

Income Recognition as per ICDS & Tax Audit

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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.
- ❑ Accordingly, two tax accounting standards were notified prior to ICDS :
 - Disclosure of accounting policies
 - Disclosure of prior period and extraordinary items and changes in accounting policies

Background

- ❑ Finance 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, CBDT had revised and issued 12 draft ICDS for public comments.
 - ❑ On 31st March, 2015, the Central Government has notified 10 out of the 12 draft ICDS which shall be effective from 1st April, 2015.
 - ❑ The introduction of ICDS may significantly alter the way companies compute their taxable income.

General Principles

- ❑ ICDS are applicable for computation of income chargeable under the head “profits and gains of business or profession” and “income from other sources” and not for maintaining books of accounts.
- ❑ ICDS applies to all taxpayers
- ❑ ICDS introduced for
 - Reduction of litigation and bring certainty to issues
 - Harmonisation of AS with the income-tax provisions
- ❑ In case of conflict between the provisions of the Act and ICDS, the provisions of the Act shall prevail to that extent.
- ❑ ICDS applies only to taxpayers following mercantile system of accounting.

General Principles

- ❑ Applies to all taxpayers irrespective of quantum of income
 - Non-resident taxpayers having a PE/ Branch shall also have to adhere to same

- ❑ Non-maintenance of separate books of accounts
 - Necessitate maintenance of Memorandum accounts
 - Additional disclosure may be required in TAR or ROI

- ❑ ICDS likely to have persuasive effect on transactions prior to 1/4/2015

- ❑ Any transitional impact in migration from old standards to new ICDS goes to P&L of FY 2015-16

- ❑ Business income to be computed as per commercial accounting in consonance with ICDS, subject to provisions such as – say, 36(1)(iii), 43B, 40(a)(ia), etc.
 - Principle of commercial accounting can be modified pursuant to notifications under section 145(2) – SC in the case of Woodward Governor

Overview

- ❑ Prior to ICDS, following two Tax Accounting Standards were notified:
 - Disclosure of accounting policies
 - Disclosure of prior period and extra ordinary items and change in accounting policies

- ❑ Introduction of 14 TAS for:
 - Harmonisation of AS with the income-tax provisions
 - Reduction of litigation and bring certainty to issues

- ❑ Introduction of ICDS – corresponding to 12 Accounting standards:
 - TAS now improvised as ICDS
 - Recommendations/Concerns raised on the draft TAS addressed

Overview

❑ Proposed draft of Income Computation and Disclosure Standards (ICDS)

- Accounting Policies
- Valuation of Inventories
- Construction Contracts
- Revenue Recognition
- Tangible Fixed Assets
- Effect of foreign exchange
- Government Grants
- Securities
- Borrowing Costs
- Leases
- Intangible Assets
- Provisions and Contingent Liabilities & Assets

Income
recognition
standards

Draft of Income Computation and Disclosure Standards (ICDS)

Construction contracts (corresponding to AS-7)

Key Provisions -

- ❑ Deals with Construction contract revenue and costs
 - Applies equally to a fixed price, or a cost plus contracts; or to a hybrid contract with characteristics of fixed price and cost plus contract
 - Applies also to Government contracts
- ❑ Recognition of revenue and expenses
 - Contract revenue to be matched with Contract costs

 - Stage of Completion determined - Method used to be disclosed
 - Contract Cost Incurred / Estimated Total Contract Costs
 - Surveys of work performed or completion of physical proportion of Contract Work
 - Ignore Progress payments and advances received from customers – To be disclosed
- ❑ Revenue Scope widened
 - Includes retention money – To be disclosed
 - Collection uncertain to be booked as Bad debts – No adjustment to revenue
 - Inclusion of borrowing cost (computed as per ICDS) in the contract cost
 - Pre-construction income to be taxed – No reduction from Construction Cost

Construction contracts (corresponding to AS-7)

Key Provisions (Contd...)

