

ICDS Workshop: ICDS I – III

11 May 2018

An introduction to ICDS



Introduction to ICDS

Framework for computation of taxable income; 10 ICDS notified; mandatory from AY 2017-18

Applicable on all tax payers following mercantile system of accounting, for computing income under the heads Profits and Gains from Business and Profession (PGPB) and Income from Other Sources (IFOS)

- Applicable for taxpayers computing income under presumptive taxation schemes;
- Not applicable for Individuals and Hindu Undivided Families (HUF) whose books of accounts are not required to be audited;
- Applicability on non-residents?

Provisions of Income-tax Act, 1961 (the Act) and Income-tax Rules 1962 (the Rules) override ICDS;

Mandatory disclosures in Tax Audit Report

Notified ICDS

ICDS I - Significant Accounting Policies

ICDS II - Valuation of Inventories

ICDS III - Construction Contracts

ICDS IV - Revenue Recognition

ICDS V - Tangible fixed assets

ICDS VI - Effects of changes in foreign exchange rates

ICDS VII - Government Grants

ICDS VII – Securities

ICDS IX - Borrowing costs

ICDS X - Provisions, Contingent Liabilities & Assets

Timeline of significant events

31 March 2015 - 10 ICDS notified and made applicable from AY 2016-17

6 July 2016 – ICDS deferred to AY 2017-18



29 September 2016 – Revised ICDS issued and made applicable from AY 2017-18



10 March 2017 – CBDT releases FAQs in Circular No. 10/2017 ('the Circular')



Finance Act, 2018 – Introduction of certain provisions of ICDS into the Act with retrospective effect from AY 2017-18



8 November 2017 – Delhi High Court judgment - The Chamber of Tax Consultants & ANR vs UOI [2018]400 ITR 178 (Del HC) ('Delhi HC judgment')



July 2017 – ICAI issues 'Technical Guidance on ICDS' ('ICAI technical guidance')

Key clarifications – FAQs by CBDT

Separate books?

No separate books of account mandated under ICDS as it is applicable for computing income under the heads PGBP and IFOS

ICDS over judicial precedents?

ICDS to prevail over judicial precedents and shall be applicable to all transactional issues. Some key considerations -

- Delhi HC judgment – Only a competent legislature can make a validation of law to override judicial precedents and that too by actually removing the defect pointed out by such precedent. Such power is not available to the executive.
- ICAI technical guidance – Judicial precedents which lay down certain basic principles for interpretation of tax law to continue to apply and should override ICDS, as such rulings have interpreted the provisions of the Act, which would prevail over ICDS

MAT and AMT

ICDS to not apply on MAT computation since it is computed on book profits

ICDS to apply on AMT, since it is computed on adjusted total income, which is derived by making adjustments to total income computed as per the regular provisions of the Act.

IND AS

ICDS to apply irrespective of accounting standards adopted by companies

ICDS I - Significant Accounting Policies



Fundamental accounting assumptions

1

Going Concern

Ability to continue business

2

Consistency

Accounting policies are consistent from one period to another

3

Accrual

Revenues and costs recognized when they are earned or incurred, *i.e.* when right to receive is established

Fundamental Accounting Assumptions same as Accounting Standard (AS) 1

Consideration in selection of Accounting Policy

Accounting policies to provide true and fair view of the state of affairs and income of the business, profession or vocation



Treatment and presentation of transactions - governed by substance over form



Marked to Market (MTM) loss or expected loss shall not be recognized, unless specified in other ICDS



Principle to apply *mutatis mutandis* to MTM gain or expected profit (*Question 8 of the Circular*)

Concept of 'Materiality and 'Prudence' not recognized under ICDS; these were important considerations in selection of accounting policies under AS 1

Consideration in selection of Accounting Policy - Prudence

Delhi HC judgment

- Concept of prudence is embedded in Section 37 of the Act as it provides for allowance of expenses 'laid out' or expended wholly or exclusively for the purpose of business
- Non acceptance of concept of prudence in ICDS I is contrary to the provisions of the Act

Retrospective amendments introduced vide Finance Act, 2018

Following provisions of ICDS I incorporated in the Act:

- ***Section 36*** - only those MTM or other expected losses shall be allowed deduction which are computed in the manner provided in ICDS
- ***Section 40A*** - no deduction or allowance in respect of MTM loss or other expected loss shall be allowed, except as allowable under Section 36

Concept of 'prudence' to now have limited applicability – as provided under ICDS

Change in Accounting Policy

Accounting policy can be changed for any “reasonable cause”



Term not defined in ICDS



Reasonable cause is an existing concept and has evolved well over a period of time conferring desired flexibility to the taxpayer in deserving cases – clarified in the Circular



As per existing judicial precedents, ‘reasonable cause’ means a cause which appeals to an man of average intelligence and ordinary prudence

- Azadi Bachao Andolan v. Union of India [2001] 116 Taxman 249/ 252 ITR 471 (Delhi)
- Woodward Governors India (P.) Ltd. v. CIT [2001] 118 Taxman 433 (Delhi)



As per AS-5, change permitted if required by statute; or for compliance with AS; or considered as resulting in more appropriate presentation

