Income Computation and Disclosure Standards

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Background

- Section 145(1) of the Income-tax Act, 1961 (Act) stipulates that the method of accounting for computation of income under the heads “Profits and gains of business or profession” and “Income from other sources” can either be cash or mercantile system of accounting.
- Section 145(2) of the Act states that the Central Government may notify the accounting standards to be followed by any class of assesses or in respect of any class of income.
- Two tax accounting standards were notified until now:
  1. Disclosure of accounting policies
  2. Disclosure of prior period and extraordinary items and changes in accounting policies

Background

- The Finance (No.2) Act, 2014 amended section 145(2) of the Act to substitute “accounting standards” with “income computation and disclosure standards” (ICDS)
- The CBDT constituted the Accounting Standards Committee which had earlier issued draft 14 Tax Accounting Standards in 2012. On the basis of the suggestions and comments received from the stakeholders, the CBDT issued revised 12 draft ICDS for public comments
- On 31st March, 2015, the Central Government notified 10 ICDS which shall be effective from 1st April, 2015
- The introduction of ICDS may significantly alter the way companies compute their taxable income

ICDS V –
TANGIBLE FIXED ASSETS

ICDS V – Tangible Fixed Assets

TANGIBLE FIXED ASSETS

- AS 10 deals with tangible and intangible fixed assets, where as ICDS only deals with tangible assets
- The CBDT had issued draft ICDS on Leases and Intangible assets which has been excluded from the final list of notified ICDS

ACTUAL COST

- Tangible fixed asset shall be recorded at actual cost including purchase price, taxes (excluding those that are recoverable) and other expenditure for bringing the asset to workable condition

DEPRECIATION

- Depreciation on a tangible fixed asset and income arising on transfer of a tangible fixed asset shall be computed in accordance with the provisions of the Act

- Draft ICDS issued earlier required FAR to be maintained for all assets, for all years. That would have additional records to be maintained for income tax purposes. The requirement has been done away with in the final ICDS

Similarity between AS and ICDS

General principles under AS 10 and ICDS are broadly similar, barring a few exceptions

Machinery spares, Stand-by equipments, etc.

- Machinery spares shall be charged to prfit and loss account, as and when consumed
- 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

Inspection Costs

- As per the AS the cost of major inspections are generally expensed out as and when incurred
- ICDS is silent on the treatment of inspection cost. However, it is mentioned that any expenditure which increases future benefits from an existing asset beyond it previously assessed performance, can be added to the cost of the asst. Since inspection costs would not normally increase future benefits from the assets, it cannot be capitalised as per ICDS

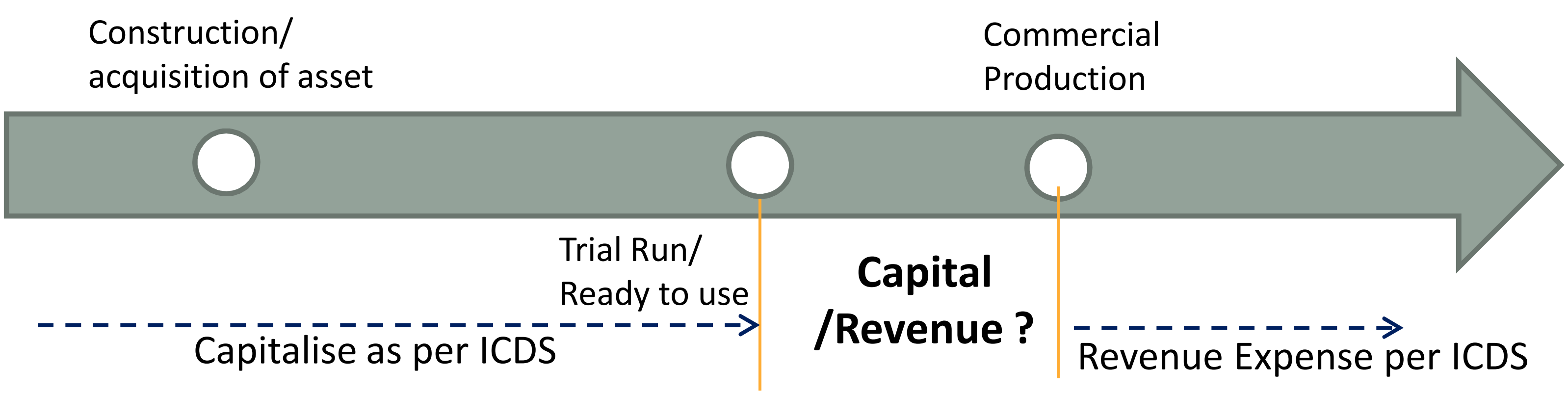
Similarity between AS and ICDS

Cost of improvement and Repairs

- Cost of any addition or extension of an existing asset, which is of a capital nature and which becomes an integral part of the existing asset is usually added to its gross book value

