NANGIA & CO LLP
CHARTERED ACCOUNTANTS

Income Computation and Disclosure Standards (ICDS)

Noida | New Delhi | Mumbai | Gurgaon | Dehradun | Singapore

Contents

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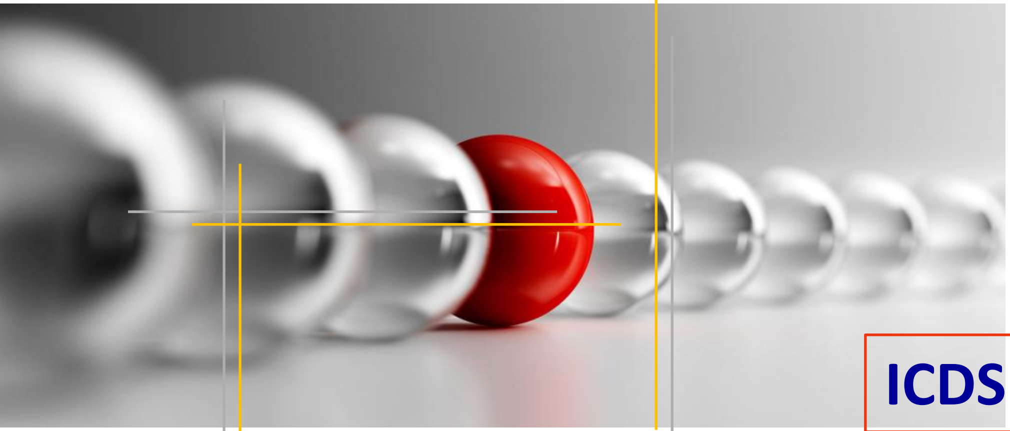

ICDS – An Overview

Introduction to ICDS

- 10 tax standards commonly referred to as Income Computation Disclosure Standards notified u/s 145(2) of the Act
- ICDS are applicable from Assessment Year (AY) 2017-18 [Financial Year / Previous Year 2016-17]
- Applicable to all assessee following mercantile system of accounting other than individual or HUF not subject to audit u/s 44AB of the Income Tax Act
- ICDS is not for the purpose of maintenance of books of accounts
- ICDS to be considered for computing income chargeable to tax under ‘income from business / profession’ or ‘income from other sources’
- In case of conflict between the provisions of the Income Tax Act, 1961 (the Act) and ICDS, the provisions of the Act shall prevail to that extent

Impact of ICDS

- ICDS have been broadly framed in accordance with comparable Accounting Standards, however there are certain deviations and departures from the same. The salient departures with treatment of transactions as per books requires careful evaluation and discussion.
- All adjustments arising due to ICDS needs to be considered in the computation of taxable income.
- Statement of adjustments owing to ICDS shall form part of the tax audit report and return of income.
- Disclosure requirements as required in ICDS shall form part of the tax audit report.

List of ICDSs with corresponding ASs

Income Computation & Disclosure Standard ('ICDS')		Corresponding Accounting Standard ('AS')	
I	Accounting policy	1	Disclosure of accounting policy
II	Valuation of Inventories	2	Valuation of inventories
III	Construction contracts	7	Construction contracts
IV	**Revenue recognition**	**9**	**Revenue recognition**
V	**Tangible fixed assets**	**10**	**Property, Plant & equipment**
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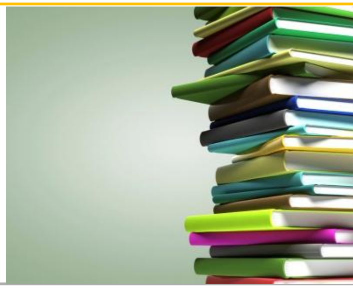


ICDS – Key provisions and impacts

ICDS IV - Revenue Recognition

ICDS IV-Scope

- Deals with recognition of revenue arising in the course of the ordinary activities of a person from
  - the sale of goods;
  - the rendering of services;
  - the use by others of the person's resources yielding interest, royalties or dividends

- This ICDS will not apply in cases and situations where other ICDS apply. If in future any ICDS is notified in relation to a specific type of revenue, that ICDS would prevail over this ICDS.

- AS 9 specifically excludes aspects of revenue recognition arising from hire purchase, lease agreements and revenue of insurance companies arising from insurance contracts. However ICDS is silent on same.

Applicability – Lease & Insurance sector

- Hire purchase and lease transactions are not covered by any specific notified ICDS. CBDT had released a draft ICDS on Leases but it is yet to be notified. Pending notification of a separate ICDS on Leases, ICDS IV is applicable.

