

TECHNICAL GUIDE ON INCOME COMPUTATION AND DISCLOSURE STANDARDS



The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)
New Delhi

Technical Guide on Income Computation and Disclosure Standards



Direct Taxes Committee
The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)
New Delhi

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Foreword

The Ministry of Finance vide Notification No. 87/2016 dated 29.09.2016 notified ten Income Computation and Disclosure Standards (ICDSs), operationalizing a new framework for computation of taxable income by all assessees (other than individual or a HUF who is not required to get his accounts of the previous year audited in accordance with the provisions of Section 44AB of the Income-tax Act, 1961) following the mercantile system of accounting for the purpose of computation of income under the heads “Profits and gains of business or profession” or “Income from other sources”. These standards became applicable w.e.f. April 1, 2016 and shall apply accordingly to the assessment year 2017-18 and subsequent assessment years. These ICDSs will be a new paradigm for computing taxable income of the assessee. Taxable profits would now be determined after making appropriate adjustments to the financial statements [whether prepared under existing AS or Ind AS] to bring them in conformity with ICDSs. With regard to the recent developments in the field of taxation and also considering the need of augmenting the knowledge and competencies of the members of our fraternity the Direct Taxes Committee of the Institute of Chartered Accountants of India has come out with this Technical Guide.

I would like to compliment CA. Sanjay K. Agarwal, Chairman Direct Taxes Committee, CA. N. C. Hegde, Vice-Chairman Direct Taxes Committee and all members of the Direct Taxes Committee particularly, CA. Tarun Jamnadas Ghia, who initiated this project and also provided his valuable unstinted inputs till the stage of finalization of the said publication.

I am confident that the Direct Taxes Committee would keep up the good work of enhancing the knowledge & expertise of the members in the field of taxation.

Date: 5th July, 2017
Place: New Delhi

CA. Nilesh S. Vikamsey
President, ICAI

Preface

Winds of change are moving fast for all businesses and professions in the world. Therefore, with the changing environment, knowledge, efficiency, performance and skills of our members need to be continuously enhanced and sharpened to enable them to succeed in this competitive business environment.

Continuous amendments have also been made in taxation laws which have rendered it necessary for members to update themselves with the legislative changes. One of the recent amendments brought in by the CBDT during the year 2015 was the notification of 10 Income Computation and Disclosure Standards (ICDSs) vide Notification no. 32/2015 dated 31st March, 2015. Although, the said notification dated 31st March, 2015 was rescinded on 29th September 2016 vide Notification no. 86/2016, yet on the same date, 10 revised ICDSs were notified vide Notification no. 87/2016. These ICDSs will have a significant impact on computation of taxable income. Therefore, the members need to be apprised about the change so that their knowledge and skills may be enhanced to the level where they can cater the needs of their clients efficiently.

The 10 ICDSs notified by the CBDT vide notification no. 87/2016 dated 29.09.2016 are to be followed by all assessees (other than individual or a HUF who is not required to get his accounts of the previous year audited in accordance with the provisions of section 44AB of the Income-tax Act, 1961) following mercantile system of accounting, for the purposes of computation of income chargeable to income tax under the head "Profits and gains of business or profession" or "Income from other sources". The said notification shall apply to the assessment year 2017-18 and subsequent assessment years. The said notification has raised various concerns regarding the applicability, interpretation, implementation and impact of ICDSs on the taxability of an assessee, especially since these are applicable to almost all persons including small businesses and proprietorship concerns.

The CBDT also sought suggestions of ICAI for smooth implementation of Income Computation and Disclosure standards (ICDSs) which were submitted to them from time to time.

Through this technical guide, an effort has been made to gear up the members of our fraternity for implementation of ICDSs and to guide the

stakeholders about the significant changes and impact which will take place in computation of taxable income. Reference to Indian Accounting Standards (Ind-AS) and Accounting Standards (AS), to the extent as considered necessary has been made at many places in this technical guide. Also, this publication will assist the members to remove the ambiguity and guide them in implementation of the ICDSs in a more effective manner.

I am extremely thankful to CA. Nilesh Shivji Vikamsey, President and CA. Naveen ND Gupta, Vice President of the Institute of Chartered Accountants of India who have been the guiding force behind bringing this Technical Guide.

I have no words to effectively appreciate the untiring efforts of CA. Tarun Jamnadas Ghia, convenor of the study group constituted in Mumbai and other members of the study group viz-a viz CA. Padam Chand Khincha, CA. Gautam Nayak, CA. Sanjeev Pandit and CA. Milind Kothari who have provided their dedicated and active support to CA. Tarun Jamnadas Ghia in bringing out this publication. I whole heartedly appreciate the contribution made by each of them towards the profession.

I also acknowledge the sincere efforts made by CA. Naveen N.D. Gupta, Vice President, ICAI and immediate Past Chairman, Direct Taxes Committee in ensuring that the work on the publication is not stopped by constituting study groups in various regions. I thank the contribution made by CA. Sanjay Vasudeva, under whose convenorship a group was constituted during 2016 in the Northern Region and the other members of his group namely CA. Sachin Vasudeva, CA. Assem Chawla, CA. Manoj Nagrath, CA. C.P. Tyagi and CA. Anuj Tiwari. I also thank the contribution made by CA. Manu Agarwal under whose convenorship a group was constituted during 2016 in the Central Region and the other members of his group namely CA. Sanjeev Verma, CA. Ashok Seth, CA. Rajiv Bansal, CA. Rajesh Bhalla, CA. Dhruv Seth, CA. Anshul Agarwal, CA. Uttam Kumar Sharma, CA. Pankaj Agarwal and CA. Rajiv Malhotra. I am also thankful for the contribution made by CA. Kemisha Soni under whose convenorship a group was constituted during 2016 in the Central Region and the other members of her group namely CA. Vijay Bansal, CA. Manish Dafria, CA. Prakash Chand Wohra Jain, CA. Manoj Gupta, CA. Pankaj Shah and CA. Chaitanya Maheshwari. I am also thankful for the contribution made by CA. K. Sripriya under whose convenorship a group was constituted during 2016 in the Southern Region and the other members of her group namely CA. N. Madhan, CA. Balaji Venkatasubramaniam and CA. Anirrudh Sankaran. I also acknowledge the

contribution made by CA. Dhinal Ashvinbhai Shah, Central Council Member and CA. Ravikanth Kamath in this publication.

Also, I wish to acknowledge the sincere contribution of all the members of the Direct Taxes Committee and am also appreciative of the valuable inputs provided by CA. Amarpal, CA. Amit Jain, CA. Sidharth Jain, CA. R. Bupathy, Past President, ICAI, CA. Sunil Bhansali, CA. Ravi Kumar Patwa, CA. Narender Rao B, CA. Vijay Gupta and CA. Ravi Tela, co-opted members & special invitees of the Direct Taxes Committee.

Last but not the least, I appreciate the dedicated efforts of CA. Nidhi Singh, Secretary, Direct Taxes Committee, CA. Shrutika Oberoi and CA. Ravi Gupta, Executive Officers and Mr. Priyanshu Malhotra, Section Officer, Direct Taxes Committee for their technical and administrative assistance in bringing out this edition of the Technical Guide.

Undoubtedly, this edition would guide and would be of great assistance to our members.

CA. Sanjay Kumar Agarwal
Chairman
Direct Taxes Committee

CA. N.C. Hegde
Vice-Chairman
Direct Taxes Committee

Date: 5th July, 2017
Place: New Delhi

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Terms, Abbreviations

In this Technical Guide, the following terms and abbreviations occur often in the text. A brief explanation of such terms and abbreviations is given below.

1.	Act	The Income-tax Act, 1961
2.	AMT	Alternate Minimum Tax as defined in section 115JF
3.	AO	Assessing Officer as defined in section 2(7A)
4.	AS	Accounting Standards prescribed under the Companies Act, 2013 for company assesseees and as notified under the Companies (Accounting Standards) Rules, 2006
5.	AS(IT)/IT-AS	Accounting Standards notified by the Central Government under section 145(2) vide Notification No. 9949 [F.No.132/7/95-TPL]/SO 69(E), dated 25-1-1996
6.	Assessee	As defined in section 2(7)
7.	AY	Assessment Year as defined in section 2(9)
8.	Board/CBDT	The Central Board of Direct Taxes constituted under the Central Boards of Revenue Act, 1963
9.	Circular	A circular or instructions issued by the Board under section 119(1)
10.	Committee	Committee constituted by the Government
11.	FY	Financial Year
12.	FASB	Financial Accounting Standards Board
13.	FIFO	First In First Out
14.	GAAP	Generally Accepted Accounting Principles/ Practices
15.	HUF	Hindu Undivided Family
16.	IAS	International Accounting Standard
17.	IASB	International Accounting Standards Board

18.	ICAI/Institute	The Institute of Chartered Accountants of India
19.	ICDS	Income Computation and Disclosure Standard(s) notified vide Notification No. 87/2016, dated 29.9.2016 by the Central Government under section 145(2)
20.	IFRS	International Financial Reporting Standards
21.	Ind AS	Indian Accounting Standards as notified under the Companies (Indian Accounting Standards) Rules, 2015
22.	IRDA	The Insurance Regulatory and Development Authority established under the Insurance Regulatory and Development Authority of India Act, 1999
23.	Limited Liability Partnership (LLP)	As defined in the Limited Liability Partnership Act, 2008
24.	MAT	Minimum Alternate Tax for the purposes of section 115JB
25.	MTM	Marked to Market
26.	NRV	Net Realisable value
27.	Person	As defined in section 2(31)
28.	POCM	Percentage of Completion Method
29.	Previous year	As defined in section 3
30.	Rule	Rule of the Income-tax Rules, 1962
31.	Rules	The Income-tax Rules, 1962
32.	Specified date	"Specified date", in relation to the accounts of the assessee of the previous year relevant to an assessment year, means the due date for furnishing the return of income under sub-section (1) of section 139
33.	SA	Standards on Auditing
34.	SCRA	Securities Contracts (Regulation) Act, 1956 (42 of 1956)

35.	Section	Section of the Income-tax Act, 1961
36.	STT	Securities Transactions Tax leviable under Chapter VII of the Finance (No.2) Act, 2004.
37.	TAS	Tax Accounting Standards
38.	Tax audit	The audit carried out under the provisions of section 44AB
39.	Tax auditor	Auditor appointed by an assessee to carry out tax audit.
40.	U/s	Under section
41.	FCTR	Foreign Currency Translation Reserve

Chapter 1

Income Computation & Disclosure Standards – Background

1. Introduction

1.1 The computation of income under various heads of income, and in particular, under the head “Profits and Gains of Business or Profession” has been the subject matter of innumerable disputes, ever since the introduction of income tax in India. Such computation was generally based on the accounts maintained by an assessee, and was dependant upon the method of accounting, subject to the adjustments for deductions, allowances and disallowances provided under the Income-tax Act, 1961 (“the Act”).

1.2 This position has changed significantly after introduction of Income Computation and Disclosure Standards (“ICDS”). In all 10 ICDS were notified on 31st March, 2015 vide notification number 32/2015 [F. NO. 134/48/2010-TPL]/SO 892(E) (“the ICDS Notification”) under section 145(2) of the Act, applicable from assessment year 2016-17. The ICDS Notification of March 2015 superceded notification number 9949 [F. No. 132/7/95-TPL], dated 25th January 1996 [which had notified two Accounting Standards under section 145(2) – (i) Disclosure of Accounting Policies and (ii) Disclosure of Prior Period and Extraordinary Items and Changes in Accounting Policies], However, vide Press Release dated 6th July 2016, it was announced that the applicability of the ICDS was being postponed to assessment year 2017-18.

1.3 On 29th September, 2016, vide Notification No 86/2016, the notification of March, 2015 containing existing ICDS was rescinded. On the same date, 10 revised ICDS were notified vide notification No. 87/2016.

1.4 Under the revised ICDS Notification, these Standards have come into force from 1st April, 2017, i.e. assessment year 2017-18, and would apply to all assesseees (other than an individual or an HUF not required to get his/its accounts of the previous year audited under section 44AB) following mercantile system of accounting, and are to be followed for the purposes of computation of income chargeable to income tax under the head “Profits and gains of business or profession” or “Income from other sources”.

2. Section 145

2.1 Section 145, which deals with method of accounting, provided till

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1995, that income under the heads “Profits and Gains of Business or Profession” or “Income from Other Sources” were to be computed in accordance with the method of accounting regularly employed by the assessee. Even if the accounts were correct and complete to the satisfaction of the Assessing Officer (“AO”), but the method employed was such that, in the opinion of the AO, income could not be properly deduced therefrom, the AO had the power to make the computation upon such basis and in such manner as he may determine. The AO also had the power to make a best judgement assessment if he was not satisfied about the correctness or completeness of the accounts of the assessee, or where no method of accounting had been regularly employed by the assessee.

2.2 Section 145 was substituted by the Finance Act, 1995, with effect from assessment year 1997-98. The amended sub-section (1) permits use of only cash or mercantile method of accounting for computation of income under the two heads of income. Effectively, the use of any hybrid method of accounting, which was possible till then, has been made impermissible. Sub-section (2) to this section, after this amendment, provided that the Central Government may notify in the Official Gazette from time to time Accounting Standards (“IT-AS”) to be followed by any class of assessee or in respect of any class of income. Only the power to make a best judgement assessment was retained, but that too where the AO was not satisfied about the correctness or completeness of the accounts of the assessee, or where the method of accounting as specified had not been regularly followed by the assessee, or the income had not been computed in accordance with the notified IT-AS.

2.3 The provisions of sub-section (1) have been made subject to the provisions of sub-section (2). Accordingly, the income chargeable under the head “Profits and gains of business or profession” or “Income from other sources” is to be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee, subject to the provisions of sub-section (2).

2.4 The CBDT Circular No 717 dated 14th August 1995, (1995) 215 ITR (St) 70, explains the amendment as under:

“Methods of Accounting and Accounting Standards for Computing Income:

44.1 Section 145(1) of the Income-tax Act prior to its amendment by the Finance Act, 1995, provided for computation of income from business or profession or income from other sources in accordance

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with the methods of accounting regularly employed by the assessee. Income is generally computed by following one of the 3 methods of accounting, namely, (i) cash or receipts basis, (ii) accrual or mercantile basis, and (iii) mixed or hybrid method which has elements of both the aforesaid methods. It was noticed that many assessees are following the hybrid method in a manner that does not reflect the correct income. The Finance Act, 1995, has amended section 145 of the Income Tax Act to provide that income chargeable under the head “Profits and Gains of Business or Profession” or “Income from Other Sources” shall be computed only in accordance with either cash or the mercantile system of accounting, regularly employed by an assessee. The first proviso to sub-section (1) of section 145 has been deleted.

44.2 The Finance Act, 1995 has also empowered the Central Government to prescribe by notification in the Official Gazette, the Accounting Standards, which an assessee will have to follow in computing his income under the head “Profits and Gains of Business or Profession” or “Income from Other Sources”. These Accounting Standards will be laid down in consultation with expert bodies like the Institute of Chartered Accountants.

44.3 The amendment will take effect from 1st April, 1997, and will, accordingly, apply in relation to assessment year 1997-98 and subsequent years.”

2.5 The Accounting Standards notified by ICAI (“AS”) in 1996 were not mandatory for the entities maintaining accounts, but were mandatory for auditors auditing general purpose financial statements. On 25th January, 1996, two IT-ASs were notified by the Central Board of Direct Taxes (“CBDT”), namely Disclosure of Accounting Policies, and Disclosure of Prior Period and Extraordinary Items and Changes in Accounting Policies.

3. TAS Committee

3.1 In July, 2002, the Government constituted a Committee for formulation of IT-AS for notification under section 145(2). In November, 2003, this Committee recommended notification of the AS issued by ICAI without any modification, since it would be impractical for a taxpayer to maintain two sets of books of account.

3.2 With the imminent introduction of International Financial Reporting Standards (IFRS) in India in the form of Ind-AS, in December 2010, the Government constituted a Committee to suggest TAS for notification under

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section 145(2) in view of the Government's intention to implement Ind AS (IFRS converged Standards) in India. The terms of the Committee were as under:

- i) to study the harmonisation of AS issued by the ICAI with the direct tax laws in India, and suggest AS which need to be adopted under section 145(2) of the Act along with the relevant modifications;
- ii) to suggest method for determination of tax base (book profit) for the purpose of Minimum Alternate Tax (MAT) in case of companies migrating to IFRS (Ind AS) in the initial year of adoption and thereafter; and
- iii) to suggest appropriate amendments to the Act in view of transition to IFRS (Ind AS) regime.

3.3 This Committee submitted an interim report in August, 2011. The recommendations of the Committee in this interim report were as under:

- 1. Separate AS should be notified under section 145(2), since the AS to be notified would have to be in harmony with the Act. The notified AS should provide specific rules, which would enable computation of income with certainty and clarity, and would also need elimination of alternatives, to the extent possible.
- 2. Since it would be burdensome for taxpayers to maintain two sets of books of account, the AS to be notified should apply only to computation of income, and books of account should not have to be maintained on the basis of such AS.
- 3. To distinguish such AS from other AS, these AS should be called Tax Accounting Standards ("TAS").
- 4. Since TAS will be based on mercantile system of accounting, they should not apply to taxpayers following cash system of accounting.
- 5. Since TAS are meant to be in harmony with the Act, in case of conflict, the provisions of the Act should prevail over TAS.
- 6. A reconciliation between the income as per the financial statements and the income computed as per TAS should be presented.

4. Implementation of TAS Committee Recommendations

4.1 Section 145 was amended by the Finance (No 2) Act, 2014 with effect from 1st April, 2015 (assessment year 2015-16), by substituting the term “Income Computation and Disclosure Standards” for the term “Tax Accounting Standards” in sub-section (2). Similarly, sub-section (3) was amended to substitute the words and figure “accounting standards as notified under sub-section (2), have not been regularly followed” with the words and figure “have not been regularly followed or income has not been computed in accordance with the standards notified under sub-section (2)”.

4.2 Finally, in March 2015, the CBDT vide notification No. 32/2015 [F. NO. 134/48/2010-TPL]/SO 892(E) dated 31st March, 2015 notified 10 ICDS as under:

ICDS I – 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 VIII – Securities

ICDS IX – Borrowing Costs

ICDS X – Provisions, Contingent Liabilities and Contingent Assets

4.3 The draft ICDS released by the CBDT for public comments but not notified finally were those relating to Leases and Intangible Assets.

4.4 All these ICDS were rescinded by the CBDT notification of September 2016, and revised ICDS on identical subjects were issued simultaneously.

Applicability & Issues

5. Period

5.1 The notified revised ICDS apply with effect from assessment year 2017-18, while section 145(2) was amended with effect from assessment year 2015-16 and also notification dated 31st March, 2015 superseded

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notification dated 25th January, 1996. Therefore, for assessment years 2015-16 and 2016-17, IT-AS would not apply, since the said section provides for ICDS to be followed. Further, since ICDS notified are applicable only from assessment year 2017-18, ICDS are also not required to be followed for those years. Effectively, therefore, for assessment years 2015-16 and 2016-17, neither IT-AS nor ICDS would apply. ICDS would apply only with effect from assessment year 2017-18.

6. Persons to Whom Applicable

6.1 ICDS would apply to every person following mercantile system of accounting, irrespective of the level of income. It would not apply to a person following cash system of accounting. It would not also apply to individuals and HUFs whose books of account for the year are not required to be audited under section 44AB. Audit under section 44AB is required only if a person is carrying on business or profession. Accordingly in case of an Individual or HUF, ICDS would apply only if such person is carrying on business or profession. ICDS would not apply if such individual or HUF has no income under the head “Profits and Gains of Business or Profession”, but has income under the head “Income from Other Sources”, though he/it follows mercantile system of accounting for income falling under such head of income.

7. Different Methods of Accounting for Different Sources of Income

7.1 An issue which arises is whether the income under all heads of income, or under a particular head of income, has necessarily to be computed under the same method of accounting, or whether an assessee can follow different methods of accounting for different sources of income under the same head of income, or different heads of income. It was well settled, prior to 1995, that the method of accounting is vis-a-vis each source of income, since computation of income is first to be done for each source of income, and then aggregated under each head of income. An assessee could choose to follow one method of accounting for some sources of income, and another method of accounting for other sources of income. In *J K Bankers v CIT 94 ITR 107 (All)*, the assessee was following mercantile system of accounting in respect of interest on loans in respect of its moneylending business, and offered lease rent earned by it to tax on a cash basis under the head “Income from Other Sources”. The Allahabad High Court held that an assessee could choose to follow a different method of

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accounting in respect of its moneylending business and in respect of lease rent. Similarly, in *CIT v Smt Vimla D Sonwane* [1994] 212 ITR 489 (Bombay), the Bombay High Court held that “*The assessee is indeed free even to follow different methods of accounting for income from different sources in an appropriate case*”.

7.2 The question which arises, after the amendment of section 145 in 1995, is whether this position still continues. One view is that the section, after amendment, now permits either the cash method of accounting or mercantile method of accounting for all sources under both the heads of income, “Profits and Gains of Business or Profession”, and “Income from Other Sources”.

7.3 CBDT Circular No 717 dated 14th August 1995, which has explained the amendment made in 1995, clarified that the amendment to section 145(1) was only to prevent the assessee from following the hybrid method in a manner that did not reflect the correct income. Therefore, the intention behind the amendment was not to change the method of computation of income from a source-wise basis to a head-wise basis. This is also clear from the fact that the provisions of section 70, which provide for set off of loss from one source against income from another source under the same head of income, were left unchanged.

7.4 Further, a reference may also be drawn to Para 22.1 of the Guidance Note on Tax Audit under section 44AB of the Income-tax Act, 1961 which is reproduced below:

“22.1 The Finance Act, 1995 amended section 145 with effect from assessment year 1997-98 to provide that the income chargeable under the head “Profits and gains of business or profession” or “Income from other sources” must be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee. It has also been provided that the Central Government may notify in the Official Gazette from time to time the Accounting Standards to be followed by any class of assessee or in respect of any class of income. The hybrid system of accounting viz. mixture of cash and mercantile hitherto allowed to be followed by the assessee was not permitted from assessment year 1997-98 & onwards. However, the assessee may adopt cash system of accounting for one business and mercantile system of accounting for other business. Once the choice of method of accounting is decided, the assessee must follow consistently the method of accounting employed. If he employs

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different methods for different businesses regularly and consistently, the profits would have to be computed in accordance with the respective methods, provided the result is a proper determination of profits. As regards the accrual system of accounting, the Institute has published a "Guidance Note on Accrual Basis of Accounting" which may be referred to."

7.5 It may also be noted that the language of section 145(1), prior to the 1995 amendment, viz., '*Income chargeable under the head "Profits and gains of business or profession" or "Income from other sources" shall be computed in accordance with the method of accounting regularly employed by the assessee*' is quite similar to the language of the section after the amendment, viz. '*Income chargeable under the head "Profits and gains of business or profession" or "Income from other sources" shall, subject to the provisions of sub-section (2), be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee*'.

7.6 Therefore, the method of computation of income still remains source-wise, even after the 1995 amendment, and the ratio of the court decisions rendered prior to the amendment, permitting following of different methods of accounting for different heads of income or different sources of income, would still apply. Following different methods of accounting for different sources of income does not distort the correct income for the particular source. What is now not permissible is following of a hybrid method for the same source of income. An assessee therefore continues to have the choice of following mercantile system of accounting for certain sources of income, and cash system of accounting for other sources of income. This view is supported by the decision of the Rajasthan High Court in the case of *CIT v VTC Leasing & Finance Ltd* [2010] 323 ITR 514 (Rajasthan), where the court held as under:

"So far as the first question is concerned, of course, it has come that the assessee was maintaining books of account by both manners viz., by receipt basis, and on mercantile basis as well, inasmuch as, with respect to accrual of lease income, mercantile system was adopted. However, for lease and hire income, the receipt basis was adopted. True it also is that, by virtue of section 145, as amended, the income chargeable under the head "Profits and gains of business or profession" or "Income from other sources" is, subject to provisions of sub-section (2), to be computed in accordance with either cash or mercantile system of accounting, regularly employed by the assessee.

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Earlier the provision was that such income was to be computed in accordance with the method of accounting regularly employed by the assessee. In the present case, the learned Tribunal has found that this is undisputed and settled principle of fiscal law, that only the real income is to be taxed, and that the same income cannot be taxed twice. It was also taken to be settled principle of law, that realities of life have to be considered while arriving at the taxable income. It was noticed that amendment in section 145 has been carried out with the sole aim of checking the escapement of income, which occurred due to heterogeneous system of accounting followed by the assessee.”

7.7 Where an assessee follows cash system of accounting for certain sources of income and mercantile system of accounting for others, ICDS would apply only to those sources of income, where mercantile system of accounting is followed and would not apply to those sources of income, where cash system of accounting is followed. For instance, an assessee may have a manufacturing business, and a separate commission agency business. He may be following mercantile system of accounting for his manufacturing business, and a cash system of accounting for his commission agency business. ICDS would then apply only to the manufacturing business, and not to the commission agency business. Similarly, if an assessee follows mercantile system of accounting for his business income, but cash system of accounting for his income from other sources, ICDS would apply only to the computation of his business income.

8. Change in Method of Accounting

8.1 A question which arises is whether a taxpayer can opt to change his method of accounting from mercantile to cash basis. An accounting method is different from an accounting policy. A change in accounting method itself does not amount to a change in accounting policy, but is a change in the method itself. Therefore, Paragraph 5 of ICDS I, which deals with change in accounting policy, and the requirement of reasonable cause for such change, would not apply. In the context of section 145, various courts have held that an assessee is entitled to change the method of accounting, if such change is *bona fide*. If such method of accounting is a permissible method and is regularly followed thereafter, the change of method cannot be rejected. Refer to the decisions of the Bombay High Court in the case of *Molmould Corporation v CIT* [1993] 202 ITR 789 (Bombay) and the Madras High Court in the case of *CIT v Carborandum Universal Limited* [1984] 149 ITR 759 (Madras).

8.2 Even if such a change is made from or after assessment year 2017-18, the year from which ICDS come into effect, an assessee is entitled to change his method of accounting, provided he follows such changed method regularly thereafter.

9. Applicability to Taxpayers Covered by Presumptive Tax Schemes

9.1 Taxpayers falling under the presumptive tax schemes are not subject to tax audit under section 44AB, since the limits for applicability of the schemes are the same as the threshold limits for tax audit. Therefore, an individual or HUF who/which falls under and opts to be covered by presumptive tax schemes would not be liable to such audit under section 44AB, and would fall under the exclusion under the notification. Hence ICDS would not apply. However, if a tax payer opts out of a presumptive taxation, he is required to get his/its accounts audited under section 44AB. In such a case the ICDS would apply.

9.2 A question arises as to what is the position of other categories of taxpayers whose income is taxed under presumptive tax schemes. The issue arises as there is no specific exclusion from ICDS for such presumptive tax cases.

9.3 Under the presumptive tax scheme, books of account are not relevant, since the income is computed on presumptive basis. It therefore, does not involve computation of income on the basis of the method of accounting, or on the basis of adjustments to the accounts. Further, provisions for determination of presumptive income, such as sections 44AD, 44ADA, 44AE, 44BB, 44BBA, 44BBB exclude the operation of sections 28 to 43C. Section 145 applies for computation of income under these sections. Therefore, though there is no specific exclusion under the notification for taxpayers falling under the presumptive tax schemes from the purview of ICDS, logically, ICDS would not apply to such taxpayers. However, where the presumptive tax scheme involves computation of tax on the basis of gross receipts, turnover, etc., the CBDT has taken a view that the ICDS on revenue recognition would apply to compute the gross receipts or turnover in such cases. In this respect, a reference may be made to the clarifications on ICDS contained in the Circular no. 10/2017, dated 23rd March, 2017 issued by the CBDT. Question no. 3 and answer thereto are reproduced below:

Question 3: *Does ICDS apply to non-corporate taxpayers who are not required to maintain books of account and/or those who are covered*

by presumptive scheme of taxation like sections 44AD, 44AE, 44ADA, 44B, 44BB, 44BBA, etc. of the Act?

Answer: *ICDS is applicable to specified persons having income chargeable under the head 'Profits and gains of business or profession' or 'Income from other sources'. Therefore, the relevant provisions of ICDS shall also apply to the persons computing income under the relevant presumptive taxation scheme. For example, for computing presumptive income of a partnership firm under section 44AD of the Act, the provisions of ICDS on Construction Contract or Revenue recognition shall apply for determining the receipts or turnover, as the case may be.*

10. Applicability to Insurance Companies

10.1 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 Insurance Regulatory and Development Authority (IRDA) Act and Regulations, subject to certain adjustments laid down under the First Schedule. The IRDA Regulations require the accounts to be prepared by application of Accounting Standards prescribed by ICAI. Section 44 read with the First Schedule would prevail over ICDS. Therefore, ICDS would not be applicable to the computation of business income of insurance companies.

10.2 This is confirmed by the clarifications on ICDS contained in Circular no. 10/2017, dated 23rd March, 2017 issued by the CBDT. Question no. 7 and answer thereto are reproduced below:

Question 7: *Whether the provisions of ICDS shall apply to Banks, Non-banking financial institutions, Insurance companies, Power sector, etc.?*

Answer: *The general provisions of ICDS shall apply to all persons unless there are sector specific provisions contained in the ICDS or the Act. For example, ICDS VIII contains specific provisions for banks and certain financial institutions and Schedule I of the Act contains specific provisions for Insurance business.*

11. Applicability to Non-Residents

11.1 The provisions of ICDS apply to all taxpayers, irrespective of residence of the person. However, where a non-resident taxpayer falls under a presumptive tax scheme, such as sections 44B, 44BB, 44BBA, 44BBB on the same logic as that of presumptive tax schemes applicable to residents, the provisions of ICDS should not apply. In cases where the income is not determined under a presumptive tax scheme, but a flat rate of tax applies, such as under section 115A, the provisions of ICDS would apply, as the rate of tax is applied after determination of the income. Further, where a non-resident claims the benefit of a double taxation avoidance agreement (DTAA), by virtue of section 90(2), the provisions of the DTAA would prevail over the provisions of the Income- tax Act, including section 145(2) and ICDS notified thereunder. In other cases of incomes of non-residents, which do not fall under presumptive tax schemes or DTAA, the provisions of ICDS would apply.

11.2 In this respect a reference may be made to the clarifications on ICDS contained in Circular no. 10/2017, dated 23rd March, 2017 issued by the CBDT. Question no. 14 and answer thereto are reproduced below:

Question 14: *Whether ICDS is applicable to revenues which are liable to tax on gross basis like interest, royalty and fees for technical services for non-residents u/s. 115A of the Act.*

Answer: *Yes, the provisions of ICDS shall also apply for computation of these incomes on gross basis for arriving at the amount chargeable to tax.*

12. Computation of Income for Ind AS Compliant Company

12.1 So far as computation under the regular provisions of the Act is concerned, provisions of ICDS will apply to companies preparing their financial statements following Ind AS as they apply to other assesseees. In this respect, a reference may be made to the clarifications on ICDS contained in Circular no. 10/2017, dated 23rd March, 2017 issued by the CBDT. Question no. 5 and answer thereto are reproduced below:

Question 5: *ICDS is framed on the basis of accounting standards notified by Ministry of Corporate Affairs (MCA) vide Notification No. GSR 739(E) dated 7 December 2006 under section 211(3C) of erstwhile Companies Act 1956. However, MCA has notified in*

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February 2015 a new set of standards called 'Indian Accounting Standards' (Ind-AS). How will ICDS apply to companies which adopted Ind-AS?

Answer: *ICDS shall apply for computation of taxable income under the head Profit and gains of business or profession” or “Income from other sources” under the Income Tax Act. This is irrespective of the accounting standards adopted by companies i.e. either Accounting Standards or Ind-AS.*

13. Maintenance of Books of Account

13.1 It has been stated in each ICDS that the ICDS would not apply for the purpose of maintenance of books of account. While this may be the position, a reconciliation may have to be prepared between the book profits and the ICDS income for the purposes of audit under section 44AB. Wherever there are substantial differences between AS being followed in the books of account and ICDS, which may also impact subsequent years' income, it may be advisable to prepare a parallel profit and loss account and balance sheet on the basis of ICDS, to ensure that ICDS and their consequences have been properly taken care of while making the adjustments.

13.2 Further, the TAS Committee had recommended that a tax auditor is required to certify that the computation of total income is made in accordance with the provisions of ICDS. Accordingly, Form 3CD containing the details annexed to the audit report has been amended vide notification No. 88 /2016, F.No.133/23/2015-TPL, dated 29.9.16 under the Income-tax (23rd Amendment) Rules, 2016. As per the amendment, details of adjustments required to be made to the profit or loss under ICDS are required to be provided. A tax payer may consider preparing a reconciliation with profit and loss account and balance sheet to ensure that all adjustments required on account of ICDS have been considered.

14. Applicability for purposes other than Computation under Two Heads of Income

14.1 It is important to note that the provisions of ICDS apply only to the computation of income under the heads of income “Profit & gains from business or profession” and “Income from Other Sources”. Therefore, for various purposes other than computation of income under these two heads of income, under the Act as well, the provisions of ICDS would not apply.

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14.2 For instance, ICDS would not apply for determining the time of credit of income for deduction of tax at source. This would continue to be governed by the date of credit in the books of account, or date of payment. The amount of expenditure on which tax has to be deducted will be determined by the entry in the books of account, and not by the computation or quantum of allowable expenditure under ICDS.

14.3 Therefore, for the purposes of sections 40(a)(i) and 40(a)(ia), it is possible that the deduction of expenditure may be claimed in one year, while the incidence of TDS may be in another year. It may be noted that both sections 40(a)(i) and 40(a)(ia) apply to sums payable where tax is deductible at source. If, at the point of claiming the expenditure, tax was not deductible at source as no entry was passed in the books of account, such amounts will not be disallowable under these sections. On the other hand, if tax was deducted at source in a year prior to the year of allowability of expenditure, such expenditure would not be covered by the disallowance under these sections as tax has been deducted at source, although in an earlier year.

14.4 However, in some cases, the ICDSs may indirectly apply to the applicability aspect of the TDS. This is for the reason that the CBDT in answer to FAQ No. 3 (Circular no. 10/2017, dated 23rd March 2017) has taken a view that the ICDS should be applied for determining gross receipts/turnover for the purposes of section 44AD and applying the same rationale, for determining gross receipts/turnover for the purposes of section 44AB also, the ICDS would apply. In case of individuals and HUFs, TDS provisions are attracted only if the gross receipts/turnover in immediately preceding financial year exceed the monetary limits specified in section 44AB. Consequently, the provisions of ICDS would indirectly have an impact on whether or not TDS provisions are attracted to an individual/HUF, even though ICDS are meant only for computation of income and not for any other purpose.

14.5 ICDS would also not apply for the purposes of computing exemption under sections 11 to 13, where, as clarified by the CBDT vide its Circular no. 5-P (LXX-6) dated 19th June, 1968, the computation of exemption is based on the commercial concept of income. However, where such income loses exemption, the computation would be under the various heads of income, and to the extent of such income falling under the heads "Profits & gains from business or profession" and "Income from Other Sources", the provisions of ICDS would apply if the books of account are maintained on mercantile system.

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14.6 However, as per section 11(4A), if the trust or institution carries on business and the business is incidental to the objects of the trust or institution and separate books are maintained in respect of such business, the exemption provisions under sections 11 to 13 would apply. In such a case, the income from business has to be computed on commercial basis and provisions of ICDSs would apply. In such a case the trust would be required to compute its business income in accordance with ICDSs, even though it would be eligible for exemption under sections 11 to 13.

14.7 In case the trust has as its object, advancement of any other object of general public utility, and it carries on any activity in the nature of trade, commerce or business, then, it would not be denied charitable status only if the aggregate receipts from such activity does not exceed 20% of the total receipts of the trust or institution. Whether ICDSs need to be applied for the purpose of computing aggregate receipts from business activity is an issue requiring consideration.

14.8 The provisions of sections 68, 69, 69A and 69B fall under “Chapter VI – Aggregation of income and set off and carry forward of loss”. These sections refer to the fact of recording in the books of account, for determination of whether a cash credit, investment, etc is to be regarded as undisclosed or not. ICDS will not affect these provisions, where one will necessarily have to consider the books of account.

15. Ratio of Judicial Rulings vis-à-vis ICDS Provisions

15.1 Each ICDS states that in the case of conflict between the provisions of the Income-tax Act and the ICDS, the provisions of the Act would prevail to that extent. Such a provision is ostensibly to harmonise the provisions of the ICDS with the provisions of the Act. While such a provision is helpful, controversies may arise where there is no express provision in the Act, but where courts have interpreted the provisions of the Act in a manner which is inconsistent with the provisions of the ICDS. ICDS at many places differ with the decisions of the Supreme Court and High Courts. Hence, one will have to apply professional judgment for the purpose of applying the ICDS for computation of income.

15.2 There have been three specific amendments made to the Act by the Finance Act, 2015, to ensure that the provisions of the Act are in line with the provisions of ICDS. These three provisions are as under:

1. The definition of “income” under section 2(24) has been amended by insertion of clause (xviii) to include assistance in the form of a subsidy

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or grant or cash incentive or duty drawback or favour or concession or reimbursement (by whatever name called) by the Central Government or a State Government or any authority or body or agency in cash or kind to the assessee, other than the subsidy or grant or reimbursement, which is taken into account for determination of the actual cost of the asset in accordance with the provisions of explanation 10 to clause (1) of section 43. This is to align it with the provisions of ICDS VII on Government Grants.

2. Proviso to section 36(1)(iii) has been modified to delete the words “for extension of existing business or profession”, after the words “in respect of capital borrowed for acquisition of an asset”, to bring the section in line with ICDS IX on Borrowing Costs, whereby interest in respect of borrowings for all assets acquired, from the date of borrowing till the date when the asset was first put to use is to be capitalised.
3. A second proviso has been inserted in section 36(1)(vii), to provide that where a debt has been taken into account in computing the income of an assessee for any year on the basis of ICDS without recording such debt in the books of account, then such debt would be deemed to have been written off in the year in which it becomes irrecoverable. This is to facilitate the claim for deduction of bad debts, where the debt has been recognised as income in accordance with ICDS, but has not been recognised in the books of account in accordance with AS.

15.3 In these cases, the provisions of the ICDS in this regard read along with the amended Act, would override the earlier judicial rulings.

15.4 There could be earlier judicial rulings which are based on the relevant generally accepted accounting practices (GAAP) or the provisions of the relevant Standards, and where the court therefore interpreted the law on the basis of such GAAP or AS. These judicial rulings would now have to be considered as being subject to the requirements of ICDS, as the method of accounting is now subject to modification by the provisions of ICDS for the purposes of computation of income under the two heads of income, and is not exclusively based on GAAP alone.

15.5 The third and the last category of judicial rulings would be those where the courts have laid down certain basic principles while interpreting the tax law, in particular, the relevant provisions of the tax law. In such cases, such judicial rulings would continue to apply and would override the provisions of

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ICDS, since such rulings have interpreted the provisions of the Act, which would prevail over ICDS.

