

# Accounting Pronouncements & Taxation

(with special reference to Tax Audit  
u/s 44 AB of IT Act '61)

For Direct Tax Refresher Course of  
WIRC of ICAI

Presented by - Jayant Gokhale, F.C.A.

# Accounting Pronouncements

## Encompasses

- Accounting Standards *prescribed* by the Central Government i.e. The *Companies (Accounting Standards) Rules, 2006*
- Accounting Standards (AS) issued by ICAI - which are relevant to non-corporate entities.
- Other accounting standards issued by ICAI (AS 30, AS 31 & AS 32) not yet notified by MCA. Companies allowed to apply these on a voluntary basis, in so far as they do not conflict with the notified standards. Earlier application of these standards is encouraged.
- Notified Accounting Standards issued u/s 145 of the IT Act 1961 (2 nos) - with the impending threat of Tax Accounting Standards -draft of which has been exposed for comments (but not presently in force )
- Ind AS – formulated by ICAI – in line with IFRS

# Accounting Pronouncements (continued)

**ICAI also issued along with the standards,**

- Guidance Notes on Accounting
- Preface to the Accounting Standards
- Framework
- The Council has also issued ‘Announcements’ from time to time which are mandatory.
- ICAI has also issued several opinions through its Expert Advisory Committee (called EAC opinions), which though binding only on the entity which has sought the opinion, does provide guidance on accounting treatment to other preparers of FS.

# Standards on Auditing issued by ICAI

- Although not strictly covered within the concept of accounting pronouncements - the SA (standards on auditing) would also be relevant to performance of tax audit.
- These requirements have to be incorporated into the format of F.3CB
- Not required for F 3CA

## Relevance of Standards on Auditing issued by ICAI in Tax Audit

Standards on Auditing		Remarks
<b>SA 700</b>	Forming an Opinion and Reporting on Financial Statements	To include in Observations when issuing clean report.
<b>SA 705</b>	"Modifications to the Opinion in the Independent Auditor's Report"	To include in Observations when issuing Modified (qualified) report.
<b>SA 706</b>	"Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report"	To include in Observations when auditor is issuing 'read with' report

# Accounting Standards dealt with

Accounting Standards		Clauses of Form 3CD / Provisions of IT Act, 1961
<b>AS 1</b>	Disclosure of Accounting Policies	Cl. 9& 11
<b>AS 2</b>	Valuation of Inventories	Cl. 12
<b>AS 4</b>	Contingencies and Events Occurring After the Balance Sheet Date	Cl. 16(k) & s. 28
<b>AS 5</b>	Net Profit or Loss for the Period, Prior Period Items & Changes in Accounting Policies	Cl. 21 & 22(b)
<b>AS 6</b>	Depreciation Accounting	Cl. 14 & s. 32
<b>AS 7</b>	Construction Contracts (revised 2002)	Cl. 13 & 20; s. 2(24)
<b>AS 9</b>	Revenue Recognition	