Period of capitalization

- Expenditure on start-up and commissioning of a project (including the expenditure incurred on test runs and experimental production) shall be capitalized. Expenditure post commencement of commercial production shall be expensed



Difference between AS and ICDS

AS- 10	ICDS
Assets acquired by exchange • An asset acquired in exchange for another asset, or for shares or securities can be recorded at the Fair value of asset given or asset acquired whichever is more clearly evident	• Where an asset is acquired in for exchange for another asset or in exchange for shares or other securities, the **fair value of the asset so acquired** shall be recorded as actual cost
Revaluation of Assets • Specific guidance in case of revaluation of fixed assets	• Revaluations are not considered as an adjustment

ICDS IX – BORROWING COSTS

ICDS IX – Borrowing Costs

MEANING OF QUALIFYING ASSETS

- Tangible assets
- Intangible assets
- Inventories requiring 12 months or more to bring them to a saleable condition

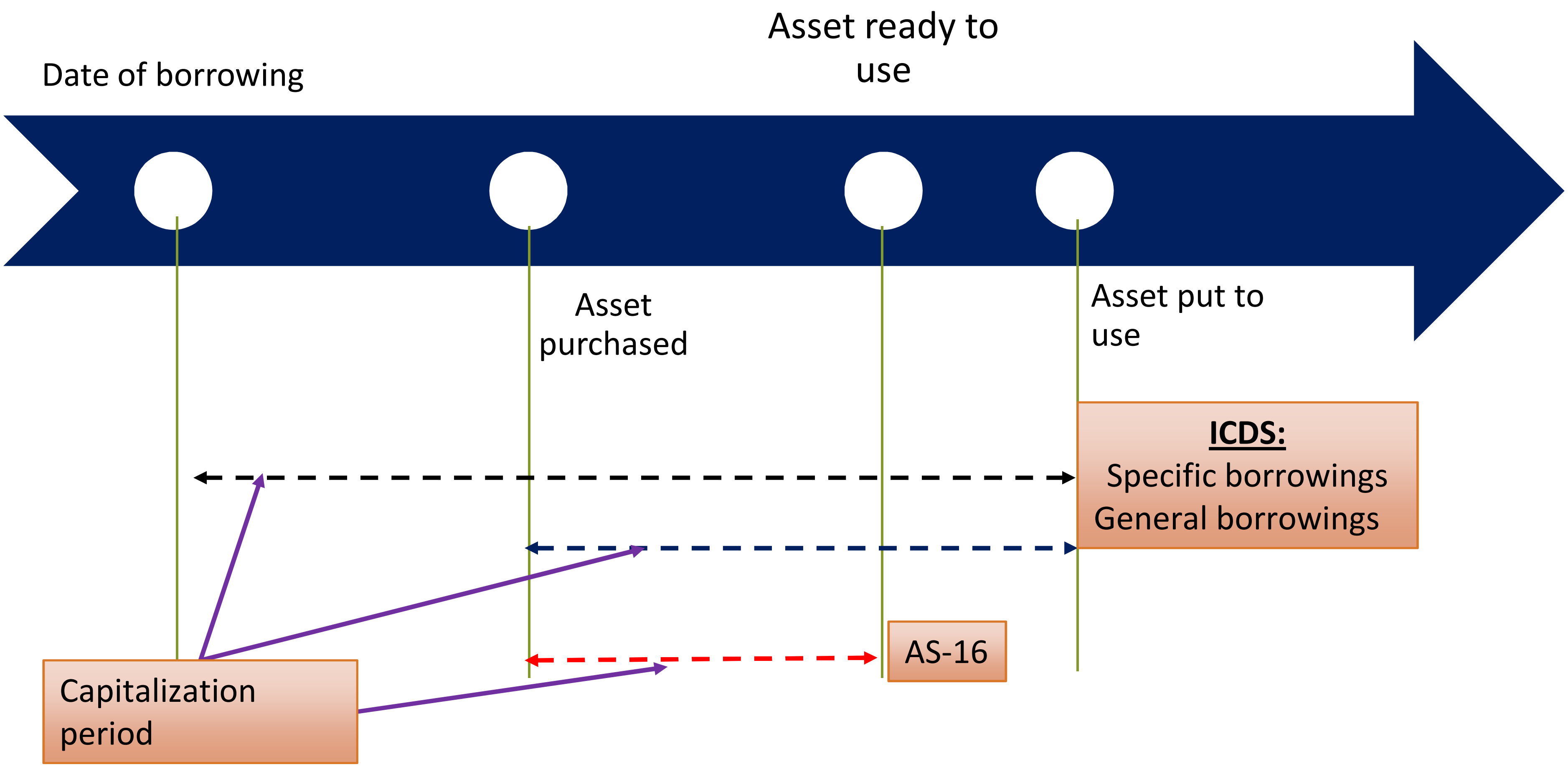
INTEREST ON BORROWING AND DEDUCTION THEREOF

- Any interest on borrowed capital, used for the purpose of business is allowable as deduction
- Interest paid in respect of capital borrowed for acquisition of asset till the date of first put to use is not allowable as deduction
- Interest paid after capital asset put to use is allowable as deduction

