for capitalising general borrowing costs, non-recognition of expected or marked-to-market (MTM) loss) would result in maintenance of separate books of accounts for tax purposes. Such maintenance of parallel set of books of accounts would be burdensome, require changes to existing IT systems and result in high cost of compliance.

1.3. Further, no time frame was granted to taxpayers to transition to ICDS.

1.4. The Indian taxpayers prepare accounts based on the accounting standards issued by the national body. These accounting standards take cognizance of the international accounting principles and the local Indian conditions. Accordingly, taxation should be based on such profits which are calculated to reflect the actual results of carrying on business. Further, we recommend the above since the major differences between ICDS and accounting standards are timing differences.

1.5. To summarise, the current ICDS will lead to increased litigation, duplication of efforts in maintaining separate tax books, increased complexity and high compliance cost which is against the intended objective. Further, the new IFRS-converged Indian Accounting Standards (IndAS) will be applicable to certain companies from financial year 2015-16 onwards. Thus, it is recommended that the current ICDS must be reviewed thoroughly in light of well-accepted accounting principles.

2. **Issue: Conflict with existing settled legal positions**

ICDS states that in case ICDS is in conflict with the provisions of the Act, the Act shall prevail. It is not clear whether the Act shall include rules, notifications and judicial precedents as well. Judicial precedents are interpretations of the Act and hence, must also be given effect in cases where there is a conflict between ICDS and the Act.

Recommendation: ICDS should also expressly clarify that the terms 'Income-tax Act, 1961' shall include income-tax rules and notifications. Further, ICDS should be made subordinate to the law represented by judicial rulings of the Supreme Court and well-settled legal positions (as may be decided by the High Courts and Tribunals). Accordingly, various areas (as elaborated later) where ICDS provisions are in conflict with existing judicial precedents must be modified/clarified.

3. **Issue: Disclosure requirements**

Each ICDS specifies disclosure requirements. However, there is no clarity on the place where such disclosures are required to be made.

Recommendation: In order to enable companies to maintain appropriate documentation, the format for such disclosures should be announced soon.

3. ICDS I: Accounting Policies

4. Issue: Disclosure of change in accounting policy

Para 7 of ICDS I requires that where a change in accounting policy has no material effect for the current previous year but which is reasonably expected to have a material effect in later previous years, the fact of such change shall be appropriately disclosed in the previous year in which the change is adopted and also in the previous year in which such change has material effect for the first time.

Recommendation: There could be situations wherein the time gap between a change in accounting policy and its impact could be too long to keep track of and hence, reporting may become difficult.

As per AS-1,if a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed **in the period in which the change is adopted**. We recommend that ICDS may be aligned to AS-1 and requirement to report in subsequent previous year be eliminated.

5. Issue: Change in accounting policy not permitted without 'reasonable cause'

ICDS states that an accounting policy shall not be changed without 'reasonable cause'. The term 'reasonable cause' is not defined and hence, could be a potential ground for litigation.

Recommendation: The words 'reasonable cause' must be clearly defined with examples such as change in statute, appropriate computation of income, etc.

6. Issue: Marked-to-market(MTM) or expected losses are not permitted

ICDS provides that MTM loss or expected loss shall not be recognized unless the recognition is in accordance with the provisions of any other ICDS. This provision vitiates the basic accounting principle of prudence and negates the various court decisions which have upheld deduction of such loss under section 37 of the Act based on the accrual method of accounting.

For example, the Hon'ble Supreme Court in the case of Woodward Governor India P. Ltd (312 ITR 254) had held that where taxpayer follows mercantile method of accounting, exchange fluctuation difference on revenue account should be recognized for tax purposes on MTM basis as is consistent with the generally accepted accounting standards. Similarly, provision for the entire expected losses in construction contracts has been allowed as a tax deduction by various high courts so long as such provision is considered to be in accordance with the accounting standard or is justified based on prudence [refer CIT vs. Triveni Engineering & Industries Ltd. (336 ITR 374) (Delhi HC), CIT vs. Advance Construction Co. Pvt. Ltd. (275 ITR 30) (Gujarat HC)]

Recommendation: In view of existing judicial positions, ICDS should allow for MTM loss or expected loss that is on revenue account. Further, in order to maintain consistency, ICDS should also provide that MTM profits or expected incomes shall be taxable only in cases corresponding to the above.

4. ICDS II: Valuation of Inventory

7. Issue: Inventory in case of service providers

Para 6 of ICDS II makes a specific reference to service providers to maintain inventory in terms of cost of labour, etc. This is not in line with the ICDS IV which prescribes percentage completion method for service providers because inventory / work-in-progress do not arise if this method is followed (except where revenue recognition is postponed). Further, inventory for service providers i.e. work-in-progress does not fall under the definition of inventory in ICDS II since the definition only refers to material consumed while providing services.