Disclosure Requirements

All significant accounting policies adopted by a person shall be disclosed

Upon change in accounting policy, disclosure required in the year of change if it has material effect

- If no material effect in current year, disclosure also required in first year of material effect
- Enhanced disclosure requirement and compliance burden
- 'Material effect' – not defined

Disclosure required in case any fundamental accounting assumption is not followed

ICDS II – Valuation of inventory



Scope

Inventories are assets -

- ➔ Held for sale in the ordinary course of business
- ➔ In the process of production for such sale
- ➔ In the form of materials or supplies to be consumed in the production process or in the rendering of services

Inventories to be valued at cost or Net Realizable Value (NRV), whichever is lower

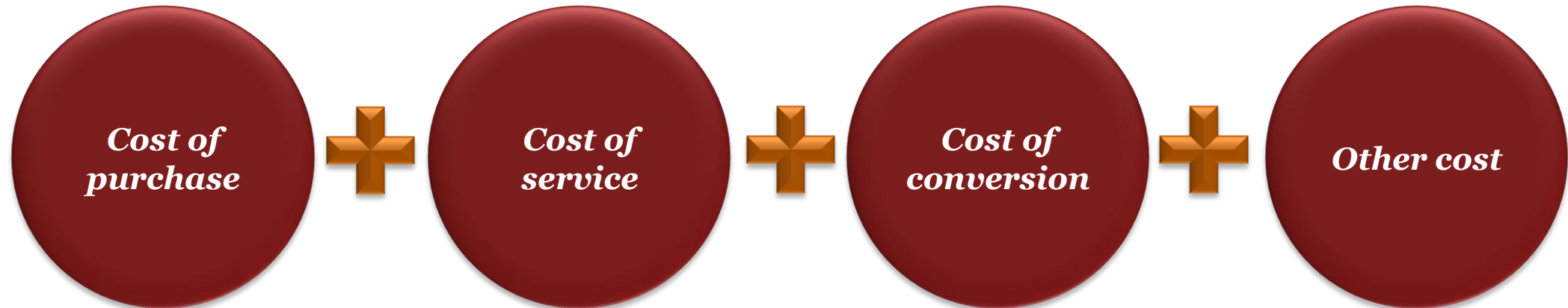
ICDS II excludes:

- ➔ Work-in-Progress arising under construction contracts (ICDS III) or dealt with under any other ICDS
- ➔ Shares, debentures and other financial instruments held as stock-in-trade covered in ICDS VIII
- ➔ Inventories of livestock, agriculture and forest products, mineral oils and gases (measured at net realizable value)
- ➔ Machinery spares used in connection with fixed assets and having irregular use, dealt with under ICDS V

Measurement of inventory

NRV: Estimated selling price in the ordinary course of business less estimated costs of completion and the estimated costs necessary for sale.

Cost of inventory:



Purchase price, duties and taxes, freight, other expenditure directly attributable to purchase; Trade discounts, rebates, other similar items to be deducted

Labour, other costs of personnel directly engaged in providing service, including supervisory personnel and attributable overheads

Costs directly related to the units of production and a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods

Included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition

Measurement: cost of inventory

Exclusions from cost of inventories

→ Interest and other borrowing costs, unless the inventories require ≥ 12 months to bring them to saleable condition

→ ***Other exclusions*** (*recognized as expenses of the period in which they are incurred*)

- Abnormal amount of material/labor cost
- Storage costs, unless necessary in production process prior to a further production stage
- Indirect administration overheads, and
- Selling costs

Techniques for measuring cost of inventory

→ Specific Identification Method

→ First in First Out Method ('FIFO')

→ Weighted Average Cost ('WAC')

→ Standard Costing

→ Retail method

Recent developments

Before ICDS	As per the provisions of erstwhile Section 145A of the Act, valuation of inventory was to be undertaken in accordance with the method of accounting regularly employed by the tax payer
ICDS II	<ul style="list-style-type: none">• Valuation of inventory at cost or NRV whichever is lower• Methods of determining costs provided
Delhi HC judgment	<ul style="list-style-type: none">• Section 145A is independent of Section 145(2) under which the ICDS has been notified.• Where the tax payer regularly follows a certain method for valuation of goods then that will govern irrespective of the ICDS notified
Retrospective amendments introduced vide Finance Act, 2018	<p><i>Section 145A of the Act has been amended to provide the following:</i></p> <ul style="list-style-type: none">• Inventory to be valued at the lower of cost or net realizable value, computed in accordance with ICDS II;• Inventory in nature of securities to be valued in line with ICDS VIII - Securities

Valuation at the time of dissolution of firm

Before ICDS

Supreme Court in *Shakti Trading Co (250 ITR 871)* and other Indian courts have observed as under:

- dissolution + **discontinuation** = **market value**
- dissolution + **continuation** = lower of **cost or market value**

ICDS II

Notwithstanding whether business is discontinued or not, the inventory on the date of dissolution to be valued at NRV

Delhi HC judgment

ICDS II fails to differentiate as to whether on dissolution of a firm, the business will be discontinued or not and therefore would lead to taxing notional income and is contrary to the decision of the Supreme Court in *Shakti Trading Co*

Retrospective amendments introduced vide Finance Act, 2018

No amendment introduced – position?