- Contract costs that relate to future activity to be recognized as asset
 - If asset not realizable may be allowed under the provisions of Act
- Losses incurred to be allowed only in proportion to the stage of completion
 - Anticipated losses not allowed unless incurred
 - Contract Cost Incurred / Estimated Total Contract Costs
- Contract revenue to be recognized when there is reasonable certainty of its ultimate collection

Points to Consider

- 'Reasonable certainty' not defined
- Bad debts to be written off, no adjustment to revenue – hence increase in sales value optically, hence thresholds to exceed and additional compliances could trigger
- Retention money treated as deferred income in judicial precedents, now brought under taxation
- Stage of completion <25 percent – No recognition required

Construction contracts (corresponding to AS-7)

Deviations in AS-7 and ICDS

Particulars	AS-7	ICDS
Recognition of contract revenue	Contract revenue to be recognized if it is possible to reliably measure the outcome of a contract	1) The criteria “if it is possible to reliably measure the outcome of a contract” has been omitted 2) Contract revenue to be recognized if there is reasonable certainty of its ultimate collection
Recognition of incentive payments	Incentive payment to be recognised only when (i) probability exists that specified performance standards would be met or exceeded (Guidance para in ICAI AS, links probability to contract progress upto sufficiently advanced stage); (ii) incentive is reliably measurable	Requires recognition under POCM if incentive reliably measurable and it is probable that it will result in revenue. In absence of further guidance, ambiguity may arise if the requirement of “sufficiently advanced stage of contract” is deleted/diluted

Construction contracts (corresponding to AS-7)

Deviations in AS-7 and ICDS

Particulars	AS-7	ICDS
Recognition of claims	Claims against customers to be recognised when (i) probability exists that the customer will accept the claim (Guidance para in ICAI AS, links probability to negotiation progress upto advanced stage); (ii) amount is reliably measurable;	Requires recognition under POCCM if claims are reliably measurable and it is probable that it will result in revenue. In absence of further guidance, ambiguity may arise if the requirement of “advanced stage of negotiation” is deleted/diluted
Retention money	Silent on treatment of accrual of income in respect of retention money	Retention money to be considered as revenue for POCCM

Construction contracts (corresponding to AS-7)

Deviations in AS-7 and ICDS

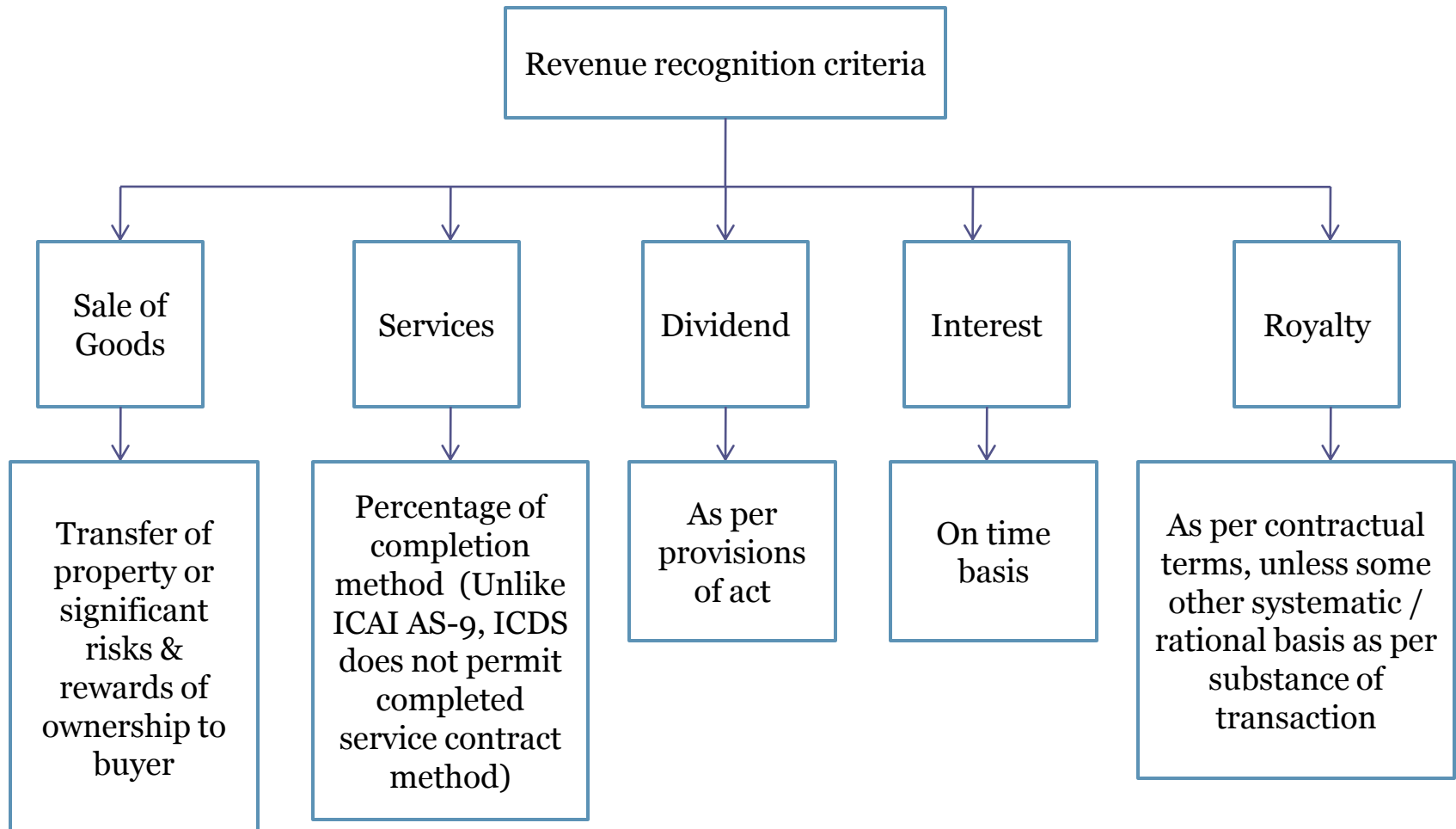
Particulars	AS-7	ICDS
Recognition of losses including probable / expected loss	To be recognised fully (and not, in proportion to the percentage of completion), irrespective of commencement, stage of completion and expected profits from other independent contracts	<ol style="list-style-type: none"> 1) Future / anticipated losses shall not be allowed unless losses are actually incurred and in proportion to the stage of completion 2) ICDS on accounting policies also does not permit recognition of foreseeable loss
Recognition of contract WIP	Contract cost which relate to future activity shall be recognized as an asset if recoverability is probable	To be recognised as an asset even when recovery not probable. If cost not realizable, the loss to be allowed under provisions of the Act
Reversal of revenue	Revenue already recognized can be reversed on account of uncertainty on realization of contract revenue	As per summary of ICDS provided by Committee, the amount needs to be written off and claim is to be made in accordance with provisions of Act regulating bad debt deduction