15.6 For instance, various judicial rulings have propounded the real income theory. The Delhi High Court, in the case of *CIT v Vasisth Chay Vyapar Ltd. [2011] 330 ITR 440 (Delhi)* has held, based on the real income theory, that interest accrued on non-performing assets of non-banking financial companies cannot be taxed until such time as such interest is actually received. Would the contrary provisions of ICDS IV on revenue recognition change the position? It would appear that the ruling will still continue to hold good even after the introduction of ICDS.

15.7 However, in this respect, a reference may be made to the clarifications on ICDS contained in Circular no. 10/2017, dated 23rd March 2017 issued by the CBDT. Question no. 2 and answer thereto are reproduced below:

Question 2: *Certain ICDS provisions are inconsistent with judicial precedents. Whether these judicial precedents would prevail over ICDS?*

The ICDS have been notified after due deliberation and after examining judicial views for bringing certainty on the issues covered by it. Certain judicial pronouncements were pronounced in the absence of authoritative guidance on these issues under the Act for computing Income under the head “Profits and gains of business or profession” or Income from other sources. Since certainty is now provided by notifying ICDS under section 145(2), the provisions of ICDS shall be applicable to the transactional issues dealt therein in relation to assessment year 2017-18 and subsequent assessment years.

15.8 This clarification does not distinguish between decisions which interpret the provisions of the Act, and decisions which are based on Accounting Standards or commercial principles.

16. ICDS vis-à-vis Rules

16.1 In case any of the provisions of ICDS is contrary to the Income-tax Rules (“the Rules”), which one would prevail? The provisions of ICDS are silent in this regard. Both are notified by the Central Government. Further, ICDS VI on Effects of Changes in Foreign Exchange Rates specifically provides in Para 6 that initial recognition, conversion and recognition of exchange difference shall be subject to provisions of section 43A of the Act

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or rule 115, as the case may be. This indicates that the provisions of the Rules are intended to prevail over provisions of ICDS.

16.2 This is confirmed by the clarifications on ICDS contained in Circular no. 10/2017, dated 23rd March, 2017 issued by the CBDT. Question no. 4 and answer thereto are reproduced below:

Question 4: *If there is conflict between ICDS and other specific provisions of the Income-tax rules, 1962 ('the Rules') governing taxation of income like rules 9A, 9B etc. of the Rules, which provisions shall prevail?*

Answer: *ICDS provides general principles for computation of income. In case of conflict, if any, between the provisions of Rules and ICDS, the provisions of Rules, which deal with specific circumstances, shall prevail.*

17. ICDS vis-à-vis Circulars & Press Releases

17.1 In case any of the ICDS provisions is contrary to a circular or press release issued by the CBDT, which would prevail over the other? A circular or a press release merely clarifies the CBDT's view relating to a particular provision of law. Such a circular therefore, merely interprets the law as it is viewed by the CBDT. Under section 119, the CBDT has the powers to relax any requirements contained in Chapter IV of the Income-tax Act (dealing with computation of income). Also, it is well established that CBDT circulars are binding only on tax officers, and not on assesseees. In such an event, where the CBDT has issued a beneficial circular, such a circular would be binding on tax officers under section 119. However, the circular issued prior to the ICDS coming into force may no longer apply if the ICDS contain a contrary provision, as the subsequent ICDS would render the circular invalid for the period after the ICDS come into force. Similarly, in case of press releases issued prior to subsequent ICDS provisions, where the ICDS provisions provide for a contrary treatment, the subsequent ICDS provisions would prevail.

18. Applicability for MAT & AMT

18.1 Since ICDS is not applicable for the purpose of maintenance of books of account, it is clear that the provisions of ICDS would not apply to the computation of "book profits" for the purposes of Minimum Alternate Tax under section 115JB.

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18.2 So far as Alternate Minimum Tax under section 115JC is concerned, since the starting point is the adjusted total income, which is derived from the total income, the adjusted total income would be based on the total income computed after giving effect to ICDS. There would therefore be no impact of ICDS on the computation of AMT.

18.3 This is confirmed by the clarifications on ICDS contained in Circular no. 10/2017, dated 23rd March, 2017 issued by the CBDT. Question no. 6 and answer thereto are reproduced below:

Question 6: *Whether ICDS shall apply to computation of Minimum Alternate Tax (MAT) under section 115JB of the Act or Alternate Minimum Tax (AMT) under section 115JC of the Act?*

Answer: *MAT under section 115JB of the Act is computed on 'book profit' that is net profit as shown in the Profit and Loss Account prepared under the Companies Act subject to certain specified adjustments. Since, the provisions of ICDS are applicable for computation of income under the regular provisions of the Act, the provisions of ICDS shall not apply for computation of MAT.*

18.4 AMT under section 115JC of the Act is computed on adjusted total income which is derived by making specified adjustments to total income computed as per the regular provisions of the Act. Hence, the provisions of ICDS shall apply for computation of AMT.

18.5 Bad debts out of income recognised on the basis of ICDS but not yet recognised in books of account

Due to provisions of some ICDS, it is likely that revenue may have to be recognised for computing the total income even though it may not have been recognised in the books of account. Section 36(1)(vii), before its amendment by the Finance Act, 2016, provided for allowance for bad debts on writing off of such debts as irrecoverable in the accounts of the assessee. This would have led to a situation where irrecoverable revenue would not have been allowed as deduction since it was not written off in the accounts of the assessee. To address this situation, Finance Act, 2016 has inserted second proviso to section 36(1)(vii) which reads as under:

“Provided further that where the amount of such debt or part thereof has been taken into account in computing the income of the assessee of the previous year in which the amount of such debt or part thereof becomes irrecoverable or of an earlier previous year on the basis of income computation and disclosure standards notified under sub-

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section (2) of section without recording the same in the accounts, then, such debt or part thereof shall be allowed in the previous year in which such debt or part thereof becomes irrecoverable and it shall be deemed that such debt or part thereof has been written off as irrecoverable in the accounts for the purposes of this clause.”

18.6 This Proviso will be applicable wherever revenue is recognised for the purposes of computation before being recognised in the books of account, but it becomes bad or irrecoverable. In such a case, the amount of such irrecoverable revenue will be allowed as deduction as bad debt.

19. Interpretation of ICDS

19.1 Each ICDS states that words and expressions used but not defined in the ICDS but defined in the Act, would have the meaning assigned to them under the Act. Under the Act, section 2 contains various definitions, which apply for all provisions of the Act. These definitions would apply for the purposes of ICDS. However, certain terms are defined in other sections, only for the limited purpose of that section. Would those definitions apply for the purposes of ICDS? It needs to be kept in mind that such definitions are for a limited purpose, intended to be achieved by that relevant section, and that is why their applicability is restricted to that particular section, and do not extend to the entire Act. The applicability of such definitions would therefore depend upon whether the use of the term in the relevant section is in the same context as the term is used in the ICDS. If so, the definition would apply; if it has been used in a different context in ICDS, the definition under the particular section would not apply.

19.2 Where a term has not been defined under ICDS, nor under the Act, but has different interpretations given to it by the courts in tax cases, and in ICAI Accounting Standards, which interpretation would prevail while interpreting ICDS? Normally, since ICDS have been based on AS, the AS interpretation would apply, where such term/phrase has also been used in the ICDS. In other cases, the tax law interpretation given to it by the courts would prevail.

20. Disclosures required by ICDS

20.1 Various ICDS provide for disclosure of different items. Given the fact that ICDS are not to be followed in the books of account, the disclosures are not required to be made in the final accounts. Where should such disclosures be made? The TAS Committee had recommended as under in its August 2012 report:

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“For ensuring compliance with the provisions of TAS by the taxpayer, the Committee recommends appropriate modification in the return of income. For tax audit cases, the Form 3CD should also be modified so that a tax auditor is required to certify that the computation of taxable income is made in accordance with the provisions of TAS.”

20.2 Further, in this respect a reference may be made to the clarifications on ICDS contained in Circular no. 10/2017, dated 23rd March, 2017 issued by the CBDT. Question no. 25 and answer thereto are reproduced below:

Question 25: *ICDS-I requires disclosure of significant accounting policies and other ICDS requires specific disclosures. Where is the taxpayer required to make such disclosures specified in ICDS?*

Answer: *Net effect on the income due to application of ICDS is to be disclosed in the Return of income. The disclosures required under ICDS shall be made in the tax audit report in Form 3CD. However, there shall not be any separate disclosure requirements for persons who are not liable to tax audit.*

20.3 The returns of income have now been amended, by insertion of a new schedule ICDS in relevant Return Forms 3, 5 and 6. The schedule is as under:

Schedule ICDS		Effect of Income Computation Disclosure Standards on profit
Sl.No.	ICDS	Amount (+) or (-)
(i)	(ii)	(iii)
I	Accounting Policies	
II	Valuation of Inventories	
III	Construction Contracts	
IV	Revenue Recognition	
V	Tangible Fixed Assets	
VI	Changes in Foreign Exchange Rates	
VII	Government Grants	
VIII	Securities	
IX	Borrowing Costs	
X	Provisions, Contingent Liabilities and Contingent Assets	
11.	Total Net effect (I+II+III+IV+V+VI+VII+VIII+IX+X)	

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20.4 It may be noted that these forms apply only to individuals/HUFs carrying on business or profession through proprietary concerns, to entities other than individuals and companies, and to companies respectively. Return Forms 2 and 4, applicable to individuals and HUFs not having business income, and having presumptive income, respectively, do not contain this Schedule, and no disclosure is required by such individuals/HUFs. In any case, ICDS do not apply to such taxpayers.

20.5 Further, from Schedule ICDS, it is clear that only the amount of net effect under each ICDS is required to be disclosed. There is no place in the returns of income for the various disclosures required to be made under each ICDS.

20.6 The tax audit report in Form 3CD has now been amended, to provide for disclosures required by ICDS in clause 13. The new sub-clauses are as under:

“(d) Whether any adjustment is required to be made to the profits or loss for complying with the provisions of income computation and disclosure standards notified under section 145(2)?

(e) If answer to (d) above is in the affirmative, give details of such adjustments:

		<i>Increase in Profit (Rs.)</i>	<i>Decrease in Profit (Rs.)</i>	<i>Net Effect (Rs.)</i>
<i>ICDS I</i>	<i>Accounting Policies</i>			
<i>ICDS II</i>	<i>Valuation of Inventories</i>			
<i>ICDS III</i>	<i>Construction Contracts</i>			
<i>ICDS IV</i>	<i>Revenue Recognition</i>			
<i>ICDS V</i>	<i>Tangible Fixed Assets</i>			
<i>ICDS VI</i>	<i>Changes in Foreign Exchange Rates</i>			
<i>ICDS VII</i>	<i>Government Grants</i>			
<i>ICDS VIII</i>	<i>Securities</i>			
<i>ICDS IX</i>	<i>Borrowing Costs</i>			
<i>ICDS X</i>	<i>Provisions, Contingent Liabilities and Contingent Assets</i>			
<i>Total</i>				

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(f) Disclosure as per ICDS

<i>(i)</i>	<i>ICDS I – Accounting Policies</i>
<i>(ii)</i>	<i>ICDS II – Inventories</i>
<i>(iii)</i>	<i>ICDS III – Construction Contracts</i>
<i>(iv)</i>	<i>ICDS IV – Revenue Recognition</i>
<i>(v)</i>	<i>ICDS V – Tangible Fixed Assets</i>
<i>(vi)</i>	<i>ICDS VII- Government Grants</i>
<i>(vii)</i>	<i>ICDS IX – Borrowing Costs</i>
<i>(viii)</i>	<i>ICDS X –Provisions, Contingent Liabilities and Contingent Assets”</i>

20.7 The disclosures as required by the various ICDS will have to be made under this sub clause.

20.8 A draft ICDS on Real Estate Transactions has been published for public comment on 11th May, 2017. It is also likely that more ICDS will also be issued in the future, as mentioned earlier. One will therefore have to keep track of the ICDS that are being issued from time to time.

Chapter 2

ICDS I : Accounting Policies

1. Preamble

“This Income Computation and Disclosure Standard is applicable for computation of income chargeable under the head “Profits and gains of business or profession” or “Income from other sources” and not for the purpose of maintenance of books of accounts.

In the case of conflict between the provisions of the Income-tax Act, 1961 (‘the Act’) and this Income Computation and Disclosure Standard, the provisions of the Act shall prevail to that extent.”

2. Introduction

2.1. This ICDS deals with application of significant accounting assumptions and policies in computation of income for the purposes of the Act. Financial statements of an assessee reflect his state of financial affairs. They form the base for computation of taxable income under the Act. The income for a particular year is significantly affected by the accounting assumptions and policies followed in the preparation of the financial statements. To ensure uniformity, it is imperative to outline the accounting policies and assumptions that need to be applied while computing income for the year.

3. Scope

“1. This Income Computation and Disclosure Standard deals with significant accounting policies.”

3.1. The scope of the ICDS is limited to significant accounting policies applied while computing income under the head “Profits and gains of business or profession” or “Income from other sources”. Like other ICDS, this ICDS also does not deal with maintenance of books of account. This ICDS is concerned with application of accounting policies and assumptions while computing income for the purposes of income-tax.

3.2. Para 1 states that the ICDS deals with ‘significant’ accounting policies. The term ‘significant’ has not been defined in the ICDS. One may rely on the guidance provided by Expert Advisory Committee in the context of accounting policy in respect of export sales [Volume XVIII] wherein what constitutes ‘significant accounting policy’ was discussed. The Committee

relied on the meaning of the term “significant” in Kohler’s Dictionary for Accountants (6th edition) which is as under:

- *Of sufficient magnitude, as measured by a departure from some norm,*
- *Of sufficient importance to warrant disclosure or the treatment accorded to larger or more important items,*
- *Likely to influence judgements or decisions,*
- *Other events or conditions peculiar to a given establishment.*

3.3. One can thus infer that significant accounting policies are those policies whose impact on financial statements is of significant magnitude. They often influence the judgement of the readers and users of financial statements.

3.4. Since ICDS is not applicable for the purposes of maintenance of books of account, a question arises as to what is the purpose and ambit of ICDS I on Accounting Policies. One view is that ICDS I should be regarded merely as a disclosure Standard and not a computation Standard. The other view is that it is a Standard relevant for computation of income as certain provisions in ICDS I relate to computation. The ICDS is not a mere disclosure Standard because it requires income computation to factor in the elements of this Standard viz accrual, going concern and consistency.

3.5. For example, the prescription that the treatment and presentation of transactions and events shall be governed by their substance and not merely by their legal form, and that mark-to-market loss or an expected loss shall not be recognised unless the recognition of such loss is in accordance with any other ICDS - relate to computation of income, and not disclosure.

3.6. The term “accounting policies” in ICDS I should be read as “computation policies”. This would make the provisions of ICDS I relating to substance over form and non-recognition of mark-to-market losses, applicable only for computation of income, and not for accounting purposes. Such an interpretation would also mean that the “accounting policies” required to be disclosed by this ICDS would mean the policies followed in the computation of income, and not those followed for the purposes of maintenance of books of account.

3.7. In this respect, a reference may be made to the clarifications on ICDS contained in Circular no. 10/2017, dated 23rd March 2017 issued by the CBDT. Question no. 1 and answer thereto are reproduced below:

Question 1: *Preamble of ICDS-I states that this ICDS is applicable for computation of income chargeable under the head “Profits and gains*

of business or profession” or “Income from other sources” and not for the purposes of maintenance of books of accounts. However, Para 1 of ICDS I states that it deals with significant accounting policies. Accounting policies are applied for maintenance of books of accounts and preparing financial statements. What is the interplay between ICDS-I and maintenance of books of accounts?

Answer: As stated in the Preamble, ICDS is not meant for maintenance of books of accounts or preparing financial statements. Persons are required to maintain books of accounts and prepare financial statements as per accounting policies applicable to them. For example, companies are required to maintain books of account and prepare financial statements as per requirements of Companies Act 2013. The accounting policies mentioned in ICDS-I being fundamental in nature shall be applicable for computing income under the heads “Profits and gains of business or profession” or “Income from other sources”.

4. Fundamental Accounting Assumptions

“2. The following are fundamental accounting assumptions, namely:—

(a) Going Concern

“Going concern” refers to the assumption that the person has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the business, profession or vocation and intends to continue his business, profession or vocation for the foreseeable future.

(b) Consistency

“Consistency” refers to the assumption that accounting policies are consistent from one period to another;

(c) Accrual

“Accrual” refers to the assumption that revenues and costs are accrued, that is, recognised as they are earned or incurred and not as money is received or paid and recorded in the previous year to which they relate.”

4.1. Certain fundamental accounting assumptions form the basis of the preparation and presentation of financial statements. They are usually not specifically stated, because their acceptance and use are assumed. They are stated only when they are not followed. The ICDS defines three such assumptions for the purposes of computation of income.

Going concern

4.2. “Going concern” refers to an assumption that the person has neither the intention nor the necessity of liquidation or curtailing, materially the scale of the business, profession or vocation and intends to continue his business, profession or vocation for the foreseeable future.

4.3. This assumption is concerned with the ‘ability to continue’ business, profession or vocation for the foreseeable future. Continuity of business may be impacted by the ‘intent’ (of the assessee) or ‘necessity’ to liquidate or curtail the spread or scale of business. When computing the total income, an evaluation of the assessee’s ability to continue as a going concern has to be made.

4.4. As financial statements are a periodic reflection of the entity’s status, computation of total income is also a periodic evaluation of the assessee’s income. The common time horizon considered for this is 12 months. A going concern during such time horizon continues to operate and earn profits. Assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.

4.5. Material uncertainties may cast doubt upon the ability of an assessee to continue as a going concern. An assessee is assumed to be a going concern in the absence of information to the contrary. Some of the instances of the said ‘contrary information’ are:

- a) Continuing trend of losses reflecting negative operating results or working capital deficiencies;
- b) Adverse key financial ratios;
- c) Defaults in debt repayments;
- d) Long-term commitments impairing the regular operations of the concern;
- e) Loss of a major market, key customer(s), franchise, license, or principal supplier(s);
- f) Legal proceedings against the company;
- g) Internal strife leading to stoppage of work or causing other labour concerns;
- h) Non-compliance with statutory requirements; etc.

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4.6. The ICDS however does not provide specific guidance as to the manner of computation in the event that the assumption of going concern is not met. The Framework for the Preparation and Presentation of Financial Statements issued by the ICAI (at para 23) states that if the assumption of going concern is impinged, then the financial statements have to be prepared on a 'different basis'. Reference may be made to "Implementation Guide to Standard on Auditing (SA) 570, Going Concern", issued by ICAI. In paragraph 1.2 thereof, it is stated that

"Certain fundamental accounting assumptions underlie the preparation and presentation of financial statements and going concern is one of those fundamental accounting assumptions. They are usually not specifically stated because their use is accepted and assumed. A disclosure is necessary if they are not followed. However, if the entity's management is required, or elects, to prepare financial statements when the use of the going concern assumption is not appropriate in the circumstances, the financial statements are prepared on an alternative basis (e.g., liquidation basis)."

4.7. One may also refer to FASB Accounting Standard Update No. 2014-15 of August 2014, which deals with 'Disclosure of uncertainties about an entity's ability to continue as going concern'. It clarifies that continuation of a reporting entity is presumed as the basis for preparing financial statements unless and until the entity's liquidation becomes imminent. If and when it becomes imminent, financial statements should be prepared on liquidation basis of accounting. A statement of realization is prepared as a part of the financial statements. The assets and liabilities will have to be valued at an amount which represents the values which would emerge if the entity were to close down. Assets are to be valued at realizable values and liabilities at settlement amounts. In the absence of specific mandate in this ICDS, one may rely upon this treatment prescribed by the Framework of Financial Statements issued by ICAI.

Consistency

4.8. The second assumption listed in the ICDS is "consistency". It is assumed that computation policies are consistent from one period to another. The import of this assumption is that the same policies will be used from one period to another, unless they or some of them are changed for reasonable cause as mentioned in paragraph 5 of this ICDS.

4.9. This assumption is critical to ensure that the total income is not impacted by changes in policies without reasonable cause.

4.10. Not every change would impinge the consistency principle. To elucidate, change in estimate (like provision for warranty, provision for bad debts, salvage value of assets etc) do not vitiate the consistency principle.

Accrual

4.11. The third assumption is that revenues and costs accrue as they are earned or incurred and recorded in the previous year to which they relate. Actual receipt or payment is not a relevant criterion. The ICDS applies only to “accrual” basis of accounting. Incomes are said to accrue when they are ‘earned’, and ‘recorded’ in the previous year to which they relate. The cumulation of ‘earning’ and ‘recording’ of income connote crystallization of the right to receive in favour of the assessee.

4.12. This definition concurs with the accounting meaning of ‘accrual’. The Guidance Note issued by ICAI on ‘Terms Used in Financial Statements’ defines accrual and accrual basis of accounting as under:

“1.05 Accrual

Recognition of revenues and costs as they are earned or incurred (and not as money is received or paid). It includes recognition of transactions relating to assets and liabilities as they occur irrespective of the actual receipts or payments.

1.06 Accrual Basis of Accounting

The method of recording transactions by which revenues, costs, assets and liabilities are reflected in the accounts in the period in which they accrue. The ‘accrual basis of accounting’ includes considerations relating to deferrals, allocations, depreciation and amortization. This basis is also referred to as mercantile basis of accounting.”

4.13. The accounting definition of accrual and the definition provided by the ICDS are similar. The Guidance note on the “Terms Used in Financial Statements” explains that accrual basis of accounting may involve deferral, allocation or non-cash deductions (such as depreciation/ amortization). Thus, under accrual system, it is acknowledged that income or expenses may be deferred or allocated.

4.14. The definition of ‘accrual’ in this ICDS operates within the aegis of section 145(2). Under the provisions of the Act, the concept of recognizing income on accrual basis has its genesis in section 5. Section 5 outlines the scope of total income. It encompasses income within its fold on the basis of

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accrual, arisal or receipt, subject to the residential status of the assessee and location of income. Thus, accrual, arisal and receipt form the basis for taxing incomes. This canon of taxation is sacrosanct and has to be strictly adhered to. It is generally section 5 of the Act on the basis of which a particular sum or its equivalent is included in the total income. In doing so, one of the tests is 'accrual' of income. The definition in this ICDS does not in any manner alter the scope and ambit of 'accrual' as envisaged under section 5 of the Act.

4.15. Judicially, the concept of 'accrual' has been explained at various forums. Some of them are as under:

- (a) The Apex Court in the case of *E.D. Sassoon & Co. Ltd. v CIT (1954) 26 ITR 27 (SC)* discussed the concepts of 'accrual', 'arisal' and 'receipt'. The relevant observations are as under:

*"Accrues', 'arises' and 'is received' are three distinct terms. So far as receiving of income is concerned there can be no difficulty; it conveys a clear and definite meaning, and I can think of no expression which makes its meaning plainer than the word 'receiving' itself. The words 'accrue' and 'arise' also are not defined in the Act. The ordinary dictionary meanings of these words have got to be taken as the meanings attaching to them. 'Accruing' is synonymous with 'arising' in the sense of springing as a natural growth or result. The three expressions 'accrues', 'arises' and 'is received' having been used in the section, strictly speaking 'accrues' should not be taken as synonymous with 'arises' but in the distinct sense of growing up by way of addition or increase or as an accession or advantage; while the word 'arises' means comes into existence or notice or presents itself. The former connotes the idea of a growth or accumulation and the latter of the growth or accumulation with a tangible shape so as to be receivable. It is difficult to say that this distinction has been throughout maintained in the Act and perhaps the two words seem to denote the same idea or ideas very similar, and the difference only lies in this that one is more appropriate than the other when applied to particular cases. It is clear, however, as pointed out by Fry, L.J., in *Colquhoun v. Brooks [1888] 21 Q.B.D. 52 at 59* [this part of the decision not having been affected by the reversal of the decision by the Houses of Lords [1889] 14 App. Cas. 493] that both the words are used in contradistinction to the word 'receive' and indicate a right to receive. They represent a state anterior to the point of time when the income*

becomes receivable and connote a character of the income which is more or less inchoate”

- (b) The Apex Court in *CIT v Excel Industries Limited (2013) 358 ITR 295 (SC)* observed:

“19. This Court further held, and in our opinion more importantly, that income accrues when there "arises a corresponding liability of the other party from whom the income becomes due to pay that amount.”

4.16. Thus, judicially ‘accrual’ has been defined to mean enforceable of right to receive (from recipient standpoint) with a corresponding obligation to pay (from payer’s perspective).

4.17. A definition of “accrual” under a Standard prescribed under section 145 should not alter the understanding of accrual under section 5. A similar definition already existed in Accounting Standard I (now rescinded) issued under section 145(2).

4.18. The Madras High Court in the case of *CIT v Standard Triumph Motor Co. Ltd. (1979) 119 ITR 573 (Mad)* held that Section 145(1) is only an enabling provision to effectuate the charge. The section cannot be used for destroying the charge to tax and the provisions of Section 5(2)(b). It was further held that Section 145 is only a machinery provision and cannot qualify the charging section so as to make the latter otiose.

4.19. Thus, the supremacy of section 5 over section 145 is well settled. This ICDS does not in any manner alter or impinge such overriding impact of section 5. Para 9 of the ICDS provides that if the fundamental accounting assumptions of Going Concern, Consistency and Accrual are followed, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact shall be disclosed. Revised Form 3CD of tax audit report provides necessary columns for such disclosures.

5. Accounting Policies

“3. The accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by a person”.

5.1. Para 3 of the ICDS defines accounting policies to mean accounting principles and method of their application. Accounting policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements¹.

¹Source: International Accounting Standard - 8

5.2. Accounting policies are the guidelines under which businesses prepare their financial statements. They are important for financial reporting analysis. There is no single list of accounting policies applicable to all circumstances. The choice of appropriate accounting principles and the methods of applying those principles in the specific circumstances of each enterprise calls for considerable judgement by the management of the enterprise.

5.3. In the context of this ICDS, accounting policies would mean the principles and methods of computation of total income. Different alternative methods may be prescribed by other specific ICDS – those methods adopted by an assessee would also be regarded as accounting policies for the purposes of this ICDS.

6. Considerations in the Selection and Change of Accounting Policies

“4. Accounting policies adopted by a person shall be such so as to represent a true and fair view of the state of affairs and income of the business, profession or vocation. For this purpose,

- (i) the treatment and presentation of transactions and events shall be governed by their substance and not merely by the legal form; and***
- (ii) marked to market loss or an expected loss shall not be recognised unless the recognition of such loss is in accordance with the provisions of any other Income Computation and Disclosure Standard.***

5. An accounting policy shall not be changed without reasonable cause.”

6.1. Presentation of financial statements in an undistorted and consistent manner is the imperative for reporting of true and fair profits and income. ‘Choice’ of an accounting policy has significant impact on such reporting. Similarly, choice of an accounting policy would affect the computation of total income.

6.2. Para 4 of this ICDS states that the accounting policies adopted by a person shall be such so as to represent a “true and fair” view of the state of affairs and income of the business, profession or vocation. To achieve this true and fair status of an assessee’s financial status, the ICDS prescribes twin considerations.

6.3. As per the first consideration, treatment and presentation of transactions and events shall be governed by their substance and not merely by the legal form. This phenomenon demands faithful representation of income. The financial information should represent the substance of an economic phenomenon rather than merely representing its legal form. Representing a legal form that differs from the underlying economic phenomenon would not result in a faithful representation. Various judicial precedents are in evidence holding that 'form' prevails over substance. Some of them being – *IRC v Duke of Westminster* (1936) AC 1; *CIT v Mugneeram Bangur and Co* (1965) 57 ITR 299 (SC); *Union of India v Azadi Bachao Andolan* (2003) 263 ITR 706(SC); *Vodafone International Holdings B.V v UOI* (2012) 341 ITR 1(SC); *Consolidated Finvest & Holdings Limited v ACIT* ITA No 494/Del/2011; *DIT v Copal Research Limited* (2015) 371 ITR 114 (Del). Courts have also taken a contrary view of preferring substance over form in many other cases such as - *McDowell and Co. Ltd. v Commercial Tax Officer* (1985) 154 ITR 148(SC); *CIT v Panburi Tea Co* (1965) 57 ITR 422 (SC); *CIT and DCIT v Wipro Limited* [ITAs Nos. 1394 and 1395 of 2006 (Kar)]; *CIT v Manipal Health Systems* (2015) 375 ITR 509 (Kar) etc.

6.4. This ICDS also gives priority to substance over form. The second consideration clarifies that marked to market loss or an expected loss shall not be recognised unless the recognition of such loss is in accordance with the provisions of any other ICDS. The reason for such treatment can be inferred from the explanation provided by Accounting Standard Committee (while introducing Tax Accounting Standards) in its final report of August 2012. The relevant extract is as under:

"Based on the concept of prudence, AS-1 precludes recognition of anticipated profit and requires recognition of expected losses. Since this amounts to differential treatment for recognition of income and losses, the TAS (AP) provides that expected losses or mark-to-market losses shall not be recognised unless permitted by any other TAS."

6.5. The Committee was of the opinion that since anticipated profits are not recognised, expected or mark-to-market losses also should not be allowed as a deduction. The objective is to bring parity between treatment of income and expenses/ losses. The ICDS specifically excludes (i) MTM losses and (ii) Expected losses not covered by another ICDS. Thus, reduction in the value of stock-in-trade, which is governed by ICDS II, can be claimed as a deduction against business income. The Supreme Court in the case of *CIT v Woodward Governor India (P) Ltd.* (2009) 312 ITR 254 (SC) held that loss

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arising on account of fluctuation in the rate of exchange in respect of loans taken for revenue purposes was allowable as a deduction under section 37 of the Act.

6.6. Clarification on ICDS contained in Circular no. 10/2017, dated 23rd March 2017 issued by the CBDT states that the principle relating to MTM losses or an expected loss shall apply to mark-to-market gains and expected gains. Question 8 and answer thereto in the above referred Circular are reproduced below:

Question 8: *Para 4(ii) of ICDS-I provides that Market to Market (MTM) loss or an expected loss shall not be recognized unless the recognition is in accordance with the provisions of any other ICDS. Whether similar consideration applies to recognition of MTM gain or expected incomes?*

Answer: *Same principle as contained in ICDS-I relating to MTM losses or an expected loss shall apply mutatis mutandis to MTM gains or an expected profit.*

Comparison with IT-AS 1

6.7. The IT-AS 1 notified under section 145(2) enlisted three considerations which govern the selection and application of accounting policies. They were - Prudence, Substance over form and Materiality. The aspect of substance over form continues to appear in this ICDS. However, the concepts of Prudence and Materiality are not retained.

6.8. IT-AS 1 [notified under section 145(2)] defined 'Prudence' to be provision made for all known liabilities and losses, even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information. "Prudence" represents a provision for 'liabilities' or 'losses'. Para 4(ii) of this ICDS prohibits the deduction of marked to market losses or expected losses not covered by other ICDS. However, the ICDS is silent on provision for liabilities. This is because, the same has been dealt with in ICDS X. A provision for liability is retention of an amount for a present liability to be paid in the future. Such retention is based on estimation, since the liability cannot be precisely quantified. The allowability of such provisions is to be examined under the relevant provisions of Chapter IV-D of the Income-tax Act read with ICDS X.

6.9. Chapter IV-D of the Income-tax Act houses section 37 which deals with expenditure which is general in nature and not covered within sections 30 to 36. Section 37 covers expenditure laid out or expended wholly and

exclusively for the purposes of the business. The phrase 'laid out' connotes setting aside or storage for future. The expression 'laid out' in section 37 thus encompasses not only actual outflow of expenses but amounts parked in the present for future settlement. Accordingly, the concept of Prudence is inherent in the business income deductions.

6.10. It is trite to state that expenditure can be claimed as a deduction on 'payable' basis save certain provisions which permit deduction of expenditure on actual payment basis [for instance, section 43B]. Therefore a view can be taken that an expenditure which was otherwise allowable under the provisions of the Act cannot be construed as 'non-deductible' on account of 'non-mention' of Prudence principle in this ICDS.

6.11. The concept of materiality is a phenomenon concerning disclosure of amounts which may influence the decision of the user of the financial statements. Omission of the principle of 'materiality' is unlikely to impact the income computation under the provisions of the Act. This is because, income computation exercise is not driven by quantum considerations.

6.12. The ICDS prohibits change in accounting policies unless there is a reasonable cause for such a change. The expression "reasonable cause" has not been defined and would have to be examined on a case to case basis. The Allahabad High Court in the case of *CWT v S.L.Khunnah (1989) 180 ITR 340 (Allahabad)* observed that no hard and fast rule can be laid down for governing or deciding when a certain ground would be considered reasonable and when it would not be so held. The change could be on account of new information or developments. The necessity to diverge from the existing policy should be because of compelling factors.

Comparison with AS 5

6.13. Accounting Standard 5 [Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies] for change in accounting policy provides as under :

"29. A change in an accounting policy should be made only if the adoption of a different accounting policy is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate presentation of the financial statements of the enterprise."

6.14. One needs to examine the reason for change in accounting policy. Any change in accounting policy should be adjudged as 'reasonable' if it satisfies the criterion outlined in para 29 of AS 5 above. Based on a factual

examination, if the change (in accounting policy) is found to be *bona fide*, imperative and driven by commercial, contractual or statutory compulsions, such a change should be construed as a 'reasonable cause'. In this respect a reference may be made to the clarifications on ICDS contained in Circular no. 10/2017 dated 23rd March, 2017 issued by the CBDT. Question no. 9 and answer thereto are reproduced below:

Question 9: *ICDS-I provides that an accounting policy shall not be changed without 'reasonable cause'. The term 'reasonable cause' is not defined. What shall constitute 'reasonable cause'?*

Answer: *Under the Act, 'reasonable cause' is an existing concept and has evolved well over a period of time conferring desired flexibility to the tax payer in deserving cases.*

7. Disclosure of Accounting Policies

“6. All significant accounting policies adopted by a person shall be disclosed.

7. Any change in an accounting policy which has a material effect shall be disclosed. The amount by which any item is affected by such change shall also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact shall be indicated. If a change is made in the accounting policies which has no material effect for the current previous year but which is reasonably expected to have a material effect in later previous years, the fact of such change shall be appropriately disclosed in the previous year in which the change is adopted and also in the previous year in which such change has material effect for the first time.

8. Disclosure of accounting policies or of changes therein cannot remedy a wrong or inappropriate treatment of the item.

9. If the fundamental accounting assumptions of Going Concern, Consistency and Accrual are followed, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact shall be disclosed.”

7.1. Para 6 mandates disclosure of all significant accounting policies adopted in computation of income. Para 7 deals with change in such accounting policies. Any change in the policy shall have to be disclosed if it has a material effect. Any change in the income or expense component due to the change in policy will have to be disclosed if it is 'ascertainable'. If it is not ascertainable, then the fact shall be indicated/ disclosed appropriately.

7.2. If any change in accounting policy has no material effect for the current previous year but is reasonably expected to have a material effect in later previous years, the fact of such change shall be appropriately disclosed: (a) in the previous year in which the change is adopted; and (b) in the previous year in which such change has material effect for the first time.

7.3. Para 7 of the ICDS requires an assessee to disclose the accounting policies along with changes made (if any). Vide Circular No. 10/2017, dated 23rd March, 2017 the CBDT has clarified as under:

Question 25: *ICDS-I requires disclosure of significant accounting policies and other ICDS requires specific disclosures. Where is the taxpayer required to make such disclosures specified in ICDS?*

Answer: *Net effect on the income due to application of ICDS is to be disclosed in the Return of income. The disclosures required under ICDS shall be made in the tax audit report in Form 3CD. However, there shall not be any separate disclosure requirements for persons who are not liable to tax audit.*

Comparison of AS-1 with para 7 of ICDS

7.4. Accounting Standard 1 stipulates that if a change is made in the accounting policies which has no material effect for the current period but which are reasonably expected to have a material effect in later periods, the fact of such change shall be appropriately disclosed in the periods in which the change is adopted. The same language had been adopted in IT-AS 1 notified under section 145(2). Both these standards do not mandate disclosure in the year in which such change has material effect for the first time. This ICDS deviates from the disclosure norms from these two standards. It provides for disclosure of such change in two years namely, the year in which change is adopted and when it takes effect for the first time.

7.5. Para 8 states that mere disclosure does not tantamount to a remedy of any wrong or inappropriate treatment of the item. Further, para 9 clarifies that if the fundamental accounting assumptions of Going Concern, Consistency and Accrual are followed, specific disclosure is not required. However, if a fundamental accounting assumption is not followed, the fact shall be disclosed. Thus, any deviation from the assumptions necessitates a disclosure.

8. Transitional Provisions

“10. All contracts or transactions existing on the 1st day of April, 2016

or entered into on or after the 1st day of April, 2016 shall be dealt with in accordance with the provisions of this standard after taking into account the income, expense or loss, if any, recognised in respect of the said contract or transaction for the previous year ending on or before the 31st March, 2016”

8.1. Para 10 prescribes that all contracts or transactions entered into by the assessee on or after 1.4.2016 shall be in accordance with this ICDS. This recognition should be carried out after considering the income, expense or loss (if any) which have already been recognised on or before 31.3.2016. This implies that contracts or transactions already reported as per Accounting Standard 1 in the previous years prior to previous year 2016-17 would have to comply with the prescription of this ICDS so far as computation of income is concerned.

8.2. Migration from income computation under IT-AS 1 to this ICDS could result in change of accounting policies such as ‘non-recognition of MTM losses’. Such change however should not impact the recognition of the MTM losses made in the earlier years. An ICDS would govern the computation of income of that year to which the ICDS is applicable. Each year is a self contained unit. This ICDS which is effective from AY 2017-18, cannot have a retrospective effect. Consequently, a view is possible that recognition of losses relating to earlier years should remain intact, and would not result in a reversal of loss during the transitional year due to the transitional provisions.

Chapter 3

ICDS II : Valuation of Inventories

1. Preamble

“This Income Computation and Disclosure Standard is applicable for computation of income chargeable under the head “Profits and gains of Business or profession” or “Income from other sources” and not for the purpose of maintenance of books of accounts.

In the case of conflict between the provisions of Income Tax Act, 1961 (‘the Act’) and this Income Computation and Disclosure Standard, the provisions of the Act shall prevail to that extent”.

1.1 This ICDS too, like other ICDSs, apply in computing income under the head “Profits and gains of Business or profession” and “Income from Other Sources”. Provisions of the Act will override the ICDS in case there is a conflict. Generally, the concept of inventory as well as the term ‘inventory’ as defined in para 2(1) of this ICDS contemplates business. Although sub-clause (iii) of clause (a) of the para 2(1) dealing with materials and supplies to be consumed in the production process or in rendering of services does not specifically refer to business, even in that sub-clause the existence of business is contemplated. Considering the above, this ICDS will generally apply only to assessee engaged in any business or profession whose income is chargeable to tax under the head “Profits and gains of Business or profession”.

2.2 This Income Computation and Disclosure Standard is based on Accounting Standard 2 - *Valuation of Inventories* as revised with effect from 1st April 2016. Generally, principles contained in the Revised AS 2 have been adopted in this ICDS. Accordingly, unless there is a difference between the provisions of this ICDS and the Revised AS 2, one may refer to the explanations and examples given in the Revised AS 2 for applying the provisions of the ICDS.