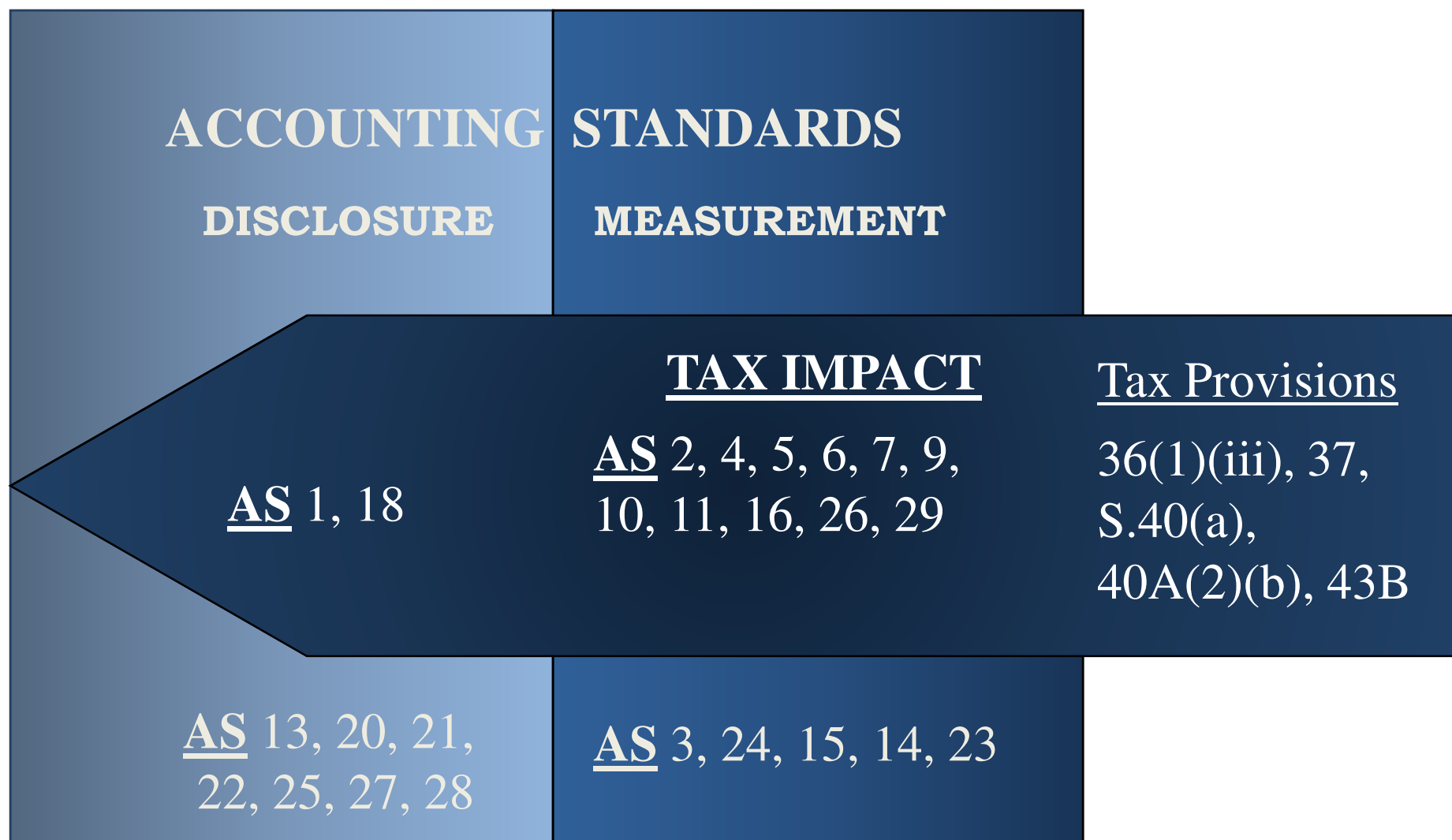
# Accounting Standards dealt with

Accounting Standards		Clauses of Form 3CD / provisions of IT Act, 1961
<b>AS 10</b>	Accounting for Fixed Assets	Cl. 17 (a)
<b>AS 11</b>	Effects of Changes in Foreign Exchange Rates (revised 2003)	s. 43A
<b>AS 16</b>	Borrowing Costs	s. 36(1)(iii)
<b>AS 18</b>	Related Party Disclosures	Cl. 18
<b>AS 26</b>	Intangible Assets	
<b>AS 29</b>	Provisions, Contingent Liabilities & Contingent Assets	Cl. 17(k)

# Accounting Standards relevant but not dealt with

<b>AS 13</b>	Accounting for Investments
<b>AS 15</b>	Employee Benefits (revised 2005)
<b>AS 24</b>	Discontinuing Operations
<b>AS 28</b>	Impairment of Assets