Construction contracts (corresponding to AS-7)

Non recognition of revenue: Early stage of contract

AS-7	ICDS
1) Revenue to be recognized only to the extent of recoverable costs. No profit to be recognized during early stages of contract 2) Early stage is not defined objectively	1) Once a contract crosses 25% completion, revenue and related costs in respect of contract needs recognition resulting in profit/loss 2) Early stage is defined objectively as not to extend beyond 25%
Impact	
1) Prevalent practice is to apply 25% threshold for determination of early stage 2) Stage of completion is determined w.r.t. proportion of cost or proportion of work performed	

Revenue Recognition (corresponding to AS-9)



Revenue Recognition (corresponding to AS-9)

Postponement of revenue recognition in case of significant uncertainty on measurability and collectability

AS-9	Current Tax Position	ICDS	Committee's Justification
Revenue recognition to be postponed if significant uncertainty exists on measurability and collectability of revenue from sale of goods, rendering of services and interest /royalties/ dividends.	No specific provision but, judicially well settled position that (i) income should be computed on commercial principles (ii) there is no accrual if there is no real income in sight.	Revenue to be recognised only if there is reasonable certainty of its ultimate collection	Condition of collectability inserted in revised draft of ICDS

Revenue Recognition (corresponding to AS-9)

Key Pointers –

- ❑ ICDS not to apply where revenue recognition dealt with by other ICDS.
(for e.g. construction contracts, leases, government grants)

- ❑ ICDS on revenue recognition silent on recognition of revenue of insurance companies from insurance contracts (dealt by specific provisions in the Act)

Revenue Recognition (corresponding to AS-9)

Disclosures for revenue recognition

AS-9	Current Tax Position	ICDS	Committee's Justification
<p>In addition to disclosure on accounting policy adopted for revenue recognition as per AS-1, AS-9 requires disclosure of circumstances in which revenue recognition has been postponed during pendency of resolution of significant uncertainties</p>	<p>No specific provisions</p>	<p>Requires additional disclosures on price escalation, export incentives, revenue from service contracts, methods used to determine stage of completion, etc.</p>	<p>Not given</p>

Government Grants (corresponding to AS-12)

Key Pointers –

- ❑ Government Grants covers – Subsidies, Cash incentives, Duty Drawbacks, Waiver, Concessions, reimbursements

- ❑ Grant not be recognized until there is a reasonable assurance on
 - Completion of conditions
 - Receipt of Grant

- ❑ Treatment of Grant to be disclosed
 - Depreciable Asset - Reduced from cost of asset
 - Non Depreciable Asset - Treated as revenue receipt income over period of obligation
 - Not directly related – Related Asset/ Total Asset
 - Non- monetary assets as grant – accounted at Acquisition Cost