2. Scope

1. ***“This Income Computation and Disclosure Standard shall be applied for valuation of inventories, except :***

(a) Work-in-progress arising under ‘construction contract’

including directly related service contract which is dealt with by the Income Computation and Disclosure Standard on construction contracts;

- (b) Work-in-progress which is dealt with by other Income Computation and Disclosure Standard;*
- (c) Shares, debentures and other financial instruments held as stock-in-trade which are dealt with by the Income Computation and Disclosure Standard on securities;*
- (d) Producers' inventories of livestock, agriculture and forest products, mineral oils, ores and gases to the extent that they are measured at net realisable value;*
- (e) Machinery spares, which can be used only in connection with a tangible fixed asset and their use is expected to be irregular, shall be dealt with in accordance with the Income Computation and Disclosure Standard on tangible fixed assets."*

2.1. Para 1 of the ICDS deals with the scope of the Standard. It is to be applied for valuation of inventories while computing income chargeable under the head "Profits and gains of Business or profession" and "Income from other sources".

2.2. The Standard does not apply to the following:

- (a) Work-in-progress of a construction contract or a contract for service directly related to a construction contract. Such work-in-progress is covered by ICDS III relating to Construction Contracts.

It may be noted that items of inventory that have not been used in the construction work and have not become part of work-in-progress of the contract will come within the scope of this ICDS and should be included as part of the inventory to be valued as per the requirements of this ICDS.

- (b) Work-in-progress which is dealt with by any other ICDS. Presently, no other ICDS except ICDS III deals with work-in-progress. Also, it may be noted that capital work-in-progress does not form part of inventory and hence ICDS II does not apply to the same.
- (c) Securities held as stock in trade which are dealt with by ICDS

VIII relating to Securities. However, ICDS VIII does not deal with securities held by mutual funds, venture capital funds, banks, public financial institutions formed under a Central Act or a State Act or entities declared as public financial institutions under the Companies Act, 1956 or the Companies Act, 2013. Consequently, valuation of securities held as stock-in-trade by entities referred above i.e. mutual funds, venture funds, financial institutions will be governed by ICDS II.

2.3. Further, ICDS VIII does not deal with securities held by a person engaged in the business of insurance, as well. However, section 44 of the Act overrides *inter alia* the provisions of the Act relating to computation of income chargeable under the head Income from other sources and provisions of sections 28 to 43B. Section 44 of the Act provides that the profits and gains of any business of insurance shall be computed in accordance with the rules contained in the First Schedule of the Act. Accordingly, provisions of ICDS II shall not apply to securities held as inventory by a person engaged in the business of insurance.

2.4. As per para 3(1)(b) of ICDS VIII, the term 'Securities' shall have the meaning assigned to it in clause (h) of section 2 of the Securities Contracts (Regulation) Act, 1956, other than derivatives. Considering that the definition of securities contained in ICDS VIII specifically excludes derivatives, if an assessee holds derivatives as a part of his inventory, provisions of ICDS II shall apply. However, if the derivatives are not held as part of inventory, then such derivatives shall not be governed by the provisions of ICDS II. The definition of the term 'Securities' in para 3(1)(b) of ICDS VIII specifically includes share of a company in which public are not substantially interested. Accordingly, provisions of ICDS II shall not apply to shares of a company in which public are not substantially interested even if these are held as inventory.

2.5. Revised AS 2 which has become applicable for accounting years beginning on or after 30th March, 2016 also exclude from within its scope shares, debentures and other financial instruments held as stock-in-trade. Ind AS 2 *Inventories* excludes all financial instruments held as stock-in-trade from its scope.

(d) Producers' inventories of livestock, agricultural and forest produce, mineral oils, ores and gases to the extent that they are measured at realisable value.

2.6. Accordingly, where inventories held by a producer of the items

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mentioned above are valued at realisable value, such inventories will be outside the scope of this ICDS. It may, however, be noted that this exclusion is only in the case of a producer of these items and not in case of a trader or dealer of these items. In case of a trader or dealer this ICDS will apply for valuation of his inventories.

Ind AS 2 also makes similar provision by making the standard inapplicable for measurement of these items of inventory and inventory held by commodity broker-traders who measure their inventories at fair value less costs to sell.

2.7. Ind AS 2 also excludes from its scope biological assets (i.e. living animals or plants) related to agricultural activity and agricultural produce at the point of harvest. These are dealt with by Ind AS 41 – *Agriculture*.

(e) Machinery spares that can be used only in connection with a tangible fixed asset and the use is expected to be irregular. Such machinery spares are to be dealt with in accordance with the provisions of ICDS V relating to Tangible Fixed Assets.

2.8. It is only spares of the nature mentioned above which are excluded from the scope of this ICDS. Other spares and stores will form part of the inventory.

2.9. The Revised AS 2 provides that inventories do not include those spare parts, servicing equipment and standby equipment which meet the definition of property, plant and equipment as per the Revised AS 10 - *Property, Plant and Equipment*. Such items are accounted for in accordance with Accounting Standard (AS) 10 - *Property, Plant and Equipment*. Revised AS 10 - *Property, Plant and Equipment* which has replaced AS 6 *Depreciation Accounting* and the original AS 10 *Accounting for Fixed Assets*. Revised AS 10 defines Property, plant and equipment as under:

“Property, plant and equipment are tangible items that:

- (a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and*
- (b) are expected to be used during more than a period of twelve months.”*

2.10. Revised AS 10 does not prescribe the unit of measure for recognition, i.e., what constitutes an item of property. One has therefore to exercise judgement. Revised AS 10 also takes into consideration the concept of materiality and recognises that an item which could otherwise have been included as property, plant and equipment, may be expensed out because the amount of the expenditure is not material.

2.11. Ind AS 2, does not have specific exclusion for machinery spares. However, para 8 of Ind AS 16 provides that items such as spare parts, stand-by equipment and servicing equipment are recognised in accordance with this Ind AS when they meet the definition of property, plant and equipment. Otherwise, such items are classified as inventory.

2.12. In view of the above, generally items of stores and spares considered as inventory under accounting standard would also constitute inventory under this ICDS. However, there could be situations where an item may be considered as inventory under ICDS II but not under the Revised AS 10 or vice-a-versa.

2.13. Revised AS 2 specifically excludes from its scope work-in-progress arising in the ordinary course of business of service providers. This ICDS does not specifically exclude it. However, except for certain service contracts, revenue for service transactions is to be recognised based on the proportion of work completed. Considering this and the changes made in this ICDS as compared to ICDS notified on 31st March, 2015, provisions of ICDS II shall not apply in case of work in progress of service providers. This is discussed in para 7 below.

3. Definitions

“2(1) The following terms are used in this Income Computation and Disclosure Standard with the meanings specified:

- (a) “Inventories” are assets:***
 - (i) held for sale in the ordinary course of business;***
 - (ii) in the process of production for such sale;***
 - (iii) in the form of materials or supplies to be consumed in the production process or in the rendering of services.***
- (b) “Net realisable value” is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.***

2(2) Words and expressions used and not defined in this Income Computation and Disclosure Standard but defined in the Act shall have the meanings assigned to them in that Act.”

3.1. Para 2(1)(a) of the ICDS defines ‘Inventories’. This definition is the same as contained in para 3.1 of the Revised AS 2.

3.2. Inventory will include items manufactured, produced, processed or purchased. It will include items held for sale, resale or to be used in manufacturing or production process. It will include raw materials, work-in-progress, finished goods, maintenance supplies, loose tools, consumables. It will also include materials and supplies held by a service provider to be used or consumed in rendering services.

3.3. Para 2(1)(b) of the ICDS defines 'Net Realisable Value' (NRV). This definition is *in verbatim* same as contained in para 3.2 of the revised AS 2. Paras 19, 20 and 21 of the ICDS deal with determination of NRV. Determination of NRV is discussed in para 13 below.

4. Measurement

"3. Inventories shall be valued at cost, or net realisable value, whichever is lower."

4.1. Para 3 of the ICDS enunciates the principle that inventories shall be valued at cost or net realisable value *whichever is lower*.

4.2. *This para is parimateria same as para 5 of the Revised AS 2.* The principle that inventories shall be valued at lower of cost and net realisable value is to be applied while valuing the inventories under this ICDS.

5. Cost of Inventories

"4. Cost of inventories shall comprise of all costs of purchase, costs of services, costs of conversion and other costs incurred in bringing the inventories to their present location and condition."

5.1. 'Cost of inventories' is defined in para 4 of the ICDS. Accordingly, 'Cost of inventories shall *comprise* of all costs of purchase, costs of services, cost of conversion and other costs incurred in bringing the inventories to their present location and condition.'

5.2. The definition of cost of inventories under the ICDS includes cost of services unlike para 6 of the Revised AS 2 which does not cover cost of services. Work in progress in case of service providers is not inventory, as discussed in para 7 below. Further, in case services have been used in manufacture, production or processing of goods, cost of such services will form part of inventory as part of cost of conversion.

6. Cost of Purchase

"5. The costs of purchase shall consist of purchase price including duties and taxes, freight inwards and other expenditure directly

attributable to the acquisition. Trade discounts, rebates and other similar items shall be deducted in determining the costs of purchase."

6.1. It may be noted that under the provisions of para 7 of the Revised AS 2, duties and taxes that are subsequently recoverable from the taxing authorities are excluded while arriving at the cost of purchase. Ind AS 2 also provides for exclusion of duties and taxes that are subsequently recoverable from the taxing authorities while arriving at the cost of purchase. ICDS II differs from Revised AS 2, as well as Ind AS 2 in this respect. The ICDS prescribes 'inclusive method' while the Accounting Standards prescribe 'exclusive method'.

6.2. Section 145A of the Act provides that the valuation of purchase and sale of goods and inventory for the purposes of determining the income chargeable under the head 'Profits and gains of business or profession' shall be -

- (i) in accordance with the method of accounting regularly employed by the assessee; and
- (ii) further adjusted to include the amount of any tax, duty, cess or fee (by whatever name called) actually paid or incurred by the assessee to bring the goods to the place of its location and condition as on the date of valuation.

6.3. Thus, even prior to the ICDS becoming applicable, under the provisions of section 145A, purchases, sales and inventory were required to be valued by including therein the amount of any tax, duty, cess or fee (by whatever name called) actually paid or incurred by the assessee. It was therefore necessary to make adjustments to comply with the provisions of section 145A.

6.4. One may refer para 23 of the Guidance Note on Tax Audit under section 44AB of the Income-tax Act, 1961 issued by the ICAI. Paras 23.7 to 23.24 deal with deviations from the method of valuation prescribed under section 145A and the effect thereof on the profit or loss to be reported under clause 14(b) of Form 3CD. These sub-paras explain the adjustments to be made to comply with the provisions of section 145A and the procedure for the adjustments to be carried out in case of both, trading and manufacturing concerns. The illustrations given in the said Guidance Note show that the overall impact of the adjustments made to comply with the provisions of section 145A on the income of the assessee is nil. Accordingly, if an exclusive method is followed for the purpose of valuation of inventory as per AS, the tax payer would be required to prepare the memorandum account to

demonstrate that vis a vis inclusive method, it is tax neutral. This will be in compliance with section. 145A and ICDS.

7. Costs of Services

“6. The costs of services shall consist of labour and other costs of personnel directly engaged in providing the service including supervisory personnel and attributable overheads.”

7.1. Where services have been utilised in manufacture, production or processing of goods, as stated in para 5.2 above, cost of such services will form part of inventory as part of cost of conversion, under this para.

7.2. The issue that one needs to consider is whether a service provider has to value his inventory under this ICDS.

7.3. Para 2(1)(a)(i) of ICDS III relating to Construction Contracts includes within the scope of the term ‘construction contract’ a contract for rendering of services which are directly related to the construction of an asset. In such a case provisions of ICDS III will become applicable. Further, para 6 of the ICDS IV relating to Revenue Recognition provides that subject to paragraph 7 of that ICDS, revenue from rendering of services shall be recognised by the percentage completion method. It further provides that requirements of ICDS III relating to Construction Contracts will apply mutatis mutandis.

7.4. It also provides that 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 over the specific period. This is a practical way of recognising the revenue from services where earnings are generally evenly spread over the period of service contract.

7.5. Para 7 of ICDS IV provides that revenue from service contracts with duration of not more than ninety days may be recognised when the rendering of services under that contract is completed or substantially completed.

7.6. However, reference to ‘service provider’ in paragraph 6 of ICDS II as notified on 31st March, 2015 has been omitted in this revised ICDS II issued on 29th September, 2016. Further, the definition of “inventories” as per paragraph 2(1)(a) does not include work-in-progress of a service provider. It only includes materials or supplies to be consumed in the rendering of services, and not even material actually consumed.

7.7. Considering this, in case of service providers ICDS II will not have application and value of service not fully rendered need not be computed under this ICDS. This is also indicated by the scope of the ICDS, which excludes work-in-progress which is dealt with by other ICDS.

7.8. It may be borne in mind that all the ICDS apply to assessee following mercantile system of accounting. ICDS do not apply to service providers following cash system of accounting. Accordingly, application of cost of services to be taken as inventory will not apply to service providers following cash system of accounting.

7.9. Para 8 of Ind AS 2 provides that in the case of a service provider, inventories include the costs of the service for which the entity has not yet recognised the related revenue. Further para 19 of the Ind AS 2 provides for measurement of inventory of service providers taking into account labour and other costs of personnel directly engaged in providing the service, including supervisory personnel, and attributable overheads. In case under Ind AS 2 if inventory of service provider has been valued, appropriate adjustment will have to be made while computing the total income.

8. Costs of conversion

“7. The costs of conversion of inventories shall include 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. Fixed production overheads shall be those indirect costs of production that remain relatively constant regardless of the volume of production. Variable production overheads shall be those indirect costs of production that vary directly or nearly directly, with the volume of production.

8. The allocation of fixed production overheads for the purpose of their inclusion in the costs of conversion shall be based on the normal capacity of the production facilities. Normal capacity shall be the production expected to be achieved on an average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production shall be used when it approximates to normal capacity. The amount of fixed production overheads allocated to each unit of production shall not be increased as a consequence of low production or idle plant. Unallocated overheads shall be recognised as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed production overheads allocated to each unit of production is decreased so that inventories are not measured above the cost. Variable production overheads shall be assigned to each unit of production on the basis of the actual use of the production facilities.

9. Where a production process results in more than one product being produced simultaneously and the costs of conversion of each product are not separately identifiable, the costs shall be allocated between the products on a rational and consistent basis. Where by-products, scrap or waste material are immaterial, they shall be measured at net realisable value and this value shall be deducted from the cost of the main product.”

8.1. Paras 7 to 9 of the ICDS deal with ‘Costs of conversion’. The corresponding paras of Revised AS 2 are paras 8 to 10. Costs of conversion are incurred for converting raw material into finished products. These costs can be classified into three categories:

- (i) costs that are directly related to the units of production;
- (ii) variable overheads; and
- (iii) fixed overheads.

8.2. Costs that are directly related to the units of production would include direct expenses, direct labour and similar items. Generally, there is no difficulty in identifying these expenses and including them in the valuation of inventory.

8.3. Variable overheads are those indirect expenses that vary directly or nearly directly with the quantum of production. On the other hand, fixed overheads are costs that remain constant or nearly constant regardless of volume of production, unless there is a change in capacity, process, equipment etc. Both variable and fixed overheads have to be allocated in a systemic manner for inclusion in the cost of inventory.

8.4. In respect of fixed overheads, para 8 of the ICDS requires the following:

- (i) fixed overheads shall be allocated based on the normal capacity of the production facility;
- (ii) where actual level of production is close to the normal capacity, actual level shall be used for allocation of the fixed overheads;
- (iii) if the level of production is low or the plant is idle, overhead allocation shall not be increased. Unallocated overheads are recognised as expense of the period in which these are incurred;
- (iv) if the level of production is abnormally high, allocation of overhead is reduced to ensure that the inventory is not valued above cost.

8.5. Determining normal capacity is a matter of judgement and various factors should be considered. Normal capacity is average production that is expected to be achieved over a number of periods under normal conditions. It is generally different from the installed capacity or rated capacity.

8.6. Normal conditions are not ideal conditions. One should take into account efficiency levels expected to be achieved, infrastructure facility available to achieve the production level, periods during which the production facility cannot be utilised on account of regular maintenance, etc. Under-utilisation of the capacity due to non-availability of market for the product does not reduce the normal capacity of the production facility.

8.7. When there is change in technology in the manufacturing facility or in case of new manufacturing facility, normal capacity should be assessed based on production expected to be achieved during the period when the plant is expected to achieve stability.

8.8. Normal capacity may be determined in terms of production units or labour hours or machine hours or such other parameter which is appropriate in the circumstances.

8.9. It may be noted that Revised AS 2, as well as Ind AS 2 permit the use of actual level of production when it approximates the normal capacity. Whether actual level of production is approximating to the normal capacity is a matter of judgement and opinion. The purpose of the valuation of inventory is to arrive at the fairest possible approximation of the costs incurred, and that the use of normal capacity is the basic parameter or norm to be used while allocating overheads. Hence, using normal capacity while allocating overheads is always permissible. When the actual production is close to normal capacity, actual production may be used for allocation of the fixed overheads.

8.10. Variable production overheads are allocated based on actual use of production facilities. Appropriate parameter of production facility should be used for this purpose. Depending on the circumstances, one or more parameters may be used for allocating various categories of variable overhead costs.

8.11. Para 9 of the ICDS deals with cost in case of joint products and treatment of by-products, scrap and waste material. In case of joint products where conversion costs for each product cannot be identified, such common costs are allocated on a rational and consistent manner. Where value of by-products, scrap or waste is immaterial, these should be measured at their realisable value and this value should be reduced from the cost of the main product.

9. Other Costs

“10. Other costs shall be included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition.

11. Interest and other borrowing costs shall not be included in the costs of inventories, unless they meet the criteria for recognition of interest as a component of the cost as specified in the Income Computation and Disclosure Standard on borrowing costs. “

9.1. Para 10 of the ICDS provides that other costs incurred should be included in the cost of inventory to the extent that these costs have been incurred in bringing the inventory to its present location and condition. Similar provision has been made in para 11 of Revised AS 2.

9.2. Where finished or intermediate product is chargeable to excise duty, the cost of inventory should include the excise duty whether or not it has been actually paid on the date as of which valuation is made. In this respect a reference may be made to the Guidance Note on Accounting Treatment for Excise Duty issued by the ICAI.

9.3. Generally, interest or other borrowing costs are not included in the cost of inventory. However, para 11 of the ICDS provides that if the inventory item meets the criterion for recognition of interest as a component of the cost as specified in ICDS IX relating to 'Borrowing Costs' interest and other borrowing costs are included as a part of cost of the inventory. ICDS IX defines what is a 'Qualifying asset' and lays down the requirements as to inclusion of interest and other borrowing costs as a component of the cost. Merely because substantial inventory is carried and heavy interest is to be paid cannot be the criteria for including interest in the cost of inventory.

10. Exclusions from the cost of Inventories

“12. In determining the cost of inventories in accordance with paragraphs 4 to paragraphs 11, the following costs shall be excluded and recognised as expenses of the period in which they are incurred, namely:—

- (a) Abnormal amounts of wasted materials, labour, or other production costs;***
- (b) Storage costs, unless those costs are necessary in the production process prior to a further production stage;***

(c) ***Administrative overheads that do not contribute to bringing the inventories to their present location and condition ;***

(d) ***Selling costs.”***

10.1. Para 12 of the ICDS provides for the costs that are not to be included in the cost of inventory. Costs referred in para 12 of ICDS do not contribute in bringing the inventory to its present location and condition. Hence, these are not included in the costs of inventory. This para is *parimateria* same as para 13 of the Revised AS 2.

10.2. Abnormal amounts of wasted materials, labour, or other production costs are excluded from cost of Inventory. Normal wastage or loss of material, labour and other production costs should form part of the cost of inventory. What is normal wastage or loss and what is abnormal wastage or loss depends on circumstances of each case.

10.3. Storage costs, unless necessary in the production process prior to a further production stage are excluded from cost of inventory. In case of certain items, during storage, inventory undergoes changes making it marketable or adding value due to change in condition of the inventory. In such a case storage costs are necessary in the production process. Such storage costs are to be added as a part of the cost of the inventory. Some common examples where storage cost is included in the cost of the inventory are wine and timber which mature during storage.

10.4. Administrative overheads that do not contribute in bringing the inventories to their present location and condition and selling costs are excluded from cost of inventory. Revised AS 2 also refers to exclusion of distribution costs from cost of inventories. Although, ICDS II does not specifically refer to distribution costs, costs such as expenses incurred at distribution depots are excluded from the costs of inventory since these are not costs incurred in bringing the inventories to their present location and condition as contemplated by para 10 of this ICDS.

11. Cost Formulae

“13. The Cost of inventories of items -

(i) ***that are not ordinarily interchangeable; and***

(ii) ***goods or services produced and segregated for specific projects***

shall be assigned by specific identification of their individual costs.

14. ‘Specific identification of cost’ means specific costs are attributed to identified items of inventory.

15. Where there are a large numbers of items of inventory which are ordinarily interchangeable, specific identification of costs shall not be made.

First-in First-out and Weighted Average Cost Formula:

16. Cost of inventories, other than the inventory dealt with in paragraph 13, shall be assigned by using the First-in First-out (FIFO), or weighted average cost formula. The formula used shall reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition.

17. The FIFO formula assumes that the items of inventory which were purchased or produced first are consumed or sold first, and consequently the items remaining in inventory at the end of the period are those most recently purchased or produced. Under the weighted average cost formula, the cost of each item is determined from the weighted average of the cost of similar items at the beginning of a period and the cost of similar items purchased or produced during the period. The average shall be calculated on a periodic basis, or as each additional shipment is received, depending upon the circumstances.

Techniques for the Measurement of Cost

18(1). Techniques for the measurement of the cost of inventories, such as the standard cost method or the retail method, may be used for convenience if the results approximate the actual cost. Standard costs take into account normal levels of consumption of materials and supplies, labour, efficiency and capacity utilisation. They are regularly reviewed and, if necessary, revised in the light of the current conditions.

18(2). The retail method can be used in the retail trade for measuring inventories of large number of rapidly changing items that have similar margins and for which it is impractical to use other costing methods. The cost of the inventory is determined by reducing from the sales value of the inventory, the appropriate percentage gross margin. The percentage used takes into consideration inventory, which has been marked down to below its original selling price."

11.1. Paras 13 to 18 of the ICDS deals with cost formulae and techniques of measurement of cost.

Specific Identification of Cost

11.2. Paras 13 to 15 deals with 'Specific Identification of Cost'. In principle, provisions of these paras are the same as prescribed in paras 14 and 15 of Revised AS 2. Under specific identification of cost, specific costs are attributed to identified items of inventory.

11.3. Specific identification of cost is used in case of items:

- (i) that are not ordinarily interchangeable; and
- (ii) goods and services produced and segregated for specific projects.

11.4. Under the above conditions, specific costs are attributed to specific or identified items of inventory. This is not common and has limited applicability. It is used only in special circumstances, for example in valuing inventory of paintings in an art gallery. It is used where goods or services have been specifically produced and segregated for specific project.

11.5. Para 15 of the ICDS provides that where items of inventory are large and interchangeable, specific cost identification shall not be made. Where items of inventory are fungible, i.e. an item can be replaced by another item which is identical or nearly identical, specific identification of costs is not resorted to. Judgement is required to decide whether the items of inventory are ordinarily interchangeable or not.

First-in-First-out (FIFO) and Weighted Average Cost Formula

11.6. First-in-First-out (FIFO) and Weighted Average Cost Formula are the most commonly used methods to assign costs. Para 16 provides that the formula used shall reflect fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition. Para 16 of ICDS is *parimateria* same as para 16 of the Revised AS 2.

11.7. ICDS II recognises that inventory valuation involves the process of approximation and estimation. It cannot be exact. Different cost formulae have different assumptions and considering the circumstances, cost formula should be chosen to reflect the fairest approximation of the cost incurred.

11.8. FIFO presumes that items of inventory that have been purchased or produced at earlier point in time are first consumed or sold and what is left in stock are out of the latest or most recent purchases or production.

11.9. Under weighted average cost formula, cost of each item is arrived at from weighted average of cost of similar items at the beginning of the period

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and cost of similar items purchased or produced during the period. The average is calculated periodically or as each additional shipment is received, depending on the circumstances. (Refer para 17 of ICDS II and para 17 of the Revised AS 2).

11.10. It may be noted that the Revised AS 2 as also Ind AS 2 require that cost of inventory is generally measured on the basis of either FIFO or Weighted Average Cost. This is the requirement of the ICDS as well.

11.11. The ICDS does not require that all items of inventory should be valued using the same cost formula. Different cost formulae may be used for inventories with different nature or use. However, inventories of the same type should be valued using the same cost formula. Cost formula used should be chosen considering the nature, characteristics and use of inventories. Generally, an assessee who has been following applicable Accounting Standard e.g. old AS 2 and now Revised AS 2 may continue to use the cost formulae which he may have been using hitherto since these are in accordance with the provisions of ICDS.

Para 18 deals with techniques of measurement of cost

11.12. Para 18(1) specifically permits the use of standard cost method and retail method. It may be noted that ICDS as notified on 31st March 2015 did not specifically permit standard cost method which has now been specifically permitted if the results approximate the actual cost.

11.13. Many large entities, particularly those using ERP packages record consumption of materials, etc. using standard cost. Periodically variances are analysed and adjusted to the cost of production and the cost of inventory on hand and the cost of inventory at the end of the period is determined on the basis of weighted average cost or FIFO to be in compliance with old AS 2 or Revised AS 2 or Ind AS 2, as the case may be. Thus, where standard costing is used to record consumption and periodically variances are appropriately adjusted to reflect the fairest approximation of cost of inventory on the basis of weighted average cost or FIFO, it will be in compliance with this ICDS.

11.14. Para 18(2) provides that retail method may be used for determining the cost where it is impracticable to use either FIFO or weighted average cost formula in retail trade for measuring inventories of large number of rapidly changing items having similar margins.

11.15. In such cases cost of inventory is arrived at by reducing from the sales value of the inventory the gross margin at appropriate percentage. If some of the items of inventory have been marked down below their selling

price earlier, while arriving at the cost by using retail method, this should be taken into account and percentage of gross margin to be reduced from the sales value should be appropriately adjusted. This is required so that the inventory is not valued below cost and NRV. Refer para 19 of the Revised AS 2.

11.16. Where different departments or product lines have significantly different margins, cost of inventory should be determined separately applying appropriate percentage of gross margin to sales value of inventory of such different departments or product lines so that the valuation approximates to the actual cost.

12. Net Realisable Value

“19. Inventories shall be written down to net realisable value on an item-by-item basis. Where ‘items of inventory’ relating to the same product line having similar purposes or end uses and are produced and marketed in the same geographical area and cannot be practicably evaluated separately from other items in that product line, such inventories shall be grouped together and written down to net realisable value on an aggregate basis.

20. Net realisable value shall be based on the most reliable evidence available at the time of valuation. The estimates of net realisable value shall also take into consideration the purpose for which the inventory is held. The estimates shall take into consideration fluctuations of price or cost directly relating to events occurring after the end of previous year to the extent that such events confirm the conditions existing on the last day of the previous year.

21. Materials and other supplies held for use in the production of inventories shall not be written down below the cost, where the finished products in which they shall be incorporated are expected to be sold at or above the cost. Where there has been a decline in the price of materials and it is estimated that the cost of finished products will exceed the net realisable value, the value of materials shall be written down to net realisable value which shall be the replacement cost of such materials.”

12.1. Cost of inventory determined in accordance with ICDS should be compared with the NRV and lower of the two should be taken as the value of the inventory. Para 19 of the ICDS requires that the comparison of cost and

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NRV should be done on item-by item basis and not globally. However, the comparison is done on an aggregate basis where all the following conditions are satisfied:

- (i) items of inventory are relating to the same product line having similar purpose or end uses;
- (ii) these are produced and marketed in the same geographical area; and
- (iii) practicably these cannot be separately evaluated from other items in that product line.

A reference may also be made to para 21 of Revised AS 2.

12.2. Para 20 of the ICDS requires:

- (i) the NRV should be determined based on most reliable evidence available at the time of valuation;
- (ii) the estimates of NRV shall take into account the purpose for which the inventory is held; and
- (iii) the estimates shall take into consideration fluctuations of price or cost directly relating to events occurring after the end of previous year to the extent that such events confirm the conditions existing on the last day of the previous year.

A reference may also be made to para 22 of Revised AS 2.

12.3. The assessee should consider and keep appropriate evidence based on which NRV was estimated. The evidence referred to in para 20 of the ICDS is evidence available when the valuation is made and not as of the last day of the previous year. Events occurring after the end of the previous year and fluctuations in price related to them should be considered if these confirm the conditions existing on the last day of the previous year.

12.4. NRV is the estimated selling price in the ordinary course of business less the cost of completion and costs necessary to make sales. Considering this, if the inventories are at various geographical locations and are expected to be sold there, NRV prevailing at each such location should be considered for comparing with the cost of inventory at such geographical location.

12.5. If the inventory is held both, for export market as well as domestic market or for markets where the NRV is not the same, NRV should be based on the estimated quantity expected to be sold in each market and the selling price prevailing in each market.

12.6. NRV of work-in-progress should be estimated by taking estimated selling price of the finished goods (to be produced from such work-in-progress) less estimated cost to complete and costs necessary to make the sale.

12.7. Para 21 of the ICDS deals with valuation of materials and supplies held for use in production of inventories. Such materials and supplies are not written down below cost if:

- (i) the finished products in which such materials and supplies are to be incorporated are expected to be sold at cost or above cost; or
- (ii) the prices of such materials and supplies have not declined.

12.8. If the prices of such materials and supplies have declined and the cost of finished goods in which these are to be incorporated is estimated to be higher than the NRV of such finished goods, then such materials and supplies are valued at their replacement cost. Refer para 24 of Revised AS 2.

13. Value of Opening Inventory

“22. The value of the inventory as on the beginning of the previous year shall be

- (i) the cost of inventory available, if any, on the day of the commencement of the business when the business has commenced during the previous year; and***
- (ii) the value of the inventory as on the close of the immediately preceding previous year, in any other case.”***

13.1. Para 22 of ICDS makes specific provision in respect of value of opening inventory. Generally, the value of inventory as on the close of the immediately preceding previous year, shall be the value of the inventory as on the beginning of the previous year.

13.2. However, where the business has commenced during the previous year, the cost of inventory available, if any, on the day of the commencement of the business is to be taken as the value of the inventory at the beginning of the previous year.

13.3. Old AS 2 did not have and Revised AS 2 does not have a corresponding provision.

13.4. An issue that one needs to consider is what would be taken as the opening value of inventory where an assessee converts his capital asset into

stock-in-trade and commences his business during the previous year. Under section 2(47)(iv) of the Act such conversion is treated as a transfer and under section 45(2) of the Act capital gain is computed taking the fair market value of the asset on the date of conversion as the full value of the consideration. The Supreme Court in the case of *CIT v Bai Shirinbai K. Kooka* [1962] 46 ITR 86 (SC) held that for computing the trading profit the fair market value of the asset on the date of conversion into stock-in-trade is cost to the business. Considering that the difference between the amount originally paid – cost of acquisition (or indexed cost of acquisition, where applicable) and the fair market value of the asset on the date of conversion is taxed as capital gain and the decision of the Supreme Court, the fair market value of the asset on the date of conversion shall be regarded as the cost of inventory for the purposes of (i) above, though the ICDS provides that the cost of inventory available has to be taken as the value of the inventory as on the beginning of the previous year. This will result in a harmonious interpretation, and avoid double taxation.

13.5. The provisions of section 43C, which provide for the cost of stock in trade, in cases of amalgamation, total or partial partition of an HUF, or receipt under a gift, will or irrevocable trust, require the value of the stock in trade to be taken as per that section, and not as per this ICDS. This is on account of the fact that provisions of the Act would override the provisions of the ICDS.

14. Change of Method of Valuation of Inventory

“23. The method of valuation of inventories once adopted by a person in any previous year shall not be changed without reasonable cause”.

14.1. Para 23 of the ICDS prescribes that unless there is reasonable cause, the method of valuation of inventories once adopted by a person in any previous year shall not be changed.

14.2. ICDS II does not indicate what reasonable cause is. This will depend on the circumstances. Change in the applicable law necessitating a change, change in the nature of business, etc. could be considered as examples of reasonable causes. Changes in the circumstances which lead to the existing method not reflecting the fairest approximation of the cost incurred in bringing the inventory to the present location and condition would be a reasonable cause for changing the method of valuation of inventory.

15. Valuation of Inventory in case of certain dissolutions

“24. In case of dissolution of a partnership firm or association of persons or body of individuals, notwithstanding whether business is discontinued or not, the inventory on the date of dissolution shall be valued at the net realisable value.”

15.1. Para 24 of the ICDS provides that in case of dissolution of a partnership firm, an association of persons or a body of individuals, the inventory on the date of dissolution shall be valued at the NRV. This is irrespective of the fact whether or not on dissolution the business of the entity is discontinued.

15.2. Old AS 2 did not and the Revised AS 2 does not have a corresponding provision.

15.3. The Supreme Court, in the case of *A.L.A. Firm v CIT [1991] 189 ITR 285 (SC)*, had held that when on dissolution of a partnership firm business is discontinued the stock has to be valued at realisable value. On the other hand, in case of *Sakthi Trading Co. v CIT [2001] 250 ITR 871 (SC)*, the Apex Court held that where business is taken over without discontinuance on dissolution of the partnership, the stock-in-trade is not required to be valued at NRV.

15.4. ICDS II now prescribes valuation of inventory at NRV in all cases where there is dissolution of a firm, AOP or BOI, irrespective of the fact whether on dissolution the business has been discontinued or not. Under section 2(23) of the Act, the term ‘firm’ includes a limited liability partnership as defined under the Limited Liability Partnership Act, 2008. Accordingly, the requirement of para 24 of the ICDS shall also apply in the case of dissolution of an LLP.

16. Transitional Provisions

“25. Interest and other borrowing costs, which do not meet the criteria for recognition of interest as a component of the cost as per para 11, but included in the cost of the opening inventory as on the 1st day of April, 2016, shall be taken into account for determining cost of such inventory for valuation as on the close of the previous year beginning on or after 1st day of April, 2016 if such inventory continue to remain part of inventory as on the close of the previous year beginning on or after 1st day of April, 2016.”

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16.1. Para 25 of the ICDS makes transitional provision in cases where interest and other borrowing costs have been included as a component of the cost of the inventory as on 1st April, 2016 although under para 11 of the ICDS the inventory does not meet the criteria for recognising interest and other borrowing cost as part of the cost.

16.2. In such a case, if such items of inventory continue to remain as part of the inventory as on the last day of the previous year beginning on or after 1st April, 2016, then in valuing those items of inventory, interest and other borrowing cost shall continue to form part of the cost. Accordingly, cost of brought forward inventory shall not be reduced by interest and other borrowing cost considered as part of cost earlier.

17. Disclosure

“26. The following aspects shall be disclosed, namely:—

- (a) the accounting policies adopted in measuring inventories including the cost formulae used. 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; and***
- (b) the total carrying amount of inventories and its classification appropriate to a person.”***

17.1. Para 26 of the ICDS deals with the disclosures to be made.

17.2. It may be noted that under this ICDS, the cost of inventory should include duties, taxes, etc., which are subsequently recoverable from taxing authorities, while inventory valued in accordance with the provisions of the Revised AS 2 does not (as also the old AS 2 did not) include such duties, taxes, etc. As stated earlier, a reference may be made to para 23 of the Guidance Note on Tax Audit under section 44AB of the Income-tax Act, 1961 issued by the ICAI. Care should be taken to make adjustment for the same and reconcile it with adjustments made under section 145A of the Act and reported under clause 14(b) of Form 3CD.

17.3. It may not be possible to make the above adjustment for each individual item of the inventory. In such a case, adjustment may be made for each class of inventory applying the rate of applicable tax, duty, etc.

17.4. The ICDS requires that where standard cost has been used, the details of such inventories be given alongwith a confirmation of the fact that standard cost approximates the actual cost. Details of such inventory would

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normally include classification of items and the value of inventory where standard cost has been used

17.5. Common classification for inventory as per para 27 of the Revised AS 2 is raw materials and components, work in progress, finished goods, stock-in-trade (in respect of goods acquired for trading), stores and spares, loose tools and others. The classification of inventories should be done keeping in mind the activities of the assessee.

ICDS III : Construction Contracts

1. Introduction

1.1 ICDS III deals with construction contracts. A construction contract is a contract negotiated for the construction of an asset or a combination of assets. A construction contract, by nature entails time and resources. In cases where the activity continues for more than a year, the question is whether the contractor is to be taxed in the year in which the work is completed or proportionately over all the years? Does the contractor earn his income on a day to day basis (or at least periodically) or on completion of the contract? No guidance in this connection was forthcoming from the Act. There is no uniform practice how income from construction contracts is being offered to tax.

1.2 The Delhi High Court in *Tirath Ram Ahuja (P.) Ltd. v CIT [1976] 103 ITR 15 (Del)* [affirmed by the Supreme Court in (1990) 186 ITR 428 (SC)] held that in the case of a contract, the profits can be estimated on the basis of receipts in each year and one need not wait till the completion of contract. The ICAI issued AS 7 in the year 1983 under which a contractor could recognize income either under the percentage of completion method (POCM) or completed contract method (CCM). The tax department, however, has been taking a position that the income should be offered as per POCM method.

1.3 ICAI revised AS 7 with effect from 01.04.2003. In the revised AS 7, the ICAI recommended that the revenue from construction contracts should be recognized only on POCM basis. Despite this prescription, from a tax perspective, an argument continued that a contractor cannot be compelled to follow POCM method. With a view to put at rest the controversy, the Central Government exercising power under section 145(2), has notified ICDS III relating to construction contracts.

2. Preamble

"This Income Computation and Disclosure Standard is applicable for computation of income chargeable under the head "Profits and gains of business or profession" or "Income from other sources" and not for the purpose of maintenance of books of account.

In the case of conflict between the provisions of the Income-tax Act, 1961('the Act') and this Income Computation and Disclosure Standard, the provisions of the Act shall prevail to that extent.

3. Scope

"1. This Income Computation and Disclosure Standard should be applied in determination of income for a construction contract of a contractor."

3.1 Paragraph 1 outlines the scope of this ICDS. It states that this ICDS should be applied in determination of income from a construction contract of a contractor. The term 'construction contract' is defined in paragraph 2(1). The term 'contractor' is however not defined. Para 2(2) states that words and expressions used and not defined in the ICDS but defined in the Act shall have the meaning respectively assigned to them in the Act. There is no definition of the term 'contractor' in the Act either. Under such circumstances, the said term would have to be understood in the light of its natural meaning. The Advanced Law Lexicon by P Ramanath Iyer ,3rd Edition defines the term 'contractor' to mean "A person who makes a contract, especially a builder who works by contract. A "contractor" is a person who, in the pursuit of an independent business, undertakes to do specific jobs or work for other persons, without submitting himself to their control in respect to the detail of the work." The Shorter Oxford Dictionary 5th edition defines the term 'contractor' to mean "a person who enters into a contract or agreement. Now chiefly spec. a person or firm that undertakes work by contract, especially for building to specified plans."