Also, ICDS states that inventories will be valued at lower of cost or net realisable value. In absence of guidance or precedents, an additional burden will be created for estimating net realisable value of work-in-progress of services.

Recommendation: Service providers should be exempt from maintaining any inventory in view of cumbersome compliance.

5. ICDS III: Construction Contracts

8. Issue: Applicability of ICDS III

ICDS III applies for determination of income for a construction contract of a contractor.

However, a contractor is not defined. Generally, the term ‘contractor’ should not include a ‘real estate developer’ who bears the risk of construction and transfers the risks and rewards in the property post completion of construction. This is based on various judicial precedents - in case the risks and rewards in the property are transferred at the beginning of the contract, revenue is recognized as per percentage completion method and in case the same are transferred at the end of the contract, revenue is recognized as per completed contract method. Thus, ICDS III should apply in case of a contractor i.e. when risks and rewards in the property are transferred at the beginning of the contract.

Recommendation: Thus, parameters must be given to distinguish between a contractor and real estate developer – the parameters could be based on AS-7 and ICAI’s guidance note on real estate. Further, tax treatment in case of real estate developer should be clarified i.e. whether recognition of income from sale of property will be the same as that from sale of goods as mentioned ICDS IV. Also, examples must be given to clarify tax treatment in various scenarios which are typical in real estate sector – taxation of construction in different phases (i.e. part sold and part unsold), etc.

9. Issue: Recognition of expected loss

ICDS III is silent about upfront recognition of expected loss. However, as mentioned in Para 6 above, judicial precedents have till date allowed deduction of such expected loss. Thus, there is a conflict between ICDS and the Act.

Further, difference in the treatment of expected loss in books and as per ICDS for tax purpose could lead to double taxation owing to fluctuation between Minimum Alternate Tax and normal tax provisions. The same is illustrated below:

Year 1 – book profits	
Revenue	100
Less: Provision for expected loss	(40)
Net profit	**60**

Year 1 – taxable income (ICDS)	
Revenue	100
Less: Provision for expected loss	NIL
Net profit	**100**

Year 2 – book profits	
Revenue	200
Less: Cost incurred and adjusted against provision	NIL
Net profit	**200**

Year 2 – taxable income (ICDS)	
Revenue	200
Less: Cost incurred as per provision	(40)
Net profit	**160**

As per income-tax, 160 would have got taxed but additional 40 gets taxed as per MAT

Mismatch of profits in books and income-tax could lead to double taxation in case book profits are taxed as per MAT provisions in Year 2.

Recommendation: Thus, expected loss must be allowed to be provided for in light of judicial precedents and to avoid double taxation.

6. ICDS IV: Revenue Recognition

10. Issue: Percentage completion method for service income

The percentage completion method (PCM) is not in line with the accrual principle under section 5 of the Act i.e. income accrues when there is a right to receive the same. Right to receive income is based on the terms of each contract and PCM ignores this concept. Thus, there is a conflict between the Act and ICDS to that extent. Accordingly, this requirement of PCM should be removed.

Separately, there are many services which are provided over a period of few months. The requirement of recognising revenue as per PCM is quite onerous for such service providers (in case the service is on-going as on the cut-off date of 31 March) for variety of reasons such as absence of mechanism to track stage of completion at the end of the year, additional costs of implementation, etc. Thus, ICDS could require the PCM to apply only in case of long-term contracts.

Recommendation: Requirement of PCM for service income must be removed. Else, it should be restricted only to long-term service contracts.

11. Issue: Applicability of 'reasonable certainty'

Para 4 of ICDS IV which relates to sale of goods states that 'revenue shall be recognised when there is reasonable certainty of its ultimate collection'. However, there is no such clause for recognition of incomes such as interest or royalty.

Recommendation: The above criteria must be extended for recognition of other kinds of revenue as well such as interest, royalties, etc.

12. Issue: Transitional provisions - discount/premium

In case of discount/premium on debt securities which are held by a taxpayer on 1 April 2015 the same may not have been offered to tax in the past. ICDS requires such income to be offered to tax over the maturity period of the security. However, it is not clear how the discount/premium relating to past years will be offered to tax.

Recommendation: ICDS must clarified whether the discount/premium relating to past years must be offered to tax during financial year 2015-16 or over balance period of security or in the last year of redemption.