- In respect of insurance sector, the computation of income of insurance companies is governed by section 44 of the Act read with the First Schedule to the Act. The First Schedule excludes the operation of sections 28 to 43B, and requires the income to be computed as per the Profit & Loss account prepared under the Insurance Act and rules, and the (IRDA) Act and Regulations, subject to certain adjustments laid down under the First Schedule. Section 44 read with the First Schedule would prevail over ICDS.

Applicability – Real Estate sector

- The term `goods' has neither been defined in this ICDS nor in the Income-tax Act, 1961. Under section 2(7) of the Sale of Goods Act, 1930, "goods" inter alia means every kind of movable property other than actionable claims and money. Thus, it does not include immovable property. Considering this, a view may be taken that this ICDS will not apply to a dealer in immovable property.

- CBDT has issued a separate draft ICDS on real estate transactions that shall cover income from all forms of transactions in real estate, which refers to land as well as buildings and rights in relation thereto. This ICDS however is yet to be notified.

- Till notification of a separate ICDS on transactions involving immovable property, another view is that for the purposes of ICDS IV, the term "goods" includes immovable properties and consequentially provisions of ICDS IV shall apply.

Applicability – Real Estate sector

- In this respect a reference may be made to the FAQs on ICDS contained in Circular no. 10/2017, reproduced below:
  - Question 12: Since there is no specific scope exclusion for real estate developers and Build -Operate- Transfer (BOT) projects from ICDS-IV on Revenue Recognition, please clarify whether ICDS-III and ICDS-IV should be applied by real estate developers and BOT operators. Also, whether ICDS is applicable for leases.
  - Answer: At present there is no specific ICDS notified for real estate developers, BOT projects and leases. Therefore, relevant provisions of the Act and ICDS shall apply to these transactions as may be applicable.

Revenue from sale of goods

- In case of sale of goods, revenue is recognized when:
  - the seller of goods has transferred to the buyer the property in the goods for a price **or**
  - all significant risks and rewards of ownership of goods have been transferred to the buyer **and**
  - the seller retains no effective control of the goods transferred to a degree usually associated with ownership
- Revenue shall be recognized when there is reasonable certainty of its ultimate collection
- Impact: The above provisions are aligned with AS 9 and may have only minimal impact for revenue recognized in books for sale of goods.

Revenue from sale of goods-ICDS IV vis-à-vis Ind AS 18

- Ind AS 18 - Revenue while dealing with revenues from sale of goods, as precondition for recognising the revenue, additionally provides that
  - (i) the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold; and
  - (ii) the amount of revenue can be measured reliably.

- ICDS IV refers to seller not retaining control but does not refer to managerial involvement to the degree usually associated with ownership.

- Due to difference in the criteria for the time of recognition as well as measurement of the revenue under ICDS and Ind AS 18, there could be difference in the amount of revenue to be recognised under ICDS as compared to the books of account. Care should be taken for making appropriate adjustment for the same.

Extended credit period-ICDS IV vis-à-vis Ind AS 18

- ICDS IV in line with AS 9 defines revenue to be the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities.

- Ind AS 18 - Revenue provides that revenue should be recognised at fair value of the consideration received or receivable. Accordingly, it provides that where the seller has extended interest free credit and when the arrangement effectively constitutes a financing transaction, the fair value of the consideration is determined by discounting all future receipts using an imputed rate of interest.

- The difference between the stated consideration and the fair value arrived at is recognised as interest income. ICDS IV however does not recognise discounting of consideration. Hence, while computing total taxable income, the revenue should be recognised without discounting.

Revenue from escalation and export incentive claims

- In case of raising of any claim for escalation of price and export incentives, where the ability to assess the ultimate collection with reasonable certainty is lacking, revenue recognition in respect of such claim shall be postponed to the extent of uncertainty involved.

- The above para requires an Assessee to recognize income from export incentive in the year of making of the claim if there is 'reasonable certainty' of its ultimate collection.

- In Excel Industries (supra), the Supreme Court held that it is only in the year in which the claim is accepted by the Government that a right to receive the payment accrues in favour of the Assessee and the corresponding obligation to pay arises in the hands of the Government. Only in such year the income from export incentive can be said to have accrued and can be recognized as income.

Export incentive-Delhi HC Ruling and subsequent Budget amendment

- It was challenged in the Delhi High Court Ruling on the grounds that this was contrary to the decision of the Supreme Court in Excel Industries (supra). As per the decision of the court, this was considered ultra vires the Act and was struck down.