# TAX ISSUES IN AS - OVERLAP & IMPACT





# AS 1-Disclosure of Accounting Policies

11. (a) *Method of accounting employed in the previous year.*  
(b) *Whether there has been any change in the method of accounting employed vis-à-vis the method employed in the immediately preceding previous year.*  
(c) *If answer to (b) above is in the affirmative, give details of such change, and the effect thereof on the profit or loss.*  
(d) *Details of deviation, if any in the method of accounting employed in the previous year from accounting standards prescribed under section 145 and the effect thereof on the profit or loss.*
- 24. All significant accounting policies adopted should be disclosed.
  - 25. Should form part of FS & be disclosed in one place.
  - 27. If any of the fundamental accounting assumptions is not followed, the fact should be disclosed.
    - Going Concern (Also refer SA 570 - Going Concern)
    - Consistency
    - Accrual

# AS 1-Disclosure of Accounting Policies

26. *Any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in later periods should be disclosed. In the case of a change in accounting policies which has a material effect in the current period, the amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.*

- Change in accounting policy is distinct from change in method of accounting. (Para 22.7 of the G.N.)
- Only two methods of Accounting possible u/s 145(1)  
- cash or mercantile system of accounting
- S.145 A speaks of valuation of Purchase, Sale & inventory in accordance with Method of Accounting employed by the Assessee

# Books of Account

9. (a) *Whether books of account are prescribed under section 44AA, if yes, list of books so prescribed.*  
(b) *Books of account maintained.*  
*(In case books of account are maintained in a computer system, mention the books of account generated by such computer system, mention the books of account generated by such computer system)*  
(c) *List of books of account examined*
- 1) What is meant by books of account? Implications u/s 144.
  - 2) Whether stock records constitute the books of the account.
  - 3) Whether vouchers are a part of the Books of account?
  - 4) What is meant by “Books of Account Generated” by the computer? Does it mean the books of account of which actual print outs are taken?
  - 5) Whether “generated” means capable of generating by the programme?
  - 6) If stock record is maintained on the computer and is inaccurate, whether it is the duty of the auditor to comment upon it?

# AS 2 Valuation of Inventories

12. (a) Method of valuation of closing stock employed in the previous year.

(b) Details of deviation, if any, from the method of valuation prescribed u/section 145A, & the effect thereof on the profit or loss.

- The clause requires only the method of valuation for e.g. Finished Goods are valued at lower of cost or realisable value. Cost Formulae (how direct and indirect costs are derived) do not have to be reported here.
- No reporting of change either in cost formulae or in method of valuation is required.
- Notes on account should normally mention the policy for determination of cost and disclose any changes in method of valuation or in cost formulae.
- Impact of Sec 145A - Revenue Neutral ??

## AS 2 Valuation of Inventories - some issues

- The clause mentions method of valuation of ‘Closing Stock’. In case there is no closing stock, will the clause not apply?
- If there is a change in the manner of computing cost, will it amount to a change in the method of valuation of stock?
- In the first year of tax audit the auditor finds that the opening stock has been valued at selling price? However there is no closing stock. Is reporting required? If so in what manner? Will the true and fair view have to be qualified?
- Assessee prepares the financial account of the company on weighted average basis w.e.f. Assessment Year 2003 – 2004 due to change in A. S. 2. However, for many years the assessee has been valuing inventory on LIFO basis, which has been consistently followed and accepted in earlier tax assessment. Assessee continues to submit account for Tax purposes on LIFO basis. Is the Tax Auditor required to make any comments?

# AS 9 Revenue Recognition excerpts.

- 4.1 Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends.
- 9.1 Recognition of revenue requires that revenue is measurable and that at the time of sale or the rendering of the service it would not be unreasonable to expect ultimate collection.
- 9.2 Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g., for escalation of price, export incentives, interest etc., revenue recognition is postponed to the extent of uncertainty involved. In such cases, it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made.
10. Revenue from sales or service transactions should be recognised when the requirements as to performance set out in paragraphs 11 and 12 are satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection. If at the time of raising of any claim it is unreasonable to expect ultimate collection, revenue recognition should be postponed.