13. Issue: Transitional provisions – income from service contracts

In case of on-going contracts where taxpayer is following completed contract method, income would not have been offered to tax in the past. ICDS requires that income on such contracts must be offered

to tax as per PCM. However, it is not clear if all the income of the past also must be offered to tax in financial year 2015-16 in case PCM was not followed in the past.

Recommendation: ICDS must clarified whether the income relating to past years must be offered to tax during financial year 2015-16 or over balance period of contract or in the last year of the contract.

7. ICDS V: Tangible Fixed Assets

14. Issue: Exchange of assets

In case of exchange of one tangible fixed asset with another, ICDS provides that 'fair value' of tangible fixed asset acquired shall be its actual cost. However, as per the Act, fixed assets must be capitalized at their actual costs and section 43 of the Act defines 'actual cost' as 'the actual cost of the assets to the assessee'. Thus, the value of capitalization must be a 'cost' to the taxpayer i.e. something given up by the taxpayer. Accordingly, the value of capitalization must be the value of asset given up and not of the asset acquired. Further, AS-10 states that when an asset is acquired in exchange for another asset, its cost shall be determined with reference to fair market value of asset given unless the fair value of the asset acquired is more clearly evident.

Recommendation: ICDS should be brought in line with the Act and established principles of accounting - value of capitalization must be the value of asset given up and not of the asset acquired.

15. Issue: Definition of tangible fixed asset

ICDS defines 'tangible fixed asset' as 'an asset... **held** with the intention of being used...' instead of as 'an asset... **owned** with the intention of being used…' The word 'held' lacks clarity - whether the same means ownership or control or both. Further, the Act provides for tax depreciation only if the asset is 'owned'. Thus, there appears to be a conflict between ICDS and the Act.

Recommendation: In order to bring ICDS in line with the Act, the word 'owned' should be used instead of the work 'held'.

16. Issue: Register for fixed assets

The final notified ICDS have deleted Para 19 of draft ICDS V which provided for maintenance of fixed asset register. However, Para 14 of the notified ICDS still continues to make a reference to fixed asset register.

Recommendation: The words 'fixed asset register' should be deleted from Para 14 of the notified ICDS.

17. Issue: Capitalization of machinery spares

ICDS V provides that machinery spares which can be used only in connection with an item of tangible fixed asset and their use is expected to be irregular, shall be capitalized. However, ICDS does not provide any further guidance on subsequent treatment.

Recommendation: It needs to be clarified that, in case machinery spares are required to be capitalized, the following consequences will follow:

- Cost thereof should form part of same block of asset to which principal asset belongs;

- The spares should enter the block soon upon its acquisition. The test of asset being "put to use" should not be applied to it on a standalone basis since these are spares which are integral to the principal asset and if the principal asset has been put to use then same should satisfy the "put to use" test of spares;
- Other machinery spares should be charged to the Profit & Loss account, as and when consumed

18. Issue: Expenses incurred between trial run and commercial production

ICDS states that expenditure incurred on start-up and commissioning of the project, including the expenditure incurred on test runs and experimental production, shall be capitalized and also states that the expenditure incurred after the plant has begun commercial production shall be treated as revenue expenditure. However, ICDS is silent in case of expenses incurred between start-up/commissioning and commercial production. Since depreciation can be claimed post the trial run, as a corollary it should follow that all expenses post trial run, rather than commercial production are revenue expenses.

Recommendation: It is recommended that the treatment of expenses in the aforementioned intermediate period be allowed as revenue deduction.

8. ICDS VI: Effects of Changes in Foreign Exchange Rates

19. Issue: Foreign exchange difference in relation to local assets

ICDS provides that exchange differences relating to monetary items must be recognised on MTM basis as income/expense. This provision is subject to section 43A of the Act which permits the exchange differences relating to assets purchased from abroad to be adjusted to the cost of the asset.

Recommendation: ICDS must specifically clarify the treatment of exchange differences on liabilities relating to purchase of assets in India.

20. Issue: Non-integral operations

AS-11 provides that exchanges differences arising on translation of the financial statements of non-integral foreign operations (such as foreign branches of banks, etc.) should be accumulated in a foreign currency translation reserve in the balance sheet until the disposal of net investment. These exchange differences are not recognised as income or expense for the period. Since all the transactions at the foreign branch are executed in foreign currency and there is ordinarily no occasion to convert the same into INR, the translation difference in terms of INR at year end merely represents a notional value. The cumulative difference is brought into the Profit & Loss statement on disposal of the foreign branch at which point of time the exchange difference is actually realized. However, para 9 (1) (c) of the ICDS mentions that such exchange differences should be recognized as income or as expense each year.