- By way of Finance Act 2018, a new section 145B has been introduced in the Act that includes the claim for escalation of price in a contract or export incentives shall be deemed to be the income of the previous year in which reasonable certainty of its realisation is achieved.

- Impact: Based on the retrospective amendment effective from AY 2017-18 made by Finance Act 2018, Para 5 of the ICDS IV has been upheld and the claims for escalation of price or export incentives shall be taxed in the year in which the reasonable certainty of ultimate collection is achieved irrespective of the year of receipt / acceptance.

Revenue from rendering of services

- Revenue from service contracts with duration of not more than ninety days may be recognised when rendering of services under that contract is completed or substantially completed (CCM).

- For other service contracts, revenue shall be recognised by reference to Percentage Of Completion Method (POCM). Under POCM, revenue from service transactions is matched with the service transaction costs incurred in reaching the stage of completion, resulting in the determination of revenue, expenses and profit which can be attributed to the proportion of work completed.

- When services are provided by an indeterminate number of acts over a specific period of time, revenue may be recognised on a straight line basis.

Revenue from rendering of services

- ICDS III on constructions contracts also requires the recognition of revenue on POCM basis. ICDS IV therefore requires application of ICDS III for recognition of revenue and the associated expenses for a service transaction on mutatis mutandis basis and following shall imply:

  - Reasonable certainty of its ultimate collection.
  - Contract revenue includes retentions
  - Threshold of 25% stage of completion for recognition of income
  - No recognition of the foreseeable losses on a contract.
  - Stage of completion can be determined with reference to (a) total estimated costs v/s. cost incurred till balance sheet date; or (b) survey of work performed; or (c) completion of physical proportion of work
  - Contract cost shall not be reduced by incidental interest, dividend and capital gains

Revenue from rendering of services – Delhi HC Ruling

- The proportionate completion method as well as the contract completion method have been recognized as valid method of accounting under mercantile system of accounting by the Supreme Court in CIT v. Bilhari Investment Pvt. Ltd. (2008) 299 ITR 1 (SC). This Court too has done likewise in CIT v. Manish Buildwell Pvt. Ltd. (2011) 245 CTR 397 (Del) and Paras Buildtech India Pvt. Ltd. V. CIT (2016) 382 ITR 630 (Del).

- Therefore, to the extent that para 6 of ICDS-IV permits only one of the methods, i.e., POCM, it was challenged in the Delhi High Court Ruling on the grounds that this was contrary to the above decisions. As per the decision of the Delhi HC Ruling, this was held to be ultra vires the Act and was struck down.

Revenue from rendering of services – Budget amendment

- By way of Finance Act 2018, a new section 43CB has been introduced in the Act to provide that profits arising from a construction contract or a contract for providing services shall be determined on the basis of percentage of completion method except for certain service contracts, and that the contract revenue shall include retention money, and contract cost shall not be reduced by incidental interest, dividend and capital gains.

- Impact: Based on the retrospective amendment effective from AY 2017-18 made by Finance Act 2018, Para 6 of the ICDS IV has been upheld.

Combined services

- There may be cases where one may have to consider whether the transaction is a service transaction attracting provisions of recognition of revenue based on percentage of completion method. This will depend upon the facts and circumstances of the transaction.

- Often a transaction involves both, sale of goods and provision of service. In such a case, one will have to examine what is the predominant aspect of the transaction, whether consideration to be received for the transaction can be split into that for sale of goods and for provision of service, etc.

Other Income – Interest & Dividend

- Interest on refund of any tax, duty or cess - To be recognized in the previous year in which such interest is received.
- Other Interest - To be recognized on the time basis determined by the amount outstanding and the rate applicable.
- Discount or premium on debt securities - To be recognized on accrual basis over the period to maturity.
- Dividends – To be recognized in accordance with provisions of the Act.

Interest Income - Definition

- The term `interest' is not defined in the ICDS, but section 2(28A) defines the term `interest' while section 2(28B) defines interest on securities' as under:
  - "(28A) "interest" means interest payable in any manner in respect of any moneys borrowed or debt incurred (including a deposit, claim or other similar right or obligation) and includes any service fee or other charge in respect of the moneys borrowed or debt incurred or in respect of any credit facility which has not been utilised.
  - (28B) "interest on securities" means (i) interest on any security of the Central Government or a State Government; (ii)interest on debentures or other securities for money issued by or on behalf of a local authority or a company or a corporation established by a Central, State or Provincial Act."
- Accordingly, while applying provisions of this ICDS, the above terms will have to be interpreted as defined in the Act.

