



Income Computation and Disclosure Standards (ICDS) - WIRC of ICAI

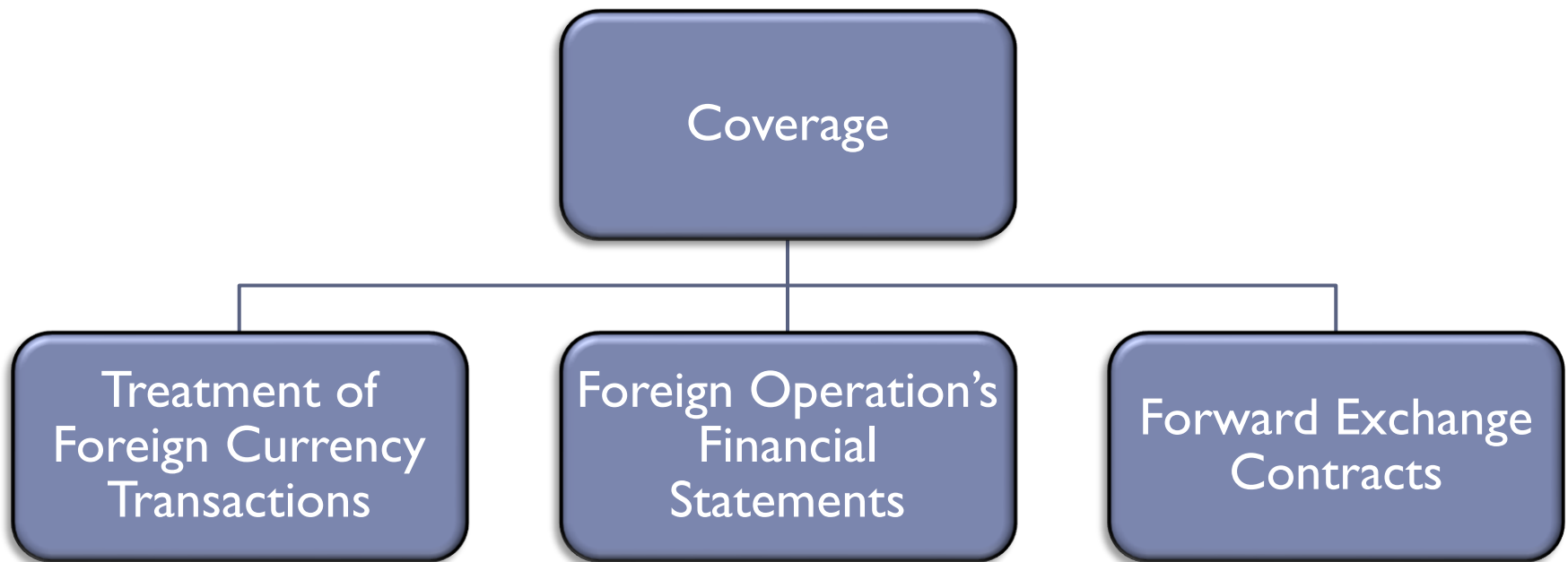
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ICDS VI – The Effects of Changes in Foreign Exchange rates

Structure - ICDS – VI (9 Paras)

| Paras | Coverage |
|--------------|---|
| 1 | Scope |
| 2 | Definitions |
| 3 | Foreign Currency Translations Initial Recognition |
| 4 | Conversion – Last date of Previous Year |
| 5 | Recognition of Exchange Difference |
| 6 | Exceptions to Para 3,4 and 5 |
| 7 | Financial Statements of Foreign Operations |
| 8 | Forward Exchange Contracts |
| 9 | Transactional Provisions |

Scope [Para 1]



A. Foreign Currency Transactions

Para 3 to 6

Relevant Definitions

- ▶ **Foreign Currency – Currency other than reporting currency [Para 2(1)(e)]**
- ▶ **Monetary items [Para 2(1)(k)]**
 - ▶ Money held
 - ▶ Assets to be received
 - ▶ liabilities to be paid } in fixed or determinable amounts of money
e.g. Cash in hand, receivables, and payables
- ▶ **Non - Monetary items [Para 2(1)(l)]**
 - ▶ Assets / liabilities other than monetary items
e.g. Fixed assets, inventories, investments in equity shares

Treatment of Foreign Currency Transactions

Foreign Currency
Transactions

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graph TD; A[Foreign Currency Transactions] --- B[Initial Recognition]; A --- C[Recognition at the last date of year]
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Initial Recognition