Recommendation: ICDS should be aligned with AS-11 and allow for accumulation of the exchange differences arising on translation of the financial statements of non-integral foreign operations in a foreign currency translation reserve in the balance sheet until the disposal of the net investment. Upfront recognition of exchange fluctuation differences on non-integral foreign operations should be done away.

9. ICDS VII: Government Grants

21. Issue: Exclusion of international Governments from definition of grants

Post ICDS, grants have been defined and included in section 2(24)(xviii) of the Act. The definition in the Act states 'income shall include assistance in the form of subsidy… by **Central Government or State Government or any body/authority/agency**…' Thus, reference is being made to Indian Government bodies and not international Governments. The reference to "international" which is present in ICDS is absent in the Act and thus, there is conflict between ICDS and the Act. Accordingly, ICDS must be brought in line with ICDS.

Recommendation: The word "international" may be dropped from the definition of "government" under Para 3(1)(a) of the ICDS.

22. Issue: Ambiguous definition of government grants

Para 3(1) of ICDS defines government grants as 'assistance by Government in cash or kind to a person for past or future compliance with certain conditions. They exclude those forms of Government assistance which cannot have a value placed upon them and the transactions with Government which cannot be distinguished from the normal trading transactions of the person'. The definition in the Act states that income will include 'assistance in the form of subsidy or grant … waiver or concession or reimbursement…' The definition is very wide and a question arises whether benefits arising from schemes such as sales tax deferral could also be taxable. Thus, the current definition could lead to undue litigation.

Recommendation: Examples must be given of popular government grants that would be taxable along with illustrations on how the same will be taxable. Further, specific exclusions must be given for schemes such as sales tax deferral where there is no inflow of a grant in cash or kind. Appropriate amendment must be made in the Act.

23. Issue: Timing of taxation

Para 4(2) of ICDS VII states that 'recognition of Government grant shall not be postponed beyond the date of actual receipt' – this goes against the accrual principle under section 5 of Income Tax Act i.e. income accrues when there is a right to receive the same. Thus, in case a grant is received but there is uncertainty about its claim and there could be a possibility of refunding the same to the Government, recognition of income should not be insisted.

Recommendation: The above requirement of recognition of Government grant on actual receipt should be dropped to bring ICDS in line with accrual principle of the Act.

10. ICDS VIII: Valuation of Securities

24. Issue: Exemption to banks

Para 4(ii) of ICDS I states that MTM loss shall not be recognised unless the recognition of such loss is in accordance with the provisions of any other ICDS. ICDS VIII deals with securities and inter alia provides for claiming MTM losses in respect of securities. However, Para 2(c) of ICDS VIII provides that it does not deal with securities held by banks.

ICDS II deals with valuation of inventories and provides that it shall not apply to shares, debentures and other financial instruments held as stock-in-trade which is dealt with by the ICDS on securities (i.e. ICDS VIII). However, ICDS II appears to be primarily intended to apply to inventories in the nature of physical assets/materials and supplies rather than financial instruments/securities.

Recommendation: In view of the above, a clarification on the valuation of securities held by banks is required.

25. Issue: Category-wise valuation of securities

ICDS states that at the end of any previous year, securities held as stock-in-trade shall be valued at actual cost initially recognized or net realizable value, whichever is lower. Further, the comparison of actual cost and net realisable value should be done category-wise and not for each individual security. Till date companies typically have been valuing securities held as stock-in-trade on an individual basis and the same has been accepted for tax purpose. Further, this method is universally accepted. Adoption of category-wise approach could lead to recognition of anticipated profits since appreciated value of certain securities will absorb fall in value of other securities. This is illustrated below:

Security	Cost	NRV at year end	Valuation as per books	Valuation as per ICDS
1	50	40	40	N.A.
2	70	60	60	N.A.
3	30	10	10	N.A.
4	60	90	60	N.A.
Total	**210**	**200**	**170**	**200**
			Itemised valuation	Category-wise valuation

Thus, the category-wise approach will have a material impact on stock valuation. Further, the stock valuation for tax purposes will differ from the stock valuation appearing in books necessitating dual book keeping.

Recommendation: ICDS should be aligned with the current accepted practice of stock valuation i.e. on individual security basis.

26. Issue: Prescription of only first-in-first out (FIFO) method for ascertaining cost of securities

Para 13 of ICDS states that for the purpose of para 9, 10 & 11 where the actual cost initially recognized cannot be ascertained by reference to specific identification, the cost of such security shall be determined on the basis of FIFO method. Till date weighted average cost method has been an accepted accounting method for accounting as well as tax purpose. Suggesting only FIFO method for valuation of securities will only increase the complexity and burden the assessee with maintaining separate tax records. This deviation also does not further any interest of the revenue.