Interest Income – Delhi HC Ruling

- As per ICDS recognition of interest shall accrue on the time basis determined by the amount outstanding and the rate applicable"
- It was challenged in the Delhi High Court Ruling on the grounds that non-performing assets of NBFCs would also become taxable on accrual basis even though such interest is not recoverable.
- It was held that the ICDS does not in any way wish to alter the well laid down principles of real income by the Hon"ble Supreme Court, but is actually ensuring that there is a trace available of the income which is foregone on this concept. Therefore, if there is an interest income which is not likely to be realised is written off by the assessee in the same very year immediately on its recognition (and even without passing through its books), then it would be first recognised as revenue and then allowed as a deduction under S. 36(1) (vii) of the Act, including in the case of NBFCs. Accordingly, its validity was upheld.

Interest Income – Reasonable certainty

- One may also refer to the FAQs on ICDS contained in Circular no. 10/2017, Question # 13 reproduced below:

  - Question 13: The condition of reasonable certainty of ultimate collection is not laid down for taxation of interest, royalty and dividend. Whether the taxpayer is obliged to account for such income even when the collection thereof is uncertain?

  - Answer: As a principle, interest accrues on time basis and royalty accrues on the basis of contractual terms. Subsequent non recovery in either cases can be claimed as deduction in view of amendment to Section 36 (1) (vii).

Royalty Income

- To be recognized on accrual basis in accordance with the terms of the relevant agreement.

- In case of non-resident assessees, royalty is generally taxed on gross basis under section 115A of the Act or under the provisions of Double Taxation Avoidance Agreements (DTAA).

- In this respect, a reference may be made to FAQs on ICDS contained in Circular no. 10/2017 where it is clarified that “the provisions of ICDS shall also apply for computation of these incomes on gross basis for arriving at the amount chargeable to tax”.

- However, where royalty is taxed under the provisions of any DTAA, provisions of such DTAA will prevail over the provisions of the Act and consequently, provisions of the ICDS will not apply.

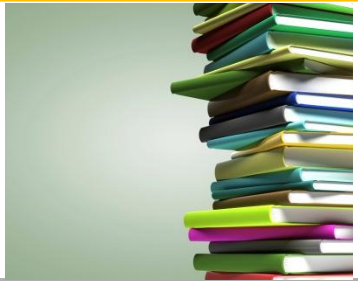
ICDS IV-Disclosure requirements

- For sale of goods - Total amount not recognised as revenue due to lack of reasonably certainty of its ultimate collection along with nature of uncertainty.

- For service income - The amount of revenue recognized.

- For service transaction – in – progress – Following disclosure is required :
  - Method used to determine the stage of completion
  - Amount of costs incurred and recognised profits/losses upto end of previous year
  - Amount of advances received
  - Amount of retentions

- These disclosures in respect of services need to be made only in respect of service transactions with duration of more than 90 days.



ICDS – Key provisions

ICDS V - Tangible Fixed Assets

Scope of ICDS V

- The principal aspect dealt with by this ICDS is the treatment with respect to what constitute **Actual Cost** i.e. determination as to whether an expenditure incurred in connection with a **Tangible Fixed Asset** is to be capitalised or is to be treated as a revenue expenditure.

- This ICDS deals with assets being land, building, machinery, plant or furniture held with the intention of being used for the purpose of producing or providing goods or services and not held for sale in the normal course of business.

- Since intangible assets are excluded from the scope of this ICDS, for the purpose of computation of income, the treatment of intangible assets would be based on the normal provisions of the Act and accounting principles.

Scope – Assets held for administration and rental

- Under Ind AS 16, Property, Plant and Equipment are tangible items that are held for use in the production or supply of goods or services, **for rental to others or for administrative purposes** and are expected to be used during more than one period.

- Under this ICDS, assets for the purpose of rental and administration are not explicitly covered. However, the definition covers **assets held with the intention of being used for the purpose of producing or providing goods or services.** Accordingly assets held for administrative purposes shall be considered included in ICDS V.

- So far as assets held for the purpose of rental are concerned, if the income from such assets is taxable either under the head business income or income from other sources, it would fall within the purview of ICDS V. If the income from such rental would fall under "Income from House Property", such rental properties would not be covered.

Scope – No monetary threshold

- Under the Act as well as this ICDS, no monetary threshold is prescribed for identification of a tangible fixed asset. Therefore all tangible fixed assets are to be capitalised to their respective blocks of assets.