Recognition at the last
date of year

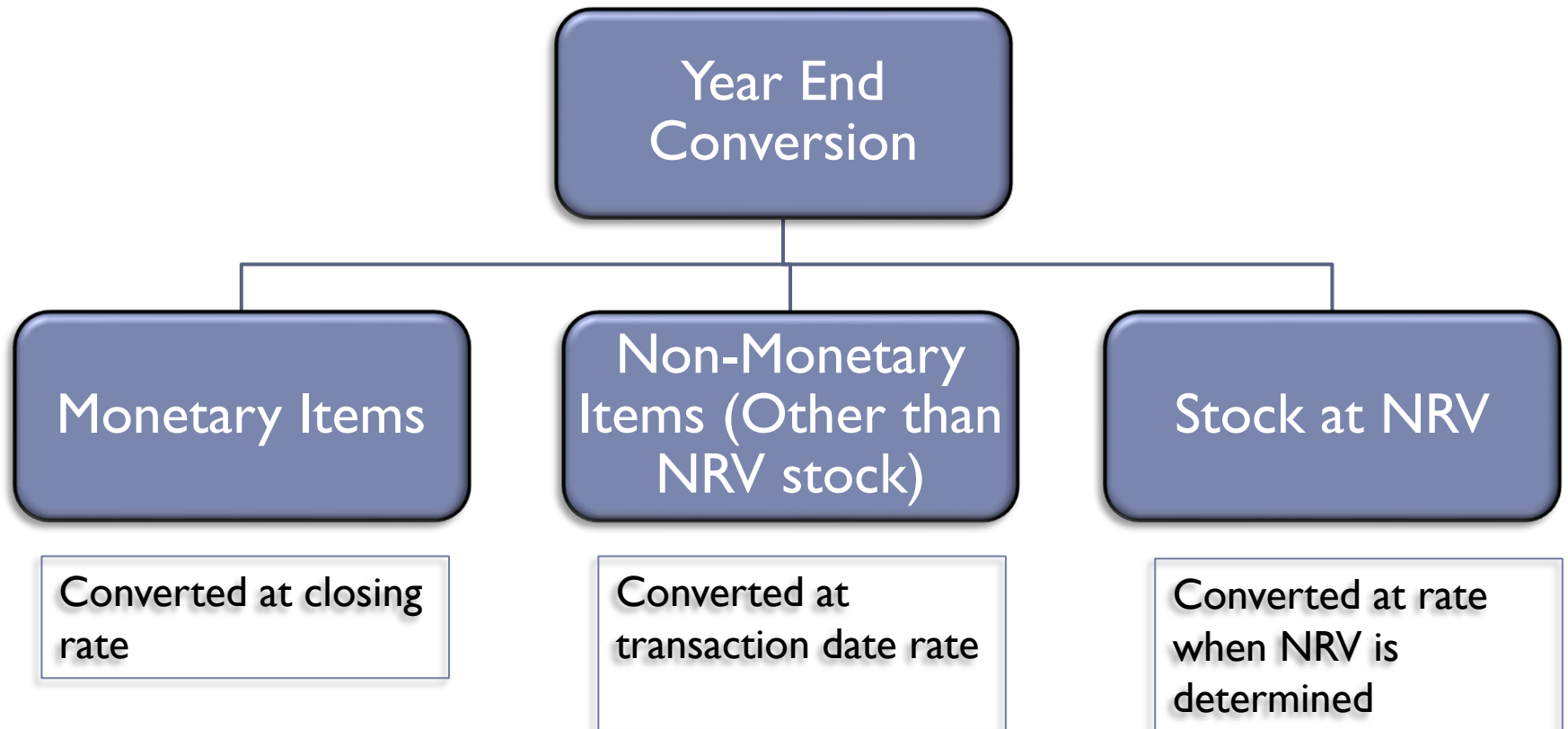
Initial Recognition [Para 3]

▶ Initial recognition

- ▶ Foreign currency conversion at the rate on date of transaction
- ▶ Alternative – Average rate for a week / month that approximates actual rate on transaction date.
- ▶ Average rate cannot be applied if exchange rate fluctuates significantly- In such cases actual rate on the date of transaction shall be used

Average rate is the mean of exchange rates in force during the period [Para 2(1)(a)]

Subsequent Year end conversion [Para 4]



Section 43A / Rule 115 shall override Initial recognition / conversion as per ICDS [Para 6]

Recognition of Foreign Exchange difference

[Para 5]