3.2 The differentiation between a contractor and a builder has also been accepted by ICAI in interpretation to AS 7 issued earlier. The 'TAS Committee' in the final report published during August 2012 in para 8.1.5 observed that a separate ICDS dealing with income recognition by the real estate developers would be notified. The CBDT has clarified in the FAQ issued on 23rd March, 2017 vide Circular No 10/2017 (Reply to Question No. 12) that this ICDS is not applicable to real estate developers.

4. Definitions

"2(1) The following terms are used in this Income Computation and Disclosure Standard with the meanings specified:

- (a) "Construction contract" is a contract specifically negotiated for the construction of an asset or a combination of assets***

that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use and includes:

- (i) contract for the rendering of services which are directly related to the construction of the asset, for example, those for the services of project managers and architects;*
- (ii) contract for destruction or restoration of assets, and the restoration of the environment following the demolition of assets.*
- (b) "Fixed price contract" is a construction contract in which the contractor agrees to a fixed contract price, or a fixed rate per unit of output, which may be subject to cost escalation clauses.*
- (c) "Cost plus contract" is a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus a mark up on these costs or a fixed fee.*
- (d) "Retentions" are amounts of progress billings which are not paid until the satisfaction of conditions specified in the contract for the payment of such amounts or until defects have been rectified.*
- (e) "Progress billings" are amounts billed for work performed on a contract whether or not they have been paid by the customer.*
- (f) "Advances" are amounts received by the contractor before the related work is performed.*

2(2) *Words and expressions used and not defined in this Income Computation and Disclosure Standard but defined in the Act shall have the meaning respectively assigned to them in the Act.*

3. *A construction contract may be negotiated for the construction of a single asset. A construction contract may also deal with the construction of a number of assets which are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.*

4. Construction contracts are formulated in a number of ways which, for the purposes of this Income Computation and Disclosure Standard, are classified as fixed price contracts and cost plus contracts. Some construction contracts may contain characteristics of both a fixed price contract and a cost plus contract, for example, in the case of a cost plus contract with an agreed maximum price.”

4.1 The definition of the terms ‘construction contract’, ‘fixed price contract’ and ‘cost plus contract’ are similar to the definitions contained in AS-7. A construction contract could be negotiated for the construction of an asset or a group of closely interrelated assets. Para 3 outlines an example when a construction contract could be regarded to have been entered in respect of a single asset or in respect of a combination of closely interrelated or inter-connected assets.

4.2 The second limb of the definition of ‘construction contract’ deems certain contracts as construction contracts. A contract for rendering of services would be a construction contract [Para 2(1)(a)(i)] provided the service contract is directly related to the construction of the asset. The expression ‘directly related’ postulates a nexus of first degree. Service contract with project managers and architects have a first degree nexus with the construction of assets. Another instance could be fire equipment inspection service in a newly constructed building.

4.3 A contract for destruction or restoration of assets, and the restoration of the environment following the demolition of the asset is also to be regarded as a ‘construction contract’. [Clause 2(1)(a)(ii)]. This clause covers contracts of demolition of buildings, breaking of ships, clearing of debris after train accident or mining accident.

4.4 A ‘fixed price contract’, is a construction contract in which consideration for the construction work is pre-determined subject to an adjustment / revision due to cost escalation clauses. This definition envisages two types of fixed price contracts. The first type is where the contract price is agreed upon as a fixed amount. A simple example of this type of contract is construction of a dam by a contractor for a fixed price of say Rs. 300 lakh. The second type of fixed price contract is where the contract price is determined based on a unit-of-measure. This type of a contract is generally entered where it is feasible to measure the underlying asset in terms of units. An example of such type of contract is a road

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construction contract. In a road construction contract it is possible to agree to the price on a per kilometer basis.

4.5 The ICDS also defines 'cost plus contract'. As per the definition, a construction contract in which the costs incurred by a contractor in constructing the asset is reimbursed with a mark-up is known as cost plus contract. The first attribute of the definition is '*reimbursement*'. The Supreme Court in *Tata Iron and Steel Co. Ltd. v Union of India*, (2001) 2 SCC 41 observed "*In common acceptance, the word 'reimburse' means and implies 'pay back' or 'refund'. It denotes restoration of something paid in excess; to indemnify.*" In the present context, the said term would mean 'to repay' or 'payback' the costs incurred by a contractor. The second attribute of the definition is that the reimbursement should be of 'allowable or defined costs'. The expression 'allowable or defined costs' denotes that the contract should outline the type, purpose and extent to which a contractor can incur costs. Costs which would be reimbursed to the contractor should either be allowable under the contract or defined under the contract. The third attribute of the definition is that the contractor should get a mark-up over and above the costs. The mark-up could be based on the reimbursed costs or be a fixed amount. The terms of the contract should specify whether the basis of mark-up is the costs incurred or is a fixed amount.

4.6 The ICDS also defines the terms 'retentions', 'progress billings' and 'advances'. These definitions are identical to the definitions contained at Para 40 of AS 7. The definition of 'retentions' outlines two situations where progress billings are to be regarded as retentions. The first situation is where the amount of progress billing is not paid to the contractor until the conditions laid down in the contract are satisfied. The second situation is where the amount of progress billing is not paid for the reason that certain defects are yet to be rectified by the contractor. It is not necessary that every construction contract has a clause stipulating a retention condition.

4.7 The term 'progress billings' is defined to mean amounts billed by the contractor for work performed under the contract. Whether the customer (contractee) has made the payment or not is inconsequential. The term 'advances' is defined to mean amounts received by the contractor before the related work is performed. The definition is in line with the commercial understanding of the term 'advance' as something paid to a person before execution of work. The character changes from advance to consideration when the related work is performed or completed. The stage of completion of

work would help characterize the amount received from the contractee as advance or consideration.

5. Combining and Segmenting Construction Contracts

“5. The requirements of this Income Computation and Disclosure Standard shall be applied separately to each construction contract except as provided for in paragraphs 6, 7 and 8 herein. For reflecting the substance of a contract or a group of contracts, where it is necessary, the Income Computation and Disclosure Standard should be applied to the separately identifiable components of a single contract or to a group of contracts together.

6. Where a contract covers a number of assets, the construction of each asset should be treated as a separate construction contract when:

- (a) separate proposals have been submitted for each asset;*
- (b) each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and*
- (c) the costs and revenues of each asset can be identified.*

7. A group of contracts, whether with a single customer or with several customers, should be treated as a single construction contract when:

- (a) the group of contracts is negotiated as a single package;*
- (b) the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and*
- (c) the contracts are performed concurrently or in a continuous sequence.*

8. Where a contract provides for the construction of an additional asset at the option of the customer or is amended to include the construction of an additional asset, the construction of the additional asset should be treated as a separate construction contract when:

- (a) the asset differs significantly in design, technology or function from the asset or assets covered by the original contract; or*

(b) *the price of the asset is negotiated without having regard to the original contract price.*

5.1 The requirements of this ICDS are to be applied separately to each construction contract. However, in certain circumstances, it would be necessary to apply the ICDS to the separately identifiable components in order to reflect the substance of a contract or a group of contracts. Paras 5 to 8 of the ICDS outline the rules to be followed for determining when a contract can be treated as a separate contract or *vice versa*. These are identical to the prescriptions in paras 7 to 9 of AS 7.

5.2 Para 6 stipulates that a single construction contract covering a number of assets would have to be segmented into separate contracts if the stipulated conditions are cumulatively satisfied. To illustrate, ABC Ltd negotiates with XYZ Ltd for construction of two petroleum refineries located at two different places. It submits separate proposals for both the refineries. The negotiations are also conducted independently for each of the refineries. XYZ Ltd ultimately awards the contract by executing a single agreement specifying separately the price for each of the refineries. Evidently, all the conditions contained in Para 6 are satisfied in this case. There is a single contract. The contract covers more than one asset. For each asset, ABC Ltd submitted a separate proposal. Negotiations are conducted independently for each of the assets. The contract specifies the price for each of the assets. As a result, the contract entered by ABC Ltd with XYZ Ltd would have to be segmented into two separate contracts notwithstanding the fact that there is only one written document. ABC Ltd would have to maintain two separate contract accounts in its books of account, recognizing revenues and costs separately for each refinery.

5.3 Para 7 covers a situation where a group of contracts is to be treated as a single contract. The fact that the contractor has negotiated the said group of contracts with a single customer or with several customers is irrelevant if the stipulated conditions for being regarded as a single contract are cumulatively satisfied. The first circumstance influencing such a conclusion is the contract having been negotiated as a single package. The second circumstance is close interrelation of the contracts with each other having an impact on the overall profit margin of the contractor. The interdependence could be in relation to design, function or use of the assets. The third circumstance is that the contracts are performed concurrently or sequentially.

5.4 All the three conditions referred to herein above would be satisfied in a case where a contractor (say RP & Co) enters into two separate contracts with a customer (say PP Ltd) one for preparing the technical design of a power plant and another for civil construction of the said plant. The civil construction work is based on the technical design. Negotiations are conducted for the two contracts and for sequential delivery of the assets in a span of 18 months. The decision on pricing of contracts is taken by PP Ltd after considering the bids made by RP & Co. RP & Co negotiates the contracts as a single package. The tasks to be performed under both the contracts are interrelated in terms of technology, function and use. All the three conditions of Para 7 of ICDS III would be satisfied to regard the two contracts [contract for technical designing and civil construction] as a single contract. RP & Co would therefore, be required to recognize revenues and costs for both the contracts as one single contract.

5.5 An additional asset may be required to be constructed by the contractor at the option of the customer or due to an amendment in the original contract. Whether construction of such an additional asset would tantamount to a new contract or an extension of an existing contract? Para 8 declares that a contractor needs to treat the construction of an additional asset as a separate contract if any of the following conditions are satisfied:

- (i) the additional asset differs significantly in terms of design, technology or function from the asset or assets covered by the original contract; or
- (ii) the price of the additional asset is negotiated without regard to the original contract price.

Illustration – In the contract between PP Ltd and RP & Co [illustration at Para 5.4], an option was available to the latter to extend the scope of work to build residential quarters for employees and a guest house near the power plant. At the end of 18th month, RP & Co extends the scope of work under the original contract. A separate price is agreed upon for the extended scope of work. RP & Co would have to treat the construction of residential quarters and guest house as separate construction contracts for the reason that the new assets viz., residential quarters and the guest house differ significantly in design, technology or function from the assets covered under the original contract.

6. Contract Revenue

“9. Contract revenue shall be recognised when there is reasonable certainty of its ultimate collection.

10. Contract revenue shall comprise of:

- (a) the initial amount of revenue agreed in the contract, including retentions; and***
- (b) variations in contract work, claims and incentive payments:***
 - (i) to the extent that it is probable that they will result in revenue; and***
 - (ii) they are capable of being reliably measured.***

11. Where contract revenue already recognised as income is subsequently written off in the books of accounts as uncollectible, the same shall be recognised as an expense and not as an adjustment of the amount of contract revenue.”

6.1 Para 9 stipulates that contract revenue is to be recognized when there is a reasonable certainty of its ultimate collection. Para 21 of AS 7 recommends that contract revenue should be recognized if the outcome of a construction contract can be estimated reliably. The TAS Committee in its final report published during August 2012 addressing the reason for this difference, observed *“As per AS-7, contract revenues are recognized if it is possible to reliably measure the outcome of a contract. This issue being subjective in nature has resulted in litigation and postponement of tax liability. Therefore, this condition is removed.”*

6.2 As per Advanced Law Lexicon, 3rd Edition, the expression ‘reasonable certainty’ means ‘being free from reasonable doubt’. The concept of reasonable certainty in collection of revenue has been explained in para 9.2 of AS 9 as under:

“9.2 Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g., for escalation of price, export incentives, interest etc., revenue recognition is postponed to the extent of uncertainty involved. In such cases, it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made. Where there is no uncertainty as to ultimate collection, revenue is recognised at the time of sale or rendering of service even though payments are made by installments.”

6.3 The expression 'reasonable certainty' would, accordingly mean that the contractor should recognize contract revenues only if there is no doubt about collection of such revenues.

6.4 Under the income tax regime, business receipts are assessable in the year in which the same accrue to the assessee [Section 5 read with section 145(1)]. The concept of 'accrual' postulates crystallization of a right in favour of the assessee to receive the income. An income accrues when the payer acknowledges a debt in his favour. In *CIT v Excel Industries Ltd (2013) 358 ITR 295 (SC)*, the Supreme Court after referring to various decisions laid down the following three tests to determine the accrual of income [Para 27 of the decision].

- (i) Whether the income accrued to the assessee is real or hypothetical;
- (ii) Whether there is a corresponding liability of the other party to pay the amount;
- (iii) Whether there is a realistic probability of realisation of the amounts by the assessee.

6.5 The stipulation of Para 9 of this ICDS reiterates the third test mentioned above. Mere satisfaction of the same would not, however, amount to accrual of income. For accrual of income under section 5 of the Act, all the three tests outlined above would have to be satisfied. Also, there has to be a corresponding liability on the other party to pay the amount. As the provisions of section 5 prevail over ICDS, the contract revenue should be recognized on satisfaction of the test of accrual and not merely on the basis of reasonable certainty of collection of contract revenue.

6.6 Para 10 of the ICDS enumerates the components of contract revenue. Clause (a) of Para 10 states that contract revenue shall comprise of initial amount of revenues agreed in the contract including retentions. The ICDS however stipulates that the retention monies are part of the contract revenue. In applying the percentage of completion method (discussed infra), the income recognition should factor retention amounts also as contract revenue. Whether retention monies accrue before satisfaction of conditions stipulated, remains debatable in the light of the legal understanding of 'accrual' under section 5.

6.7 Para 16 of this ICDS mandates that contract revenue should be recognized by reference to the stage of completion of a contract, commonly known as percentage of completion method. Retention monies also have to

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be recognized proportionately. The TAS Committee in its final report has recommended that retention money accrues proportionately on the basis of work completed by the contractor and therefore needs to be recognized for tax purposes as per percentage of completion method. The relevant extract from the TAS Committee's final report reads as follows (Para 5.2.5):

"The Tax Accounting Standard for Construction Contracts [TAS (CC)] is based on the Accounting Standard-7 (AS-7) for Construction Contracts issued by the ICAI. While recommending the TAS (CC), the Committee made the following changes to AS-7:

AS-7 is silent about treatment of accrual of income in respect of the retention money. There are some judicial pronouncements holding that the retention money is not deemed to have accrued for tax purposes. To overcome this unintended meaning, the TAS (CC) specifically provides that the retention money shall accrue to the person for computing revenue based on the percentage of completion method."

6.8 A reference may also be made to the clarifications on ICDS contained in Circular no. 10/2017, dated 23rd March 2017 issued by the CBDT. Question no. 11 and answer there to are reproduced below:

Question 11: *Whether the recognition of retention money, receipt of which is contingent on the satisfaction of certain performance criterion is to be recognized as revenue on billing?*

Answer: *Retention money, being part of overall contract revenue, shall be recognised as revenue subject to reasonable certainty of its ultimate collection condition contained in para 9 of ICDS-III on Construction contracts.*

6.9 Despite the recommendation of the TAS Committee and the clarification contained in the Circular referred above, one would have to ascertain whether the test of accrual under section 5 of the Act would be satisfied. This is because, section 5 being a part of the Act would prevail over ICDS in case there is any conflict between the two. It may be noted that the definition of 'accrual' in Para 2(c) of ICDS I is for the purposes of section 145(2). A similar definition already existed in AS I issued under section 145(2) vide Notification No. 9949, dated 25-1-1996. It was nobody's contention that the said definition altered the understanding of accrual under section 5. The definition of accrual in ICDS I being in a similar setting, should not assume a different meaning or purpose.

6.10 The ICDS states that amount of retentions constitutes contract revenue. This proposition was never in doubt. The issue was with regard to the year in which such revenue satisfied the test of accrual. Courts have held that a contractor cannot be said to have earned the retentions in terms of section 5 of the Act unless the conditions stipulated in the contract are satisfied or defects are rectified. No enforceable right arises till the conditions are satisfied or defects are rectified. Till such time the right to receive vis-à-vis retentions is contingent in nature [*CIT v Simplex Concrete Piles (India) (P) Ltd* [1989] 179 ITR 8 (Cal), *CIT v P&C Constructions (P) Ltd* [2009] 318 ITR 113 (Mad), *Amarshiv Construction (P) Ltd v DCIT* [2014] 367 ITR 659 (Guj)].

6.11 Clause (b) of Para 10 states that variations in contract work, claims and incentive payments would constitute contract revenue provided the following conditions are satisfied:

- (i) It is probable that these items would result in revenue; and
- (ii) They are capable of being reliably measured.

6.12 The above limb of the definition of 'contract revenue' is identical to Para 10(b) of the definition of 'contract revenue' under AS 7. Under such circumstances, the explanations given under paras 11 to 14 of AS 7 could be referred for understanding the scope of clause (b) of Para 10 of the ICDS. The variations, claims and incentives referred to above are to be understood from the contractor's viewpoint.

Contract revenue written off from books as uncollectible – Dealt with in Para 11 of ICDS - Situation I

6.13 Para 11 of this ICDS deals with a situation where any contract revenue which has already been recognized as income is written off from the books for the reason that the same is uncollectible. Para 11 recommends that the amount written off should be claimed as a deductible expense.

6.14 Section 36(1)(vii) of the Act envisages two situations when bad debts can be allowed as a deduction. The first situation envisages any bad debt or part thereof written off as irrecoverable in the accounts of the assessee. The prescription under para 11 of the ICDS that the written off amount should be claimed as an expense is therefore in line with the operative portion of section 36(1)(vii) of the Act.

6.15 Another stipulation of para 11 is that the amount of contract revenue written off in the books should not be adjusted from the contract revenue.

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Adjustment of contract revenue on account of reversal would have disturbed the incomes already offered to tax on POCM basis in the earlier years. The prescription under Para 11 that bad debts should be recognized as an expense and not as an adjustment from the contract revenue would preserve the contract revenue already offered to tax on POCM basis.

Contract revenue not recorded in books but offered to tax as per ICDS turned bad - Not dealt with in ICDS III - Situation II

6.16 This ICDS does not cover the second situation envisaged in section 36(1)(vii) viz., where contract revenue not recorded in the books of account, but offered to tax as per ICDS, turns bad. An assessee cannot write-off a debt which was not recorded in the books of account but offered to tax. In such a case, Para 11 of the ICDS cannot be invoked to claim deduction of uncollectible amounts as the same cannot be written-off in the books of account. To illustrate, retention amount is generally recognized in the books of account when the right to receive the same is established. However as per the ICDS, retention amount is to be recognized as contract revenue for tax purposes in proportion to the stage of completion. The assessee having paid tax on the whole or a part of the retention monies would not be in a position to claim deduction towards the uncollectable retention amount as the condition of writing off the bad debts in the books of account would not be satisfied. The deduction under such a situation would, however, be available by virtue of second proviso to section 36(1)(vii). As per the said proviso, bad-debts could be claimed as deduction without a write off in books of account. The condition precedent is that the amount of debt or part thereof has been taken into account in computing the income of the assessee of the previous year in which the amount of such debt or part thereof becomes irrecoverable or of an earlier previous year.

7. Contract Costs

“12. Contract costs shall comprise of:

- (a) costs that relate directly to the specific contract;***
- (b) costs that are attributable to contract activity in general and can be allocated to the contract;***
- (c) such other costs as are specifically chargeable to the customer under the terms of the contract; and***
- (d) allocated borrowing costs in accordance with the Income Computation and Disclosure Standard on Borrowing Costs.***

These costs shall be reduced by any incidental income, not being in the nature of interest, dividends or capital gains, that is not included in contract revenue.

13. Costs that cannot be attributed to any contract activity or cannot be allocated to a contract shall be excluded from the costs of a construction contract.

14. Contract costs include the costs attributable to a contract for the period from the date of securing the contract to the final completion of the contract. Costs that are incurred in securing the contract are also included as part of the contract costs, provided

- (a) they can be separately identified; and***
- (b) it is probable that the contract shall be obtained.***

When costs incurred in securing a contract are recognised as an expense in the period in which they are incurred, they are not included in contract costs when the contract is obtained in a subsequent period.

15. Contract costs that relate to future activity on the contract are recognised as an asset. Such costs represent an amount due from the customer and are classified as contract work in progress.”

7.1 Para 12 of the ICDS outlines constituents of contract costs. Clause (a) states that contract costs should comprise of costs which are directly related to a specific contract. Such costs comprise of labour costs, cost of materials, depreciation on plant and machinery, plant and machinery hiring charges, sub-contractor charges, architect fees, soil testing charges, etc. One may, in this connection, refer Para 16 of AS 7 wherein other examples of costs directly related to a specific contract have been enumerated. The same reads as under:

“Costs that relate directly to a specific contract include:

- (a) site labour costs, including site supervision;***
- (b) costs of materials used in construction;***
- (c) depreciation of plant and equipment used on the contract;***
- (d) costs of moving plant, equipment and materials to and from the contract site;***
- (e) costs of hiring plant and equipment;***

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- (f) *costs of design and technical assistance that is directly related to the contract;*
- (g) *the estimated costs of rectification and guarantee work, including expected warranty costs; and*
- (h) *claims from third parties.”*

7.2 Clause (b) of para 12 covers costs that are attributable to contract activity in general and can be allocated to the contract. There are two conditions for an expense to fall within clause (b). The first condition is that the costs should be attributable to the construction contract activity. The term ‘attributable’ has a wide connotation. It covers costs having direct as well as indirect nexus. The second condition is that such costs should be allocable to a contract.

7.3 Para 17 of AS 7 contains examples of costs which are attributable to contract activity in general and allocable to specific contracts. These include (a) insurance, (b) costs of design and technical assistance not related to a specific contract, and (c) construction overheads such as preparation and processing of construction personnel payroll. The allocation should be done using a systematic and rational method. As recommended in para 17 of AS 7, the level of construction activity could be taken as a base for allocating these costs to specific contracts.

7.4 Clause (c) of para 12 covers costs that are specifically chargeable to the customer under the terms of the contract. These include administration costs and research costs which are agreed to be reimbursed by the contractee.

7.5 Clause (d) of para 12 of the ICDS stipulates that borrowing cost allocable to a construction contract would also constitute contract cost. As this Standard itself contains the mandate for including borrowing costs as part of construction cost, ICDS IX is not to be referred for the purpose of determining whether borrowing cost forms part of the contract cost.

Borrowing cost attributable to a construction contract not covered under proviso to section 36(1)(iii)

7.6 Section 36(1)(iii) of the Act deals with deduction of interest paid in respect of capital borrowed for the purposes of the business. Proviso to section 36(1)(iii) stipulates that interest paid on capital borrowed for acquisition of an asset is not allowable as deduction if the same relates to a period beginning from the date of borrowing till the date on which such asset

is first put to use. The condition precedent for applicability of the proviso to section 36(1)(iii) is that the assessee should have borrowed the capital for the purpose of acquisition of an asset. Capital borrowed by a contractor for the purpose of executing a construction contract is not in the nature of capital borrowed for acquisition of an asset. A contractor does not acquire an asset under a construction contract. As a result, interest paid on capital borrowed by a contractor attributable to a construction contract would not be hit by the embargo created under proviso to section 36(1)(iii) of the Act. As a result, interest paid on capital borrowed by a contractor attributable to a construction contract would be allowed as a deduction.

Borrowing cost attributable to a construction contract not covered under ICDS IX

7.7 Borrowing costs attributable to a construction activity carried by a contractor is not covered under ICDS IX. According to para 3 of ICDS IX, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset shall be capitalized as part of the cost of that asset. Para 2(1)(b) therein defines the term 'qualifying asset'. The definition contains three clauses. None of these clauses specifically mention that an asset being created under a construction contract constitutes a qualifying asset. Clause (iii) of the definition states that inventories which require a period of twelve months or more to bring them to a saleable condition, constitute a qualifying asset. Whether a construction contract constitutes an inventory of a contractor? Para 2(1)(a) of ICDS II defines the term 'inventories' to mean (i) assets held for sale in the ordinary course of business; (ii) assets in the process of production of such sale; and (iii) assets in the form of materials or supplies to be consumed in the production process or in the rendering of services. An asset or group of assets constructed by a contractor is not an asset which is held for sale by the contractor. The asset or combination of assets is constructed by the contractor for the contractee. The asset or combination of assets constructed by the contractor would not thus satisfy the definition of "inventory". Para 1(a) of ICDS II supports such an understanding. Para 1(a) states that ICDS II shall be applied for valuing the inventories except work-in-progress arising under 'construction contract' which is dealt with by ICDS III. This indicates that an asset or group of assets constructed under a construction contract does not constitute inventory of the contractor. As ICDS III and IX would not be applicable regarding the treatment of borrowing costs, the deductibility of the same would be governed by section 36(1)(iii). For the reasons detailed in para 7.6, interest

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paid on capital borrowed by a contractor attributable to a construction contract would be allowable as a deduction.

7.8 Para 12 of the ICDS declares that incidental incomes which do not form part of contract revenue shall be reduced from the contract costs. An example of incidental income is sale of surplus materials and the disposal of plant and equipment at the end of the contract [Para 16 of AS 7]. Incidental income for this purpose does not include incomes in the nature of interest, dividends and capital gains. These incomes would be taxed separately in accordance with the applicable provisions of the Act.

7.9 Para 13 declares that costs that do not satisfy the conditions laid down in clause (b) of Para 12 cannot form part of contract costs. One could, in this connection refer to Para 19 of AS 7, which lists out examples of such costs to include (a) general administration costs for which reimbursement is not specified under the contract; (b) selling costs; (c) research and development costs for which reimbursement is not specified under the contract; and (d) depreciation of idle plant and equipment that is not used on a particular contract.

7.10 Para 14 of the ICDS stipulates that costs incurred from the date of securing the contract to the date of completion of contract should form part of contract costs. It also stipulates that costs incurred to secure the contract should also be included in contract costs subject to fulfillment of the following two conditions:

- (i) Such costs should be capable of being separately identified; and
- (ii) Such costs should have been incurred with a probability of obtaining the contract.

Cost of tender forms and site visit charges paid to technicians for initial assessment are examples of costs incurred for securing the contract.

7.11 It could happen that certain costs are incurred for securing the contract in a particular financial year but the contract is secured in the subsequent year. The question is whether the costs incurred for securing the contract would have to be claimed in the year of incurrence or in the year in which contract is secured? The first limb of para 14 stipulates that contract costs include costs incurred from the date of securing the contract to the date of completion of the contract. It further provides that costs incurred in securing the contract are also included as a part of the contract costs on satisfaction of specified conditions. The last limb of para 14 stipulates that when costs

incurred in securing a contract have been recognized as an expense in the year of incurrence, such costs are not to be included again as a part of contract costs in the year in which contract is obtained.

7.12 Para 15 of the ICDS covers situations where costs are incurred in advance for a contract work of subsequent years. Para 15 directs that such costs should not be claimed as a deduction as the same represents amount due from customers. The ICDS provides that such costs are in the nature of an asset and should be characterised as work-in-progress. Para 15 of the ICDS corresponds to Para 26 of AS 7. However, Para 15 of the ICDS does not contain the requirement that it should be probable that such costs will be recovered as provided in AS 7. Since the reference is to the amount due from the customer, in any case even under Para 15 of the ICDS, the requirement of the probability of recovery is implied. To illustrate, ABC Pvt Ltd enters into a contract during January 2017 to construct a multistorey building. The construction activity is to be completed within 36 months. During February 2017, ABC Ltd procures electrical fittings to be used in all the floors at a cost of Rs 10 lakhs. The electrical work is scheduled to be undertaken during August 2018. The amount of Rs 10 lakhs cannot be claimed as deduction in the return of income filed for the AY 2017-18 as the same relates to a work which would be undertaken in the subsequent financial year. Another instance could be of advance payment in December 2017 to an agency for installing wireless routers in common area of a residential project. The installation work is to be undertaken during June 2018. The payment to the agency cannot be claimed as a part of the construction costs in the return of income for A Y 2018-19 as the same relates to a work which would be undertaken in the subsequent financial year.

8. Recognition of Contract Revenue and Expenses

“16. Contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the reporting date.

17. The recognition of revenue and expenses by reference to the stage of completion of a contract is referred to as the percentage of completion method. Under this method, contract revenue is matched with the contract costs incurred in reaching the stage of completion,

resulting in the reporting of revenue, expenses and profit which can be attributed to the proportion of work completed.

18. The stage of completion of a contract shall be determined with reference to:

- (a) the proportion that contract costs incurred for work performed upto the reporting date bear to the estimated total contract costs; or**
- (b) surveys of work performed; or**
- (c) completion of a physical proportion of the contract work.**

Progress payments and advances received from customers are not determinative of the stage of completion of a contract.

19. When the stage of completion is determined by reference to the contract costs incurred upto the reporting date, only those contract costs that reflect work performed are included in costs incurred upto the reporting date. Contract costs which are excluded are:

- (a) contract costs that relate to future activity on the contract; and**
- (b) payments made to subcontractors in advance of work performed under the subcontract.**

20. During the early stages of a contract, where the outcome of the contract cannot be estimated reliably contract revenue is recognised only to the extent of costs incurred. The early stage of a contract shall not extend beyond 25 % of the stage of completion.”

8.1 In terms of para 16, contract revenue and contract costs should be recognized as revenue and expenses respectively by reference to the stage of completion of the construction activity at the reporting date. Para 17 states that recognition of revenue and expenses by reference to the stage of completion is referred as the percentage of completion method. Under this method, contract revenue is matched with the contract costs actually incurred in reaching the stage of completion of construction activity. Para 17 states that percentage of completion method results in reporting of revenue, expenses and profit attributable to the proportion of work completed on the reporting date.

8.2 The pre-condition for recognizing contract revenue and contract costs under this ICDS is actual performance of work. Based on the

recommendation of the TAS Committee, the ability of making a reliable estimate of the outcome of the contract before recognizing revenues and costs has been deleted. The TAS Committee had opined that recognition of revenue based on reliable estimates of outcome of contract is a subjective condition and results in postponement of tax liability. Consequently, the ICDS does not envisage reliable estimation of the outcome of a contract as a condition precedent of recognizing contract revenue or costs.

8.3 The aforementioned difference between this ICDS and AS 7 could have implications on account of MAT. ICDS requires recognition of revenue in the year in which work is performed on percentage of completion method even if the contractor is unable to make a reliable estimate of outcome of contract. In a subsequent year, when the contractor is able to reliably estimate the outcome of a contract, the contract revenue would be 'accounted' as income in the books of account [as per Para 21 of AS 7]. Having paid tax in the first year on the basis of ICDS, the tax payer may be exposed to a MAT liability in the subsequent year due to the recognition of income in the books of account.

8.4 Para 18 of the ICDS outlines three parameters on the basis of which the stage of completion of contract is determined. The first is the contract costs incurred till the reporting date. The second parameter is the survey of actual work performed till the reporting date. The third parameter is the stage of completion of a physical proportion of the contract work. A contractor could choose any one of these criteria to determine the stage of completion of contract. Progress payments and advances received from customers cannot be adopted as a criterion for determining the stage of completion of contract.

8.5 Para 19 of the ICDS stipulates that where contract costs incurred upto the reporting date is chosen as the factor for determining the stage of completion of contract, only such costs that are relatable to work performed should be included. Other costs would have to be excluded. Examples of costs to be excluded are (a) contract costs that relate to future activity and (b) advance payment to sub-contractors.

8.6 Para 20 of the ICDS stipulates that contract revenue should be recognized only to the extent of costs incurred till the reporting date. Revenue recognition can be postponed in the initial phase of the contract, which in no case shall exceed 25% of the contract work. The language does

not mandate a recognition of income only after the threshold of 25% completion is reached.

Allowance of losses

8.7 Para 35 of AS 7 provides that expected losses shall be recognized in the financial statements and not in proportion to percentage of completion of contract. Similar prescription is absent in the ICDS. The TAS Committee in Para 5.2.5 of its report stated that only the “actual losses” (and not expected losses) are to be recognized. ICDS I also says that expected losses shall not qualify as a deduction unless otherwise specifically permitted under any ICDS. Thus only actual losses are allowable under the ICDS.

8.8 The actual loss made by the tax payers would be eligible for the deduction in compliance with the provision of section 28 or 37 of the Income-tax Act. One will also have to make a distinction between incurred loss and expected loss. ICDS only prohibits allowability of expected loss and not an incurred loss.

9. Changes in Estimates

“21. The percentage of completion method is applied on a cumulative basis in each previous year to the current estimates of contract revenue and contract costs. Where there is change in estimates, the changed estimates shall be used in determination of the amount of revenue and expenses in the period in which the change is made and in subsequent periods.”

9.1 Para 21 of the ICDS recognizes that the percentage of completion method is based on the current estimates of contract revenue and contract costs. It further stipulates that any change in estimates of contract revenue and contract costs would have to be given effect in the year in which such change is made and to the subsequent years. The change in estimate would not affect the contract revenue and costs recognized in the prior years. To illustrate, RB Pvt Ltd enters into a construction contract with NK Pvt Ltd during FY 2016-17 for constructing a wind mill. The contract revenue and contract costs estimated at the time of entering the contract are Rs 10 crores and Rs.8.5 crores respectively. The contract revenue and costs are revised on account of escalation in prices of wind turbine to Rs 10.5 crores and Rs.9 crores respectively in the subsequent year (FY 2017-18). The effect of the change in estimates of contract revenue and contract costs would have to be given effect in the assessment year 2018-19 [relevant to FY 2017-18] and

subsequent assessment years. Contract revenue and costs offered to tax in assessment year 2017-18 (relevant to FY 2016-17) would remain unchanged.

10. Transitional Provisions

“22.1 Contract revenue and contract costs associated with the construction contract, which commenced on or after 1st day of April, 2016 shall be recognized in accordance with the provisions of this ICDS.

22.2 Contract revenue and contract costs associated with the construction contract, which commenced on or before the 31st day of March, 2016 but not completed by the said date, shall be recognized based on the method regularly followed by the person prior to the previous year beginning on the 1st day of April, 2016.”

10.1 As regards transitional provisions, para 22 of the ICDS contains twin prescriptions. The first prescription is that this ICDS would apply to contracts which have commenced on or after 01.04.2016. Thus, this ICDS is not applicable for construction contracts that commenced prior to financial year 2016-17. The second prescription is that the contract revenue, contract costs in respect of contracts commenced prior to financial year 2016-17 would have to be offered to tax as per the method regularly followed by the contractor. If a contractor has continuously followed completed contract method, the contract revenue and costs in relation to contracts commenced prior to financial year 2016-17 would have to be recognised under the said method and not as per this ICDS.

11. Disclosure

“23. A person shall disclose:

- (a) the amount of contract revenue recognised as revenue in the period; and***
- (b) the methods used to determine the stage of completion of contracts in progress.***

24. A person shall disclose the following for contracts in progress at the reporting date, namely:-

- (a) amount of costs incurred and recognised profits (less recognised losses) upto the reporting date;***

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(b) *the amount of advances received; and*

(c) *the amount of retentions.*”

11.1 Paras 23 and 24 outline the disclosure requirements under this ICDS. As the ICDS do not apply to the manner of maintaining books of account, these disclosures have to be made in tax audit report in clause 13(d) to (f) of Form 3CD. It is also clarified that the disclosure requirement will also apply to the new contracts as per transitional provisions contained in Para 22.

Chapter 5

ICDS IV : Revenue Recognition

1. Preamble

“This Income Computation and Disclosure Standard is applicable for computation of income chargeable under the head “Profits and gains of business or profession” or “Income from other sources” and not for the purpose of maintenance of books of accounts.

In the case of conflict between the provisions of the Income-tax Act, 1961 (‘the Act’) and this Income Computation and Disclosure Standard, the provisions of the Act shall prevail to that extent.”

1.1 This ICDS, like other ICDS, applies in computing income under the head “Profits and gains of business or profession” and “Income from other Sources”. Provisions of the Act will override the ICDS in case there is a conflict.

1.2 This Income Computation and Disclosure Standard is based on *Accounting Standard 9–Revenue Recognition*. While some of the principles contained in AS 9 have been adopted in this ICDS, there are also certain significant differences between the ICDS and AS 9. Where the provisions of this ICDS and AS 9 are similar, one may refer to the explanations and examples given in AS 9 for applying the provisions of the ICDS.

2. Scope

“1(1) This Income Computation and Disclosure Standard deals with the bases for recognition of revenue arising in the course of the ordinary activities of a person from

- (i) the sale of goods;***
- (ii) the rendering of services;***
- (iii) the use by others of the person’s resources yielding interest, royalties or dividends.***

1(2) This Income Computation and Disclosure Standard does not deal with the aspects of revenue recognition which are dealt with by other Income Computation and Disclosure Standards.”

2.1 Para 1(1) of the ICDS deals with the scope of the Standard. It is to be

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applied for recognition of the revenue from sale of goods, rendering of services and use by others of the assessee's resources that yield interest, royalties or dividends. Primarily, the ICDS deals with the point of time when the revenue should be recognised. It also indicates the method of measurement of revenue to be recognised.

2.2 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. Another view is that for the purposes of this ICDS, the term "goods" includes immovable properties. Accordingly, if the assessee is dealing in land then in such a case, the term "goods" may include immovable properties like land and consequentially provisions of ICDS shall apply. It may be noted that para 3 of Ind AS 18 makes that Standard applicable to a dealer in land.

2.3 AS 9 also covers recognition of the revenue from sale of goods, rendering of services and use by others of the assessee's resources that yield interest, royalties or dividends. It, however, specifically excludes from its scope revenue from construction contracts, hire-purchase and lease agreements, revenue from government grants and similar subsidies and revenue of insurance companies from insurance contracts.

2.4 Para 1(2) of the ICDS provides that the ICDS does not apply to cases of revenue recognition dealt with by other ICDS. Although a contractor renders service while executing a construction contract, ICDS III relating to Construction Contracts deals with revenue recognition in case of construction contracts. ICDS V relating to Tangible Fixed Assets deals with income arising from transfer of a tangible fixed asset. Similarly, ICDS VII specifically deals with Government Grants. Hence, this ICDS will not apply in such 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. It may be noted that as and when an ICDS is notified, as a consequence to comply with the provisions of such new ICDS, a change in policy may also become necessary.

2.5 Hire purchase and lease transactions have not been covered by any specific notified ICDS. The TAS Committee had drafted a separate ICDS on Leases, which was also published by the CBDT for public comment. However, it has not yet been notified. Pending notification of a separate

ICDS on Leases, the issue arises as to the tax treatment of lease transactions and hire purchase transactions. This is discussed in para 5.4 below.

3. Definitions

“2(1) The following term is used in this Income Computation and Disclosure Standard with the meanings specified:

- (a) ***“Revenue” is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of a person from the sale of goods, from the rendering of services, or from the use by others of the person’s resources yielding interest, royalties or dividends. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration.***

2(2) Words and expressions used and not defined in this Income Computation and Disclosure Standard but defined in the Act shall have the meanings assigned to them in that Act.”