- Under AS 10 and Ind AS 16, with regard to purchase of insignificant items, it provides that it may be appropriate to aggregate the value of such items and, on the basis of judgement and materiality of the amount, decide to expense such items in its books.

- ICDS does not have the concept of materiality and therefore one will have to consider the principle of enduring benefit of the asset for the purpose of treating the particular item as tangible fixed asset.

Scope– Biological assets

- As compared to the scope under this ICDS, both AS 10 and Ind AS 16 specifically exclude from their scope assets such as biological assets related to agricultural activity other than bearer plants, produce on bearer plants, wasting assets including mineral rights, expenditure on the exploration for and extraction of minerals, oil, natural gas and similar non-regenerative resources. However, both these Standards include property, plant and equipment used to develop or maintain such assets.

Stand-by equipment and spare parts

- Stand-by equipment and servicing equipment are to be capitalized.
- Machinery spares shall be capitalized only when such spares can be used only in connection with an item of tangible fixed asset and their use is expected to be irregular.
- Both under AS 10 and Ind AS 16 spare parts, stand-by equipment and servicing equipment are to be recognised as assets if they meet the definition of PPE i.e. an item of PPE shall be recognised as asset, if and only if, it is probable that future economic benefits associated with the item will flow to the entity and the cost can be measured reliably.
- In cases where, stand-by equipment, servicing equipment or spares are classified as inventory in books, but as per ICDS V, these are required to be recognised as tangible assets, necessary adjustment will have to be done in computing the taxable income.

Cost of Assets – Cost of dismantling and restoration

- The actual cost of an acquired tangible fixed asset shall comprise its purchase price, import duties and other taxes, excluding those subsequently recoverable, and any directly attributable expenditure on making the asset ready for its intended use. Any trade discounts and rebates shall be deducted in arriving at the actual cost.

- Both AS 10 and Ind AS 16 define elements of cost in an identical manner. Under both Standards, cost includes the initial estimate of the dismantling and restoration.

- Under ICDS, such estimated costs of dismantling and removing the item and restoring the site cannot be considered as expenditure directly attributable in making the asset ready for its intended use and therefore while computing the total taxable income such expenditure should be excluded from the cost of the fixed asset and arriving at the amount to be included in the block of assets.

Cost of Assets – Imputed interest cost

- The Accounting Standards provide that in case the payment for PPE is beyond the normal credit terms, the difference between the cash price equivalent and the total payment is to be recognised as interest over the period of credit, unless such interest is capitalised in accordance with AS 16 or Ind AS 23.

- However, such differentiation of cost between cost of asset and interest expense is to be ignored for the purpose of this ICDS. Accordingly, interest debited to the profit and loss account out of the price to be paid for such asset should be disallowed in the computation of income and should be added to the cost of asset under respective block.

Cost of Assets – Government Grant

- In a case where subsidy or grant is receivable from Government in relation to an asset is concerned, Explanation 10 to section 43(1) provides for excluding such amount from the actual cost of the asset. This is in line with ICDS VII on Government Grant, AS 10 & AS 12.

- However Ind AS 20 on Government Grant does not permit reduction of the carrying amount of an item of PPE by the amount of government grant received in respect of such an item and the corresponding reference in Ind AS 16 has therefore been removed.

- Therefore, where financial statements are drawn in compliance with Ind AS 16 if such government grant has been credited to the profit and loss account then, while computing the total taxable income, amount of such grant should be excluded from income and the amount should be reduced from corresponding block of assets.

Cost of Assets – Pre commercial production

- The expenditure incurred on start-up and commissioning of the project, including the expenditure incurred on test runs and experimental production, shall be capitalized and cannot be claimed as revenue expenditure.

- The expenditure incurred after the plant has begun commercial production, that is, production intended for sale or captive consumption, shall be treated as revenue expenditure.

- In this respect a reference may be made to the FAQs on ICDS, where it has been clarified that on the treatment of expense incurred after the conduct of test runs and experimental production but before commencement of commercial production.

- As clarified the expenditure incurred till the plant has begun commercial production shall be treated as capital expenditure.

Cost of Assets – Ready to put to use vs. put to use

- Treatment of expenditure incurred during the interval between the **date when the asset is ready to commence** commercial production and the **date of actual commencement** of production is not addressed in this ICDS.

- AS 10 provides that costs incurred while an item capable of operating in the manner intended by management has yet to be brought into use, is not included in the carrying amount of an item of PPE. As per Ind AS 16, recognition of costs in carrying amount of an item of PPE ceases if the item is in the location and condition necessary for it to be operating in the manner intended by the management.