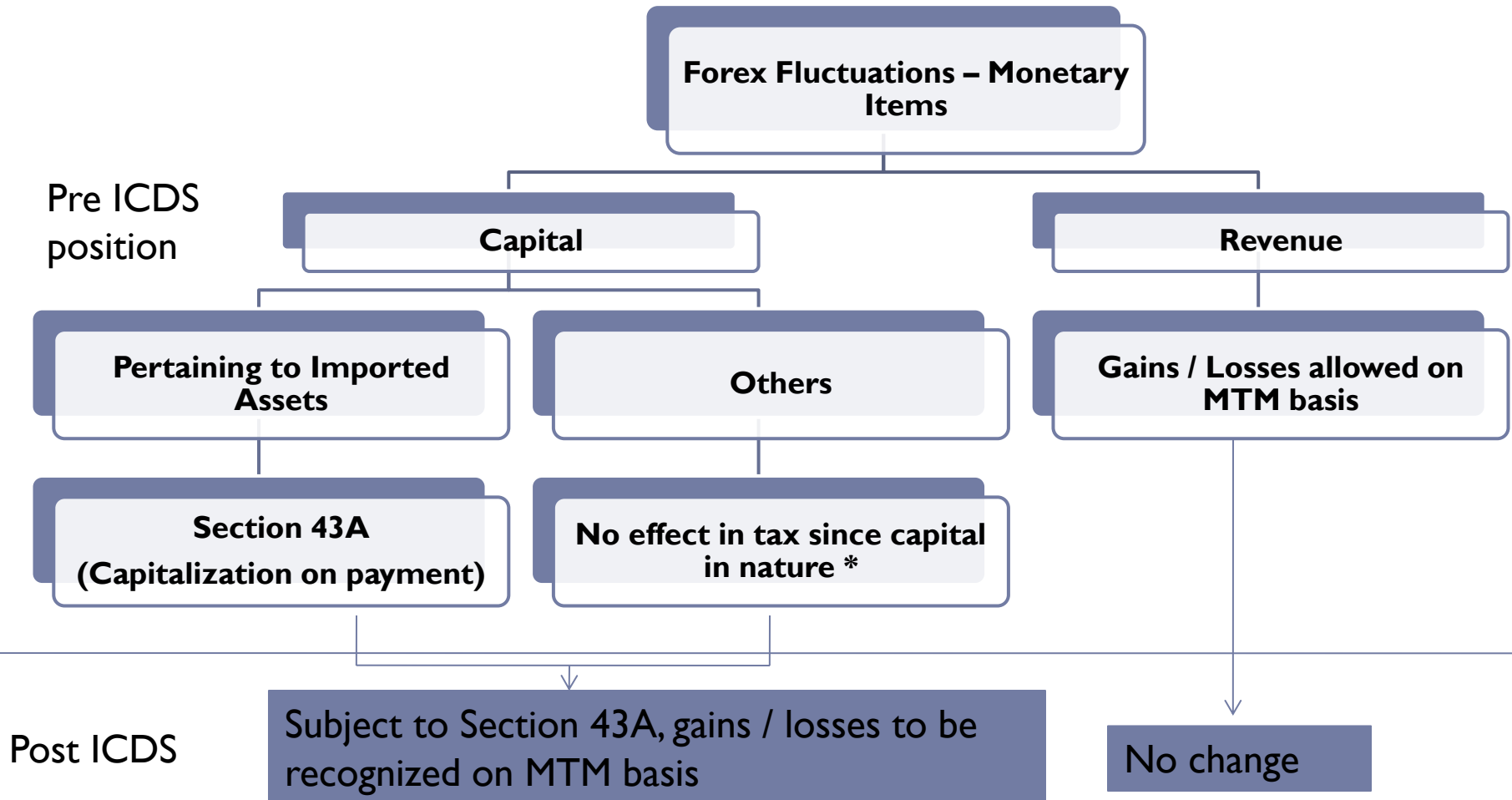
▶ Monetary Items

- ▶ Exchange difference arising on account of settlement / year end conversion **to be recognized** as income / expense in that previous year

▶ Non-monetary Items

- ▶ Exchange difference arising on account of year end conversion **shall not be recognized** as income / expense in that previous year

Summary of effect on Monetary items



* Treatment under ICDS is in conflict with SC decision in case of Tata Iron & Steel (98 Taxman 459)

B. Foreign Operation's Financial Statements

Para 7

Relevant Definitions

- ▶ **Foreign Operation of a Person [Para 2(1)(f)]**
 - ▶ Branch (by whatever name called), the activities of which are conducted in a country other than India
- ▶ **Reporting Currency [Para 2(1)(m)]**
 - ▶ For Indian operations – Indian rupee
 - ▶ For foreign operations – currency of the country where the operations are carried out
- ▶ **Integral foreign operation**
 - ▶ a foreign operation, the activities of which are an integral part of those of the reporting enterprise (Not defined in ICDS – definition as per AS-11)

Foreign Operation's Financial Statements [Para 7]

- ▶ No difference between integral and non-integral foreign operations
- ▶ All foreign operations deemed as integral
- ▶ Financial Statements of foreign operations to be translated as if such transactions are those of the Indian entity
- ▶ Principles of initial recognition / conversion to be followed as in all other cases