Government Grants (corresponding to AS-12)

Deviation in provisions of ICAI and ICDS –

Point to be considered	AS-12	ICDS
Recognition of grant	1) On reasonable assurance of compliance of attached conditions and reasonable certainty of ultimate collection 2) Mere receipt is not sufficient	1) On reasonable assurance of compliance of attached conditions and reasonable certainty of ultimate collection 2) Recognition cannot be postponed beyond date of actual receipt
General (other than those covered by specific provisions)	Revenue grant to be credited as income or reduced from related expense	Same as ICAI AS-12 but no clarification that it is restricted only to revenue grants
Grant in the nature of promoters contribution	To be credited to capital reserve and to be treated as shareholders funds	Silent on this category (and, by implication, requiring recognition as income)

Government Grants (corresponding to AS-12)

Deviation in provisions of ICAI and ICDS –

Point to be considered	AS-12	ICDS
Relatable to depreciable fixed assets	1) To reduce from cost or 2) To be recognised as deferred revenue by systematic credit to P&L A/c	1) Consistent with Explanation 10 to S. 43(1), requires reduction from the cost base of fixed asset
Relatable to non depreciable fixed assets	1) To be credited as capital reserve, if no conditions attached to the grant 2) To be credited to P&L A/c over period of incurring cost of meeting conditions of grant	1) To be considered as income on an upfront basis, if there are no conditions attached to grant 2) To be treated as income over period over which cost of meeting conditions is incurred
Compensation for expenses / loss incurred or for giving immediate financial support	To be recognised in P&L A/c. in the year in which it is receivable	To be recognised as income in the year in which it is receivable
Disclosure requirement	Does not require disclosure of unrecognized grants	Requires disclosure of unrecognized grants

Leases (corresponding to AS-19)

Key Pointers –

- ❑ Lease includes a hire purchase agreement
- ❑ Does not cover sale and lease-back transactions since these are specifically covered by the Act
- ❑ Minimum lease payments include only the residual value guaranteed by the lessee and not the value guaranteed by any third party
- ❑ Operating lease requires straight lining of income and expense

Leases (corresponding to AS-19)

Key Pointers (Contd..) –

- ❑ The Committee has recognized that, pending statutory amendment, grant of depreciation to lessee in finance lease conflicts with law, since asset is owned by the lessor

- ❑ Subject thereto, ICDS leans in favour of economic ownership

- ❑ ICDS provides that lessor and lessee should execute joint confirmation on classification of lease
 - What will happen in absence of joint confirmation? No depreciation to lessor as well as lessee?
 - Will such joint confirmation be binding on Tax Authority or Courts?

Leases (corresponding to AS-19)

Key Pointers (Contd..) –

- ❑ ICDS deems lease to be a finance lease in any of following situations
 - Transfer of ownership of asset to lessee at the end of lease term (OR)
 - Lessee has option to purchase at lower than fair value such that exercise of option is a reasonable certainty at inception of lease (OR)
 - Lease term is for major part of economic life even if title is not transferred (OR)
 - Present value of minimum lease payments at inception amounts to at least substantially all of the fair value of asset (OR)
 - Leased asset is of a specialized nature such that only lessee can use it without major modifications

- ❑ Classification under ICAI governed by overall review of all five factors to determine substance of transaction

- ❑ Lease may get classified as finance lease under any deeming fiction irrespective of other relevant parameters like quantum of minimum lease payments, length of lease term, residual value, cancellability of lease, etc.

Leases (corresponding to AS-19)

Impact of deemed Finance lease classification –

- ❑ Mismatch of characterization in books and ICDS has inherent implication on MAT liability

- ❑ Governing rules for tax withholding obligation of lessee require perusal
 - Will this apply only if joint confirmation on characterization is executed?
 - Should amount paid be classified as interest, or, as lease rent?
 - Will compliance be w.r.t amount as expensed, or, w.r.t. gross payment?
 - Will this apply also to treaty scenario?
 - How best should DTAA be applied?
 - Does this impact entitlement of lessor to claim credit in home country if treaty excludes Industrial, Commercial or Scientific equipment rental from royalty definition (e.g. India-Netherlands)?
 - Does this impact ability of lessor to opt for presumptive taxation u/s.44BB?