- Under ICDS such cost is not incurred for making the asset ready for its intended use and hence should not be included as part of its cost in line with AS & Ind AS.

Cost of Assets – In exchange for another asset

- When a tangible fixed asset is acquired in exchange for another asset, the fair value of the tangible fixed asset so acquired shall be its actual cost.

- As per AS 10, when a fixed asset is acquired in exchange for another asset, its cost is usually determined by reference to the fair market value of the consideration given. It may be appropriate to consider also the fair market value of the asset acquired if this is more clearly evident.

- Ind AS 16, subject to certain exceptions, contains similar provisions as this ICDS. The cost of asset acquired is to be measured at its fair value, unless the exchange transaction lacks commercial value or fair value of neither asset received or given up is capable of being reliably measured.

Cost of Assets – In exchange for another asset

- Therefore, the deviation between this ICDS and AS 10 / Ind AS 16 would arise where the asset acquired is recognised at an amount other than the fair value of the asset acquired in books.

- However, in so far as computation of income is concerned, addition to the block of assets would be required to be recorded at the fair value of the asset acquired and, to that extent, the difference needs to be adjusted in computing the total income.

Other related provisions

- Where several assets are purchased for a consolidated price, the consideration shall be apportioned to the various assets on a fair basis. The term ‘fair basis’ has not been separately defined and therefore an apportionment based on a logical and fair basis should suffice.

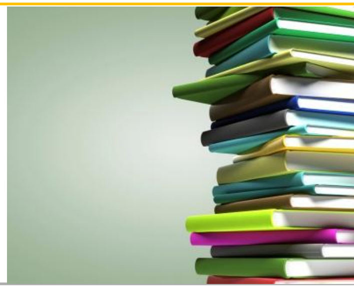
- Adjustment to assets on account of exchange fluctuations is dealt in accordance with ICDS VI - Effects of changes in foreign exchange rates & section 43A of the Act. It has been discussed in detail under provisions of ICDS VI.

- Depreciation on a tangible fixed asset shall be computed in accordance with the provisions of the Act.

- Income arising on transfer of a tangible fixed asset shall be computed in accordance with the provisions of the Act.

ICDS V- Disclosure requirements

- Following disclosure shall be made in respect of tangible fixed assets:
  - Description of asset or block of assets
  - Rate of depreciation
  - Actual cost or written down value, as the case may be
  - Additions or deductions during the year with dates; in the case of any addition of an asset, date of put to use; including adjustments on account of
    - Central Value Added Tax credit claimed and allowed;
    - Change in rate of exchange of currency;
    - Subsidy or grant or reimbursement, by whatever name called;
  - Depreciation Allowable
  - Written down value at the end of year
- The disclosures prescribed by this ICDS are similar to the requirements of clause 18 of Form 3CD.



ICDS – Key provisions

ICDS VI - The effects of changes in foreign exchange rates

Foreign Currency Transactions – Initial recognition

- A foreign currency transaction shall be recorded in the reporting currency, by applying **exchange rate at the date of the transaction** to the foreign currency amount.
- An average rate for a week or a month may be used if the average rate approximates the actual rate at the date of the transaction.
- The above provisions of ICDS VI is similar to corresponding provisions contained in AS 11 and Ind AS 21. Consequently, no adjustment would be required in computing the taxable income.

Foreign Currency Transactions - Conversion

- As per ICDS VI, monetary items shall be converted into reporting currency by applying the closing rate. If closing rate is unrealistic then the rate to be applied is the rate at which such monetary item is likely to be realised or disbursed.

- Such exchange differences arising on the settlement or on conversion shall be recognised as income or as expense in that previous year.

- It is similar to provisions contained in AS 11. Consequently, no adjustment would be required in computing the taxable income.

- However, Ind AS 21 defines closing rate to be the spot exchange rate at the end of the period. Further Ind AS 21 provides adoption of only closing rate for the conversion of such items. Considering that the rate used for the year-end conversion as per ICDS and Ind AS may be different, an adjustment may be required in the taxable income.

Foreign Currency Transactions - Conversion

- As per ICDS VI, non monetary items (except inventory carried at net realisable value) shall be converted into reporting currency by using the exchange rate at the date of the transaction.
- Both, AS 11 and Ind AS 21 provide that non-monetary items carried at historical cost shall be translated using the exchange rate at the date of transaction, while non-monetary items carried at fair value shall be translated using the exchange rate at the date when the fair value was determined.
- For non-monetary items carried at historical cost, no adjustment would be required in computing the taxable income.
- For non-monetary items carried at fair value, considering that the rates used as per ICDS and Ind AS will be from different dates, difference will arise requiring an adjustment in the taxable income.