Difference between AS and ICDS

AS 16	ICDS
Foreign Exchange on Borrowing costs • AS includes such difference to the extent that they are regarded as an adjustment to interest cost	• Borrowing cost will not include exchange difference arising from foreign currency borrowings
Income from temporary investments • Any income from temporary investment of borrowed funds to be reduced from the borrowing costs	• Income from temporary deployment of unutilised funds from specific loans shall be taxable as Income from other sources under the ICDS. The same cannot be set off against borrowing costs. • Ratio of SC ruling in **Tuticorin Alkali Chemicals (227 ITR 172)** followed
Commencement of Capitalisation • Fulfillment of 3 conditions required for capitalisation of borrowing: (a) Incurrence of capital expenditure (b) Incurrence of borrowing cost and (c) Preparatory activities in progress	• Capitalisation of specific borrowing cost still shall commence from date of borrowing. Condition of asset already purchased or preparatory activities in progress are absent in ICDS

Period of capitalization



Method of Capitalization

AS- 16	ICDS
Specific Borrowings • To the extent the funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs incurred on that borrowing during the period <u>less any income on temporary investments of those borrowings</u>	• To the extent the funds are borrowed specifically for the purpose of acquisition, construction or production of a qualifying asset, the amount of borrowing costs to be capitalised on that asset shall be the actual borrowing cost incurred during the period on the funds so borrowed
General Borrowings • Costs determined by applying capitalisation rate to the expenditure incurred on the asset. • The rate is weighted average of borrowing costs applicable to the borrowings during the period other than specific borrowings	• Costs determined by following formula; $A * \frac{B}{C}$

Method of Capitalization

In the formula given in ICDS for capitalisation of general borrowing costs A, B and C stands for:

A = Borrowing costs incurred during previous year except on specific borrowings

B = a) Average cost of QA appearing in balance sheet on first and last day of the previous year

b)Half of the cost of QA, if it does not appear in balance sheet on the first day or both first and last day of the previous year

c)Average cost of QA as on first day of previous year and date of completion, if it does not appear in balance sheet on the last day of the previous year

C = Average of total assets, other than those funded by specific borrowings, as appearing in balance sheet as on first and last day of previous year

*** QA = Qualifying Assets other than those funded by specific borrowings.**

There are several shortcomings in the above formula. For example In B (b) -Cost of QA has to be taken as half, irrespective of the date when the asset was put to use

Other Impacts

DEFERRED TAX IMPACT

- This ICDS would have impact on deferred tax working of the Company. Earlier, the reconciliation was between income as per the financials vis-à-vis income as per the tax return. Now impact of ICDS would have to be factored.

IMPACT ON MAT LIABILITY

- A view is possible that as impact of ICDS is outside the books of accounts, the same would not have any impact on MAT liability

HARDSHIP TO THE ASSESSEE

- Accounting and administration work of the assessee would multiply
- Two sets of fixed assets records required

ICDS VI –

EFFECT OF CHANGES IN FOREIGN EXCHANGE RATES

ICDS VI– Effect of changes in foreign exchange rates

SCOPE

- Treatment of foreign exchange gain/loss governed by section 37(1) of the Act.
- ICDS now specifies the treatment of
  - (a) transactions in foreign currency
  - (b) translating the financial statement of foreign operations
  - (c) treatment of forward contracts

FOREIGN CURRENCY TRANSACTION

- Initial recognition – Rate at the date of transaction . Average rate for the week or a month where there is a large fluctuation
- Conversion at year end at the rate – foreign exchange rate as on the last date

FINANCIAL STATEMENTS OF FOREIGN OPERATIONS

- Integral foreign operations
- Non- integral foreign operations

TREATMENT OF FORWARD CONTRACT

Forward Exchange Contracts

Forward exchange contracts – Trading purposes

- Premium/discount is amortized over the life of contract.
- Restated on MTM basis at year end and difference is recognized in P & L
- Profit/loss on cancellation or renewal is also recognized in P & L

AS- 11	ICDS
Others (i.e. trading, speculation, firm commitment, highly probable forecast) • Marked to market at each balance sheet date and the gain or loss be recognised in the P&L a/c • No amortization of premium/ discount	• Premium, discount or exchange difference on contracts be recognised at the time of settlement only

Thank you