Transition provisions and disclosure requirements

Particulars	As prescribed in ICDS
Change of Method of Valuation of Inventory	Method of valuation once adopted shall not be changed without reasonable cause
Transitional Provisions	<ul style="list-style-type: none">• Interest and other borrowing costs, which do not qualify to be a part of inventory valuation as per ICDS - IX but is a part of the opening value of inventory, shall be taken into account for determining cost of closing inventory of period beginning on or after April 1, 2016 if it continues to remain part of inventory
Disclosure	<ul style="list-style-type: none">• The accounting policy adopted in measuring inventories including cost formulae used;• Total carrying amount of inventories and its appropriate classification; and• Where Standard Costing has been used as a measurement of cost, details of such inventories and a confirmation of the fact that standard cost approximates the actual cost

Service inventory?

Cost of services – defined under old ICDS:

*“The costs of services **in the case of a service provider** shall consist of labour and other costs of personnel directly engaged in providing the service including supervisory personnel and attributable overheads”*



In the **revised ICDS**, the term “in the case of a service provider” removed



ICAI Technical Guidance also provides that service inventory not to be maintained

ICDS III – Construction contracts



Scope

Contract for construction of an asset

Contract for destruction or restoration of an asset

Contract for rendition of services related to construction of an asset

Fixed price, cost plus, hybrid contracts

*No specific ICDS notified for **real estate developers; build-operate transfer projects; and leases** - relevant provisions of the Act and ICDS shall apply as per Question No. 12 of the Circular*

Combining and Segmenting Construction Contracts

Segmenting of contracts

Contract covers a number of assets

Construction of each asset should be treated as a **separate contract**:

- separate proposals have been submitted for each asset;
- each asset has been subject to separate negotiation; and
- the costs and revenues of each asset can be identified

Construction of an additional asset

Should be treated as a **separate contract** where:

- asset differs significantly in design, technology or function from that covered by the original contract; or
- the price of the asset is negotiated without having regard to the original contract price

Combining of contracts

Group of contracts with single/ several customers

Should be treated as a **single contract** where:

- the group of contracts is negotiated as a single package;
- the contracts are so closely interrelated; and
- contracts are performed concurrently or in a continuous sequence

Contract revenue

Revenue to be recognized when there is reasonable certainty of ultimate collection; bad debts to be recognized as expense (no adjustment to contract revenue)



- Indian courts have held that retention money should be recognized as income when right to receive is established -
 - CIT vs Simplex Concrete Tiles India Pvt Ltd (179 ITR 8) (Cal HC)
 - CIT vs East Coast Constructions & Industries (283 ITR 297) (Mad HC)
- Question 11 of the Circular clarifies that retention money shall be recognized **subject to reasonable certainty of ultimate collection**
- Delhi High Court held – retention money should be recognized based on accrual;

- Section 43CB has been inserted by Finance Act, 2018 with retrospective effect; provides for mechanism of computation of income from construction contracts
- Specifically includes retention money as a part of contract revenue – accrual?

- To the extent it is probable that they will result in revenue; and
- They are capable of being reliably measured.

Contract costs



- Costs of securing contract - included in contract cost provided -

- They can be separately identified
- It is probable that the contract shall be obtained

When cost is recognized as expense at the time of incurrence – not to be included in contract cost

- Exclusions

- Cost related to future activities
- Costs which cannot be attributed to contract activity/allocated to contract costs

Delhi High Court held that all receipts/ incidental income inextricably linked to construction should be allowed

Section 43CB of the Act specifically excludes interest, dividends or capital gains from scope of 'incidental income' which can be reduced from contract costs

Recognition – POCM

Recognition of revenue and costs – based on ‘Percentage of Completion Method’ (POCM) - revenue is matched with the contract costs incurred in reaching the ‘stage of completion’

- ‘Stage of completion’ to be determined on the basis of:
 - Proportion of cost incurred up to the reporting date to estimated total cost; or
 - Surveys of work performed; or
 - Completion of physical proportion of contract
- Progress payments and advances received - not determinative of the stage of completion
- Exclusions in determining the contract cost incurred up to the stage of completion:
 - Contract cost that relate to future activity on the contract; and
 - Advance payments to subcontractors.
- *No profit to be recognized, where the stage of completion is less than 25%*



Section 43CB prescribes POCM method for determination of profits and gains from construction contracts

Transitional provisions and disclosure requirements

Transitional provisions

- Contract revenue and costs, commencing ***on or after*** April 01, 2016 to be recognised in accordance with ICDS III
- Contract revenue and costs, which commenced ***on or before*** March 31 , 2016 but not completed by the said date, grandfathered – ICDS III not to apply

Disclosure requirements

- Amount of contract revenue recognized as revenue
- Methods used to determine the stage of completion
- For contracts in progress as on 31 March -
 - costs incurred and recognized profits (less recognized losses)
 - advances received
 - Retentions

Thank you



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