Further, ICDS II allows both FIFO and weighted average cost method for valuing inventories. Hence, on the same footing, even securities held as stock-in-trade should be allowed to be valued as per weighted average cost method.

Recommendation: To bring harmony alignment of ICDS VIII with ICDS II, accounting and taxation practices followed consistently over the years, it is suggested that both FIFO and weighted average cost methods should be acceptable methods for ascertaining cost of securities held as stock-in-trade, where cost cannot be ascertained by reference to specific identification.

27. Issue –'Net Realizable Value' needs to be defined

Para 9 of ICDS VIII prescribes that at the end of any previous year, securities held as stock-in-trade shall be valued at actual cost initially recognised or net realisable value at the end of that previous year, whichever is lower. Further, Para 10 also uses the said term 'net realisable value'. However, the said term is not defined in this ICDS while it has been defined in Para 2(1)(b) of ICDS II on Valuation of Inventories.

Recommendation: In order to avoid unnecessary confusion, it is suggested that the term 'net realisable value' be defined in ICDS VIII as is defined in ICDS II.

11. ICDS IX: Borrowing Costs

28. Issue: Threshold for qualifying assets

The definition of 'qualifying assets' includes inventory if the same takes more than 12 months to bring to saleable condition. However, such threshold is not mentioned in case of other assets. As a result, capitalisation of borrowing costs will be required for short periods of time (few days to few months) in case of ready-to-use assets. Typically, there are hundreds of assets which are purchased by companies during the year. It is very cumbersome to track the capitalisation period for each asset together with finding a nexus each asset to borrowed funds.

Recommendation: Common threshold of 12 months should be applicable for tangible and intangible fixed assets as well. Appropriate amendment must be made in section 36(1)(iii) as well.

29. Issue: Alignment of capitalisation formula with AS-16

AS-16 already prescribes a specific formula for capitalising general borrowing costs. ICDS prescribes a very different formula for the same. This difference will lead to additional compliance burden on taxpayers including maintenance of separate tax records.

Recommendation: The provisions relating to capitalisation of borrowing costs must be made in line with AS-16.

30. Issue: Without prejudice to our recommendation in point 29 above - Blanket inclusion of general borrowed funds in general borrowing cost formula

Para 6 of ICDS IX states that 'to the extent the funds are borrowed generally **and utilised for the purposes** of acquisition… of a qualifying asset, the amount of borrowing costs to be capitalised shall be computed in accordance with the following formula'. This means that general borrowings must be utilised for acquisition, etc. of an asset to be considered for the formula. However, part A of the formula permits exclusion of only those borrowing costs that relate to borrowings for specific purposes and this creates ambiguity.

Recommendation: Without prejudice to our recommendation in point 29 above, ICDS must clarify that in case it can be proved that general borrowings were not utilised for acquisition, etc. of qualifying assets, borrowing costs on the same must be excluded from the formula.

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

31. Issue: Recognition of provisions

ICDS provides that provisions should be recognized if they meet the criteria of 'reasonably certain' whereas AS-29 prescribe the criteria of 'probable' (i.e. more likely than not) for recognising provisions. The term 'reasonably certain' is not defined in ICDS. This is likely to result in subjective interpretation leading to increased litigation. The provisions created in books till date, based on criteria of 'probable' have been accepted by judicial precedents. Further, this will entail cumbersome process of separately measuring each provision and maintaining separate tax records for the same which is not the objective of ICDS.

Recommendation: To avoid unnecessary complications and litigations on the basic concept of recognition of provisions, ICDS should be aligned with AS-29 and incorporate the same parameters for recognition of provisions.

32. Issue: Contingent assets and liabilities

ICDS provides for recognition of contingent assets and liabilities. These are off-balance sheet items and have no impact on tax computation. These concepts are irrelevant to that extent and will only lead to increased compliance for the tax payers.

Recommendation: Concepts of contingent assets and liabilities should be removed from ICDS.

This material has been prepared by Deloitte Haskins & Sells LLP (DHS LLP) and contains general information only. This information is not intended to constitute professional advice or services or is to be relied upon as the sole basis for any decision which may affect you or your business. Before making any decision or taking any action that might affect your personal finances or business, you should consult a qualified professional adviser. The information contained in this material is intended solely for you thereby, any disclosure, copy or further distribution of this material or the contents thereof may be unlawful and is strictly prohibited.

None of DHS LLP or its affiliates shall be responsible for any loss whatsoever sustained by any person who relies on this material.

© 2015 Deloitte Haskins & Sells LLP