Leases (corresponding to AS-19) - Finance Lease

Comparison between ICAI AS and ICDS – Lessor (mfg/dealer)

Particulars	AS-19	ICDS
De-recognition of leased asset	Yes	Yes
De-recognition value	<ol style="list-style-type: none"> 1) Lower of (i) fair value of asset as per sale policy ;(or) (ii) NPV of future rentals 2) Guarantee of residual value could be by lessee or by third party 3) Profit on sale should be adjusted to commercial interest rate if artificially low interest rate is quoted 	<ol style="list-style-type: none"> 1) Fair value of leased asset. 2) Does not provide for adoption of NPV of future rentals if lower than fair value 3) However, provides that if artificially high or low rate of interest is quoted, sale should be recognised at NPV of future rentals** computed at commercial rate of interest. 4) Guaranteed residual value does not include value guaranteed by third party
Initial direct cost being legal fees, commission brokerage, etc. for arranging lease	Recognised as expense on upfront basis	Mandatory to amortize over lease term

Leases (corresponding to AS-19) - Finance Lease

Comparison between ICAI AS and ICDS – Lessor (mfg/dealer)

Particulars	AS-19	ICDS
Recognition of interest income	1) Over lease term based on inherent IRR (i.e. constant periodic rate of return on outstanding balance) 2) Requires periodic review and basis of IRR can be changed. (e.g. change in unguaranteed residual value can impact IRR)	1) Same as ICAI AS 2) Periodic review not permitted

Leases (corresponding to AS-19) - Finance Lease

Comparison between ICAI AS and ICDS – Lessor (Other than mfg/dealer)

Particulars	AS-19	ICDS
De-recognition of leased asset	Yes	Yes
De-recognition value	<ol style="list-style-type: none"> 1) NPV of future rentals 2) Guarantee of residual value could be by lessee or by third party 	<ol style="list-style-type: none"> 1) Cost of acquisition if asset 'immediately' leased or fair value of asset in other cases 2) Ambiguity can arise on meaning of 'immediately'
Initial direct cost being legal fees, commission brokerage, etc. for arranging lease	Option to recognise on upfront basis or amortize over lease term	Mandatory to amortize over lease term
Recognition of interest income	<ol style="list-style-type: none"> 1) Over lease term based on inherent IRR (i.e. constant periodic rate of return on outstanding balance) 2) Requires periodic review and basis of IRR can be changed. (e.g. change in unguaranteed residual value can impact IRR) 	<ol style="list-style-type: none"> 1) Same as ICAI AS 2) Periodic review not permitted

Leases (corresponding to AS-19) - Finance Lease

Comparison between ICAI AS and ICDS – Lessee

Particulars	AS-19	ICDS
Recognition of leased asset	Yes	Yes
Basis of recognition	<ol style="list-style-type: none"> 1) Lower of (a) fair value of asset or (b) NPV of lease payments. 2) Lease payment will include residual value only if guaranteed by lessee. 	1) Same as ICAI AS
Initial direct cost being legal fees, commission brokerage, etc. for arranging lease	To be added as cost of asset.	Same as ICAI AS
Future interest payment	Calculated based on periodic rate of return on interest rate implicit in lease (if practicable to determine) or lessee's comparative borrowing rate for loan	Same as ICAI AS

Leases (corresponding to AS-19) - Operating Lease

Comparison between ICAI AS and ICDS – Lessor

Particulars	AS-19	ICDS
De-recognition of asset on lease	No	No
Basis of recognition of lease rentals	SLM basis or another systematic basis reflective of pattern of benefits	SLM basis only
Initial direct cost being legal fees commission, brokerage, etc. for arranging lease	Option to recognise on upfront basis or amortize over lease term	Mandatory to amortize over lease term

Leases (corresponding to AS-19) - Operating Lease

Comparison between ICAI AS and ICDS – Lessee

Particulars	AS-19	ICDS
Recognition of asset on lease	No	No
Basis of recognition of lease rental payments	SLM basis or another systematic basis reflective of pattern of benefits	SLM basis only

Leases (corresponding to AS-19)

Comparison between ICAI AS and ICDS – Sale and Lease Back

ICAI AS-19	Current Tax Position	ICDS	Committee's Justification
Specific treatment is provided in case of SLB transactions resulting in either finance lease or operating lease.	Specific provisions exist to deem tax written down value of seller to be the actual cost for buyer in SLB transaction	Provides that SLB transaction shall be dealt with in accordance with the provisions of the Act.	<ol style="list-style-type: none"> 1) Since Act contains specific provision, no provisions for SLB in ICDS. 2) Further, the Committee has recommended that necessary amendments to the Act should be made to address cases of SLB transaction resulting in operating lease

Conclusion - No change in current tax position.

Q & A

Thank You !