3.1 The term ‘Revenue’ has been defined to mean the gross inflow of cash, receivable or other consideration arising from transactions undertaken in the ordinary course of activities. Transactions covered are - sale of goods, rendering of services or use by others of certain resources of the assessee. Section 145A of the Income-tax Act, 1961 provides that value of sale of goods should be adjusted to include the amount of any tax, duty, cess or fee (by whatever name called). For the purpose of computing the gross turnover, members may also refer the Guidance Note on Tax Audit under section 44AB of the Income-tax Act, 1961 issued by the ICAI.

3.2 This ICDS specifically recognises that it is only the commission which is the gross revenue of the agent. This principle may also apply in other similar cases, depending upon the relationship as determined by the terms of the contract.

3.3 It may be noted that 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 or credit at low rate of interest 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

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interest. The difference between the stated consideration and the fair value arrived at by discounting is recognised as interest income (Refer paras 9 to 11 of Ind AS 18 - Revenue). This ICDS does not recognise discounting of consideration. Hence, while computing total income, the revenue should be considered/recognised without discounting.

3.4 Further, para 13 of Ind AS 18 - Revenue provides that in certain circumstances, it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction. Similarly, Ind AS 18 - Revenue provides that the recognition criteria are applied to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole. This may not always be appropriate while applying the provisions of this ICDS depending upon the facts. Considering this, revenue recognised under Ind AS 18 - Revenue should be adjusted wherever necessary to comply with the provisions of the ICDS.

3.5 This ICDS deals with recognition of interest. 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.

4. Sale of Goods

"3. In a transaction involving the sale of goods, the revenue shall be recognised 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 have been transferred to the buyer and the seller retains no

effective control of the goods transferred to a degree usually associated with ownership. In a situation, where transfer of property in goods does not coincide with the transfer of significant risks and rewards of ownership, revenue in such a situation shall be recognised at the time of transfer of significant risks and rewards of ownership to the buyer.

4. Revenue shall be recognised when there is reasonable certainty of its ultimate collection.

5. Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim for escalation of price and export incentives, revenue recognition in respect of such claim shall be postponed to the extent of uncertainty involved.”

4.1 The two cumulative criteria for recognising revenue from sale of goods are:

(i) The seller has transferred the property in the goods to the buyer for a price or significant risks and rewards associated with the ownership of the goods have been transferred to the buyer and the seller has not retained effective control over the goods transferred. Control contemplated here is control that an owner usually has over the goods.

4.2 Generally, transfer of significant risks and rewards associated with the ownership of the goods coincides with or is the result of transfer of property in the goods. In some cases, the two events may not happen simultaneously on account of agreement between the parties or due to fault of one of the parties. In such a case, revenue should be recognised when significant risks and rewards associated with the ownership of the goods are transferred to the buyer.

4.3 The issue that needs to be considered is how revenue from leases and hire purchase transactions will be recognised. ICDS I relating to Accounting Policies states that the treatment and presentation of transactions shall be governed by their substance and not by the legal form. Considering this and provisions of para 3 of this ICDS, there may be different views in respect of recognition of revenue from lease agreements (particularly transactions in the nature of finance lease) and hire-purchase agreements.

4.4 The Supreme Court, in the case of *I.C.D.S. Ltd. v CIT (2013) 350 ITR 527 (SC)*, held that the lessor was the owner of the asset and had used the asset for its business, and was thus entitled to depreciation under section 32

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of the Act. Having regard to this decision of the Apex Court and also the present position under section 32, lease transactions would not be treated as sale, but the lease rent would be taxed as income and the lessor will be entitled to depreciation. This view is supported by the fact that the definition of “revenue”, contemplates revenue arising from use of assessee’s resources by others, though the definition restricts itself to interest, royalties or dividends.

4.5 In case of hire purchase agreements, invariably there is an option to the person taking the asset on hire to purchase the asset by paying the amount due. So far as such transactions in the nature of hire purchase are concerned, a reference may be made to Circular No. 9 of 1943, dated March 23, 1943 (Sl. No. 255) issued by the CBDT. Para 3 of this Circular reads as under:

“Where the terms of the agreement provide that the equipment shall eventually become the property of the hirer or confer on the hirer an option to purchase the equipment, the transaction should be regarded as one of hire purchase. In such cases the periodical payments made by the hirer should for tax purposes be regarded as made up of:

- a. Consideration for hire, to be allowed as a deduction in the assessment, and*
- b. payment on account of purchase to be treated as capital outlay, depreciation being allowed to the lessee on the initial value (i.e., the amount for which the hired subject would have been sold for cash at the date of agreement).*

The allowance to be made in respect of hire should be the difference between the aggregate amount of the periodical payments under the agreement and the initial value (as described above), the amount of this allowance being spread evenly over the term of the agreement. If, however, the agreement was terminated either by the outright purchase of equipment or of its return to the owner, the deduction should cease as from the date of the termination.”

4.6 This was reiterated by Instruction No. 1097, dated 19-9-1977. The Circular and the Instruction do not directly deal with the recognition of revenue by a person giving an asset on hire, but deal with allowance of depreciation to a person taking an asset on hire. Considering that both, the person taking the asset on hire and the person giving the asset on hire, cannot claim depreciation in respect of the same asset, it would appear that

the person giving the asset on hire will need to recognise the sale of the asset and the hirer would be entitled to claim the depreciation. This would also be in consonance with the requirement of the ICDS I that the treatment and presentation of transactions and events shall be governed by their substance and not merely by the legal form.

(ii) The other criteria for recognising the revenue is that there is reasonable certainty of ultimate collection of the revenue. If there does not exist reasonable certainty of ultimate collection of the revenue, recognition of revenue is postponed.

4.7 Apart from the general proposition, this ICDS specifically mentions that in case of export incentives or claim for price escalation, where reasonable certainty of ultimate collection is lacking, recognition of the revenue is postponed. In such a case, revenue, collection of which is not reasonably certain, is not recognised when the claim for such revenue is raised.

4.8 Para 9 of AS 9 deals with the effect of uncertainties on revenue recognition generally. However, para 4 of the ICDS is under the heading 'Sale of Goods' indicating that it applies only to recognition of revenue from sale of goods. AS 9 provides for postponement of recognition of revenue where it cannot be reliably measured or determined. However, before any revenue can be recognised for the purposes of the Act, it must accrue or arise as contemplated under section 5 of the Act. Unless revenue has accrued, it cannot be brought to tax. This is a general proposition. In this respect a reference may be made to the decision of the Supreme Court in the case of *CIT v A. Gajapathy Naidu* [1964] 53 ITR 114 (SC). The Court held that income accrues or arises when the assessee acquires a right to receive the same. Where revenue cannot be measured, it could also lead to the conclusion that the assessee has not acquired the right to receive the same. This will depend on the facts and circumstances surrounding the transaction.

Interplay between ICDS and Ind AS 18

4.9 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. This ICDS refers to seller not retaining control but does not refer to managerial involvement to the degree usually associated with ownership. If due to these conditions contained in Ind AS 18 -Revenue, if any revenue has not been recognised in

the books of account, then wherever necessary appropriate adjustment may be made while applying this ICDS. Due to difference in the criteria for the time of recognition of revenue as well as measurement of the revenue under ICDS and the accounting standards, particularly 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.

5. Rendering of Services

***“6. Subject to Para 7, revenue from service transactions shall be recognised by the percentage completion method. Under this method, revenue from service transactions is matched with the service transactions 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. Income Computation and Disclosure Standard on construction contract also requires the recognition of revenue on this basis. The requirements of that Standard shall mutatis mutandis apply to the recognition of revenue and the associated expenses for a service transaction. However, 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 over the specific period.*”**

7. Revenue from service contracts with duration of not more than ninety days may be recognised when the rendering of services under that contract is completed or substantially completed.”

5.1 The ICDS prescribes that revenue from rendering of services has to be recognised generally by applying percentage of completion method. Para 12 of AS 9 gives an option to recognise revenue from service transactions on completed service contract method. The ICDS does not provide for this option except where the duration of the service contract does not exceed ninety days.

5.2 It may however be noted that the notified ICDS do not apply to assesseees following cash method of accounting. These apply only to assesseees following mercantile system of accounting. Hence, assesseees following cash system of accounting are not required to recognise revenue on percentage of completion method.

5.3 Under percentage of completion method, profit or loss proportionate to the work completed is computed. This is done by estimating the revenue

which is attributable to the work completed and matching it with the costs and expenses incurred to reach the stage of completion at the end of the previous year.

5.4 ICDS III relating to Construction Contracts also prescribes percentage of completion method for recognising the revenue from construction contracts. The requirements of the ICDS III apply with necessary changes for recognising the revenue from service transactions as well. Para 9 of ICDS III provides that “Contract Revenue shall be recognised when there is reasonable certainty of its ultimate collection”. Accordingly, when the criterion of reasonable certainty is not met, recognition of revenue from service transactions is to be postponed.

5.5 A detailed discussion relating to construction contracts is given in the Chapter relating to ICDS III on Construction Contracts of this Technical Guide. A reference may be made to the same.

5.6 ICDS also provides that in cases where services are provided by an indeterminate number of acts over a specific period of time, revenue may be recognised on a straight-line basis over the specific period. Similar provision is in AS 9 in para 7.1(i). In such a case the assessee need not apply the provisions of ICDS III dealing with construction contracts.

5.7 Where the duration of the contract for service does not exceed ninety days, ICDS gives an option of computing income from such service contract when rendering of service is completed or substantially completed. Thus, in case of small contracts which are not directly covered by ICDS III, the assessee is not required to apply complex provisions of ICDS III.

5.8 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.

5.9 Merely, because a transaction is liable to service tax it will not *ipso facto* mean that it is a service transaction as contemplated under this ICDS. For example, a real estate developer developing a property on his own account and not as a contractor will not be covered by this ICDS, since the predominant aspect of the transaction as understood under the Act is of sale

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of immovable property. Considering this, provisions of ICDS will not apply to recognition of the revenue by a developer of real estate. Also, the CBDT has issued a separate draft ICDS on Real Estate Transactions. Pending notification of such ICDS, revenue in such cases will have to be recognised based on the method of accounting followed, general accounting principles and various judicial pronouncements on the issue. In this respect a reference may be made to the clarifications on ICDS contained in Circular no. 10/2017, dated 23rd March, 2017 issued by the CBDT. Question no. 12 and answer thereto are 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.*

6. The Use of Resources by Others Yielding Interest, Royalties or Dividends

“8(1). Subject to sub paragraph (2), interest shall accrue on the time basis determined by the amount outstanding and the rate applicable.

(2) Interest on refund of any tax, duty or cess shall be deemed to be the income of the previous year in which such interest is received.

(3) Discount or premium on debt securities held is treated as though it were accruing over the period to maturity.”

6.1 As mentioned above, the term ‘interest’ is not defined in the ICDS; however it is defined in section 2(28A) of the Act. Accordingly, the term ‘interest’ will carry the meaning assigned to it under the Act.

6.2 Para 8(1) of the ICDS requires that interest shall accrue on time basis and calculated on the basis of the amount outstanding and the applicable rate. Rate of interest is generally agreed between the parties. It may vary and such variation may, in some cases, be contingent upon certain events.

6.3 As stated earlier, what can be taxed is only the income which has accrued or arisen in the previous year relevant to the assessment year as

contemplated under section 5. A reference may be made to the discussion in para 4.8 above. In the context of interest, the Delhi High Court, in the case of *CIT v Vasisth Chay Vyapar Ltd.* [2011] 330 ITR 440 (Del) held that where recovery of inter corporate deposits (ICD) itself had become doubtful due to precarious financial position of the borrower and the ICD had become a non-performing asset as per the Directions of the Reserve Bank of India, the interest thereon could not be said to have accrued to the assessee. The Court also referred to section 45Q of the Reserve Bank of India Act, 1934. A reference may also be made to the decision of the Bombay High Court in the case of *DIT v Credit Suisse First Boston (Cyprus) Ltd.* [2013] 351 ITR 323 (Bom). Considering this, based on facts and circumstances, where reasonable certainty of recovery of revenue is lacking, it will be appropriate to say that revenue has not accrued at all as contemplated under section 5.

6.4 One may however refer to the clarifications on ICDS contained in Circular no. 10/2017, dated 23rd March, 2017 issued by the CBDT. Question no. 13 and answer thereto are 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). Further, the provision of the Act (e.g. Section 43D) shall prevail over the provisions of ICDS.*

6.5 The tax payer would be required to apply the principles of accrual and reasonable certainty in respect of Interest, royalty and dividend income also.

6.6 The ICDS applies for computing income under the head 'Profits and gains from business or profession' as well as 'Income from other sources'. Accordingly, in case of an assessee following mercantile system of accounting, requirements of this ICDS will have to be complied with. Even in case of individual assesses following mercantile system of accounting, all interest income including interest on savings accounts, fixed deposits, debt securities, etc. will have to be computed following this ICDS.

6.7 Section 145A(b) of the Act provides that interest received by an assessee on compensation or on enhanced compensation, as the case may be, shall be deemed to be the income of the year in which it is

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received. Such interest shall be taxed under the head 'Income from other sources' in the year of receipt, irrespective of whether assessee follows mercantile system of accounting or cash system. Section 57(iv) allows a deduction of 50% in respect of such interest. ICDS-IV will not apply to interest received by an assessee on compensation or on enhanced compensation, since, in case of conflict between ICDS and the Act, the Act shall prevail.

6.8 At times, debt securities are issued at a discount and redeemed at par or issued at par and redeemed at a premium after the term of the security. In such cases, the debt security may or may not carry interest. The ICDS in para 8(3) requires that in such cases the discount or the premium is effectively treated as interest accruing over the period to maturity. The ICDS does not specify whether the accrual should be based on compound interest or simple interest. If interest is to be computed by compounding, at what 'rests' will it be compounded – will it be compounded every quarter or every six months or on yearly basis? While the total revenue to be recognised over the term of the security will be the same, amount to be recognised from year to year will be different based on whether the calculation is done considering simple interest or compound interest and the method of compounding. In such a case, the assessee may follow any reasonable method consistently for calculation of interest considering the facts and terms and conditions of the debt security.

6.9 A person may hold a debt security for a part of the previous year and may sell the debt security before interest on the same becomes payable in accordance with the terms of such security. He may still have to compute interest for the period during which he was holding the security, although he will not receive any interest. For harmonious construction, while computing the capital gain (or business income in case of a dealer in securities) on transfer of security, the consideration should be reduced by the amount of interest offered for taxation.

6.10 Similarly, once the discount or premium is considered as interest and offered for taxation as mandated by the ICDS or interest is computed on time basis and offered for taxation although not received, while computing the capital gain or business income on transfer or redemption of the debt security, the discount or the premium so computed and taxed should be reduced from the amount received on transfer. It should not form part of the full value of consideration for the purposes of computing capital gain under section 48 of the Act or for computing business income, as the case may be. Doing otherwise will result in double taxation.

6.11 It may be noted that ICDS VIII relating to Securities applies to securities held as stock-in-trade by certain entities. Para 8 of that ICDS deals with a case where unpaid interest accrued before acquisition of security is included in the purchase price of interest bearing security. The said para 8 provides for allocation of such interest between pre-acquisition period and post-acquisition period. The cost of security purchased is to be reduced by interest for the pre-acquisition period.

6.12 Such specific provision for reduction of the sale price by interest computed and offered for taxation but not received is absent when a dealer in securities sells securities. However, as discussed above, such interest will have to be reduced from the sale price. Doing otherwise will amount to double taxation.

6.13 The moot question that needs to be considered is whether any part of the full value of consideration which is chargeable to capital gain under section 45 read with section 48, can be taxed as interest on account of provisions of this ICDS. It may be noted that ICDS do not apply for computation of capital gain. It is therefore possible to take a view that where the Act provides the mode of computation of capital gain under section 48 by taking the full value of consideration, no part of such consideration can be taxed as interest under the provisions of ICDS.

6.14 However, in this respect, a reference may be made to the clarifications on ICDS contained in Circular no. 10/2017, dated 23rd March, 2017 issued by the CBDT. Question no. 18 and answer thereto are reproduced below:

Question 18: *If the taxpayer sells a security on the 30th day of April 2017. The interest payment dates are December and June. The actual date of receipt of interest is on the 30th day of June 2017 but the interest on accrual basis has been accounted as income on the 31st day of March, 2017. Whether the taxpayer shall be permitted to claim deduction of such interest i.e. offered to tax but not received while computing the capital gain?*

Answer: *Yes, the amount already taxed as interest income on accrual basis shall be taken into account for computation of income arising from such sale.*

6.15 The above clarification states that the amount already taxed on accrual basis shall be taken into account for computation of income arising from such sale. However, in cases where the income on disposal of security is taxable as capital gain, taking into account the interest already taxed

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would effectively mean that the 'full value of the consideration' contemplated under section 48 of the Act will have to be adjusted by the amount of interest taxed but not received. But as stated earlier, ICDS do not apply to computation of capital gains.

6.16 Further, where the terms of a debt security provide that interest becomes due on a particular day, say on 30th June and 31st December every year, can it be said that the assessee has acquired a right to receive any interest prior to such date. In this respect a reference may be made to the decision of the Bombay High Court in the case of *DIT v Credit Suisse First Boston (Cyprus) Ltd.* [2013] 351 ITR 323 (Bom). The Court held that interest accrued only on due dates and the right to receive the interest vested only on the due dates and cannot be said to have accrued on any date other than stipulated date. Considering this decision and also the provisions of section 48, a view can be taken that so far as interest on debt security is concerned, it will accrue only on the due dates specified in terms of the debt security and not on time basis.

6.17 By computing the interest as mandated by the ICDS, there is a likelihood of mismatch of tax deducted at source, since interest income will be computed and taxed in one assessment year, but certificate for tax deduction will be available in the subsequent year. It may also happen that before the interest becomes payable as per the terms of issue of the security, the holder of the security may sell the security. In such a case, interest may not have been booked as an expense by the issuer, and tax will not have been deducted by the issuer of the security.

6.18 The assessee offering the income computed on the basis of this ICDS will not receive certificate for tax deducted at source. On the other hand, the purchaser of the security, who receives the certificate for tax deducted at source, would have held the security only for a part of the period covered by the TDS certificate. So, the person receiving the certificate for TDS will consider interest only for the period for which he held the security, while the TDS certificate will reflect interest for a longer period.

6.19 This ICDS is for recognising the revenue and not expenditure or cost by way of interest. Hence, the ICDS will not apply to the payer of interest.

6.20 Para 8(2) of this ICDS provides that interest on any refund of any tax, duty or cess shall be deemed to be income of the previous year in which such interest is received. It may be noted that such interest will be taxed only on receipt basis and not when interest is merely determined. Effectively,

refund of tax (such as VAT) itself may be taxed when it is determined while the interest thereon will be taxed on receipt basis.

“9. Royalties shall accrue in accordance with the terms of the relevant agreement and shall be recognised on that basis unless, having regard to the substance of the transaction, it is more appropriate to recognise revenue on some other systematic and rational basis.”

6.21 The ICDS requires that royalties shall accrue in accordance with the terms of agreement between the parties and be recognised accordingly. However, the ICDS provides that, considering the substance of the transaction, if it is more appropriate to recognise royalties on other systematic and rational basis, then such other basis shall be adopted for recognising the royalties.

6.22 In case of non-resident assessee, royalty is generally taxed on gross basis under section 115A of the Act or under the provisions of Double Taxation Avoidance Agreements (DTA). In such cases where royalty is taxed under section 115A of the Act, provisions of this ICDS will have to comply with. In this respect, a reference may be made to the clarifications on ICDS contained in Circular no. 10/2017, dated 23rd March, 2017 issued by the CBDT. Question no. 14 and answer thereto are reproduced below:

Question 14: *Whether ICDS is applicable to revenues which are liable to tax on gross basis like interest, royalty and fees for technical services for non-residents u/s. 115A of the Act.*

Answer: *Yes, the provisions of ICDS shall also apply for computation of these incomes on gross basis for arriving at the amount chargeable to tax.*

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

6.24 The ICDS does not define the term 'Royalty'. Explanation 2 to clause (vi) of section 9(1) which defines the term 'Royalty' for the purpose, reads as under:

“Explanation 2—For the purposes of this clause, "royalty" means consideration (including any lump sum consideration but excluding any consideration which would be the income of the recipient chargeable under the head "Capital gains") for—

(i) the transfer of all or any rights (including the granting of a

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- licence) in respect of a patent, invention, model, design, secret formula or process or trade mark or similar property;*
- (ii) the imparting of any information concerning the working of, or the use of, a patent, invention, model, design, secret formula or process or trade mark or similar property;*
 - (iii) the use of any patent, invention, model, design, secret formula or process or trade mark or similar property;*
 - (iv) the imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill;*
 - (iva) the use or right to use any industrial, commercial or scientific equipment but not including the amounts referred to in section 44BB;*
 - (v) the transfer of all or any rights (including the granting of a licence) in respect of any copyright, literary, artistic or scientific work including films or video tapes for use in connection with television or tapes for use in connection with radio broadcasting, but not including consideration for the sale, distribution or exhibition of cinematographic films; or*
 - (vi) the rendering of any services in connection with the activities referred to in sub-clauses (i) to (iv), (iva) and (v)."*

Explanation 3 defines the term 'computer software'. Further, Explanations 4 to 6 to clause (vi) of section 9(1) inserted by the Finance Act, 2012 by way of clarification and for removal of doubts read as under:

"Explanation 4—For the removal of doubts, it is hereby clarified that the transfer of all or any rights in respect of any right, property or information includes and has always included transfer of all or any right for use or right to use a computer software (including granting of a licence) irrespective of the medium through which such right is transferred.

Explanation 5—For the removal of doubts, it is hereby clarified that the royalty includes and has always included consideration in respect of any right, property or information, whether or not—

- (a) the possession or control of such right, property or information is with the payer;*

- (b) *such right, property or information is used directly by the payer;*
- (c) *the location of such right, property or information is in India.*

Explanation 6—For the removal of doubts, it is hereby clarified that the expression "process" includes and shall be deemed to have always included transmission by satellite (including up-linking, amplification, conversion for down-linking of any signal), cable, optic fibre or by any other similar technology, whether or not such process is secret."

6.25 The definition is wide and complex, more particularly when read with the above Explanations to clause (vi) of section 9(1) of the Act. Considering this, the assessee will have to examine various transactions to ascertain whether these are covered by the definition of royalty in Explanation 2 to clause (vi) of section 9(1) and hence covered by the requirements of para 8 of the ICDS.

6.26 The definition of royalty also includes consideration for rendering of services in connection with the activities referred to in sub-clauses (i) to (iv), (iva) and (v) of the said Explanation 2. The question that arises is whether revenue from such services should be recognised as per the requirements of para 6 (dealing with services) of the ICDS or para 8 (dealing with royalties) of the ICDS. The services referred in sub-clause (vi) of the said Explanation 2 are services incidental to transfer, imparting or use of various rights or information referred to in sub-clauses (i) to (iv), (iva) and (v) of Explanation 2. These services have been specifically defined as royalty by Explanation 2. The ICDS provides that words and expressions used and not defined in this ICDS but defined in the Act shall have the meanings assigned to them in that Act. Considering this, it would be appropriate that the consideration for rendering of services in connection with the activities referred to sub-clauses (i) to (iv), (iva) and (v) of the above said Explanation 2 is considered as royalty and recognised in accordance with requirements of para 8 of the ICDS and not as revenue from services in accordance with para 6 of the ICDS.

"10. Dividends are recognised in accordance with the provisions of the Act."

6.27 The term "dividend" has been defined inclusively by section 2(22) of the Act. It includes certain distributions and payments. Although, dividends in respect of which dividend distribution tax is paid under section 115-O of the Act are exempt under section 10(34) of the Act, dividends received from a foreign company are chargeable to tax. Similarly, the amount deemed to be

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dividend under section 2(22)(e) of the Act is not subject to dividend distribution tax and is chargeable to tax.

6.28 Dividends, when chargeable to tax, will be recognised as revenue in accordance with the provisions of section 8 of the Act. Section 8 of the Act makes specific provision for taxation of dividend. It reads as under:

“8. For the purposes of inclusion in the total income of an assessee, —

- (a) any dividend declared by a company or distributed or paid by it within the meaning of sub-clause (a) or sub-clause (b) or sub-clause (c) or sub-clause (d) or sub-clause (e) of clause (22) of section 2 shall be deemed to be the income of the previous year in which it is so declared, distributed or paid, as the case may be;
- (b) any interim dividend shall be deemed to be the income of the previous year in which the amount of such dividend is unconditionally made available by the company to the member who is entitled to it.”

6.29 Dividend, as is normally understood, is declared by the company in a general meeting and is to be recognised on declaration. Sub-clauses (a) to (d) of Section 2(22) deems certain distributions by a company of its accumulated profits as dividend. Such distributions are to be recognised as revenue on distribution and dividend under sub-clause (e) of section 2(22) is recognised as revenue when paid. Interim dividend is to be recognised as revenue when it is made unconditionally available to shareholders.

6.30 It may be noted that the term ‘dividend’ for the purposes of the Act, does not include dividend from mutual funds. Under the various provisions of the Act, dividends from mutual funds are referred as ‘income in respect of units of mutual funds’ (refer sections 10(35) and 194K). Accordingly, para 9 of the ICDS has no application in respect of income in respect of units of mutual funds.

7. Transitional Provisions

“11. The transitional provisions of Income Computation and Disclosure Standard on construction contract shall mutatis mutandis apply to the recognition of revenue and the associated costs for a service transaction undertaken on or before the 31st day of March, 2016 but not completed by the said date.”

7.1 Para 6 of the ICDS makes provisions contained in ICDS III relating to

construction contracts applicable to service transactions for recognising revenue from rendering of certain services. Similarly, para 11 of the ICDS makes transitional provisions of the ICDS III applicable to service transactions.

7.2 Transitional provisions of ICDS III are contained in para 22.1 and para 22.2 of that ICDS. Para 22.1 of ICDS III provides that contract revenue and contract costs associated with the construction contract, which commenced on or after 1st April, 2016 shall be recognised in accordance with the provisions of that ICDS. Para 22.2 further provides that revenue and costs associated with construction contract which commenced on or before 31st March but was not complete on that date shall be recognised based on the method regularly followed by the person prior to the previous year beginning on 1st April, 2016. Effectively, in case where a service contract which was not complete as on 31st March, 2016 and in respect of which provisions of ICDS III are otherwise applicable, the assessee shall continue to recognise the revenue and costs of such service contract as per the method he was following in assessment year 2016-17.

“12. Revenue for a transaction, other than a service transaction referred to in Para 10, undertaken on or before the 31st day of March, 2016 but not completed by the said date shall be recognised in accordance with the provisions of this standard for the previous year commencing on the 1st day of April, 2016 and subsequent previous year. The amount of revenue, if any, recognised for the said transaction for any previous year commencing on or before the 1st day of April, 2015 shall be taken into account for recognising revenue for the said transaction for the previous year commencing on the 1st day of April, 2016 and subsequent previous years.”

7.3 In case of transactions, other than service transactions, that have commenced on or before 31st March, 2016 but not completed on that date, revenue should be recognised in accordance with the provisions of this ICDS and revenue that may have been recognised in any earlier previous year is to be adjusted in the subsequent years i.e. from the previous year ending on or after 31st March, 2017.

7.4 It appears that reference to para 10 in para 12 of ICDS is incorrect. It ought to be para 11 dealing with transition provisions relating to service transactions. In the ICDS notified on 31st March, 2015 reference was to para 10. However, in the ICDS notified on 29th September, 2016 para numbers have changed, while reference to old para no. 10 continued.

8. Disclosure

“13. Following disclosures shall be made in respect of revenue recognition, namely:—

- (a) in a transaction involving sale of good, total amount not recognised as revenue during the previous year due to lack of reasonably certainty of its ultimate collection along with nature of uncertainty;***
- (b) the amount of revenue from service transactions recognised as revenue during the previous year;***
- (c) the method used to determine the stage of completion of service transactions in progress; and***
- (d) for service transactions in progress at the end of previous year:***
 - (i) amount of costs incurred and recognised profits (less recognised losses) upto end of previous year;***
 - (ii) the amount of advances received; and***
 - (iii) the amount of retentions.”***

8.1 In case of sale of goods, where there is no reasonable certainty about ultimate collection of revenue, recognition of such revenue can be postponed under provisions contained in paras 4 and 5 of the ICDS. Para 13 of the ICDS requires that the amount of revenue not recognised due to lack of reasonable certainty of ultimate collection be disclosed.

8.2 In case of service transactions, the amount of revenue from service transactions recognised during the previous year and the method used to determine the stage of completion of service transactions in progress have to be disclosed. This ICDS read with para 18 of the ICDS III provides for three options to determine stage of completion. The ICDS requires disclosure as to how the stage of completion of service transactions is determined.

8.3 In case of service transactions in progress at the end of previous year following disclosures are required:

- (a) amount of costs incurred and recognised profits (less recognised losses) upto the end of previous year;***
- (b) the amount of advances received; and***
- (c) the amount of retentions.***

8.4 These disclosures in respect of services need to be read in the context of para 7 of this ICDS. The disclosures need to be made only in respect of service transactions with duration of more than 90 days.

Chapter 6

ICDS V : Tangible Fixed Assets

1. Preamble

“This Income Computation and Disclosure Standard is applicable for computation of income chargeable under the head “Profits and gains of business or profession” or “Income from other sources” and not for the purpose of maintenance of books of accounts.

In the case of conflict between the provisions of the Income-tax Act, 1961 (‘the Act’) and this Income Computation and Disclosure Standard, the provisions of the Act shall prevail to that extent.”

1.1 This ICDS, like other ICDS, applies in computing income under the head “Profits and gains of business or profession” and “Income from other sources”. Provisions of the Act will override the ICDS in case there is a conflict.

1.2 This ICDS corresponds to Accounting Standard (AS) 10 – ‘Property, Plant and Equipment’ as notified on March 30, 2016 under the Companies (Accounting Standards) Amendment Rules, 2016 and Indian Accounting Standard (Ind AS) 16 - ‘Property, Plant and Equipment’ prescribed under section 133 of the Companies Act, 2013, as notified under the Companies (Indian Accounting Standards) Rules, 2015.

1.3 This ICDS covers 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.

1.4 The principal aspect dealt with by this ICDS is the treatment with respect to what would 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.

2. Scope

1. “This Income Computation and Disclosure Standard deals with the treatment of tangible fixed assets.”

2.1 Since this ICDS specifically deals with only tangible fixed assets, intangible assets are outside the purview of this ICDS. Thus, fittings are not

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specifically covered under the definition of Tangible fixed Assets as per this ICDS; however, since the same are considered as part of Block of Assets referred to in Clause II of Part A of New Appendix I, the provisions of this ICDS shall also be accordingly applicable to 'Fittings' either under Plant and Machinery or Furniture. Under the Act, assets such as plant, machinery, buildings, furniture etc. are to be recorded as forming part of separate blocks of assets as defined in section 2(11) and are to be depreciated in accordance with the provisions of section 32 of the Act. Also, the resultant written down value of assets is defined in section 43(6) of the Act.

2.2 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.

2.3 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.

3. Definitions

2. ***“(1) The following terms are used in this Income Computation and Disclosure Standard with the meanings specified:***

- (a) ***“Tangible fixed asset” is an asset 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 is not held for sale in the normal course of business.***
- (b) ***“Fair value” of an asset is the amount for which that asset could be exchanged between knowledgeable, willing parties in an arm’s length transaction.***

(2) Words and expressions used and not defined in this Income Computation and Disclosure Standard but defined in the Act shall have the meanings assigned to them in that Act.”

3.1 Section 2(11) of the Act defines 'block of assets' to mean a group of assets falling within a class of assets comprising (i) tangible assets; and (ii)

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intangible assets in respect of which same percentage of depreciation is prescribed. Tangible fixed assets as defined in above Para 2(1)(a) of the ICDS includes land, building, machinery, plant or furniture. Tangible assets under the definition of block of assets cover all these items except land. This ICDS clarifies as to what part of cost of such assets forms part of the block of assets (including assets in the case of an undertaking engaged in the generation or generation and distribution of power).

3.2 This ICDS does not define asset categories namely building, machinery, plant or furniture. The word 'plant' is not defined in this ICDS, but is defined in section 43(3) of the Act and thus it shall have the meaning assigned to it in that section. According to the said section, plant includes ships, vehicles, books, scientific apparatus and surgical equipment used for the purpose of the business or profession but does not include tea bushes or livestock or buildings or furniture or fittings. In respect of the rest of asset categories, in the absence of definition under the Act and this ICDS, for classification of asset as to what is building, machinery or furniture, interpretation of the Courts in the context of depreciation allowance under section 32 of the Act can be relied upon.

3.3 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 of tangible fixed asset covers assets held with the intention of being used for the purpose of producing or providing goods or services. Assets held for this purpose would include assets held for administrative purposes for producing or providing goods or services. So far as assets held for the purpose of rental are concerned, these could be regarded as held for the purposes of providing services, if the income from such assets is taxable either under the head business income (such as malls) or income from other sources and would therefore fall within the purview of this ICDS. However, in most cases, the income from such rental would fall under the head "Income from House Property", and such rental properties would not be covered.

3.4 Section 32 of the Act provides that depreciation is to be allowed on assets that are owned by the assessee and used for the purpose of business or profession. In the case of *Mysore Minerals Ltd v CIT* [1999] 239 ITR 775 (SC), the Hon'ble Supreme Court has held that the term 'owned' must be assigned a wider meaning and that a person having acquired possession

over an asset in his own right, though a legal title may not have been conveyed to him, could still be considered as the 'owner'. This enlarged meaning of 'owner' as interpreted by the Hon'ble Supreme Court can be correlated to the term used namely 'asset held' in this ICDS. Possession of the asset in own right and exercise of dominion over the asset are important tests to determine whether the asset is 'held' as covered by this ICDS. Further, ICDS I requires the treatment and presentation of transactions and events to be governed by their substance and not merely by their legal form. This supports the view that assets, where possession has been acquired and the assessee has control over the asset, are covered under this ICDS.

3.5 This ICDS defines the term 'fair value' of an asset as the amount for which that asset could be exchanged between knowledgeable, willing parties in an arm's length transaction. The definition of the fair value is given in the ICAI publication on Accounting Standards and is also explained in Ind AS 113 on Fair Value. One can refer both the documents for a detailed explanation.

3.6 This ICDS, AS 10 and Ind AS 16 all define the term 'fair value' in an identical manner. It would be more appropriate to rely on the meaning imparted by the said Standards.

4. Identification of Tangible Fixed Assets

"3. The definition in clause (a) of sub-paragraph (1) of paragraph 2 provides criteria for determining whether an item is to be classified as a tangible fixed asset."

4.1 While Para 2(1)(a) of this ICDS defines tangible fixed asset, under the Act as well as this ICDS, no monetary threshold is prescribed for any asset to be identified as a tangible fixed asset and therefore all purchases of tangible fixed assets are to be capitalised to their respective blocks of assets as per section 2(11) of the Act. 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.

“4. Stand-by equipment and servicing equipment are to be capitalised. Machinery spares shall be charged to the revenue as and when consumed. When such spares can be used only in connection with an item of tangible fixed asset and their use is expected to be irregular, they shall be capitalised.”

4.2 Both AS 10 and Ind AS 16 provide that spare parts, stand-by equipment and servicing equipment are to be recognised as assets if they meet the definition of Property, Plant and Equipment. Otherwise, they are classified as inventory. An item of Property, Plant and Equipment 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.

4.3 In cases where, under the tests laid down under AS 10 and Ind AS 16, stand-by equipment, servicing equipment or spares are classified as inventory, but as per this ICDS, these are required to be recognised as tangible assets and necessary adjustment will have to be done in computing the income. In such situations, the amount expended on stand-by equipment, servicing equipment and spares which has been debited to the profit and loss account will have to be reduced from the expenditure to be claimed in computing the taxable income and added to the appropriate block of assets, with corresponding depreciation claim.

4.4 In this regard reference may be made to the Explanation to section 30 as well as Explanation to section 31 of the Act which provide that capital expenditure will not be allowed as current repairs.

4.5 Useful reference in the above context may be made to the following judicial pronouncements

CIT v Sri Mangayarkarasi Mills (P.) Ltd. [2009] 315 ITR 114 (SC)

CIT v Saravana Spinning Mills (P.) Ltd. [2007] 293 ITR 201 (SC)

Surinder Madan v ACIT [2014] 364 ITR 461 (Del)

CIT v H.P. Global Soft Ltd. [2012] 349 ITR 462 (Kar)

5. Components of Actual Cost

“5. 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.”

5.1 The term ‘actual cost’ is defined under section 43(1) of the Act and means the actual cost of the assets to the assessee as reduced by that portion of the cost thereof, if any, as has been met directly or indirectly by any other person or authority. The section, read with several explanations provided therein, states as to what would be treated as actual cost under specific circumstances. Such circumstances, inter-alia, include transfer and re-acquisition, transfer in demerger, scheme of amalgamation etc. The actual cost determined under this ICDS will be subject to the provisions of section 43(1) of the Act.

5.2 Due consideration also needs to be given to ICDS IX on Borrowing Costs that provides for capitalisation of borrowing cost on qualifying assets, which include tangible assets. ICDS IX requires capitalisation of borrowing costs (interest and other costs incurred in connection with borrowing of funds) attributable to the acquisition, construction or production of a qualifying asset till the asset is first put to use as part of the cost of that asset. The amount of such borrowing cost (in respect of specific and general borrowing) to be capitalised is to be computed as per the provisions of ICDS IX.

5.3 The Hon’ble Supreme Court in the case of *Challapalli Sugars Ltd v CIT [1975] 98 ITR 167 (SC)* has held that interest on amount borrowed for acquiring and installing machinery for the period prior to commencement of production, forms part of actual cost. It has also been held in *CIT v Fort Gloster Industries Ltd [1971] 79 ITR 48 (Cal)* that expenses on registration, stamp duty, insurance, guarantee commission necessary for acquisition of a depreciable asset shall form part of the actual cost.

5.4 Both AS 10 and Ind AS 16 define elements of cost in an identical manner and contain several examples of costs that are includible or excludible in the determination of cost of assets. Under both the Accounting Standards, cost includes the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located. However, under this ICDS, in the components of cost such estimated costs of dismantling and removing the item and restoring the site are not included. Such expenditure cannot be considered as expenditure directly attributable in making the asset ready for its intended use. Accordingly, if such expenses have been considered as part of the cost of the fixed asset in the books of

account, these may be reviewed and adjustment should be made while computing the total income, by excluding such expenditure from the cost of the fixed asset and arriving at the amount to be included in the block of assets.

5.5 In so far as Measurement of Cost is concerned, the Accounting Standards provide that in case the payment for Property, Plant and Equipment 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 bifurcation of cost 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 reduced from the interest and the entire cost of such asset including such bifurcated interest should be added to the respective block of assets. It may also be noted that Explanation 8 to section 43(1) provides that interest in connection with acquisition of asset, as relatable to period after asset is first put to use, is not to be included in the actual cost of such asset.

“6. The cost of a tangible fixed asset may undergo changes subsequent to its acquisition or construction on account of

- (i) price adjustment, changes in duties or similar factors; or***
- (ii) exchange fluctuation as specified in Income Computation and Disclosure Standard on the effects of changes in foreign exchange rates.”***

5.6 Para 6 of the ICDS contemplates that the cost of a tangible fixed asset may undergo changes subsequent to its acquisition on account of price adjustments, changes in duties etc. or exchange fluctuation.