C. Forward Exchange Contracts

Para 8

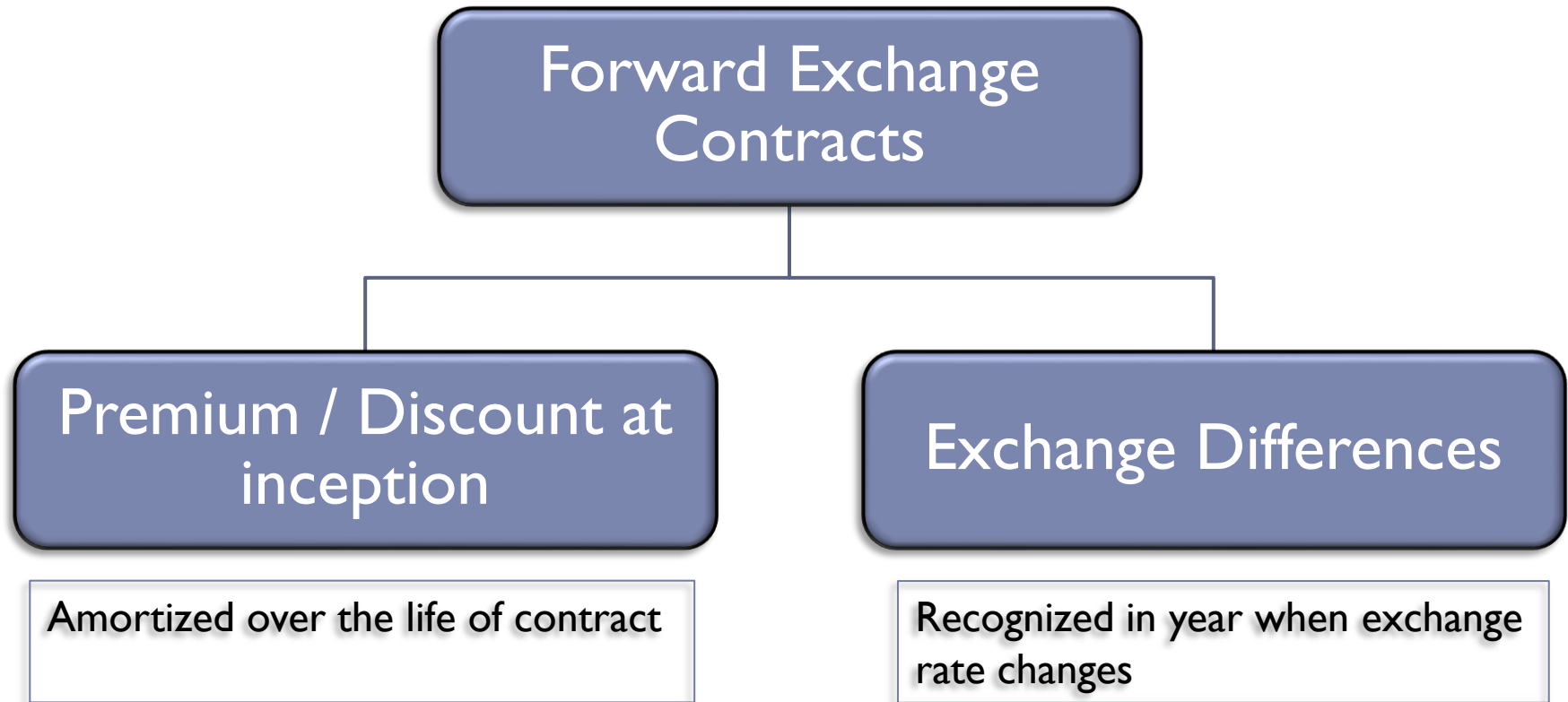
Relevant Definitions

- ▶ **Forward Exchange Contract [Para 2(1)(h)]**
 - ▶ Agreement to exchange different currencies at a forward rate, and includes a foreign currency option contract or another financial instrument of a similar nature
- ▶ **Forward Rate [Para 2(1)(i)]**
 - ▶ specified exchange rate for exchange of two Currencies at a specified future date
- ▶ **Premium / Discount [Para 8(4)]**

Forward rate specified in the contract
Less: Exchange rate at the date of the inception of the contract
- ▶ **Exchange Differences [Para 8(5)]**

Contract amount translated at last day rate / settlement rate
Less: Translation at inception / last day of preceding year

Forward Exchange Contracts Treatment [Para 8(1)]



Treatment to apply only on case of fulfillment of certain conditions

Forward Exchange Contracts – Conditions

[Para 8(2)]

- ▶ On-Balance Sheet item Contracts entered into to establish the amount of reporting currency required at the settlement date
- ▶ Contract is not intended for trading / speculation purposes
- ▶ Contract is not entered to hedge foreign currency risk of
 - ▶ Firm commitment; or
 - ▶ Highly probable forecast transaction