Foreign Currency Transactions - Conversion

- As per ICDS VI, non-monetary items being inventory which is carried at NRV shall be converted into reporting currency by using the exchange rate that existed when such value was determined.
- Exchange differences arising on conversion shall not be recognised as income or as expense in that previous year.
- Under the Accounting Standards, such inventory is covered by the provision relating to the non - monetary items carried at fair value and is translated using the exchange rate at the date when the fair value was determined. Thus the treatment under the ICDS and the Accounting Standards is similar.

Exchange fluctuations on assets acquired from outside India

- ICDS VI provides that recognition of exchange difference shall be subject to provisions of section 43A of the Act.

- As per the provisions of section 43A, in case of an asset acquired from a country outside India, exchange differences arising while making payment towards the cost of the asset or repayment of the moneys borrowed for acquiring the asset, shall be added to or deducted from the actual cost of asset in the year of payment.

- It may be noted that adjustment to the actual cost of the asset under the provisions of section 43A is to be done for exchange differences on realization basis only and any unrealized exchange gain/loss is to be ignored.

Exchange fluctuations – External Commercial Borrowings

- It is to be noted that provisions of section 43A do not cover a situation where assets are acquired in India by availing a foreign currency loan.
- The income and expenditure on account of exchange differences in respect of capital account transactions have been held as income not liable to tax, being capital receipt, and expenditure not allowable, being capital loss, by Hon'ble Supreme Court in the case of Sutlej Cotton Mills Ltd v CIT [1979] 116 ITR 1 (SC).
- ICDS VI does not specifically provide for treatment in such cases. However for monetary items as a whole, the gain/loss is recognised in profit and loss account and in case of non-monetary items, the gain/loss would be neither taxable nor deductible.
- This situation is in contradiction to the accepted judicial view. One will have to make the professional judgment on a case to case basis.

Foreign operations

- Foreign operation of a person as per this ICDS is an overseas branch, whereas under AS 11 and Ind AS 21, the meaning extends to a subsidiary, associate, joint arrangement or branch. Under the Act a foreign subsidiary, associate or a joint arrangement would be a separate assessee.

- Financial Statements of a foreign operation shall be translated using principles as applied for foreign exchange transactions as if the transactions of foreign operation had been those of the person himself.

Forward Exchange Contracts

- 'Forward exchange contract' as defined under this ICDS means an agreement to exchange different currencies at a forward rate, which is also the definition of this term under AS 11. However, the definition under this ICDS also specifically includes a foreign currency option contract or another financial instrument of a similar nature.

- When the contract is not intended for trading or speculation purposes **or** not to hedge the foreign currency risk of a firm commitment or a highly probable forecast transaction –
  - Premium or discount arising at the inception is amortised over the life of the contract.
  - Exchange difference is recognised in previous year in which the exchange rates change.
  - Any profit or loss arising on cancellation or renewal shall be recognised as income or as expense for that previous year.

Forward Exchange Contracts

- When the contract is intended for trading or speculation purposes
- **Or** to hedge the foreign currency risk of a firm commitment or a highly probable forecast transaction –
  - Premium, discount or exchange difference shall be recognised at the time of the settlement.

- It implies marked to market loss/gain in case of such foreign currency derivatives are not to be allowed for tax purposes.

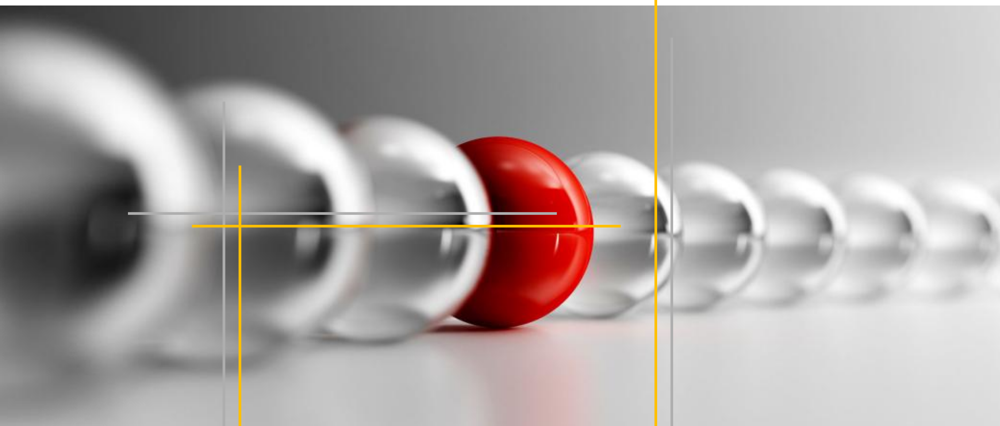
- It was challenged in the Delhi High Court Ruling on the grounds that it is not in consonance with the ratio laid down by the Supreme Court in Sutlej Cotton Mills Limited v. CIT (supra), so far as it relates to marked to market loss arising out of forward exchange contracts held for trading or speculation purposes. It was, therefore, held to be ultra vires the Act.