5.7 Both AS 10 and Ind AS 16 mandate that the cost of an item of property, plant and equipment should be recognised as an asset only if it is probable that future economic benefits associated with the item will flow to the enterprise and further, such costs can be measured reliably. Under ICDS V, this condition is absent and therefore, the initial recognition of the asset and subsequent addition to the cost due to factors referred above would be made to the cost of the asset regardless of the pre-condition that economic benefits will flow to the enterprise. While computing the total income, to the extent of any expense that is debited to the profit and loss account which, under para 6 of this ICDS, is required to be added to the cost of the asset,

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this should be reduced from the expenditure in the profit and loss account and added to the written down value of the relevant block of assets.

5.8 In so far as subsidy or grant receivable from Government relating to acquisition of an asset is concerned, Explanation 10 to section 43(1) provides for excluding such amount from the actual cost of the asset. In a case where grant relates to a depreciable fixed asset, ICDS VII on Government Grants provides that such grant shall be deducted from the actual cost of the asset or from the written down value of block of assets to which such asset belongs to. Under AS 10, the carrying amount of an item of property, plant and equipment may be reduced by government grants in accordance with AS 12- *Accounting for Government Grants*. However, Ind AS 20- *Accounting for Government Grants and Disclosure of Government Assistance* does not permit reduction of the carrying amount of an item of property, plant and equipment 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 in financial statements drawn in compliance with Ind AS 16 if any government grant relating to an item of property, plant and equipment has been credited to the profit and loss account, then, while computing the total income, amount of such grant should be excluded and the amount should be reduced from corresponding block of assets.

5.9 Also, in so far as the adjustment to assets on account of exchange fluctuations is concerned, para 6 of this ICDS refers to ICDS VI - Effects of changes in foreign exchange rates and therefore is relevant. ICDS VI provides that recognition of exchange difference shall be subject to provisions of section 43A of the Act. As per the provisions of this section, in case of an asset acquired from a country outside India, the increase or reduction in liability of the assessee while making payment towards the cost of the asset or repayment of the moneys borrowed for acquiring the asset in consequence of change in the rate of exchange, shall be added to or deducted from the actual cost (as defined in section 43(1) of the Act). Therefore, application of provisions of section 43A of the Act will also have an impact on the cost of imported tangible fixed asset and is also recognised by this ICDS. It may be noted that adjustment to the actual cost of the asset under the provisions of section 43A is to be done for the reduction or increase in the liability at the time of payment towards such liability and not for the reduction or increase in the liability calculated for the amount

outstanding at the end of the previous year at the exchange rate prevailing on that day.

5.10 Provisions of section 43A do not cover a situation where assets are acquired in India by availing a foreign currency loan or borrowing. ICDS VI does not specifically provide for treatment in such cases, as it refers to monetary items as a whole, without differentiating between capital or revenue transactions. 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)*.

5.11 The treatment of exchange fluctuation as per this ICDS and section 43A of the Act are unique in nature. Therefore, the extent of the amount of exchange fluctuation charged or credited to the profit and loss as per Accounting Standards which is required to be adjusted to the cost of assets as per this ICDS and ICDS VI, would need to be excluded in computing the total income with corresponding addition/deletion to the relevant block of assets.

“7. Administration and other general overhead expenses are to be excluded from the cost of tangible fixed assets if they do not relate to a specific tangible fixed asset. Expenses which are specifically attributable to construction of a project or to the acquisition of a tangible fixed asset or bringing it to its working condition, shall be included as a part of the cost of the project or as a part of the cost of the tangible fixed asset.”

5.12 Administrative and general overhead expenses that are specifically attributable to construction of a project or to the acquisition of a tangible fixed asset or bringing it to its working condition are to be included as part of the cost of the project or the asset, as the case may be.

5.13 However, administration and general overheads in case of a running concern would be considered as revenue expenditure unless such expenditure is specifically attributable to the construction of an asset and hence would not form part of the actual cost. On the other hand, such costs that are incurred specifically for a project would need to be allocated to the assets of the project.

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5.14 The principles of including the administrative and general overheads in the cost of the assets are substantially same as per the Accounting Standards and ICDS.

“8. The expenditure incurred on start-up and commissioning of the project, including the expenditure incurred on test runs and experimental production, shall be capitalised. 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.”

5.15 Expenditure incurred on test runs, experimental production, start up and commissioning of a project are required to be capitalised as per this ICDS.

5.16 There have been conflicting judicial rulings relating to allowability of depreciation from the date of commencement of trial production to the date of commencement of commercial production, and as to whether trial production costs are revenue expenditure or to be capitalised. According to this ICDS, such costs incurred during trial production stage, will need to be capitalised, and cannot be claimed as revenue expenditure.

5.17 In this respect a reference may be made to the clarifications on ICDS contained in Circular no. 10/2017, dated 23rd March, 2017 issued by the CBDT. Question no. 15 and answer thereto are reproduced below:

Question 15: *Para 8 of ICDS-V states expenditure incurred on commissioning of project, including expenditure incurred on test runs and experimental production shall be capitalized. It also states that expenditure incurred after the plant has begun commercial production i.e., production intended for sale or captive consumption shall be treated as revenue expenditure. What shall be the treatment of expense incurred after the conduct of test runs and experimental production but before commencement of commercial production?*

Answer: *As clarified in Para 8 of ICDS-V, the expenditure incurred till the plant has begun commercial production, that is, production intended for sale or captive consumption, shall be treated as capital expenditure.*

5.18 However, such capitalisation would be subject to the provisions of Para 7 of this ICDS, that deals with administration and other general overhead expenses to be excluded from the cost of tangible fixed assets if

they do not relate to a specific tangible fixed asset. Such expenditure should, therefore, be allowable as revenue expenditure.

5.19 However, both AS 10 and Ind AS 16 do not make a specific reference to such cases. Therefore, any such trial run expenditure that is otherwise charged in the accounts but under the provisions of this ICDS is required to be considered as part of the cost of the asset, should be excluded while computing the total income and added to the cost of the asset as per this ICDS.

5.20 Expenditure incurred post commencement of commercial production, whether for sale or internal consumption, is to be treated as a revenue expense under this ICDS as well as under AS 10 & Ind AS 16. However, 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 by this 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. 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 property, plant and equipment. According to Ind AS 16, recognition of costs in carrying amount of an item of plant, property or equipment ceases if the item is in the location and condition necessary for it to be operating in the manner intended by the management.

6. Self-constructed Tangible Fixed Assets

“9. In arriving at the actual cost of self-constructed tangible fixed assets, the same principles shall apply as those described in paragraphs 5 to 8. Cost of construction that relate directly to the specific tangible fixed asset and costs that are attributable to the construction activity in general and can be allocated to the specific tangible fixed asset shall be included in actual cost. Any internal profits shall be eliminated in arriving at such costs.”

6.1 In case the entity/ person constructs any fixed asset on its/ his own, the principles as explained in paras 5 to 8 of this ICDS shall apply to arrive at the actual cost of such asset. Cost of construction that relates directly to specific asset and attributable costs of construction activity in general are to be allocated to the specific asset. It is to be noted that any internal profits (e.g. inter-departmental/inter-branch profits in case of self-constructed asset)

are to be eliminated in arriving at such cost. The requirements on this subject under this ICDS, AS 10 and Ind AS 16 are similar.

7. Non-monetary Consideration

“10. 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.

11. When a tangible fixed asset is acquired in exchange for shares or other securities, the fair value of the tangible fixed asset so acquired shall be its actual cost.”

7.1 This ICDS provides that where an asset is acquired in exchange for another asset, the actual cost of the asset acquired to be recognised, is the fair value of the asset so acquired. ‘Fair’ value has been defined in para 2 of this ICDS.

7.2 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, in cases where property, plant and equipment is acquired in exchange of non-monetary assets, or a combination of monetary and non-monetary assets. Under Ind AS 16, 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. Further, in case of assets acquired, they need to be measured at fair value, even if the assets given up are not de-recognised immediately in accordance with paragraph 24 of Ind AS 16. In cases where an acquired item is not measured at fair value, its cost is measured at the carrying amount of the asset given up.

7.3 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. 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. This would also be necessary when an asset belonging to one block of assets is exchanged for an asset belonging to another block of assets. Also, if the

exchange of assets is within the same block, the amount of addition and reduction would be the same and therefore no adjustment would be required.

8. Improvements and Repairs

“12. An Expenditure that increases the future benefits from the existing asset beyond its previously assessed standard of performance is added to the actual cost.”

8.1 An asset may undergo improvement and repairs from time to time. This ICDS provides that any expenditure in the nature of repairs or improvements that increases the future benefits from an asset beyond the previously assessed standard of performance is to be added to the actual cost and to that extent this clause deals with cases of replacements rather than mere repairs to assets. Both, AS 10 and Ind AS 16 provide that the cost of replacing a part of the asset or cost of major inspections is to be added to carrying amount, if it meets recognition criteria.

8.2 It is pertinent to mention that section 30 of the Act which *inter alia* deals with repairs to buildings, provides that cost of repairs (which is not capital expenditure) to premises where the assessee is a tenant, is deductible as an expenditure. Also, section 31 of the Act that deals with repairs and insurance of machinery, plant and furniture, provides that the amount expended on current repairs is also deductible as an expenditure.

8.3 In cases where parts of machinery have completely worn out, expenditure on their total replacement is held as allowable business expenditure under the aforesaid sections {*New Shorrock Spg. & Mfg. Co Ltd v CIT [1956] 30 ITR 338 (Bom)*}. Expenditure incurred on repairs that does not bring into existence any benefit or advantage of an enduring nature or any new asset or new advantage, nor changes the nature of the asset as a whole or increases its earning capacity, is also held as deductible expenditure. {*CIT v I.C.I (India) (P) Ltd [1983] 139 ITR 105 (Cal)*}. However, it has been held that the amount spent on new machinery, furniture and extensive repairs would not qualify as 'current repairs' and hence not a deductible expenditure {*Ballimal Naval Kishore v CIT [1997] 224 ITR 414 (SC)*}. The Hon'ble Supreme Court in *CIT v Saravana Spg. Mills (P.) Ltd [2007] 293 ITR 201 (SC)* held that section 31(i) limits the scope of allowability of expenditure as deduction in respect of repairs made to machinery, plant or furniture by restricting it to the concept of current repairs and all repairs are not current repairs. The Court further held that the test is not whether expenditure is revenue or capital in nature, but whether expenditure is

current repairs. For an expenditure to be allowable to constitute current repairs what is necessary is that the expenditure must have been incurred to preserve and maintain an already existing asset, and object of expenditure must not be to bring a new asset into existence or to obtain a new advantage. In this case, each machine was held to be an independent and separate machine capable of independent and specific function and, therefore, expenditure incurred for replacement of entire machine would not come within meaning of words 'current repairs'.

“13. The cost of an addition or extension to an existing tangible fixed asset which is of a capital nature and which becomes an integral part of the existing tangible fixed asset is to be added to its actual cost. Any addition or extension, which has a separate identity and is capable of being used after the existing tangible fixed asset is disposed of, shall be treated as separate asset.”

8.4 This para of the ICDS deals with cost of addition or extension to an existing tangible fixed asset in two parts; one where such addition or extension becomes integral part of the existing tangible fixed asset and the second, that is capable of a separate identity or capable of being used after the existing tangible *fixed* asset is disposed of. Both AS 10 and Ind AS 16 do not explicitly deal with such situations.

9. Valuation of Tangible Fixed Assets in Special Cases

“14. Where a person owns tangible fixed assets jointly with others, the proportion in the actual cost, accumulated depreciation and written down value is grouped together with similar fully owned tangible fixed assets.

15. Where several assets are purchased for a consolidated price, the consideration shall be apportioned to the various assets on a fair basis.”

9.1 Where a fixed asset is owned jointly with others, the proportionate share of actual cost, depreciation and written down value is to be grouped with similar assets that are fully owned by the assessee. In case of assets of an undertaking engaged in generation or generation and distribution of power, such cost, depreciation and written down value would be determined on the basis of cost borne in such jointly held assets. The provisions of para 14 of this ICDS derive support from section 32(1) that refers to depreciation on assets owned, wholly or partly, by the assessee.

9.2 Para 15 of this ICDS provides that in case of purchase of several assets for a consolidated price, the consideration is to be bifurcated between 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.

10. Transitional Provisions

“16. The actual cost of tangible fixed assets, acquisition or construction of which commenced on or before the 31st day of March, 2016 but not completed by the said date, shall be recognised in accordance with the provisions of this standard. The amount of actual cost, if any, recognised for the said assets for any previous year commencing on or before the 1st day of April, 2015 shall be taken into account for recognising actual cost of the said assets for the previous year commencing on the 1st day of April, 2016 and subsequent previous years.”

10.1 The transitional provision states that the actual cost of tangible fixed assets whose acquisition or construction is completed after March 31, 2016 shall be governed by the provisions of this ICDS. In recognising actual cost of such assets, actual cost considered in the earlier years is to be taken into account.

11. Depreciation

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

11.1 Under AS 10 and Ind AS 16, property, plant and equipment are componentized and are depreciated separately and there is no concept of minimum statutory depreciation.

11.2 This ICDS refers to the provisions of Act for computation of depreciation on tangible fixed asset. Section 32(1) of the Act read with Rule 5(1A), Rule 5(1) and Appendix IA, Appendix I of the Income-tax Rules provide for deduction of depreciation at prescribed percentage on the actual cost of the asset in case of undertakings engaged in generation or generation and distribution of power and on written down value in case of any block of assets.

11.3 Unlike AS 10 and Ind AS 16, this ICDS does not have a provision for change in the method of depreciation and revaluation of fixed assets, since these are not relevant under the Act.

12. Transfers

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

12.1 This para of the ICDS draws reference to the provisions of the Act for computation of income arising on transfer of a tangible fixed asset. Accordingly, income on transfer is to be computed by applying relevant provisions of the Act. For this purpose, provisions of section 41(2) (business income) and those falling under Chapter IV-E (Capital Gains) need to be complied with.

13. Disclosures

“19. Following disclosure shall be made in respect of tangible fixed assets, namely:—

- (a) description of asset or block of assets;***
- (b) rate of depreciation;***
- (c) actual cost or written down value, as the case may be;***
- (d) additions or deductions during the year with dates; in the case of any addition of an asset, date put to use; including adjustments on account of—***
 - (i) Central Value Added Tax credit claimed and allowed under the***
 - (ii) CENVAT Credit Rules, 2004;***
 - (iii) change in rate of exchange of currency;***
 - (iv) subsidy or grant or reimbursement, by whatever name called;***
- (e) depreciation Allowable; and***
- (f) written down value at the end of year.”***

13.1 Disclosures as required by AS 10, Ind AS 16, Schedule II and Schedule III of the Companies Act, 2013 are more elaborate in nature. The disclosures prescribed by this ICDS are similar to the requirements of clause 18 of Form 3CD.

Chapter 7

ICDS VI : Effects of Changes in Foreign Exchange Rates

1. Preamble

“This Income Computation and Disclosure Standard is applicable for computation of income chargeable under the head “Profits and gains of business or profession” or “Income from other sources” and not for the purpose of maintenance of books of accounts.

In the case of conflict between the provisions of Income Tax Act, 1961 (‘the Act’) and this Income Computation and Disclosure Standard, the provisions of the Act shall prevail to that extent.”

1.1 This ICDS corresponds to Accounting Standard (AS) 11 – *The Effects of Changes in Foreign Exchange Rates* of the Companies (Accounting Standards) Rules, 2006 and Indian Accounting Standard (Ind AS) 21 – *The Effects of changes in foreign exchange rates*, prescribed under section 133 of the Companies Act, 2013 as notified under the Companies (Indian Accounting Standards) Rules, 2015.

2. Scope

“This Income Computation and Disclosure Standard deals with:

- (a) treatment of transactions in foreign currencies;***
- (b) translating the financial statements of foreign operations;***
- (c) treatment of foreign currency transactions in the nature of forward exchange contracts.”***

2.1 Whereas the scope of transactions that are covered under this ICDS *inter-alia* includes foreign currency borrowings, AS 11 specifically excludes exchange differences arising from such transactions to the extent they are regarded as an adjustment to interest cost; these are separately covered in Para 4(e) of AS 16 - Borrowing Cost. Also, the corresponding Ind AS 21 applies to all foreign currency transactions and balances, except certain foreign currency derivative transactions and balances, as well as accounting of hedge transactions in relation to foreign currency items; these are separately covered by Ind AS 109 - Financial Instruments.

3. Definitions

“2. (1) The following terms are used in this Income Computation and Disclosure Standard with the meanings specified:

- (a) “Average rate” is the mean of the exchange rates in force during a period.***
- (b) “Closing rate” is the exchange rate at the last day of the previous year.***
- (c) “Exchange difference” is the difference resulting from reporting the same number of units of a foreign currency in the reporting currency of a person at different exchange rates.***
- (d) “Exchange rate” is the ratio for exchange of two currencies.***
- (e) “Foreign currency” is a currency other than the reporting currency of a person.***
- (f) “Foreign operations of a person” is a branch, by whatever name called, of that person, the activities of which are based or conducted in a country other than India.***
- (g) “Foreign currency transaction” is a transaction which is denominated in or requires settlement in a foreign currency, including transactions arising when a person:—***
 - (i) buys or sells goods or services whose price is denominated in a foreign currency; or***
 - (ii) borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency; or***
 - (iii) becomes a party to an unperformed forward exchange contract; or***
 - (iv) otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency.***
- (h) “Forward exchange contract” means an agreement to exchange different currencies at a forward rate, and includes a foreign currency option contract or another financial instrument of a similar nature;***

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- (i) ***“Forward rate” is the specified exchange rate for exchange of two Currencies at a specified future date;***
- (j) ***“Indian currency” shall have the meaning as assigned to it in section 2 of the Foreign Exchange Management Act, 1999 (42 of 1999);***
- (k) ***“Monetary items” are money held and assets to be received or liabilities to be paid in fixed or determinable amounts of money. Cash, receivables, and payables are examples of monetary items;***
- (l) ***“Non-monetary items” are assets and liabilities other than monetary items. Fixed assets, inventories, and investments in equity shares are examples of non-monetary items;***
- (m) ***“Reporting currency” means Indian currency except for foreign operations where it shall mean currency of the country where the operations are carried out.***

(2) Words and expressions used and not defined in this Income Computation and Disclosure Standard but defined in the Act shall have the meaning assigned to them in the Act.”

3.1 In this ICDS, ‘Average Rate’ is defined as the mean of the exchange rates in force during a period. This definition is common between this ICDS and AS 11. Ind AS 21 does not specifically define this term but refers to this rate as a rate that approximates the actual rate at the date of the transaction.

3.2 ‘Closing Rate’ is defined as the exchange rate on the last day of the previous year. While this ICDS and AS 11 define the rate in an identical manner, the definition under Ind AS 21 refers to spot exchange rate at the end of the reporting period. Spot exchange rate is the exchange rate for immediate delivery.

3.3 The term ‘Exchange difference’ is the difference resulting from reporting the same number of units of foreign currency in the reporting currency of a person at different exchange rates. The definition of this term in AS 11 is identical, while it is similar to the definition in Ind AS 21.

3.4 The term ‘Exchange rate’ is defined in an identical manner in this ICDS, AS 11 and Ind AS 21. It basically means the amount of one currency that can be exchanged for the given amount of another currency. It may be noted that Explanation 1 to section 43A of the Act, for the purposes of that section, defines the term ‘Rate of exchange’ (and not ‘Exchange rate’) and

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that definition is substantially different from the definition in this ICDS. Since this ICDS has defined 'exchange rate', the term will have the meaning assigned by the ICDS.

3.5 'Foreign currency' under this ICDS means currency other than the reporting currency. Reporting currency has been defined to be the Indian currency, except for foreign operations, where it would mean currency of the country where the operations are carried out. Considering this, generally, reporting currency would be the Indian currency and accordingly, foreign currency would generally mean currency other than the Indian currency.

Under AS 11, foreign currency is currency other than the reporting currency. Under Ind AS 21, foreign currency is currency other than the functional currency. Under the Accounting Standards, in certain circumstances, even in the case of Indian operations the reporting currency or the functional currency may not be the Indian currency.

3.6 'Foreign operation of a person' as per this ICDS is an overseas branch, whereas under AS 11 and Ind AS 21, the meaning of foreign operation extends to a subsidiary, associate, joint arrangement or branch. A taxable enterprise under the Act may have a foreign subsidiary, associate or a joint arrangement. However, under the Act such a foreign subsidiary, associate or a joint arrangement would be a separate assessee. Hence, under this ICDS, the meaning of foreign operation is restricted to a branch by whatever name called. Under AS 11 and Ind AS 21, the extended meaning of foreign operation is necessary for the purpose of preparation of consolidated financial statements.

3.7 Unlike AS 11, Ind AS 21 has no concept of segregation of foreign operations into 'integral' and 'Non integral' but the factors prescribed in AS 11 for this purpose are prescribed in Ind AS 21 to determine the foreign operation's functional currency.

3.8 On the other hand, ICDS VI, like Ind AS 21, does not provide for any classification of foreign operation.

3.9 'Foreign currency transaction' has been defined to mean a transaction that is either denominated in foreign currency or is required to be settled in foreign currency.

3.10 The definition further clarifies that foreign currency transaction includes the following:

- purchase or sale of goods

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- borrowing or lending transaction
- transaction where a person becomes a party to unperformed forward exchange contract
- transaction involving acquisition or disposal of assets
- incurring or settling of liabilities

In all the above cases the amounts are denominated in foreign currency.

3.11 AS 11 in para 8 defines the term 'Foreign currency transaction' in similar manner. Ind AS 21 has made a reference in para 20 where a similar meaning has been expressed. However it does not include within its meaning a transaction of becoming a party to unperformed forward exchange contract. Forward exchange contracts are covered by Ind AS 109 dealing with Financial Instruments.

3.12 '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.

3.13 The terms 'monetary items' and 'non-monetary items' are defined in this ICDS. The key difference between these two terms can be understood in the context of the question 'is there a right/obligation to deliver fixed/determinable amount of currency units?' If yes, then the item is monetary and if not, the item is non-monetary. Given below is a table of examples of assets and liabilities that are classified on the basis of this distinction:

Item	Monetary/Non-monetary
Assets	
Property, plant and equipment	Non-monetary
Intangible assets (including goodwill)	Non-monetary
Investments in associates	Non-monetary
Equity investments (e.g. shares)	Non-monetary
Biological assets	Non-monetary
Deferred tax asset	Non-monetary
Inventories	Non-monetary

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Trade receivables	Monetary
Other receivables to be settled in cash	Monetary
Advances and prepayments	Could be Monetary and Non-Monetary; dependent on each advance or pre-payment
Deposits and bank accounts	Monetary
Cash	Monetary
Equity and liabilities	
Share capital	Non-monetary
Other components of equity	Non-monetary
Provisions for employee benefits	Monetary
Finance lease liability	Monetary
Deferred tax liability	Non-monetary
Bank and other loans	Monetary
Accruals	Monetary
Deferred income	Monetary
Trade payables	Monetary
Advances received	Could be Monetary and Non-Monetary; dependent on each advance
Current tax liability	Monetary

3.14 As mentioned earlier, under this ICDS, 'Reporting currency' means Indian currency (except for foreign operations), whereas AS 11 defines reporting currency as the currency used in presenting the financial statement.

3.15 Explanation 1 to section 43A of the Act defines the terms 'Foreign currency' and 'Indian currency' with reference to Foreign Exchange Management Act, 1999.

4. Foreign Currency Transactions

“Initial Recognition

3.(1) A foreign currency transaction shall be recorded, on initial recognition in the reporting currency, by applying to the foreign

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currency amount the exchange rate between the reporting currency and the foreign currency at the date of the transaction.

(2) An average rate for a week or a month that approximates the actual rate at the date of the transaction may be used for all transaction in each foreign currency occurring during that period. If the exchange rate fluctuates significantly, the actual rate at the date of the transaction shall be used."

4.1 In so far as initial recognition of a foreign exchange transaction is concerned, the requirement of this ICDS is similar to corresponding provisions contained in AS 11 and Ind AS 21. Sub-para (1) requires that the foreign currency transactions are to be recorded initially in the reporting currency i.e. Indian currency and at exchange rate of the foreign currency on the date of the transaction. However, sub-para (2) provides an option to use an average rate during a period for recording the foreign currency transactions in the reporting currency, if the average rate approximates the actual rate at the date of the transaction. However, the ICDS requires usage of actual rate, if the exchange rate fluctuates significantly.

4.2 Provision in AS 11 is similar. Ind AS 21 is also similar, except that it requires use of 'spot exchange rate' to be used for the conversion. Also, Ind AS 21 refers to 'functional currency'.

5. Conversion at Last Date of Previous Year

"4. At last day of each previous year:—

- (a) foreign currency monetary items shall be converted into reporting currency by applying the closing rate;*
- (b) where the closing rate does not reflect with reasonable accuracy, the amount in reporting currency that is likely to be realised from or required to disburse, a foreign currency monetary item owing to restriction on remittances or the closing rate being unrealistic and it is not possible to effect an exchange of currencies at that rate, then the relevant monetary item shall be reported in the reporting currency at the amount which is likely to be realised from or required to disburse such item at the last date of the previous year; and*
- (c) non-monetary items in a foreign currency shall be converted into reporting currency by using the exchange rate at the date of the transaction.*

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(d) *non-monetary item being inventory which is carried at net realisable value denominated in a foreign currency shall be reported using the exchange rate that existed when such value was determined.*

5.1 The aforesaid provisions of this ICDS vis-à-vis AS 11 and Ind AS 21 are summarized below:

- Clause (a) – Para 4 of this ICDS, AS 11 and Ind AS 21 prescribe recording of monetary items at the end of the year by applying closing rate. Since the treatment is the same under ICDS as well as the Accounting Standards, difference would not arise and consequently, no adjustment would be required in computing the income. However, it may be noted that Ind AS 21 defines closing rate to be the spot exchange rate at the end of the period. Thus, if for conversion under ICDS, rate other than spot rate is used, then necessary adjustment will have to be done.
- Clause (b) provides an exception to Clause (a) to the effect that 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. AS 11 has a similar clause. However, 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, the variance if any, needs to be considered while computing the income.
- Clause (c) of para 4 of the ICDS covers all non-monetary items whether carried at historical cost or fair value, except inventory carried at net realisable value (NRV). It prescribes conversion of these non-monetary items at the exchange rate at the date of 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.
- Clause (d) provides for translation in the case of inventory carried at NRV. It requires that such inventory be translated at the exchange rate existing when NRV was determined. 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

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exchange rate at the date when the fair value was determined. Thus the treatment under the ICDS and the Accounting Standards is similar.

- Provisions of clauses (c) and (d) that create differences between ICDS, AS 11 and Ind AS 21 along with related adjustments in computing income are summarised below:

Particulars	ICDS	AS 11	Ind AS 21	Adjustments to be considered
Non-monetary items - clause (c)				
Carried at historical cost	Exchange rate at the date of the transaction	Exchange rate at the date of the transaction		No difference
Carried at fair value or other similar valuation	Exchange rate at the date of the transaction	Exchange rates that existed when the fair value or other similar valuation was determined		Difference will arise due to respective exchange rates used
Non-monetary items - clause (d)				
Non-monetary items being inventory carried at NRV	Exchange rate that existed when NRV was determined	Exchange rate that existed when NRV was determined		No difference

5.2 The aforesaid provision of conversion at the last date of the previous year under ICDS is illustrated below with examples of monetary and non-monetary assets:

Item of Asset / Liability	Monetary Non-Monetary	Exchange Rate on Transaction Date	Closing Rate on March 31	Exchange Rate realised / disbursed	Conversion on Last Date of Previous Year	Remarks
Trade Receivables - Debtor X	Monetary	65.00	Unrealistic due to currency restriction	35.00	35.00	Stated at exchange rate likely to be realised - sub-para (b) applied
Trade Receivables - Debtor Y	Monetary	63.00	65.50		65.50	Stated at closing rate - sub-para (a) applied

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Item of Asset / Liability	Monetary Non-Monetary	Exchange Rate on Transaction Date	Closing Rate on March 31	Exchange Rate realised / disbursed	Conversion on Last Date of Previous Year	Remarks
Investment in Shares - Company A	Non-Monetary	64.00	65.50		64.00	Stated at Exchange rate on Transaction Date - see sub-para (c)
Inventory	Non-Monetary	65.00	60.00		60.00	Stated at Exchange rate on the date when net realisable value was determined - sub-para (d) applied

6. Recognition of Exchange Differences

“5. (i) In respect of monetary items, exchange differences arising on the settlement thereof or on conversion thereof at last day of the previous year shall be recognised as income or as expense in that previous year.

(ii) In respect of non-monetary items, exchange differences arising on conversion thereof at the last day of the previous year shall not be recognised as income or as expense in that previous year.”

6.1 Para 5(i) of this ICDS deals with exchange difference in respect of monetary items that may arise on settlement or conversion at the year end and provides that such difference is to be accounted as income or expense in that previous year. Identical treatment is also prescribed under the Accounting Standards.

6.2 In respect of transactions that are settled beyond the end of the previous year, AS 11 provides that the exchange difference is to be recognised in each intervening period up to the date of final settlement. For instance, if a monetary item (debtor) is accounted for Rs.100 and is settled subsequently after 3 years for Rs.120, the exchange gain or loss on settlement or conversion would be accounted and treated as income or

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expense (except in case of such items relating to non-integral foreign operations as explained below) as under:

Date of Acquisition	Acquisition Rate	Settlement Rate	Year-End Conversion Rate	Income Expense
				ICDS, AS 11 and Ind AS 21
1-Jan-14	100.00		104.00	4.00
31-Mar-14			112.00	8.00
31-Mar-15			108.00	(4.00)
28-Feb-16		120.00		12.00

6.3 While, ICDS does not distinguish the treatment of monetary items whether these belong to foreign operation or otherwise, AS 11 requires that foreign exchange difference in respect of monetary items of non-integral foreign operations is required to be accumulated in a foreign currency translation reserve until the disposal of the investment in such foreign operation and on disposal, recognise the same as income or expense as the case may be, in that year. Accordingly, the differential treatment of recognition of exchange difference under ICDS as income or expense [Para 5(i)] and under AS 11 as an accumulation to foreign currency translation reserve, will need to be factored in for computing the income.

6.4 The recognition of exchange differences arising out of illustration in para 4 above is shown below:

Item of Asset / Liability	Monetary Non-Monetary	Exchange Rate on Transaction Date	Closing Rate on March 31	Exchange Rate realised disbursed	Conversion on Last Date of Previous Year	Remarks	Profit / Loss Recognised
Trade Receivables - Debtor X	Monetary	65.00	Unrealistic currency restriction	35.00	35.00	sub-para (b)	(30.00)
Trade Receivables - Debtor Y	Monetary	63.00	65.50		65.50	sub-para (a)	2.50
Investment in Shares - Company A	Non-Monetary	64.00	65.50		64.00	sub-para (c)	-
Inventory	Non-Monetary	65.00	60.00		60.00	sub-para (d) applied	-

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6.5 In respect of long term foreign currency monetary item for acquisition of depreciable asset and other assets / items, AS 11 prescribes specific accounting treatment. As per this Standard, the entity can exercise an option which is irrevocable for such class of assets i.e. to capitalise or de-capitalise the exchange difference to the cost of the asset and to be depreciated over the balance life of the asset. In case of long term foreign currency monetary items for acquisition of other assets, the entity can exercise an irrevocable option, i.e. to accumulate the exchange difference in foreign currency monetary item translation reserve account to be amortized over the balance period of such long-term asset or liability.

6.6 Under Ind AS 21, the exchange difference on translation of monetary items is recognised in profit and loss account.

6.7 Para 5(ii) provides that exchange differences arising on year end conversion of non-monetary items are not to be recognised as income or expense. Applying provisions of para 4(d) above, though exchange difference may arise between initial recognition and conversion at year end, the same is not to be recognised as income or expense. Therefore, in the valuation of closing stock, corresponding adjustment would be required to be incorporated to account for non-recognition of income or expense mandated by this clause as illustrated below:

Illustration for year end conversion of non-monetary item as per Accounting Standard and ICDS

Facts	Non-monetary Item: Inventory		
	Cost \$100		
	Net Realisable value (NRV) at year end \$ 50		
	Exchange rate on date of transaction Rs. 55		
	Closing Rate on March 31 Rs. 60		
		Treatment in books – as per Accounting Standard	Treatment as per ICDS
(A)	Inventory recorded on date of acquisition Cost \$100 *Exchange rate on date of transaction Rs. 55 Valuation at year end – Cost or NRV whichever is lower	5,500 \$50	5,500 \$50
(B)	NRV \$50*Exchange rate on date of transaction Rs. 55	<u>2,750</u>	<u>2,750</u>

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(C)	Impact of reduced valuation without exchange fluctuation	(2,750)	(2,750)
	Impact of exchange fluctuation on year end Conversion [Para 4(d) & 5(ii)]		
(D)	NRV \$50*(Closing Rate Rs. 60 – Exchange Rate on date of transaction Rs. 55)	250	250
	Inventory valued at year end in Balance Sheet (B) + (D)	3,000	3,000
	Total Impact on Profit and Loss (C)+(D)	(2,500)	(2,500)
	Impact on Books of Accounts		
	Profit before adjustment on account of valuation and exchange fluctuation	100,000	
	Add/Less:		
	Reduction in valuation – Cost v. NRV	(2750)	
	Exchange fluctuation gain – exchange rate on initial recognition v. on date of determination of NRV	250	
		<u>(2,500)</u>	
	Net Accounting Profit & ICDS Income (Note 1)	97,500	

Note 1 : As per Para 5(ii), exchange difference arising on year end conversion shall not be recognised as income or as expense in that previous year. Therefore, exchange difference recognised through closing value of inventory in accounts will have to be adjusted to compute taxable income.

6.8 As illustrated above, the impact of para 4(d) read with para 5(ii) is two-fold:

(i) *Decrease in valuation of inventory, since net realisable value is lower than cost as at year end (i.e. on balance sheet date)* – The impact of reduced valuation of inventory will be treated similarly in books of accounts as well as ICDS, i.e. charge to profit and loss and therefore, no separate adjustment is required in tax computation.

(ii) *Recognition of exchange difference (i.e. fluctuation) on year end conversion* – The amount of exchange difference will be same as per Accounting Standards and ICDS, since both refer to usage of exchange rate that existed when such values were determined. However, note that the exchange difference will be accounted for in the inventory valued and recognised in Balance Sheet and Profit and Loss account of the enterprise. Therefore, following the provisions of para 5(ii) with respect to non-

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recognition of such difference as income or expense, the exchange difference recognised in books of accounts in value of inventory ought to be adjusted in the tax computation.

7. Exceptions to Paragraphs 3, 4 and 5

“6. Notwithstanding anything contained in paragraph 3, 4 and 5; initial recognition, conversion and recognition of exchange difference shall be subject to provisions of section 43A of the Act or Rule 115 of Income-tax Rules, 1962, as the case may be.”

7.1 Para 6 of this ICDS has an overriding effect over the provisions explained above in respect of paras 3, 4 and 5 to accommodate specific provisions of section 43A that deals with assets acquired from outside India. As per the said section, if there exists an unpaid foreign currency liability towards the cost of an asset or for repayment of moneys borrowed for the purpose of acquiring such asset, then the exchange difference i.e. increase or decrease in the liability as expressed in Indian currency would entail a corresponding increase or decrease in the actual cost of the asset as defined in section 43(1) of the Act in the year of payment.

7.2 With reference to the provisions of AS 11 in respect of depreciable asset as explained above, the exchange difference may be added or reduced from cost of the asset at each balance sheet date. However, since provisions of section 43A mandate adjustment to the cost of asset only in the year of payment, the related difference with respect to the year in which such exchange differences are adjusted to cost of asset will need to be eliminated in the computation of income.

7.3 Rule 115 of the Income Tax Rules deals with rate of exchange for conversion into rupees of income expressed in foreign currency. Sub-rule (1) provides that the rate of exchange for the calculation of the value in rupees of any income of the assessee in foreign currency shall be the telegraphic transfer buying rate of such currency as on the 'specified date' which is defined in explanation 2 to the said sub-rule. Further, sub-rule (2) provides that where such income is received in or brought into India during the year then the provisions of sub-rule (1) shall not apply. The impact on income, if any, on application of this Rule needs to be considered in computing the income.

7.4 It is important to note that Section 43A is applicable for a foreign currency liability in respect of an asset acquired from a country *outside India*. Therefore, in the case of a foreign currency liability for purchase of an asset

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in India Section 43A will not be applicable and it shall be recognised as per this ICDS.

7.5 Para 5(ii) provides that in case of non-monetary item the foreign exchange gain/loss will not be recognised to profit and loss account. Para 6 is an exception to para 5 which is only applicable to a situation covered by section 43A.

7.6 Therefore, the foreign exchange gain/loss in respect of a liability for purchase of an asset not covered by section 43A, would be subject to the treatment as per para 5(i). Hence, in case of monetary items the gain/loss would be recognised in profit and loss account and in case of non-monetary items, the gain/loss would be neither taxable nor deductible.

7.7 This situation is in contradiction to the accepted judicial view that the foreign exchange gain/loss in case of a liability for purchase of an indigenous asset is neither taxable nor deductible. Hence, one will have to make the professional judgment on a case to case basis.

8. Financial Statements of Foreign Operations

“7. The financial statements of a foreign operation shall be translated using the principles and procedures in paragraphs 3 to 6 as if the transactions of the foreign operation had been those of the person himself.”

8.1 Para 7 of ICDS provides that for translation of financial statements of foreign operations, same principles as mentioned in paras 3 to 6 are to be applied, as if the transactions were of the person himself.

8.2 ICDS does not make any distinction between integral and non-integral operations unlike AS 11. Hence in case of foreign operations the principles of paras 3 to 6 would be applicable.

8.3 Accordingly, the assets and liabilities of the foreign operations would need to be classified into monetary and non-monetary items and the foreign exchange gain/loss would be recognized to profit and loss or not will be as per para 5 (subject to para 6).

8.4 Under AS 11, exchange differences arising on translation of non-integral foreign operation to be accumulated separately in foreign currency translation reserve till investment in foreign operation is disposed of. Therefore, the resultant income/expenses arising from following principles as per paras 3 to 6 above for monetary and non-monetary items, as opposed to

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principles under AS 11 for non-integral operations would need to be adjusted in computing the taxable income.

8.5 Interestingly, Ind AS 21 does not distinguish between integral and non-integral foreign operations. In translating the financial statement of the foreign operations from their functional currency to the reporting entity's currency, the reporting entity has to follow the procedure which is similar to non-integral foreign operation under AS 11, with the exception that the resulting exchange differences are to be recognised in other comprehensive income and accumulated separately.

9. Forward Exchange Contracts

“8. (1) Any premium or discount arising at the inception of a forward exchange contract shall be amortised as expense or income over the life of the contract. Exchange differences on such a contract shall be recognised as income or as expense in the 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 the previous year.