Premium, Discount or exchange difference on contract intended for trading / speculation or to hedge foreign currency risk of firm commitment or highly probable forecast transaction recognized only at the time of settlement [Para 8(5)]

Transitional Provisions [Para 9]

- ▶ ICDS to apply to all transactions undertaken on or after 1 April 2016
- ▶ Exchange rate differences on monetary and non-monetary items during the first year or first year end to be recognized after taking into account the amount recognized on 31 March 2016
- ▶ Foreign Operation's financial statements for first year to be translated taking into account the amount recognized on 31 March 2016
- ▶ Forward exchange contracts existing on 1 April 2016 to be dealt considering income / expenses recognized on 31 March 2016

Case Study – Forward Contract

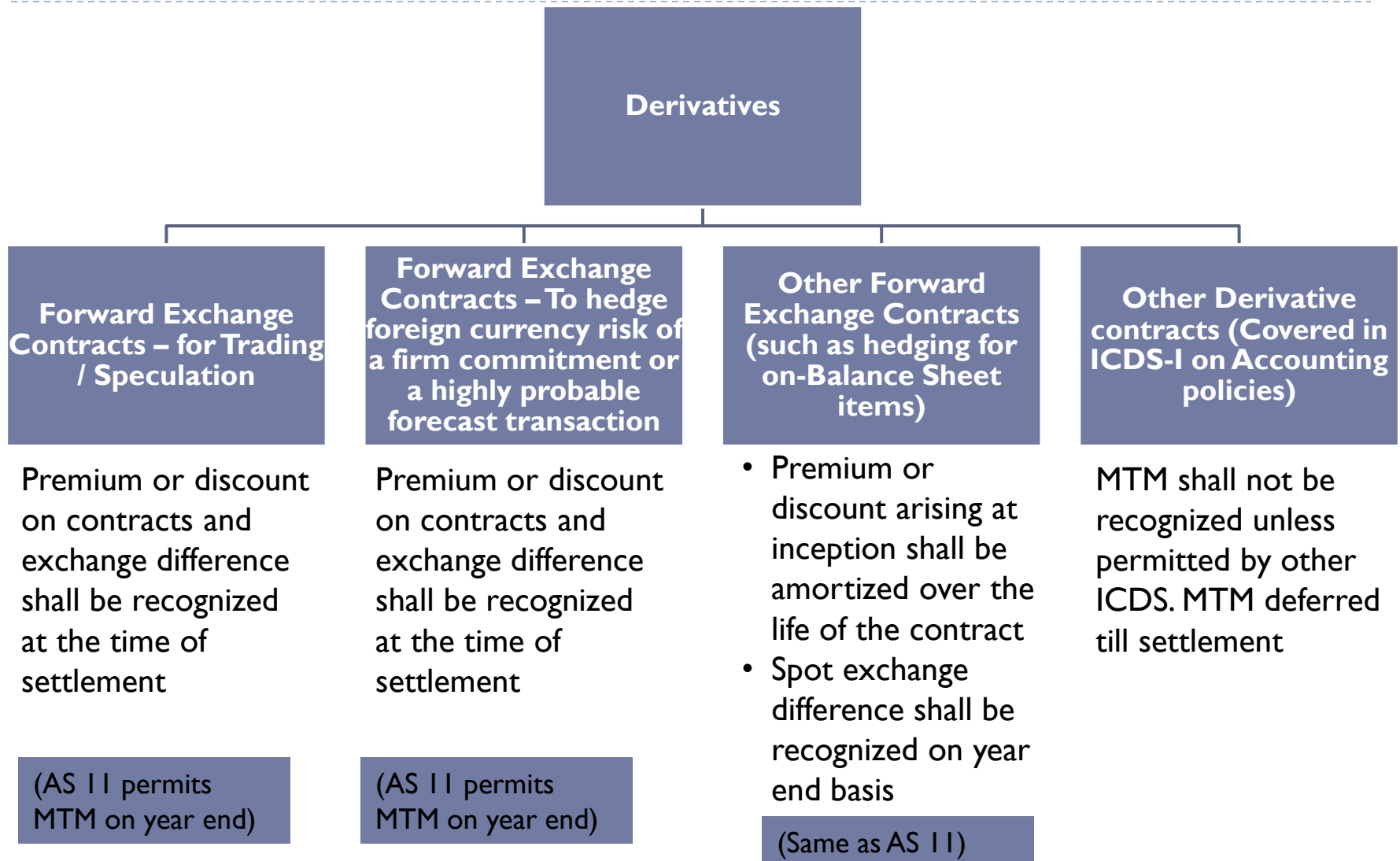
- ▶ Indian Company has entered into a contract with foreign enterprise for export of services worth USD 1,00,000
- ▶ On 1 January 2018, the contract was partly executed to the extent of USD 50,000 and therefore debtors were recorded and is outstanding in the books as on 31 March 2018
- ▶ Balance USD 50,000 is firm commitment to be exported before 31 July 2018
- ▶ Indian Company enters into forward contract with bank to hedge its currency exposure of USD 1,00,000 on 1 January 2018
- ▶ What will be the amount of MTM to be allowed for tax purposes?