# AS 9 Revenue Recognition

## Turnover

- a) Whether Sec. 145A has any relevance to the issue of determination of `turnover'? To be considered in light of Explanation to Para 10 of AS-9.
- b) Whether method of accounting followed by the assessee and manner of treatment in the books of items such as service tax or reimbursements is decisive or only an indicative test in such matters. (Refer para 5.6 of G.N.).
  - **Tools India Distributors v. ITO [2000] 111 Taxman 216 (Mag) (Mum) (SMC)**
  - **De Beers India (P) Ltd. Vs. DCIT ITAT, (2011) 48 SOT 506 (Mumbai)**

## AS 7 implications & applicability

- Construction Contracts, GN on Real Estate,
- Project completion method / Completed Contract Method
- **Haware Constructions (P) Ltd. Vs. ITO (2011) 64 DTR (Mumbai)(Trib) 251**

# AS 9 Revenue Recognition *contd.*

*Clause 13 - Amounts not credited to the profit and loss account, being,  
(a) the items falling within the scope of section 28*

*Clause 20 – Any amount of profit chargeable to tax u/s 41 and computation thereof*

- 1) Possible items which will come under this clause?
- 2) Whether the answer to this question is limited to books of account?
- 3) If the obvious evidence/reference is found during the verification of books but the same is not accounted for in the books, e.g., interest on saving bank account of the proprietor, rent received on let out property, whether the same is required to be mentioned?



# AS 9 Revenue Recognition contd.

- ❖ **State Bank of Travancore 158 ITR 102**, - the method of accounting cannot enlarge or restrict the content of the taxable income or it does not determine the range of taxable income or ambit of taxation.
- ❖ **Concept of Real Income –**
  - J.K. Industries Ltd. & Anr. V. Union of India & Others 297 ITR 176 (SC)
  - CIT Vs. Shapoorji Vallabhadas & Co. 46 ITR 144 (SC)
  - **Matching Concept** - Revenue Mismatch - De Beers India (P) Ltd. Vs. DCIT ITAT, (2011) 48 SOT 506 (Mumbai)
  - **Reimbursements -whether amounts to revenue –** Applicability of S. 195 & S. 40(a)(i) [or (ia)] - ITA No.577/Mum/2011 – No.

# AS 16 Borrowing Costs

*3.1 Interest and other costs incurred in connection with borrowing of funds.*

*4. Borrowing Costs may include :-*

- a. Interest, commitment charges, on LT/ST borrowing
- b. Amortisation of discounts/premiums related to borrowing
- c. Amortisation of ancillary costs regarding arrangement of funds
- d. Finance charges for assets acquired under finance leases etc.
- e. Exchange differences from FC borrowing to the extent they are regarded as an adjustment to interest costs. (refer ASI 10)

# AS 16 Borrowing Costs

## 3.2 Qualifying asset: An asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

- ❖ Does not distinguish between fixed assets and current assets - can include inventory under certain circumstances
- ❖ Substantial period - subjective - but ASI 1 (interpretation) issued by ASB

- **Proviso inserted in Section 36 (1) (iii)**

- intention may be to block cases of capitalisation in books & claim of expenditure for tax

### Impact of Amendment

- even assets that do not take significant time - borrowing costs to be capitalised for tax purposes
- cut-offs are different
- meaning of extension of business
  - different from extension / integration of business

# AS 16 Borrowing Costs contd

- Existing business or New business is a factor
- After asset is first put to use - no capitalisation.
- Partial user of asset
- Treatment of interest earned on temporary investment of funds
- Cut-off date for capitalisation
- Interest allowable where not in regard to in regard to capital borrowed.

Allowable u/s 37(1), 43 B will also not apply.