(2) The provisions of sub-para (1) shall apply provided that the contract:

- (a) is not intended for trading or speculation purposes; and***
- (b) is entered into to establish the amount of the reporting currency required or available at the settlement date of the transaction.***

(3) The provisions of sub-para (1) shall not apply to the contract that is entered into to hedge the foreign currency risk of a firm commitment or a highly probable forecast transaction. For this purpose, firm commitment, shall not include assets and liabilities existing at the end of the previous year.

(4) The premium or discount that arises on the contract is measured by the difference between the exchange rate at the date of the inception of the contract and the forward rate specified in the contract. Exchange difference on the contract is the difference between:

- (a) the foreign currency amount of the contract translated at the exchange rate at the last day of the previous year, or the settlement date where the transaction is settled during the previous year; and***

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(b) the same foreign currency amount translated at the date of inception of the contract or the last day of the immediately preceding previous year, whichever is later.

(5) Premium, discount or exchange difference on contracts that are intended for trading or speculation purposes, or that are entered into to hedge the foreign currency risk of a firm commitment or a highly probable forecast transaction shall be recognised at the time of settlement.”

9.1 Para 8 of this ICDS deals with

- (1) treatment of premium or discount that arise at the inception of a forward exchange contract and
- (2) exchange difference on such a contract.

As per para 3 of Part B of ICDS VIII on Securities for forward exchange contracts of scheduled bank or public financial institutions, provisions of ICDS VIII shall apply and provisions of ICDS VI shall not apply.

9.2 The premium or discount that arises on the contract is measured by the difference between the exchange rate at the date of the inception of the contract and the forward rate specified in the contract. For example, if a forward exchange contract is entered in respect of an obligation to pay a vendor in foreign currency after 2 months and the prevailing foreign exchange rate at the inception is Rs.65.00 and the forward contract is booked at Rs.65.60. In this case, the premium paid is Rs.0.60.

9.3 Further, if at the end of the period of 2 months, if the prevailing exchange rate is Rs.66.50, then the exchange difference would be an expense of Rs.0.90. However, there would be a corresponding exchange gain of Rs.0.90 also during the intervening period on account of the forward contract.

9.4 In this example, the premium of Rs.0.60 is to be claimed as an expense, pro-rated over 2 months, being the period of forward exchange contract and the exchange difference of Rs.0.90 with a corresponding exchange gain on forward contract of Rs.0.90 is to be recognised as income and expense at the end of the said period.

9.5 This ICDS also provides that any profit or loss arising on cancellation or renewal shall be recognised as income or as expense in the previous year when such cancellation or renewal arises.

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9.6 This treatment of income or expense arising on account of premium, discount or exchange difference does not apply to contracts that are intended for trading or speculation purposes. They also do not apply to a contract that is entered into to hedge the foreign currency risk of a firm commitment or a highly probable forecast transaction. Firm commitment does not refer to assets and liabilities existing at the end of the previous year.

9.7 On the other hand, the premium, discount or exchange difference in respect of transactions intended for trading or speculation purposes, or that are entered into to hedge the foreign currency risk of a firm commitment or a highly probable forecast transaction, shall be recognised at the time of settlement.

9.8 As per AS 11, the provisions regarding recognising income or expense on account of premium, discount or exchange difference in respect of forward contracts to establish the amount of the reporting currency required or available at the settlement date of a transaction and which are not intended for trading or speculation, are identical to this ICDS. However, for forward exchange contract intended for trading or speculation purposes, the premium or discount on the contract is ignored and on each balance sheet date, the value of the contract is marked to its current market value and the gain or loss on the contract is recognised.

9.9 In other words, while this ICDS recognises the premium, discount or exchange difference on contracts that are intended for trading, speculation purposes or specified hedging transaction to be recognised only at the time of settlement, AS 11 provides that such gain or loss to be recognised at each balance sheet date as the contract value is marked to its current market value.

9.10 Therefore, while computing income, the marked-to-market gains or losses on such open contracts at the end of the previous year under AS 11 would need to be excluded in computing income. Also, in subsequent period when such contracts are settled, the gain or losses as per this ICDS would need to be recognised and the corresponding gain or loss recognised as per AS 11 would need to be excluded.

9.11 Thus, the Marked to Market loss or gain in respect of foreign exchange contract shall be recognized to profit and loss account and would be deductible which are covered under para 8(1) of ICDS. On the other hand the gain/loss including the Marked to Market in respect of forward exchange

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contract covered under paras 8(2) and 8(3) will be eligible for deduction in the year of settlement.

9.12 With the introduction of this ICDS, marked-to-market gain/loss on forward exchange contract intended for trading or speculation cannot be recognised as income/expense till such time they are eventually settled.

10. Transitional Provisions

“9. (1) All foreign currency transactions undertaken on or after 1st day of April, 2016 shall be recognised in accordance with the provisions of this standard.

(2) Exchange differences arising in respect of monetary items or non-monetary items, on the settlement thereof during the previous year commencing on the 1st day of April, 2016 or on conversion thereof at the last day of the previous year commencing on the 1st day of April, 2016, shall be recognised in accordance with the provisions of this standard after taking into account the amount recognised on the last day of the previous year ending on the 31st March, 2016 for an item, if any, which is carried forward from said previous year.

(3) The financial statements of foreign operations for the previous year commencing on the 1st day of April, 2016 shall be translated using the principles and procedures specified in this standard after taking into account the amount recognised on the last day of the previous year ending on the 31st March, 2016 for an item, if any, which is carried forward from said previous year.

(4) All forward exchange contracts existing on the 1st day of April, 2016 or entered on or after 1st day of April, 2016 shall be dealt with in accordance with the provisions of this standard after taking into account the income or expenses, if any, recognised in respect of said contracts for the previous year ending on or before the 31st March, 2016.”

10.1 This ICDS provides for transitional provisions which are summarized as follows:

Particulars	Provisions under this ICDS
Foreign Currency Transactions entered on or after April 1, 2016	As per this ICDS

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Exchange differences on monetary/ non-monetary items on settlement during previous year commencing April 1, 2016 or conversion on last day of previous year commencing April 1, 2016	In cases where the monetary or non-monetary items are settled during the year ending on March 31, 2017, the resultant exchange difference is to be routed to Profit and Loss account on the date of settlement. In the rest of the cases, where such settlement has not occurred during the year, the exchange difference arising on account of conversion as on March 31, 2017 is to be routed to the Profit and Loss account.
Financial Statements of foreign operations for previous year commencing on April 1, 2016	To be translated in accordance with this ICDS after taking into account, the amount recognised on March 31, 2016 for any carry forward item
All forward exchange contracts existing on April 1, 2016 or entered on or after April 1, 2016	To be dealt with in accordance with this ICDS after taking into account the income/expense if any recognised in respect of said contract for previous year ending on or before March 31, 2016

10.2 There are no specific disclosures required under this ICDS.

10.3 As regards the treatment of the opening Foreign Currency Translation Reserve, a reference may be made to the clarifications on ICDS contained in Circular no. 10/2017, dated 23rd March, 2017 issued by the CBDT. Question no. 16 and answer thereto deal with the impact of the transitional provision of the ICDS. The same are reproduced below:

Question 16: *What is the taxability of opening balance as on 1st day of April 2016 of Foreign Currency Translation Reserve (FCTR) relating to non-integral foreign operation, if any, recognised as per Accounting Standards (AS) 11?*

Answer: *FCTR balance as on 1 April 2016 pertaining to exchange differences on monetary items for non-integral operations, shall be recognised in the previous year relevant for assessment year 2017-18 to the extent not recognised in the income computation in the past.*

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10.4 The correctness of the answer seems debatable as there is no real income that is really earned on the conversion. Further the treatment as prescribed in ICDS VI cannot apply to earlier years where the amount may not be taxable. Hence one will have to take appropriate professional judgment.

Chapter 8

ICDS VII : Government Grants

1. Background

1.1. Government grants and assistance play a key role in any economy. The objective is to provide impetus to the economy as a whole or in certain sectors which need monetary fillip. The purpose of assistance is to encourage an entity to embark on a course of action which it would not have otherwise taken in the absence of such assistance. These grants could assume varied forms. Such multifarious grants or assistance do not necessarily mean giving away doles or “free money”. It is not a bounty gifted. Government grants are seldom gratuitous. It is a ‘purposive funding’ which fructifies on accomplishment of certain conditions; past actions or future assurances.

1.2. Such funding often fastens Government surveillance on the grantee. They have to ensure compliance with the Government’s norms, achieve stipulated performance standards or assure channeling of grants in the intended direction. Government funding is often loaded with covenants of performance guarantees or are based upon past accomplishments. They are spent or used according to the terms and conditions of the grant.

1.3. Receipt of grants which carry the burden of associated conditions is, however, not a liability. Judicial precedents indicate that the question whether a grant/ subsidy is ‘income’ or ‘capital receipt’ would depend upon the ‘purpose’ of the funding. Even if they are styled as ‘advances’ which may be repayable in certain circumstances they continue to partake the character of ‘income’ [*Smart v Lincolnshire Sugar Co Limited (1937) 20 TC 643 (HL)*]. Having been received in the character of advance (but treated as income for tax purposes) if they are required to be returned for non compliance of conditions, the tax treatment thereof is provided for in this ICDS and discussed a little later.

1.4. Circular No. 142 [F. No. 204/25/74-IT(A-II)], dated 1-8-1974 of the CBDT gave primacy to the objective of grant. It prescribed a ‘purpose’ test to reckon the taxability of grant in the hands of recipient. The circular concluded that if the subsidy is intended to be a contribution towards capital outlay, such subsidy should be regarded as capital receipt in the hands of the

recipient. The Supreme Court in *CIT v Ponni Sugars & Chemicals Limited* (2008)306 ITR 392 (SC) concluded on this aspect in the following words:

"It is the object for which the subsidy/assistance is given which determines nature of incentive subsidy. The character of the receipt in the hands of the assessee has to be determined with respect to the purpose for which the subsidy is given. In other words, in such cases one has to apply the 'Purpose Test'. The point of time when the subsidy is paid is not relevant. The source is immaterial, the form of subsidy is also immaterial... If the object of the subsidy scheme was to enable the assessee to run the business more profitably, then the receipt was on revenue account. On the other hand, if the object of the assistance under the subsidy scheme was to enable the assessee to set up a new unit or to expand its existing units, then the receipt of the subsidy was on capital account. Therefore, it is the object for which the subsidy/assistance is given which determines the nature of incentive subsidy. The form of the mechanism through which the subsidy is given is irrelevant."(emphasis supplied)

1.5. Other important rulings on this subject are *Sahney Steel Works Ltd. v CIT* 228 ITR 253 (SC); *CIT v Kirloskar Oil Engines Ltd* (2014) 364 ITR 88 (Mum); *CIT v Bougainvillea Multiplex Entertainment Centre P Limited* (2015) 373 ITR 14 (Del).

1.6. However, Finance Act 2015 amended section 2(24) of the Income-tax Act [defining income], by inserting sub-clause (xviii) which reads as under:

*"2(24)(xviii) **assistance** in the form of a **subsidy or grant or cash incentive or duty drawback or waiver or concession or reimbursement** (by whatever name called) by the Central Government or a State Government or any other authority or body or agency in cash or kind to the assessee other than the subsidy or grant or reimbursement which is taken into account for determination of the actual cost of the asset in accordance with the provisions of Explanation 10 to clause (1) of section 43."*

1.7. Government assistance received in any form (cash or kind) bearing any nomenclature (subsidy or grant or cash incentive or duty drawback or waiver or concession or reimbursement) would, now be treated as 'income'.

1.8. The only exception is subsidy/ grant/ reimbursement considered as cost of asset as per explanation 10 to section 43(1). In other words, save subsidies in relation to depreciable assets, all other forms of government

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grants are enveloped within the forte of income. However, a loan or debt simplicitor should be excluded from the domain of income as generally understood as also this ICDS. Sales tax deferral schemes offered by Government whereby sales tax collected by assessee is converted into a loan, may not qualify as Government grant. LPG subsidy or any other welfare subsidy received by individuals has been clarified by the Ministry of Finance to be outside the ambit of income vide press release dated 5.5.2015. This ICDS deals with the meaning, scope, forms, point of taxation and disclosure aspects of government grants. Although the Finance Act, 2015 expanded the definition of 'income' to include all kinds of government grants save asset specific grants, there are many aspects such as the year of taxation or capitalization, refund mechanism, point of recognizing grants, treatment of grants in relation to group of assets etc., the guidance for which is available in this ICDS.

2. Preamble

“This Income Computation and Disclosure Standard is applicable for computation of income chargeable under the head “Profits and gains of business or profession” or “Income from other sources” and not for the purpose of maintenance of books of account.”

2.1 This ICDS outlines income computation and disclosure aspects relating to grants or assistance received from Government agencies and similar bodies. The ICDS is applicable only in case of income computed under the head 'Profits and gains from business or profession' and 'Income from other sources'. The ICDS therefore excludes any receipts or grants from Government which may be chargeable to tax under other heads. It would also exclude Government grants received or receivable by Charitable trusts (which are governed by sections 11 to 13).

2.2 The ICDS is applicable for computation of income. The contents of this ICDS are not relevant for the purposes of maintenance of books of account. The accounting aspects are governed by Accounting Standard 12- Accounting for Government Grants and Ind AS 20- Accounting for Government Grants and Disclosure of Government Assistance. The Preamble clarifies that the ICDS is not for the purposes of maintenance of books of account. The accounting treatment of Government grant (and its variants) is therefore excluded from this ICDS (being an exclusive domain of AS 12 or Ind AS 20). However the interplay of this ICDS with AS 12 or Ind AS 20, provisions in the Act which deal with the method of accounting

(section 145) and taxing provisions which operate on accounting income (Minimum Alternate Tax regime) would have ramifications for tax purposes.

“In case of conflict between the provisions of the Income Tax Act, 1961 (‘the Act’) and this Income Computation and Disclosure Standard, the provisions of the Act shall prevail to that extent.”

2.3 The contents of this ICDS have to be read subject to Income-tax Act (“Act” for brevity). The Preamble of this ICDS gives the provisions of the Act an overriding effect over the ICDS. The ICDS has to yield, therefore, to the provisions of the Act in case of any contradiction between the two.

3. Scope

“1. This Income Computation and Disclosure Standard deals with the treatment of Government grants. The Government grants are sometimes called by other names such as subsidies, cash incentives, duty drawbacks, waiver, concessions, reimbursements, etc.

2. This Income Computation and Disclosure Standard does not deal with:—

- (a) Government assistance other than in the form of Government grants; and***
- (b) Government participation in the ownership of the enterprise”.***

3.1 Paras 1 and 2 of the ICDS outline the scope of the ICDS. The ICDS deals with income-tax treatment of Government grant (defined in para 3 of the ICDS). The nomenclature of this grant could be ‘subsidy’; ‘cash incentive’; ‘duty drawback’; ‘waiver’; ‘concession’; or ‘reimbursement’. It has to essentially satisfy the definition of ‘government grant’ provided in para 3(1)(b). The ICDS excludes the following two forms of government aids:

- (a) Government assistance other than in the form of Government grants; and
- (b) Government participation in ownership of an enterprise.

3.2 The first exclusion requires carving out ‘government assistance’ from ‘government grant’. The second exclusion concerns ‘government’

participation in enterprise ownership. For understanding the scope of the stipulated exclusions, the meaning of the terms 'government'; 'government grant' and 'government assistance' become relevant. These are defined in para 3(1)(a) and (b) of this ICDS.

4. Definitions

“3(1) The following terms are used in the Income Computation and Disclosure Standard with the meanings specified:

- (a) “Government” refers to the Central Government, State Governments, agencies and similar bodies, whether local, national or international.***
- (b) “Government grants” are assistance by Government in cash or kind to a person for past or future compliance with certain conditions. They exclude those forms of Government assistance which cannot have a value placed upon them and the transactions with Government which cannot be distinguished from the normal trading transactions of the person.***

3(2) Words and expressions used and not defined in this Income Computation and Disclosure Standard but defined in the Act shall have the meaning assigned to them in the Act.”

4.1 Government Grants are amounts received or receivable from the exchequer, namely, the Government. The term 'Government' has been defined in the Standard as - *Central Government, State Governments, agencies and similar bodies, whether local, national or international*. The term 'Government' is defined to mean Central or State government including 'forms and organs' of the government, be it national, provincial, municipal etc. The definition covers government agencies and other entities 'vested with' and 'exercising' governmental authority. The essence of including agencies and similar bodies is to include those entities or departments which enjoy the power to regulate, control, supervise or restrain public conduct through exercise of lawful authority. The definition seeks to include bodies or agencies which perform State functions. Such bodies or agencies are instrumentalities for achieving the objectives of a State. These could be national or international. Thus, the term 'Government' would include bodies formed under the foreign laws as well. The scope is wider as compared to

provisions like section 50C or 56 wherein the law specifically restricts itself to Central or State Government.

4.2 The definition excludes Government participation in 'ownership' of the enterprise. Ownership is accomplished by direct holding in equity or capital. Such holding could be substantial or partial. The exclusion is of ownership participation.

4.3 Para 3(1)(b) of the ICDS defines "Government Grants" as assistance by government in cash or kind to an enterprise for past or future compliance with certain conditions. The grant involves transfer of an asset (cash or kind) from Government to the beneficiary. This can take many forms varying both in the nature of the resources transferred and in the conditions attached. These conditions may also include negative restrictions (for instance, a condition that the beneficiary entity should not take up production of certain specified items). Strictly going by the language of the definition, a grant without conditions would not qualify as government grant and would therefore be outside the ICDS.

4.4 In addition to the inherent exclusions mentioned above, the closing portion of the definition indicates two explicit exclusions from the definition of government grants which are as under:

- (a) Government assistance which cannot reasonably have a value placed upon them; and
- (b) transactions with government which cannot be distinguished from the normal trading transactions of the enterprise.

4.5 The first exclusion is government assistance other than government grants. Government may provide various types of assistances. Every form of 'government assistance' is not government grant. A government grant is an entity-specific transfer of resources. Resources that are made available by a government to a wide range of entities, such as the right to use public roads or other infrastructure, do not constitute government grant. The term 'government assistance' is not defined in this ICDS. One can therefore take guidance from the internationally accepted definitions. The term government assistance is defined in para 3 of Ind AS 20 as follows:

"Government assistance is action by government designed to provide an economic benefit specific to an entity or range of entities qualifying under certain criteria. Government assistance for the purpose of this Standard does not include benefits provided only indirectly through

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action affecting general trading conditions, such as the provision of infrastructure in development areas or the imposition of trading constraints on competitors.”

4.6 The opening portion of the above definition defines ‘government assistance’ to mean action by the government which is specific to an entity. This part of the definition in Ind AS 20 corresponds to the definition of ‘Government grant’ in this ICDS. The secondary/ closing portion of the above quoted definition provides for certain exclusions. Government assistance excludes benefits provided indirectly through actions affecting general trading condition or infrastructural facilities. Ind AS 20 thus excludes certain forms of ‘government assistances’. These exclusions are sought to be imported into this ICDS by clarifying that ‘Government assistance other than Government grants’ are outside the precincts of this ICDS.

4.7 The second exclusion in para 2 of the Standard is on government participation in the ownership of the enterprise. Participation in ownership of an enterprise is normally made in anticipation of a return on investment. Participation in ownership of an enterprise would not qualify as a government grant under this ICDS. The participation in ownership could take any form (through owning of shares, interest in a firm, management or voting rights). There is no specification on the extent or quantum (whether wholly, substantially, partly or even a minority interest) of ownership. The ICDS is also silent on the question as to whether only a direct participation is excluded or even an indirect holding or participation is to be excluded.

4.8 In addition to the two exclusions provided by para 2, Government Grant as defined in para 3(1)(b) has twin exclusions, which form the third and fourth exclusions from the operation of this ICDS (in addition to the two already discussed supra). The term ‘Government Grant’ (as defined above) excludes:

- (a) those forms of Government assistance which cannot have a value placed upon them; and
- (b) transactions with Government which cannot be distinguished from the normal trading transactions of the person.

4.9 The ICDS excludes assistance whose value cannot be ascertained. In other words, although the grant is a valuable one, such grants cannot be translated into precise numbers. It is difficult (if not impossible) to ascribe their impact arithmetically. Examples of assistance that cannot reasonably have a value placed upon them are free technical or marketing advice or

provision of guarantees by the government. Interest free debt or concessional loaning is a form of government assistance, benefit of which cannot be quantified by the imputation of notional interest.

4.10 There are various exclusions from the applicability of this ICDS which are placed at various portions of this ICDS. A combined reading of Paras 2 and 3 divulge the following exclusions from the scope of this ICDS:

- (a) Exclusions from the scope of this ICDS [Para 2]:
 - Government assistance other than in the form of government grants;
 - Government participation in the ownership of the enterprise
- (b) Explicit exclusions from the definition of government grant [Para 3(1)(b)]
 - Government assistance which cannot reasonably have a value placed upon them; and
 - Transactions with government which cannot be distinguished from the normal trading transactions of the enterprise.
- (c) Implicit exclusions from the definition of government grant [Para 3(1)(b)]
 - Government grant without any associated or attached conditions.

5. Recognition of Government Grants

“4(1) Government grants should not be recognised until there is reasonable assurance that the person shall comply with the conditions attached to them, and the grants shall be received.

4(2) Recognition of Government grant shall not be postponed beyond the date of actual receipt.”

5.1 Para 4 of the ICDS[Recognition of government grants] stipulates the year of recognition of Government grants. A government grant traverses through various stages in its lifecycle namely:

- (a) Application for grant or event which makes an assessee eligible for grant;

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- (b) Declaration or communication of grant to the assessee;
- (c) Fulfillment of conditions in the grant;
- (d) Actual receipt of grant.

5.2 As mentioned earlier, the Act recognizes government grant (and its variants) as income under section 2(24)(xviii) except for grants in relation to depreciable assets (which are reduced from actual cost). There are no explicit provisions in the Act which pinpoint the year in which such treatment should be given. Although, section 43(1) mandates reduction of grant from cost of asset in the year of acquisition, there is no guidance available in the Act as to when government grants are to be recognised as income.

5.3 The amendment to section 2(24) refers to assistance by whatever name called, in cash or kind other than those covered by explanation 10 to section 43(1) as income. Section 2(24) does not use the word '*assistance received or receivable*'. Further the reference to '*in cash or kind*' supports the inference that subsidies are to be taxed as income only on receipt basis. Such reading would be against the prescription of ICDS which states that a reasonable assurance should be the cause for recognizing grants.

5.4 Another view is that section 2(24) lists a catalogue of items which are to be recognised as incomes. Section 2(24) does not generally deal with prescription of these items being regarded as income only upon either their accrual or receipt. Having outlined the catalogue of items, the inclusion of these items in the total income of the person would depend upon the various limbs of section 5 which is accrual, arisal or receipt or deeming thereof.

5.5 In the absence of specific or particular principles one will have to take recourse to the general principles enunciated under section 5 of the Act. Section 5 outlines the scope of total income. It encompasses income on the basis of accrual, arisal or receipt subject to the residential status of the assessee and locale of the income. This canon of taxation is sacrosanct and has to be strictly adhered to. Only when a grant satisfies any of the said criterion of section 5 (ie, it either accrues, arises or received or is deemed to be so), then only tax liability can be fastened on such grants. It is therefore important to establish that the grant has first passed the litmus test of section 5.

5.6 ICDS I [dealing with accounting policies] recognizes 'accrual' as one of the fundamental accounting assumption. It defines 'accrual' as under:

“Accrual” refers to the assumption that revenues and costs are accrued, that is, recognised as they are earned or incurred (and not as money is received or paid) and recorded in the previous year to which they relate.”

5.7 ICDS I requires revenues to be recognized as and when it is earned. It clarifies that government grant should not be recognized as money is received or paid. Cash system of accounting is not permissible under ICDS. Under the ICDS(s) incomes are said to accrue when they are ‘earned’ and ‘recorded’ in the previous year to which they relate. The presence of ‘earning’ and ‘recording’ income connote crystallization of right to receive income in favour of the assessee. It is indicative of the payer acknowledging a debt in favour of the assessee. Judicial precedents have provided some guidance as to what constitutes ‘accrual’ in the life cycle of a government grant.

5.8 In *CIT v Ashoka Lungi Company (1979) 120 ITR 413 (Madras)*, the Madras High Court examined a case of taxability of cash incentive receivable from the Government. The question before the High Court was whether the income by way of cash incentives accrued to the assessee when an application was made in this regard by the assessee. The Court held that the amount received on the basis of application made during the relevant accounting year was liable to be included for assessment in the year of application itself. The fact that there was some delay on the part of the authorities concerned in making the actual disbursement was not to come in the way of the assessee being assessed with reference to the said amount. The Court concluded that cash incentives became due to the assessee at the time of the application.

5.9 Similar view was taken in *CIT v Punjab Bone Mills (1998) 232 ITR 795 (Punj. & Har.)* which was subsequently affirmed by Apex Court [reported in (2001) 251 ITR 780 (SC)].

5.10 By inference, the judiciary has sought to tax the government grants at the very first stage which is the year of application. The ICDS, however, prescribes ‘reasonable assurance’ of receipt and compliance with inherent conditions of the grant. Therefore, one may have to adhere to the recognition norms propounded by para 4 subject to the principal tests of section 5 of the Act.

5.11 Para 4 of the ICDS has two limbs. The two limbs collectively provide the timing of recognizing government grants. The first limb provides the starting point of recognition, while the second limb draws the cut-off date. In

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the first limb, there are two conditions to recognize government grants. It stipulates that the government grant cannot be recognized until there is 'reasonable assurance' that:

- (a) the person shall comply with the conditions attached to the grant; and
- (b) the grants shall be received.

5.12 The use of the conjunction 'and' implies that both the conditions have to be cumulatively satisfied to recognise the government grant as income. Failure of either of the conditions would prevent recognition of government grants as income. Further, there has to be a 'reasonable assurance' that the two conditions would occur. The factum of reasonable assurance is attached to both 'compliance (of conditions)' and receipt (of grant)'. The term 'reasonable' has not been defined in the Act. The Delhi High Court in the case of *Azadi Bachao Andolan v Union of India* [2001] 252 ITR 471 (Delhi) has observed - *"The expression 'reasonable' is not susceptible of a clear and precise definition; for an attempt to give a specific meaning to the word 'reasonable' is trying to count what is not number and measure what is not space. It can be described as rational according to the dictates of reason and is not excessive or immoderate. The word 'reasonable' has in law the prima facie meaning of reasonable with regard those circumstances of which the actor, called on to act reasonably, knows or ought to know."*

5.13 The phrase 'reasonable assurance' has also not been defined by the ICDS. It connotes something which has a sufficient degree of certainty. Often, one cannot obtain absolute assurance because of the following limitations :

- (a) Grant conditions which are contingent upon the performance of outsiders or third parties;
- (b) Change in Government policies;
- (c) Delay in communicating the precise quantum of grant;

5.14 Accordingly, absolute assurance in complying with conditions and receipt of grant may not be attainable. The ICDS does not visualize an absolute or virtual certainty in compliance with the conditions. The recognition of Government grant as income requires a reasonable vision of due compliance from both ends - grantee (by complying with the conditions) and Government (by paying the grant).

5.15 Para 4(2) of the ICDS provides for the end-point of recognition of government grant. It states that the government grant recognition cannot be postponed beyond the date of actual receipt. The Government grant has to be recognised on or before the date of receipt.

5.16 The question is whether grants should be recognised even in cases where there is no certainty that the conditions attached to the grant would be fulfilled? A reading of Para 4(2) on a standalone basis, may suggest that under any circumstances, the revenue recognition cannot be deferred beyond the date of receipt. However, paras 11 and 12 of the ICDS which deal with refund of grants provide that grants sometimes become refundable because the attached conditions are not fulfilled. Refund of government grants would require reversal of treatment carried out at the time of its initial recognition. The ICDS requires that in the event of reversal of government grant, it has to be first applied to unamortized deferred credit. Therefore, the ICDS visualizes situations wherein the entire grant 'received' is not recognised as income but parked as unamortized deferred credit account. Thereby, income recognition should factor both receipt as well certainty in complying with the attached conditions to recognise grants as income. This aligns with the real income theory which mandates that income recognition cannot be based on contingencies. Save such circumstances, the recognition of government grants cannot be deferred beyond date of receipt.

5.17 The objective of recognition criteria in Para 4 can be inferred from the explanation provided by the Accounting Standard Committee (while introducing Tax Accounting Standards) in its final report of August 2012 as under:

"5.2.9 The Tax Accounting Standard for Government Grants [TAS (GG)] is based on the Accounting Standard-12 (AS-12) for Government Grants issued by the ICAI. While recommending the TAS (GG), the Committee made the following changes to AS-12:

- i. AS-12 has adopted two broad approaches for the accounting treatment of Government grants. The first approach is the 'Capital Approach' under which, a Government grant is treated as a part of share holders' funds and the second approach is the 'Income approach' under which, a government grant is taken to income over one or more periods. The Committee extensively deliberated on the above approaches and also considered the judicial precedence on the issue. To reduce litigation and to give*

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a certainty to TAS (GG) provides that the government grants should be treated either as revenue receipt or they should be reduced from the cost of fixed assets based on the purpose for which such grant or subsidy is given.

- ii. *AS-12 provides that mere receipt of a grant is not necessarily a conclusive evidence that the conditions attached to the grant have been or will be fulfilled. To reduce litigation and to provide certainty, the TAS(GG) provides that recognition of Government grant shall not be postponed beyond the date of actual receipt."*

Comparison with AS 12

5.18 On a reading of paras 4(1) and 4(2) of the ICDS, it is evident that the two (ICDS and AS 12) are independent. It is evident that this ICDS has inserted an additional condition in para 4(2). Under AS 12, mere receipt of a grant would not necessarily be conclusive to recognise such grant as income. However, under this ICDS, recognition cannot be postponed beyond 'receipt'. Accordingly, government grant should be recognised (as income or as adjustment to assets) latest on 'receipt' basis. In other words, from an income-tax standpoint, government grant has to be recognised on 'reasonable assurance' of conditions compliance and receipt [para 4(1)] or 'actual receipt' [para 4(2)] whichever is earlier. ICDS VII thus deviates from AS 12 on the aspect of 'receipt' basis of taxation.

5.19 The aforementioned difference could invite double taxation due to interplay of ICDS, AS 12 and Minimum Alternate Tax computation mechanism. To elucidate, this Standard requires recognition of grants immediately on receipt even without awaiting the reasonable assurance that the conditions attached therein would be satisfied. In a subsequent year, when the assessee confirms such reasonable assurance, the grant would have to be mandatorily 'accounted' in the financials as income. The Minimum Alternate Tax (MAT) computation in relation to such subsequent year would include such grants recognized in the Statement of Profit or loss. This would fasten MAT liability on grants recognized as revenue as per financial statements. This would be despite tax liability having been discharged on grants being included as income in the year of receipt. The assessee could contest such 'double tax' liability by relying on the decision of Telangana & Andhra Pradesh High Court in the case of *CIT v Nagarjuna Fertilizers and Chemicals Limited (2015) 373 ITR 252 (T&AP)*. The Court observed that the

legislature has taken every precaution to ensure that no amount is subjected to taxation twice.

5.20 Paras 5 to 10 of the ICDS deal with 'initial' recognition of grants under specific circumstances. The various categories discussed in these paras could be broadly split into those which are specific to acquisition of assets and those which deal with expenses/ losses/ support. Para 11 deals with treatment of grants at the time of refund. The initial recognition in paras 5 to 10 can broadly fall into the following two categories:

Asset specific grants

5.21 Grants related to assets are government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire long-term assets. Subsidiary conditions may also be involved, regarding the type or location of the assets or the periods during which they are to be acquired or held. This is also as per the definition provided in Ind AS 20 dealing with Accounting for Government Grants and disclosure of Government Assistance. For ready reference relevant excerpts from Ind AS 20 are reproduced below :

"Government grants are assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. Grants related to assets are government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire long-term assets. Subsidiary conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held."

Grants related to income/ loss

5.22 These are grants other than the asset specific grants. These could be grants relating to monetary support provided to enterprises or could assume the form of expense/ loss compensation.

Treatment of Government Grants

"5. Where the Government grant relates to a depreciable fixed asset or assets of a person, the grant shall be deducted from the actual cost of the asset or assets concerned or from the written down value of block of assets to which concerned asset or assets belonged to."

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5.23 Para 5 of the ICDS deals with grants relating to depreciable fixed assets. Depreciable fixed assets for the purposes of this ICDS should mean assets depreciable under section 32 of the Act. Such grants are required to be reduced from the actual cost of the asset or written down value of the block of which such asset is a part.

Comparison with Act

5.24 Para 5 of the ICDS stipulates reduction of grants from the 'actual cost' or 'WDV' of the asset. Such reduction of Government grants from the 'actual cost' of the asset is in accordance with explanation 10 to section 43(1) which reads as under:

"Explanation 10.—Where a portion of the cost of an asset acquired by the assessee has been met directly or indirectly by the Central Government or a State Government or any authority established under any law or by any other person, in the form of a subsidy or grant or reimbursement (by whatever name called), then, so much of the cost as is relatable to such subsidy or grant or reimbursement shall not be included in the actual cost of the asset to the assessee"

5.25 The aforesaid Explanation was explained by the Board in Circular No. 772 dated 23.12.1998 [reported in [1999] 235 ITR (St.) 35]. The relevant part of the Circular is reproduced below:

"22.2 Explanation 10 provides that where a portion of the cost of an asset acquired by the assessee has been met directly or indirectly by the Central Government or a State Government or any authority established under any law or by any other person, in the form of a subsidy or grant or reimbursement (by whatever name called), then, so much of the cost as is relatable to such subsidy or grant or reimbursement, shall not be included in the actual cost of the asset to the assessee. Cost incurred/payable by the assessee alone could be the basis for any tax allowance. This Explanation further provides that where such subsidy or grant or reimbursement is of such nature that it cannot be directly relatable to the asset acquired, so much of the amount which bears to the total subsidy or reimbursement or grant the same proportion as such asset bears to all the assets in respect of or with reference to which the subsidy or grant or reimbursement so received, shall not be included in the actual cost of the asset to the assessee."

5.26 As regards reduction of government grants from Written Down Value, sub-section (6) of section 43 could be referred to. Section 43(6) *inter alia* provides that 'written down value' in case of assets acquired during the previous year would be the actual cost to the assessee. The phrase 'actual cost', according to section 43(1), means the actual cost of the assets to the assessee, reduced by that portion of the cost thereof, if any, as has been met directly or indirectly by any other person or authority. Explanation 10 clarifies that if the Government has given a grant for purchase of any asset, then such amount has to be reduced while calculating the actual cost. The consequence would be that the 'written down value' would, to that extent, be required to be reduced [*Banaskantha District Co-operative Milk Producers' Union Ltd. v CIT (1994) 210 ITR 962 (Guj)*].

Comparison with AS -12

5.27 As per AS 12 two methods of presentation in financial statements of grants (or the appropriate portions of grants) related to specific fixed assets are regarded as acceptable alternatives. As per the first method, the grant is shown as a deduction from the gross value of the asset concerned in arriving at its book value. Under the other method, grants related to depreciable assets are treated as deferred income and recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset. Such allocation to income is usually made over the periods and in the proportions in which depreciation on related assets is charged. However, the ICDS recognises only one method which synchronizes with first method of AS 12. A mismatch in the methodology adopted between AS 12 and this ICDS could lead to unintended results.

5.28 For instance, an assessee recognises government grant as reduction from actual cost in the year of acquisition as per this ICDS. However, for the purposes of financial statements it recognises grants by the second method of AS 12 - ie, such grants are recognised as income. In such an eventuality, grants recognised in the financial statements would be subject to tax under the MAT regime in addition to tax in the year the grants become taxable by virtue of ICDS.

Interplay of para 4 and 5

5.29 As per Para 4 of the ICDS, it is mandatory not to postpone the recognition beyond 'receipt' of grant. Para 5 requires such grant to be reduced from the actual cost of the asset. If the two events of 'receipt of grant' and 'purchase of asset' occur in the same year, the grant received

would be reduced from the asset acquired. However, in case these events occur in two different years, there would be challenges around recognition of grant. For instance, grant is received in Year 1 but the asset is purchased in Year 2. The question is whether the grant has to be recognised in Year 1 or 2?

5.30 The grant recognition cannot be postponed beyond Year 1 (being the year of receipt). However, the recognition mechanism fails since the assessee is not aware of the cost of asset which is acquired in Year 2. A recognition in Year 2 would be a contravention of para 4(2) of the ICDS. It may be prudent to deem Year 2 as the year of receipt and recognise the grant as a deduction from the actual cost.

“6. Where the Government grant relates to a non-depreciable asset or assets of a person requiring fulfillment of certain obligations, the grant shall be recognised as income over the same period over which the cost of meeting such obligations is charged to income.”

5.31 Grants are sometimes received as part of financial or fiscal aids to which a number of conditions are attached. In such cases, costs and expenses incurred for meeting the attached conditions determine the periods over which the grant will be recognised. The grant is allocated over the period during which such costs are charged to income.

5.32 Para 6 deals with grants that relate to non-depreciable assets requiring fulfillment of certain obligations. The phrase ‘requiring fulfillment of certain obligations’ appears to be a surplusage since government grant as defined in para 3(1)(b) already incorporates this condition. This part of para 6 may therefore be read as a reference out of abundant caution. Similar treatment is evident in AS 12.

5.33 Para 4 of the ICDS states that the recognition of grant cannot be deferred beyond the date of ‘receipt’. Grants are either to be recognised as income or as reduction from the actual cost of depreciable assets. If grants are received for assets which are outside the block of assets, the question is the treatment of such grants.

5.34 Not being related to depreciable assets, these grants have, necessarily, to be recognized as incomes. However, para 6 says that the recognition of income should be spread over the period during which the cost has been incurred for meeting obligations in relation to the assets. The prescription in this para dilutes the mandate of para 4 as also of the definition in section 2(24) that grants cannot be recognised as income beyond the year

of receipt. In such circumstances, as the Act does not envisage a spread over beyond year of receipt, the prescription in para 6 should yield to provisions of the Act. It is only when the grant is recognised because there is reasonable certainty of receipt, that the same may be recognised as income over the period of incurring costs in meeting the obligations in relation to non-depreciable assets.

“7. Where the Government grant is of such a nature that it cannot be directly relatable to the asset acquired, so much of the amount which bears to the total Government grant, the same proportion as such asset bears to all the assets in respect of or with reference to which the Government grant is so received, shall be deducted from the actual cost of the asset or shall be reduced from the written down value of block of assets to which the asset or assets belonged to.”

5.35 Para 7 is a continuation of Paras 5 and 6. While para 5 deals with government grant received in relation to depreciable fixed assets and para 6 deals with non-depreciable assets, para 7 deals with grants which cannot be directly relatable to asset acquired (whether depreciable or not). In case ‘one-to-one’ nexus cannot be established between government grant and assets, the same proportion as such asset bears to all the assets in respect of or with reference to which the Government grant is so received, shall be deducted from the actual cost or written down value of the asset.