| Date | Spot Rate | Forward Rate |
|----------------|---------------|---------------|
| 1 January 2018 | 1 USD = Rs.62 | 1 USD = Rs.64 |
| 31 March 2018 | 1 USD = Rs.63 | 1 USD = Rs.66 |

Case Study – Forward Contract

| Item | Treatment in books | ICDS treatment |
|--|--|---|
| <u>On-balance Sheet Items</u> | | |
| Premium on forward contract | Rs.1,00,000 [(64-62) * 50,000] | To be amortized over the life of the forward contract |
| Exchange differences on monetary item i.e. debtors | Loss of Rs.50,000 [(63-62) * 50,000] | } Gain and loss would offset each other with no impact on the P&L A/c |
| Exchange differences on forward contract | Gain of Rs. 50,000 [(63-62)*50,000)] | |
| <u>Off-Balance Sheet items</u> | | |
| MTM gain / loss | MTM gain Rs.1,00,000 [(66-64) * 50,000] | Not to be allowed / taxed |

Treatment of derivatives - Summary



Extract of FAQs issued by CBDT on 23 March 2017

- ▶ **Question 10 :Which ICDS would govern derivative instruments?**
 - ▶ ICDS -VI (subject to para 3 of ICDS-VIII) provides guidance on accounting for derivative contracts such as forward contracts and other similar contracts. For derivatives, not within the scope of ICDS-VI, provisions of ICDS-I would apply

Comparison – ICDS VI, AS 11 and Ind AS 21

| Particulars | ICDS – VI | AS – 11 | Ind AS 21 |
|--|---|--|---|
| Initial Recognition | No difference in the principles of Initial recognition | | |
| Year end recognition | No difference in the principles of year-end recognition | | |
| Foreign Operations | No bifurcation between integral and non-integral operations. All differences charged to P & L Account | <ul style="list-style-type: none"> ➤ Integral operations – Same treatment as ICDS ➤ Non-integral operations – Difference recognized as FCTR and recognized as income/expense only on disposal of net investments | No bifurcation between integral and non-integral operations. Exchange difference initially recognized in OCI and reclassified from Equity to P & L A/c on disposal of net investments |
| Exchange difference arising from foreign currency borrowing for capital purposes | Treatment in ICDS – IX (Part of incidental borrowing cost) | Borrowing cost for qualifying assets includes exchange differences also | Borrowing cost for qualifying assets includes exchange differences also |

Comparison – ICDS VI, AS 11 and Ind AS 21

| Particulars | ICDS – VI | AS – 11 | Ind AS 21 |
|--|--|--|--|
| Forward exchange contracts for on-balance sheet items | No difference in the principles of recognition | | |
| Forward exchange intended for trading / speculation or to hedge foreign currency risk of firm commitment or highly probable forecast transaction | Premium, Discount or exchange difference recognized only at the time of settlement. However, ICDS VI is subject to Section 43A | MTM approach followed – Gain / Loss is recognized in P & L Account | Recognized in statement of Profit and Loss except in case of Equity Instruments designated as fair value through OCI and Equity component of Cash flow hedge |

Case Study – Adjusting items

Extract of details of XYZ Pvt. Ltd.

- ▶ Profit for the previous year 2017-18 as per books – Rs.80 lakhs
- ▶ Profit and Loss A/c includes loss on forward contract held for trading – Rs.6 lakhs
- ▶ Translation gain of foreign operation as on 31 March 2018 credited to Foreign Currency Translation Reserve A/c – Rs.9 lakhs

Case Study – Adjusting items

Computation of Profit & Gains from Business or profession

| Particulars | Amount (Rs. In lakh) | Amount (Rs. In lakh) |
|---|-------------------------|-------------------------|
| Profit as per books of Account | | 80 |
| Adjustment under ICDS – VI | | |
| Add: Loss to be allowed at the time of settlement on forward contract [Para 8(5)] | 6 | |
| Add: Translation Gain in foreign operations [Para 7] | 9 | 15 |
| Income from Business or profession after ICDS adjustments | | 95 |

Delhi High Court's verdict on ICDS

In the **Chamber of Tax Consultants v. Union of India** (2017) 87 Taxmann.com 92, the Delhi HC held that:

“ICDS-VI which states that MTM loss / gain in case of foreign currency Derivates held for trading or speculation purposes are not to be allowed, is not in consonance with the ratio laid down by the Supreme Court in **Sutlej Cotton Mills Ltd. v. CIT** (1979) 116 ITR 1, in so far as it relates to MTM loss arising out of forward exchange contracts held for trading or speculation purposes. It is, therefore, held to be *ultra virus* the Act.”