D.C. Range 9 (2) vs. M/s. MTZ Polyfilms Ltd - ITA No. 5015/Mum/2009

Order dt. 30/12/2011

## Coverage under AS 18 and u/s 40A(2)(b)

Particulars	As per AS 18	As per 40A(2)(b)
<b>Holding, Subsidiary &amp; Fellow subsidiaries</b>	Yes – Related Party	Yes. Fellow subsidiaries are covered <i>w.e.f. 1<sup>st</sup> April, 2013.</i>
<b>Fellow Associates</b> i.e., the investing party has substantial interest in the reporting enterprise as well as in other company	Yes -Related Party	Yes, <i>w.e.f 1<sup>st</sup> April, 2013.</i>
Phrase / Terminology used	Significant Influence	Substantial Interest
Definition of “Relative”	Spouse	Relatives as per AS 18 + <i>Lineal ascendant or descendant</i> , i.e., grandparents, grandchildren, great grandparents and great grandchildren.
	Mother & Father	
	Brother & Sister	
	Son & Daughter	

# Other Standards – Relevant to Year of Allowability

- **AS 4 - Events Occurring After Balance Sheet Date**
- **AS 5 - Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies**

*22(b) Particulars of income or expenditure of prior period credited or debited to the profit and loss a/c.*

Line omitted in Notified standard : “In view of the uncertainty attached to future events, profits are not anticipated, but recognised only when realised, though not necessarily in cash.”

- Amounts not debited in Books –
  - Kedarnath Jute Mfg. Co. Ltd. v CIT 82 ITR 363 (SC) Applied in
  - Pranik Shipping & Services Ltd. Vs ACIT 135 ITD 233 (Mumbai) (2012)

# Other Standards – Relevant to Year of Allowability

## **AS 29 - Provisions, Contingent Liabilities & Contingent Assets**

17(k) Particulars of any liability of a contingent nature.

- ❖ Provision made on the basis of notice is not deductible 32 ITD 406
- ❖ Issues of interpretation often arise - point of time when liability has crystallised
  - Distinction between statutory & other liabilities
  - Kerala Transport 239 ITR 183
  - Legal obligation vs Constructive obligation
  - Kaveri Engg. Industries Vs. Dy. CIT 43 ITD 527) (Mad.)
- ❖ Amount provided for Expenditure on Corporate Social Responsibility

# Depreciation & Fixed Assets

## AS 6 Depreciation Accounting

## AS 10 Accounting for Fixed Assets

## AS 26 Intangible Assets

17(a) Amounts debited to the profit & loss Account, being : - Expenditure of capital nature;

14 Particulars of depreciation allowable as per the Income Tax Act, 1961 in respect of each asset or block of assets, as the case may be.

- ❖ Concept of “**block of assets**” which finds no recognition in the AS continues to find a place in the Income Tax Act
- ❖ commencement of applicability of depreciation on assets “first put to use” is different in regard to IT & AS. The concept of "ready to use" as a cut-off point is not acceptable under the IT Act, but finds reference in AS-10.
- ❖ ‘Business or commercial rights of similar nature’ –S. 32(1)(ii)
  - Areva T & D India Ltd. & Ors. Vs.DCIT - (2012) 345 ITR 421 (Delhi)
  - S. Ambika vs. DCIT - (2011) 245 CTR (Ker) 103



# AS 11 Effects of Changes in Foreign Exchange Rates (revised 2003)

- Where the notional loss on exchange fluctuation is debited to profit and loss in accordance with the requirements of the standard, the same should be allowable even though subsequent to the balance sheet date, the currency fluctuation may have reversed. CIT Vs. Woodward Governor India (P) Ltd. ( 2009 ) 312 ITR 254
- Impact on computation of benefits such as 10B, 80 HHC etc - *Renaissance Jewellery (P) Ltd. v Income Tax Officer 101 ITD 380 (Mumbai).*

**THANK YOU**

Jayant Gokhale F.C.A.