Forward Exchange Contracts

- By way of Finance Act 2018, a new section 43AA has been introduced in the Act to provide that, subject to the provisions of section 43A, any gain or loss arising on account of effects of changes in foreign exchange rates in respect of specified foreign currency transactions shall be treated as income or loss, which shall be computed in the manner provided in ICDS as notified under sub-section (2) of section 145.

- Further section 36(1)(xviii) provides marked to market losses or other expected losses as computed in accordance with the ICDS notified under section 145(2) shall be allowed as deduction.

- Impact: Based on the amendments made by Finance Act 2018, Para 8(5) of the ICDS VI has been upheld and accordingly the mark to market losses on such forward exchange contracts shall not be allowed. The expense shall be allowed in the year of settlement.



ICDS – Transitional provisions

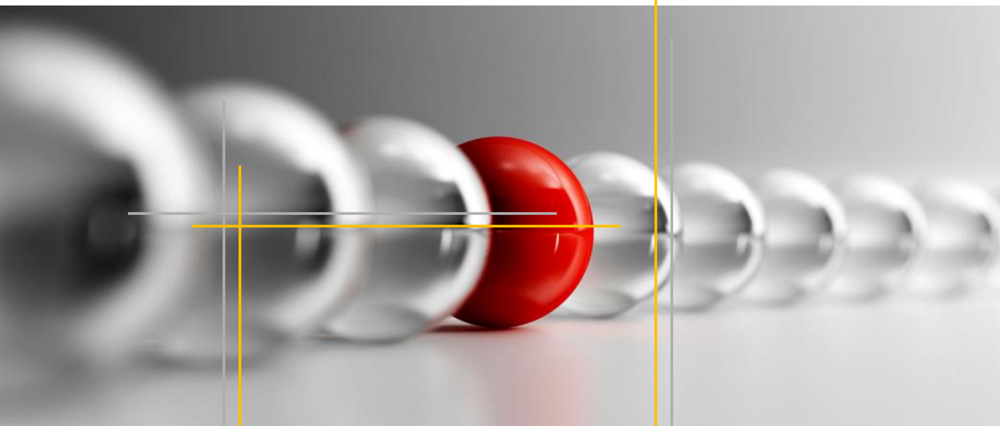
ICDS IV, V & VI

Transition Provisions of ICDS

- Transitional provisions specified under ICDS IV provides relief on service contracts, which commenced on or before 31st March 2016 but not completed by the said date, to recognise service revenue and service cost based on the method regularly followed by the person in previous financial years.

- Transitional provisions of ICDS IV (other than service transaction) ICDS V & VI requires all existing transactions on 1st April 2016 shall be dealt with in accordance with provisions of ICDS after taking into account impact recognised in respect of the said transaction for the previous year ending on or before the 31st March, 2016.

- The intent of transitional provision is there is neither “double taxation” of income nor escape of any income due to application of ICDS from a particular date. Application of transitional provisions does not require revisions of any previous year income tax returns filed due to ICDS.



Effect in Tax Audit Report

Impact & Disclosures

Effect in Tax Audit Report

- Tax audit forms have been suitably modified to include adjustments pertaining to ICDS. The adjustments shall be mentioned in clause 13(d) to 13(f) in Form 3CD as under:
  - (d) Whether any adjustment is required to be made to the profits or loss for complying with the provisions of ICDS notified under section 145(2) – [Yes / No]
  - (e) If answer to (d) above is in the affirmative, give details of such adjustments:

ICDS No.	Name of the ICDS	Increase in profit (Rs.)	Decrease in profit (Rs.)	Net (Rs.)

  - (f) Disclosure as per ICDS

ICDS No.	Name of the ICDS	Disclosure

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