- ▶ Accordingly, ICDS-VI was struck down as such.

New section inserted – Finance Act 2018

- ▶ To overcome the above judicial precedent, a new Section 43AA has been inserted to provide as below:

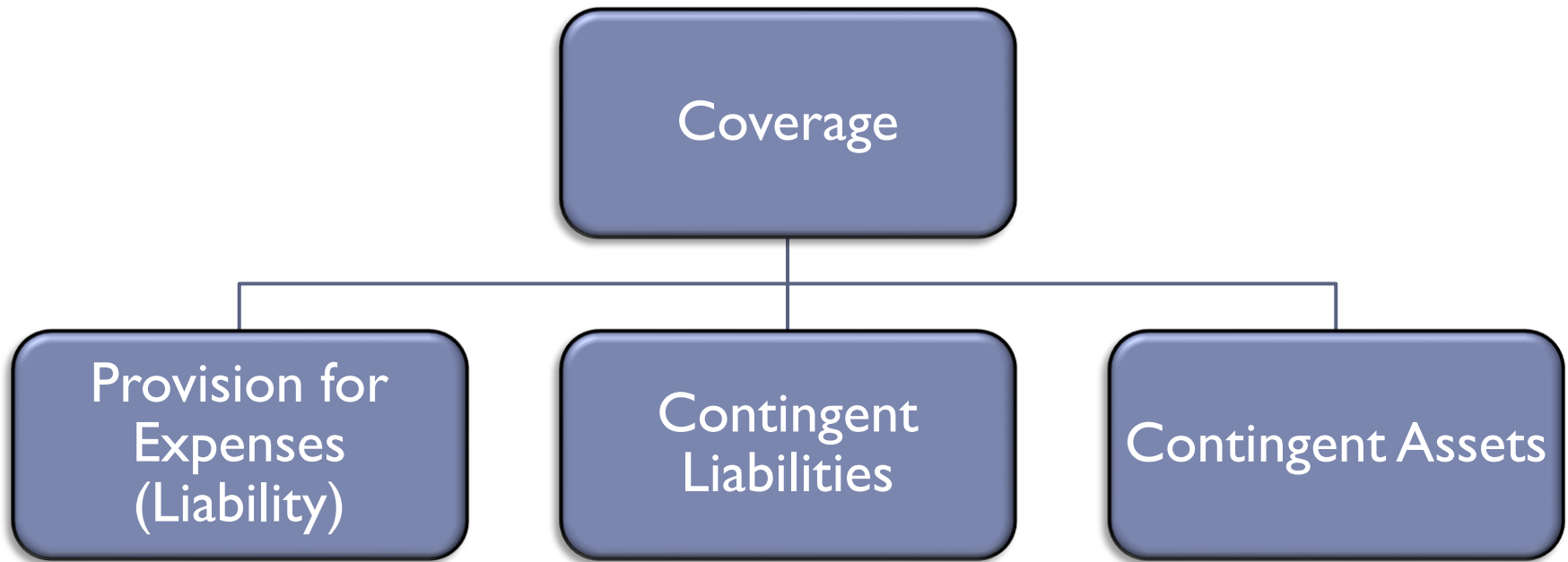
“Any gain or loss arising on account of effect of changes in foreign exchange in respect of specified foreign currency transactions shall be treated as income or loss, which shall be computed in the manner provided in ICDS”

ICDS X – Provisions, Contingent liabilities & Contingent Assets

Structure - ICDS – X (21 Paras)

| Paras | Coverage |
|--------------|-------------------------|
| 1 - 3 | Scope |
| 4 | Definitions |
| 5 - 8 | Provisions |
| 9 | Contingent Liabilities |
| 10 - 11 | Contingent Assets |
| 12 - 13 | Measurement |
| 14 - 16 | Reimbursements |
| 17 - 18 | Review |
| 19 | Use of Provisions |
| 20 | Transitional Provisions |
| 21 | Disclosure |

Scope [Para 1]



Scope Exclusions [Para 2 and 3]

- ▶ ICDS X will not apply to:
 - ▶ Provision for
 - ▶ Depreciation
 - ▶ Impairment loss of assets
 - ▶ Doubtful debts
 - ▶ Items dealt in ICDS – IV i.e. Revenue Recognition
 - ▶ Provisions / liabilities resulting from
 - ▶ Financial instruments
 - ▶ Executory contracts
 - ▶ Insurance business (Contracts with policy holders)
 - ▶ Any other ICDS

Scope Exclusions

- ▶ ICDS also not to apply to specific provisioning treatments dealt with in the Act such as
 - ▶ Section 36(1)(vii) dealing with provision for bad and doubtful debts,
 - ▶ Section 40(A)(7) dealing with provision for gratuity, etc.
- ▶ CBDT Clarification - provisioning for employee benefit covered by AS 15 to be governed by specific provisions of Act and are not dealt with by ICDS-X

A. Provisions

Para 5 to 8

Relevant Definitions

▶ Provision

- ▶ Liability which can be measured only by using a substantial degree of estimation

▶ Liability

- ▶ Present obligation arising from past events, the settlement of which is expected to result in an outflow from the person of resources embodying economic benefits.

▶ Present Obligation

- ▶ An obligation whose existence is considered reasonably certain based on the available evidence.

Provisions

- ▶ **Provision is recognized when:**
 - ▶ There is a present obligation as a result of a past event;
 - ▶ It is reasonably certain that outflow of resources embodying economic benefits will be required to settle the obligation; and
 - ▶ A realistic estimate can be made of the amount of obligation
- ▶ **Present Obligation**
 - ▶ Proposed new law yet to be finalized, obligation arises only when legislation is enacted
 - ▶ No provision for cost to be incurred to operate in future
- ▶ **Past Event**
 - ▶ Past event to be independent of person's future actions

ICDS X – Pre-ICDS v Post-ICDS

▶ Recognition of Provisions

- ▶ Pre-ICDS - Provisions recognized if it is **probable** that outflow of economic resources will be required
- ▶ Pot-ICDS - Provision to recognized if it is **reasonably certain** that outflow of economic resources will be required

▶ Provision for warranty possibly satisfies all conditions

- ▶ Present Obligation – to service / replace without consideration
- ▶ Past event – sale of goods / services
- ▶ Reasonably certain – to have some cases
- ▶ Realistic estimate – based on past trend

B. Contingent Assets and Liabilities

Para 9 to 11

Contingent Asset and Liability

- ▶ **Recognition of Contingent Liability**
 - ▶ Not recognized in both pre and post ICDS scenario
- ▶ **Recognition of Contingent Assets**
 - ▶ Not recognized as income
 - ▶ Contingent assets are assessed continually
 - ▶ Recognized when it becomes reasonably certain that inflow of economic benefit will arise – in the year in which change occurs
- ▶ **Comparison pre / post ICDS**
 - ▶ Pre-ICDS - Recognition only in case of virtual certainty regarding inflow of economic benefit (100% sure)
 - ▶ Post ICDS - Recognition even in case of reasonable certainty regarding inflow of economic benefit (MLTN)

Reimbursements [Para 14 – 16]

- ▶ Where expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement shall be recognized when it is reasonably certain that reimbursement will be received if the person settles the obligation.
- ▶ The amount recognized for the reimbursement shall not exceed the amount of the provision.
- ▶ Where a person is not liable for payment of costs in case the third party fails to pay, no provision shall be made for those costs.
- ▶ An obligation, for which a person is jointly and severally liable, is a contingent liability to the extent that it is expected that the obligation will be settled by the other parties.

Year end Review of Provisions / assets [Para 17 and 18]

- ▶ Provisions shall be reviewed at the end of each previous year and adjusted to reflect the current best estimate.
- ▶ If it is no longer reasonably certain that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision should be reversed.
- ▶ An asset and related income recognized shall be reviewed at the end of each previous year and adjusted to reflect the current best estimate.
- ▶ If it is no longer reasonably certain that an inflow of economic benefits will arise, the asset and related income shall be reversed.

Transitional provisions [Para 20]

- ▶ All the provisions or recognition of assets / related income after 1 April 2016 to be made considering the amount recognised for the same on or before 31 March 2016.

Disclosure - Provisions [Para 21(1)]

- ▶ Brief description of the nature of the obligation;
- ▶ Carrying amount at the beginning and end of the year;
- ▶ Additional provisions made during the previous year, including increases to existing provisions;
- ▶ Amount incurred and charged against the provision, during the year (provisions used)
- ▶ Unused amounts reversed during the year; and
- ▶ The amount of any expected reimbursement and the amount of asset that has been recognized for the expected reimbursement.

Disclosure - Assets [Para 21(2)]

- ▶ Brief description of the nature of the asset / related income;
- ▶ Carrying amount at the beginning and end of the year;
- ▶ Additional asset / income recognized during the year, including increases to existing asset /income; and
- ▶ Amount of asset / income reversed during the year.

Questions ?

Questions ?

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Thank You