5.36 The treatment of government grant not relatable to depreciable fixed asset is in accordance with the proviso to explanation 10 to section 43(1) which reads as under:

“Provided that where such subsidy or grant or reimbursement is of such nature that it cannot be directly relatable to the asset acquired, so much of the amount which bears to the total subsidy or reimbursement or grant the same proportion as such asset bears to all the assets in respect of or with reference to which the subsidy or grant or reimbursement is so received, shall not be included in the actual cost of the asset to the assessee.”

5.37 Thus, where a government grant is not directly relatable to depreciable fixed asset acquired, the total grant has to be apportioned over the various assets to reduce their cost proportionately. The amount to be reduced from the actual cost or written down value can be computed in the following manner:

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$$\text{Amount to be reduced from actual cost/ written down value} = \frac{A \times B}{C}$$

Where A = Value of the asset acquired;
B = Total government grant received or receivable; and
C = Sum of all assets in respect of or with reference to which Government grant is received.

5.38 The same treatment is applicable in case of non-depreciable assets as well. The following conclusion may be drawn in relation to non-depreciable assets.

Particulars	Treatment of government grant in income computation
If the grant is in relation to non-depreciable asset	Grant is allocated over the period during which costs incurred in relation to asset are charged to income.
If the grant is not directly relatable to non-depreciable asset	Proportionate (ie, non-depreciable asset to all the assets) portion of the Government grant shall be deducted from the actual cost or written down value of the asset.

Consequences of this split-approach

5.39 As evident from the table above, grants which are directly relatable to non-depreciable assets would be apportioned over the period of costs in the profit and loss account. However, the same grants not directly relatable to depreciable assets require a different treatment - namely, reduction from the cost of the asset.

5.40 It may be relevant to reiterate that section 2(24)(xviii) provides that government grant including all its variants (whether in cash or kind) are categorized as income save grants in relation to depreciable assets referred in explanation 10 to section 43(1). Therefore, grants in relation to non-depreciable assets would be categorized as 'income' or 'revenue item' for the purposes of the Act. The question therefore is:

Whether a grant which is not directly relatable to non-depreciable assets should be concluded as an income (in accordance with section 2(24)(xviii) and therefore be offered to tax?

OR

Whether such grant should be proportionately reduced from the cost of the asset in accordance with para 7 of the ICDS?

5.41 As mentioned in the Preamble to this ICDS, in the event of contradiction between the Act and the ICDS, the provisions of the Act would prevail. Accordingly, grants which are not directly relatable to non-depreciable assets should be offered to tax as income and not recognised as a deduction from the cost of the asset. Consequently, operation of para 7 of the ICDS would be confined to depreciable assets only.

“8. The Government grant that is receivable as compensation for expenses or losses incurred in a previous financial year or for the purpose of giving immediate financial support to the person with no further related costs, shall be recognised as income of the period in which it is receivable.”

5.42 Para 8 deals with government grant receivable as ‘compensation’ in relation to (i) expenses incurred in a previous financial year; or (ii) losses incurred in a previous financial year or (iii) giving immediate financial support to the person with no further related costs. In the event of occurrence of any of these three events, grants shall be recognised as income of the period in which it is receivable. Actual receipt of compensation is irrelevant for the purpose of income recognition. It is also not relevant whether such expenditure or loss was incurred in relation to assets (damage of assets - whether depreciable or otherwise) or in the normal course of business (eg: loss of stock-in-trade). This para deals with expenses or losses (irrespective of its characterization) incurred in a previous financial year for which compensation is receivable from the Government.

5.43 The last situation is compensation payable for the purposes of giving ‘immediate financial support’ with no further related cost. In this circumstance, a government grant is awarded for giving immediate financial support to an enterprise rather than as an incentive to undertake specific expenditure. Such grants may be confined to an individual enterprise and may not be available to a whole class of enterprises. A post facto payment is visualized herein. In such a case, the grantee is considered to have complied with the grant related conditions and has to recognize grant in the period in which such sums become receivable. Actual receipt is immaterial for the purposes of income recognition.

The aforesaid treatment concurs with AS 12 wherein grants of such nature are accounted in the year in which they become receivable. The phrase

'receivable' employed in this ICDS presupposes that the assessee has a reasonable assurance that the grant shall be received.

Comparison with Act

5.44 Para 8 requires grant in relation to expense or loss to be recognised in the year in which it is 'receivable'. This timing of recognition deviates from the provisions of section 41(1) which deals with profits chargeable to tax. Clause (a) to sub-section (1) herein provides that where an allowance or a deduction has been made in the assessment for any year in respect of loss, expenditure or trading liability; and subsequently during any previous year the assessee has obtained any amount in respect of such loss or expenditure, the amount so received shall be chargeable to tax. Section 41(1) states that amount 'obtained' towards loss or expense should be subject to tax. The expression 'obtained' has been interpreted to mean actual receipt [*CIT v Rashmi Trading* (1976) 103 ITR 312 (Guj); *B. V. Aswathiah & Brothers v CIT* (1992) 198 ITR 108 (Kar)]. Para 8 of this ICDS advocates a preponement of taxing the compensation of loss/ expenditure. Due to the contradiction between para 8 and section 41(1) of the Act, the contents of para 8, to this extent, have to yield to the mandate of section 41(1). Therefore, grants received as compensation for expenses or loss would be chargeable to tax only on actual receipt basis.

“9. The Government grants other than covered by paragraph 5, 6, 7, and 8 shall be recognised as income over the periods necessary to match them with the related costs which they are intended to compensate.”

5.45 Under the income approach, government grants should be recognised on a systematic basis over the periods in which the entity recognises as expenses and related costs which the grant is intended to compensate. Para 9 deals with grants received or receivable from Government other than those covered within paras 5, 6, 7 and 8. These grants are required to be recognised over the period necessary to match them with the related costs which are intended to be compensated. Primarily, grants visualized in para 9 are in the nature of 'compensation'. The recognition mechanism requires grants to be recognized over the period necessary to match them with the costs sought to be compensated.

5.46 This para deals with grants other than grants included in paras 5 to 8. The excluded grants are as under:

Para 5 – grants relating to depreciable assets;

Para 6 – grants relating to non-depreciable assets requiring satisfaction of implicit grant conditions;

Para 7 – grants which are not directly relatable to assets;

Para 8 – grants in the nature of compensation in relation to expenses or losses or giving immediate financial support

5.47 Paras 5, 6 and 7 deal with grants in relation to assets. The grants visualized in paras 5, 6 and 7 are made at the time of acquisition. Consequently, they are excluded from the scope of para 9.

5.48 Para 9 deals with any grant provided “as compensation” in relation to depreciable or non-depreciable asset. Grant intended for compensating unearned income could also be an instance covered within this para.

“10. The Government grants in the form of non-monetary assets, given at a concessional rate, shall be accounted for on the basis of their acquisition cost.”

5.49 The last variant of government grant discussed in this ICDS deals with ‘non-monetary’ assets which are granted at a concessional rate. The para visualizes the grantee paying some portion of the value/ cost of the impugned asset. Non-monetary assets (such as land or other resources) granted without any consideration or nil consideration are outside the scope of this provision. A non-monetary asset granted at a concessional price shall be recognized at ‘acquisition’ cost or the concessional price paid by the grantee. The closing portion of the para states that the grant shall be ‘accounted’ for on the basis of acquisition cost.

5.50 For instance, a government body may grant lands to an assessee at a price which is lower than market value. However, it grants such land at the same price to all its grantees. In such an eventuality, the grant of such land is not an income in the hands of the allottees. The allottees should not look at the market rate to compute the concession but the price at which such lands are granted by the body in its normal course.

5.51 The ICDS does not deal with accounting aspects of government grant. Further, para 9 states that the grant shall be accounted on the basis of acquisition cost. Thus, the basis of recognition is provided. The quantum (should it be equal to or less than or more than acquisition cost); timing (at the time of acquisition or over the period during which costs incurred in relation to such assets are recognised) and methodology (to be recognized

as income or reduce from the cost of asset) of recognition is not explicit. It may however be appropriate to recognise the grant in a manner which is compliant with the language employed in para 10 read with section 2(24)(xviii) of the Act.

6. Refund of Government Grants

“11. The amount refundable in respect of a Government grant referred to in paragraphs 6, 8 and 9 shall be applied first against any unamortised deferred credit remaining in respect of the Government grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount shall be charged to profit and loss statement.

12. The amount refundable in respect of a Government grant related to a depreciable fixed asset or assets shall be recorded by increasing the actual cost or written down value of block of assets by the amount refundable. Where the actual cost of the asset is increased, depreciation on the revised actual cost or written down value shall be provided prospectively at the prescribed rate.”

6.1 Government grants sometimes become refundable because the attached conditions are not fulfilled. Refund of government grants would require reversal of treatment carried out at the time of its initial recognition. The ICDS requires that in the event of reversal of government grant, it has to be first applied to unamortized deferred credit. If the amount so refundable exceeds any such deferred credit, or where no deferred credit exists, the amount is charged to profit and loss statement.

6.2 The ICDS refers to ‘amount refundable’. The import of this expression would be that the para only deals with monies refunded. If grants which were provided in the form of assets (say, non-monetary assets) and the same are returned to the government on account of non-fulfillment of certain conditions, the tax treatment of this contingency is not covered within this para. Further, the para only requires the amount to be refundable; actual refund of amount is not relevant for the purposes of recognition.

6.3 The closing portion of Para 11 reads - ‘*shall be charged to profit and loss statement*’. On a literal reading of this phrase, it appears to provide for the ‘accounting treatment’. This may not have been the possible intent since the ICDS does not deal with accounting aspects. One may, therefore, have to

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interpret the phrase 'charge to profit and loss account' as allowability of expenditure while computing business income under Chapter IV-D of the Act.

6.4 Para 11 deals with refund of grants discussed in paras 6, 8 and 9 of the ICDS. On initial recognition of these grants, an amount equivalent to the grant shall be:

- (a) transferred to deferred credit account and subsequently charged to Profit and loss account in case of recognition on deferred income basis [like in paras 6 and 9];
- (b) directly recognised as income in Profit and loss account [like in para 8].

6.5 Refund of such grants shall be given the following treatment while computing taxable income:

Situation	Refund - Tax Treatment	Consequence
If balance exists in deferred credit	Step I: Reverse the unamortized deferred government grant a/c against refundable grant Step II: Balance (Grant refundable – unamortized grant) should be charged to Profit and loss account or should be claimed as a deduction from business income	Excess of refundable grants over the unamortized deferred grant is claimed as a deduction in the total income computation. Effectively, amount which was earlier recognised as income is claimed as an allowable expenditure in the year of refund.
If no balance exists in deferred credit [or if the grant wholly recognised as income in the year of initial recognition]	The whole of grant refundable should be charged to Profit and loss account or claimed as a deduction from business income.	Amount which was earlier recognised as income is claimed as an allowable expenditure in the year of refund.

6.6 Para 12 deals with refund of grants in relation to depreciable assets. The amount refundable in respect of a government grant related to depreciable fixed asset is recorded by increasing the actual cost of the asset or written down value of the asset, as appropriate, by the amount refundable.

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On the revised actual cost or written down value, depreciation shall be claimed at the prescribed rates.

6.7 To elucidate, grants in relation to depreciable assets are required to be reduced from the actual cost of the asset or written down value of block of assets which houses the concerned asset. This is the mandate of paras 5 and 7 of this ICDS. In the year such grant is refunded:

- (a) the carrying amount of the depreciable asset is increased by the grant refundable; and
- (b) Depreciation is claimed on the increased carrying amount over the remaining useful life of the asset prospectively.

6.8 The ICDS does not prescribe the treatment of refund for grants in relation to the following:

- (a) Grants which are not directly relatable to acquisition of non-depreciable assets; and
- (b) Grants in relation to non-monetary assets.

6.9 The tax treatment of such refund would depend upon the general principles of the Act.

7. Transitional Provisions

“13. All the Government grants which meet the recognition criteria of para 4 on or after 1st day of April, 2016 shall be recognised for the previous year commencing on or after 1st day of April, 2016 in accordance with the provisions of this standard after taking into account the amount, if any, of the said Government grant recognised for any previous year ending on or before 31st day of March, 2016.”

7.1 Para 4 prescribes the income recognition criteria in case of grants wherein reasonable assurance of compliance with conditions and receipt is considered as the starting point and actual receipt as the end point. Any grant which meets these criteria after 1.4.2016 shall be recognised as per this Standard. This recognition should be carried out after considering the grants which have already been recognised on or after 31.03.2016.

7.2 So far as grant or subsidy which has been actually received prior to 1st April 2016 but which has not been recognized in the books of account pending satisfaction of the related conditions, Circular no. 10/2017, dated 23rd March, 2017 issued by the CBDT containing clarifications on ICDS provides that such government grant shall be deemed to have been

recognised on its receipt in accordance with Para 4(2) of the ICDS and will be outside the transitional provision. Question no. 17 and answer thereto in the above referred circular are reproduced below:

Question 17: *For subsidy received prior to 1st day of April 2016 but not recognised in the books pending satisfaction of related conditions and achieving reasonable certainty of receipt, how shall the same be recognised under ICDS on or after 1st day of April 2016?*

Answer: *Para 4 of ICDS-VII read with Para 5 to Para 9 of ICDS-VII provides for timing of recognition of government grant. The transitional provision in Para 13 of ICDS-VII provides that a government grant which meets the recognition criteria on or after 1st day of April 2016 shall be recognised in accordance with ICDS-VII. All government grants actually received prior to 1st day of April 2016 shall be deemed to have been recognised on its receipt in accordance with Para 4(2) of ICDS-VII and accordingly will be outside the transitional provision and therefore the government grants received on or after 1st day of April 2016 and for which recognition criteria provided in Para 5 to Para 9 of ICDS-VII is also satisfied thereafter, the same shall be recognised as per the provisions of ICDS-VII. The grants received prior to 1st day of April 2016 shall continue to be recognised as per the law prevailing prior to that date.*

For example, if out of total subsidy entitlement of 10 Crore an amount of 6 Crore is recognised in the books of accounts till 31st day of March 2016 and recognition of balance 4 Crore is deferred pending satisfaction of related conditions and/or achieving reasonable certainty of receipt. The balance amount of 4 Crore will be taxed in the year in which related conditions are met and reasonable certainty is achieved. If these conditions are met over two years, the amount of 4 Crore shall be taxed over the period of two years. The amount of 6 Crore for which recognition criteria were met prior to 1st day of April 2016 shall not be taxable post 1st day of April 2016.

But if the subsidy is already received prior to 1st day of April 2016, Para 13 of ICDS-VII shall not apply even if some of the related conditions are met on or after 1 April 2016. This is in view of Para 4(2) of ICDS-VII which provides that Government grant shall not be postponed beyond the date of actual receipt. Such grants shall

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continue to be governed by the provisions of law applicable prior to 1st day of April 2016.

8. Disclosures

“14. Following disclosure shall be made in respect of Government grants, namely:—

- (a) nature and extent of Government grants recognised during the previous year by way of deduction from the actual cost of the asset or assets or from the written down value of block of assets during the previous year;**
- (b) nature and extent of Government grants recognised during the previous year as income;**
- (c) nature and extent of Government grants not recognised during the previous year by way of deduction from the actual cost of the asset or assets or from the written down value of block of assets and reasons thereof; and**
- (d) nature and extent of Government grants not recognised during the previous year as income and reasons thereof.”**

8.1 Broadly, there are two variants of grants deliberated in this ICDS. One which requires to be reduced from actual cost or written down value of asset and other which requires recognition of grants as income for a year. The ICDS requires disclosure in respect of both these grants to the extent recognised (and not recognised) during the year. The following disclosures are therefore prescribed:

Nature of grant	Amount recognised	Remarks/ Reason
Government grants recognised during the previous year by way of deduction from the actual cost of the asset or assets or from the written down value of block of assets during the previous year		
Government grants not recognised during the previous year by way of deduction from the actual cost of		

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the asset or assets or from the written down value of block of assets		
Government grants recognised during the previous year as income		
Government grants not recognised during the previous year as income		

Chapter 9

ICDS VIII : Securities

1. Preamble

“This Income Computation and Disclosure Standard is applicable for computation of income chargeable under the head “Profits and gains of business or profession” or “Income from other sources” and not for the purpose of maintenance of books of accounts.

In the case of conflict between the provisions of the Income-tax Act, 1961 (‘the Act’) and this Income Computation and Disclosure Standard, the provisions of the Act shall prevail to that extent.”

1.1 This ICDS, like other ICDS, applies in computing income under the head “Profits and gains of business or profession” and “Income from Other Sources”. Provisions of the Act will override the ICDS in case there is a conflict between the two.

1.2 This ICDS corresponds to Accounting Standard (AS) 13 – *Accounting for Investments* of the Companies (Accounting Standards) Rules, 2006 and Indian Accounting Standard (Ind AS) 109 – *Financial Instruments*, prescribed under section 133 of the Companies Act, 2013 as notified under the Companies (Indian Accounting Standards) Rules, 2015.

1.3 ICDS VIII is divided into two parts. Part A deals with securities held as stock-in-trade by taxpayers, but does not apply to securities held by taxpayers engaged in the business of insurance, securities held by mutual funds, venture capital funds. Securities held by banks and public financial institutions are also excluded from the purview of Part A. Specific provisions have been incorporated in Part B of this ICDS for scheduled banks and public financial institutions. Therefore, this ICDS does not apply at all to insurance companies, mutual funds, venture capital funds, and non-scheduled banks.

PART A

2. Scope

“1. This part of Income Computation and Disclosure Standard deals with securities held as stock-in-trade.

2. This part of Income Computation and Disclosure Standard does not deal with:

- (a) the bases for recognition of interest and dividends on securities which are covered by the Income Computation and Disclosure Standard on revenue recognition;**
- (b) securities held by a person engaged in the business of insurance;**
- (c) securities held by mutual funds, venture capital funds, banks and public financial institutions formed under a Central or a State Act or so declared under the Companies Act, 1956 (1 of 1956) or the Companies Act, 2013 (18 of 2013)."**

2.1 The Part A of ICDS deals with securities held only as stock-in-trade. Therefore, in respect of securities not held as stock-in-trade, the tax treatment would be governed by normal provisions of the Act. ICDS IV - Revenue Recognition, which deals with interest and dividend, applies to all securities, whether held as stock-in-trade or otherwise.

2.2 AS 13 specifically deals with securities held as investments and therefore securities held as stock-in-trade are excluded; it also clarifies that since the manner in which they are accounted is similar to current investments, the provisions of the Standard to the extent applicable to current investments, would also apply to securities held as stock-in-trade with suitable modifications.

2.3 This part of ICDS applies to securities held as stock-in-trade by any assessee, such as stock broker or a regular trader in securities, whose income is taxable under the head Business Income. On the other hand, securities held by persons engaged in business of insurance, securities held by mutual funds, venture capital funds, banks and public financial institutions are specifically excluded from the scope of Part A (Part B of ICDS VIII deals with securities held by scheduled banks or public financial institutions). Securities held by foreign institutional investors are treated as capital assets under the provisions of section 2(14)(b) of the Act, including securities which could otherwise be considered to be held as stock-in-trade by such entities, and therefore this part of ICDS will also not apply to such assesseees.

2.4 This Part of ICDS does not deal with the criteria for classification of securities as stock-in-trade or as capital assets. In this regard, the CBDT had

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issued Instruction No 1827 dated 31 August 1989 and Circular No. 4/2007 dated 15 June 2007. Thereafter, the CBDT issued Circular 6/2016 dated February 29, 2016 on this subject. Likewise, letter F.No. 225/12/2016/ITA.II dated 2 May 2016 has been issued which deals with taxation of income/loss arising from transfer of unlisted shares. The guidance provided in these Circulars and instructions deal with the issue regarding taxability of surplus on sale of shares and securities i.e. whether the income arising from such investment is capital gains or business income and sets out the principles in determining whether shares are held as investment or as stock-in-trade. These principles, *inter-alia*, include the magnitude of purchases and sales, manner of maintaining books of accounts, objective of purchase etc. The Circulars also provide that no single principle would be decisive and the total effect of all the principles is to be considered to determine whether the shares are held by the assessee as investment or stock-in-trade.

2.5 Part A of the ICDS also does not deal with the basis of recognition of interest and dividends on securities, which is covered by ICDS IV on Revenue recognition.

3. Definition

“3(1) The following terms are used in this part of Income Computation and Disclosure Standard with the meanings specified:

- (a) “Fair value” is the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm’s length transaction.***
- (b) “Securities” shall have the meaning assigned to it in clause (h) of Section 2 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956) and shall include share of a company in which public are not substantially interested but shall not include derivatives referred to in sub-clause (ia) of that clause (h).***

3(2) Words and expressions used and not defined in this part of Income Computation and Disclosure Standard but defined in the Act shall have the meaning respectively assigned to them in the Act.”

3.1 The term ‘Fair value’ under this part of ICDS is similar to that in AS 13. Ind AS 109 requires entities to refer to another Standard viz. Ind AS 113 on *Fair Value Measurement* for definition of fair value and how to measure fair value. The term ‘Fair value’ is also found in ICDS V that deals with Tangible Fixed Assets.

3.2 For the meaning of the term “securities”, Part A, Para 3(1)(b) of this ICDS refers to the definition provided under the Securities Contracts (Regulation) Act, 1956 (SCRA). The relevant definition under SCRA reads as under:

(h) “securities” include—

- (i) *shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate;*
- (ia) *derivative;*
- (ib) *units or any other instrument issued by any collective investment scheme to the investors in such schemes;*
- (ic) *security receipt as defined in clause (zg) of section 2 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002;*
- (id) *units or any other such instrument issued to the investors under any mutual fund scheme;*

Explanation. — For the removal of doubts, it is hereby declared that "securities" shall not include any unit linked insurance policy or scrips or any such instrument or unit, by whatever name called, which provides a combined benefit risk on the life of the persons and investment by such persons and issued by an insurer referred to in clause (9) of section 2 of the Insurance Act, 1938 (4 of 1938);

- (ie) *any certificate or instrument (by whatever name called), issued to an investor by any issuer being a special purpose distinct entity which possesses any debt or receivable, including mortgage debt, assigned to such entity, and acknowledging beneficial interest of such investor in such debt or receivable, including mortgage debt, as the case may be;*
- (ii) *Government securities;*
- (iia) *such other instruments as may be declared by the Central Government to be securities; and*
- (iii) *rights or interest in securities;*

3.3 The above definition of securities under the SCRA refers to ‘other marketable securities’. There were divergent judicial views whether share of an unlisted public company is a marketable security. The Supreme Court of

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India in *Bhagwati Developers (P) Ltd. v. Peerless General Finance & Investment Co. Ltd.*, (2013) 9 SCC 584 held that such shares were covered in the definition of securities under SCRA.

3.4 The definition of securities in this Part specifically includes shares of a company in which public are not substantially interested. Section 2(18) of the Income-tax Act defines as to when a company is said to be a company in which public are substantially interested. A private company, an unlisted public company unless it is a subsidiary of a listed company, would be a company in which public are not substantially interested [subject to certain cases referred in section 2(18) of the Act]. However, all such shares, whether or not marketable, will be 'securities' under the definition given in this Part. Whether a person can hold shares of a private company as stock in trade is, however, a moot question, since such shares are not freely transferable and thus cannot be traded.

3.5 Although derivatives are 'securities' under the definition of securities contained in section 2(h) of the SCRA, these have been specifically excluded from the definition of 'securities' under this Part of the ICDS. Hence, in case of derivatives held as stock in trade, the CBDT has clarified that it would be governed by the General Principles of accounting and tax as per ICDS I.

3.6 In this context, the CBDT has clarified vide Circular no. 10/2017, dated 23rd March 2017, as under:

Question 10: Which ICDS would govern derivative instruments?

Answer: 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.

3.7 This clarification seems to be not in accordance with the ICDS provisions. Derivative instruments, which are capital assets, would not be governed by ICDS at all.

4. Recognition and Initial Measurement of Securities

“4. A security on acquisition shall be recognised at actual cost.

5. The actual cost of a security shall comprise of its purchase price and include acquisition charges such as brokerage, fees, tax, duty or cess.

6. Where a security is acquired in exchange for other securities, the fair value of security so acquired shall be its actual cost.

7. Where a security is acquired in exchange for another asset, the fair value of the security so acquired shall be its actual cost.

8. Where unpaid interest has accrued before the acquisition of an interest-bearing security and is included in the price paid for the security, the subsequent receipt of interest is allocated between pre-acquisition and post-acquisition periods; the pre-acquisition portion of the interest is deducted from the actual cost.”

4.1 The initial recognition of security is to be at cost (see para 4 of this ICDS). Further, such cost would comprise of acquisition charges such as brokerage, fees, taxes or cess (see para 5 of this ICDS). However, if, in the cost of acquisition, unpaid interest is accrued and later, interest is received, the interest prior to date of acquisition is to be reduced from the cost and portion of interest post-acquisition would be accounted for as income. The provisions of AS 13 are identical in this regard, and therefore, while computing income, no adjustment would be required. Securities are financial instruments under Ind AS 109 and initial measurement is always at fair value plus transaction costs in case of securities other than those classified as fair value through profit and loss. Subsequent measurement of securities depends upon the classification of securities into either Amortised Cost, Fair Value through Profit & Loss A/c or Fair value through other comprehensive income.

4.2 In case of securities acquired and accounted for as investments and later converted to stock-in-trade, AS 13 mandates that such conversion ought to take place at cost or market value on the date of conversion, whichever is lower. In cases, where the market value on the date of conversion is lower than the original cost, it would result into a loss and reported in the profit and loss account. Thereafter, when such securities are eventually sold, the profit or loss arising therefrom would be accounted for with reference to the conversion value as stated earlier.

4.3 However, for the purpose of computing taxable gain or loss on sale of securities held as stock-in-trade, the fair market value of such securities on the date of conversion shall be considered as the cost. This will be in accordance with the provisions of section 45(2). The difference between the market value on the date of conversion and the original cost would be capital gain or loss under the provisions of Section 45(2) of the Act. This tax

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treatment is in line with the decision of Hon'ble Supreme Court in the case of *CIT v Bai Shrinbai K. Kooka* [1962] 46 ITR 86 (SC).

4.4 As per para 5 of this ICDS, the cost of a security shall comprise of purchase price paid for acquiring the security and other incidental expenses incurred in relation to such acquisition. However, since securities transaction tax (STT) is deductible under specific provisions of section 36(1)(xv) of the Income-tax Act, such STT ought not be added to cost, otherwise this would amount to claiming double deduction.

4.5 In case a security is acquired in exchange for other security, the fair value of security so acquired shall be its actual cost. Also, in case a security is acquired in exchange of another asset, the fair value of security so acquired shall be its actual cost. What is 'fair value' is a settled concept under the International Accounting Standards (Refer Chapter 6 on ICDS V – Tangible Fixed Assets' for guidance on the term 'fair value'). The gain or loss arising on account of transfer of security or asset would be accounted in the profit and loss account. However, if the asset exchanged belongs to a block of assets, such credit of value shall be taken to the relevant block of assets.

4.6 Under AS 13, if an investment is acquired, or partly acquired, by issue of shares or other securities, the acquisition cost should be the fair value of the securities issued (which in appropriate cases may be indicated by the issue price as determined by statutory authorities). The fair value may not necessarily be equal to the nominal or par value of the securities issued. If an investment is acquired in exchange for another asset, the acquisition cost of the investment should be determined by reference to the fair value of the asset given up. Alternatively, the acquisition cost of the investment may be determined with reference to the fair value of the investment acquired if it is more clearly evident.

4.7 When one compares the provisions of this Part of ICDS with that of AS 13 in case of acquisition of securities in exchange of other securities or another asset, the basis of recognition of cost is different; under Part A of ICDS, the fair value of the security acquired is to be recognised as its actual cost, whereas, under AS 13, the actual cost of securities acquired is to be determined in the context of fair value of securities issued or the asset given up. Therefore, the actual cost of such asset under this Part of ICDS and AS 13 would be different. Thus, while ascertaining the actual cost and also in valuation of closing stock, the differences arising on account of these differing methods of measuring actual cost must be considered.

4.8 The differential treatment of determination of cost under this Part of

ICDS and AS 13 will result in different costs of securities for tax purposes and books, respectively and therefore, while computing gain/loss on sale of such securities, these differences would have to be factored in claiming the deduction of cost.

5. Subsequent Measurement of Securities

“9. At the end of any previous year, securities held as stock-in-trade shall be valued at actual cost initially recognised or net realisable value at the end of that previous year, whichever is lower.

10. For the purpose of para 9, the comparison of actual cost initially recognised and net realisable value shall be done categorywise and not for each individual security. For this purpose, securities shall be classified into the following categories, namely:-

- (a) Shares;***
- (b) debt securities;***
- (c) convertible securities; and***
- (d) any other securities not covered above.***

11. The value of securities held as stock-in-trade of a business as on the beginning of the previous year shall be:

- (a) the cost of securities available, if any, on the day of the commencement of the business when the business has commenced during the previous year; and***
- (b) the value of the securities of the business as on the close of the immediately preceding previous year, in any other case.***

12. Notwithstanding anything contained in para 9, 10 and 11, at the end of any previous year, securities not listed on a recognised stock exchange; or listed but not quoted on a recognised stock exchange with regularity from time to time, shall be valued at actual cost initially recognised.

13. For the purpose of Para 9, 10 and 11 where the actual cost initially recognised cannot be ascertained by reference to specific identification, the cost of such security shall be determined on the basis of first-in-first-out method or weighted average cost formula.”

5.1 Para 9 of this ICDS, requires securities held as stock-in-trade to be recognized at cost or net realisable value ('NRV'), which is similar to the

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provision in AS 13, which requires securities held for sale under ordinary course of business to be disclosed as stock-in-trade and valued at cost or fair value, whichever is lower.

5.2 However, unlike AS 13, as per Part A of this ICDS, comparison of actual cost initially recognised and NRV is to be done categorywise and not for each individual security. For this purpose, securities are to be classified into the following categories:

1. Shares
2. Debt Securities
3. Convertible Securities
4. Any other securities not covered above

5.3 On the other hand, under AS 13, valuation of securities held as stock-in-trade on overall global basis is not considered appropriate. It specifies that it would be more prudent and appropriate to carry investments individually, at the lower of cost and fair value.

5.4 As per para 9 of this ICDS, the securities held as stock-in-trade are to be valued at actual cost initially recognised or NRV at the end of the previous year, whichever is lower.

5.5 For the purpose of determining the cost of closing stock, first-in-first-out method or weighted average cost formula is used in the absence of specific identification of closing stock. Although, this Part of ICDS provides that initial cost or NRV shall be used for the category and not for individual security, one may need to keep track of the cost of individual security. For instance, if some shares are held throughout the next financial year, but at the end of that year, the NRV of such shares is higher than the actual cost recognised at the time of acquisition, then for the purpose of valuation of closing stock, the actual cost would require to be used.

5.6 Under AS 13, the closing stock of each security (and not by category as provided in this ICDS) is to be valued at cost or fair value, whichever is lower. Further, it does not distinguish between the securities as listed or listed but not quoted on a recognized exchange with regularity from time to time. For such securities, this Part of ICDS requires such securities to be valued at actual cost, even though the NRV may be lower. However, under AS 13, such shares are to be valued at cost or fair value, whichever is lower. Therefore, the difference arising on account of the value of closing stock as per AS 13 and this ICDS would need to be considered in computing the total income.

5.7 Para 11 of this ICDS provides that closing value of security at the end of preceding year is to be considered as value of security at the beginning of the year. Although, it is not specifically mentioned under AS 13 and Ind AS 109, the balance at the beginning of the period is the value of the closing stock brought forward from the previous period.

5.8 It may be noted that the difference arising on account of valuation of securities held at the end of the previous year as stock-in-trade under this Part of ICDS and AS 13/Ind AS 109 may end up in the creation of deferred tax asset/ liabilities, as the case may be.

5.9 Para 12 of this ICDS provides that the securities listed but not quoted on a recognised stock exchange with regularity from time to time, shall be valued at actual cost initially recognized. However, the expression, 'not quoted on a recognised stock exchange with regularity from time to time' has not been defined.

5.10 In this connection, a reference may be made to the clarifications on ICDS contained in Circular no. 10/2017, dated 23rd March, 2017 issued by the CBDT. Question no. 19 and answer thereto deal with the method of valuation under the ICDS. The same are reproduced below:

Question 19: *Para 9 of ICDS-VIII on securities requires securities held as stock-in-trade shall be valued at actual cost initially recognised or net realisable value (NRV) at the end of that previous year, whichever is lower. Para 10 of Part-A of ICDS-VIII requires the said exercise to be carried out category wise. How the same shall be computed?*

Answer: *For subsequent measurement of securities held as stock-in-trade, the securities are first aggregated category wise. The aggregate cost and NRV of each category of security are compared and the lower of the two is to be taken as carrying value as per ICDS-VIII. This is illustrated below –*

Security	Category	Cost	NRV	Lower of Cost or NRV	ICDS Value
A	Share	100	75	75	
B	Share	120	150	120	
C	Share	140	120	120	
D	Share	200	190	190	
	Total	560	535	505	535

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E	Debt Security	150	160	150	
F	Debt Security	105	90	90	
G	Debt Security	125	135	125	
H	Debt Security	220	230	220	
	Total	600	615	585	600
		1160	1150	1090	1135

PART B

6. Scope

“1. This part of Income Computation and Disclosure Standard deals with securities held by a scheduled bank or public financial institutions formed under a Central or a State Act or so declared under the Companies Act, 1956 (1 of 1956) or the Companies Act, 2013 (18 of 2013).”

6.1 Unlike Part A, Part B deals with securities held by specific entities, namely Scheduled banks or public financial institutions. Therefore, mutual funds, banks other than scheduled banks, insurance companies and non-public financial institutions are not covered by this ICDS.

6.2 Whereas Part A deals with only the securities held as stock in trade, Part B is silent in this respect. Therefore, securities held by banks and public financial institutions as stock in trade as well as investments seem to be covered within the ambit of Part B. However, since ICDS itself does not apply to computation of income under the head “Capital Gains”, Part B would not apply to investments, but only to stock-in-trade.

6.3 In respect of Scheduled banks, this classification will be governed by the RBI guidelines as mentioned in Circular No 665 dated 5 October, 1993. It provides :

“The question whether a particular item of investment in securities constitutes stock-in-trade or a capital asset is a question of fact. In fact, the banks are generally governed by the instructions of the

Reserve Bank of India from time to time with regard to the classification of assets and also the accounting standards for investments. The Board has, therefore, decided that the Assessing Officers should determine on the facts and circumstances of each case as to whether any particular security constitutes stock-in-trade or investment taking into account the guidelines issued by the Reserve Bank of India in this regard from time to time.”

6.4 Further, Part B of ICDS is also silent on provision regarding recognition of income on securities (interest/dividend etc) and therefore, computation of income from such source would be governed by normal provisions of the Act read with ICDS IV - Revenue Recognition.

7. Definitions

“2(1) The following terms are used in this part of Income Computation and Disclosure Standard with the meanings specified:

- (a) “Scheduled Bank” shall have the meaning assigned to it in clause (ii) of the Explanation to clause (viia) of sub-section (1) of section 36 of the Act.***
- (b) “Securities” shall have the meaning assigned to it in clause (h) of Section 2 of the Securities Contract (Regulation) Act, 1956 (42 of 1956) and shall include share of a company in which public are not substantially interested;***

2(2) Words and expressions used and not defined in this part of Income Computation and Disclosure Standard but defined in the Act shall have the meaning respectively assigned to them in the Act.”

7.1 Explanation (ii) to Section 36(1)(viia) of the Income-tax Act defines Scheduled Bank as the State Bank of India constituted under the State Bank of India Act, 1955 (23 of 1955), a subsidiary bank as defined in the State Bank of India (Subsidiary Banks) Act, 1959 (38 of 1959), a corresponding new bank constituted under section 3 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 (5 of 1970), or under section 3 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 (40 of 1980), or any other bank being a bank included in the Second Schedule to the Reserve Bank of India Act, 1934 (2 of 1934).

7.2 Public Financial Institutions are not defined in this part of ICDS, therefore its meaning can be derived from relevant provisions of the Act. Explanation (iii) to Section 36(1)(viia) of the Income-tax Act provides that public financial institution shall have the meaning assigned to it in section 4A

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of the Companies Act, 1956. As per Companies Act, the following are regarded as a public financial institution, i.e.

- (i) the Industrial Credit and Investment Corporation of India Limited, a company formed and registered under the Indian Companies Act, 1913 (7 of 1913) ;
- (ii) the Industrial Finance Corporation of India, established under section 3 of the Industrial Finance Corporation Act, 1948 (15 of 1948) ;
- (iii) the Industrial Development Bank of India, established under section 3 of the Industrial Development Bank of India Act, 1964 (18 of 1964) ;
- (iv) the Life Insurance Corporation of India, established under section 3 of the Life Insurance Corporation Act, 1956 (31 of 1956) ;
- (v) the Unit Trust of India, established under section 3 of the Unit Trust of India Act, 1963 (52 of 1963) ;
- (vi) the Infrastructure Development Finance Company Limited, a company formed and registered under this Act ;
- (vii) the securitisation company or the reconstruction company which has obtained a certificate of registration under sub-section (4) of section 3 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.

7.3 The Central Government is empowered to notify other institutions as public financial institution.

7.4 The definition of securities is similar to that provided in Part A above, except that in the absence of a specific exclusion as in Part A, derivatives would also be considered as securities under this Part.

8. Classification, Recognition and Measurement of Securities

“3. Securities shall be classified, recognised and measured in accordance with the extant guidelines issued by the Reserve Bank of India in this regard and any claim for deduction in excess of the said guidelines shall not be taken into account. To this extent, the provisions of Income Computation and Disclosure Standard VI on the effect of changes in foreign exchange rates relating to forward exchange contracts shall not apply.”

8.1 Para 3 of Part B of this ICDS provides that securities shall be

classified, recognised and measured in accordance with the guidelines issued by the Reserve Bank of India (RBI) from time to time.

8.2 It also provides that ICDS VI relating to Effects of Changes in Foreign Exchange Rates also will not apply in relation to forward exchange contracts and the RBI guidelines would apply to such forward exchange contracts.

8.3 This ICDS, unlike most others, does not stipulate any disclosure requirements.

Chapter 10

ICDS IX : Borrowing Costs

1. Preamble

“This Income Computation and Disclosure Standard is applicable for computation of income chargeable under the head “Profits and gains of business or profession” or “Income from other sources” and not for the purpose of maintenance of books of account.

In the case of conflict between the provisions of the Income-tax Act, 1961 (‘the Act’) and this Income Computation and Disclosure Standard, the provisions of the Act shall prevail to that extent.”

2. Scope

“1.(1) This Income Computation and Disclosure Standard deals with treatment of borrowing costs.

(2) This Income Computation and Disclosure Standard does not deal with the actual or imputed cost of owners' equity and preference share capital.”

2.1 This Standard, dealing with Borrowing Costs, corresponds to AS 16 of the Companies (Accounting Standards) Rules, 2006 and Indian Accounting Standard (Ind AS) 23.

2.2 The reason for the specific exclusion of actual or imputed cost of owners' equity and preference share capital is on account of the fact that under Ind AS, redeemable preference share capital is treated as a liability. Ind AS 23 specifically excludes only actual or imputed cost of equity and of preferred capital not classified as a liability.

2.3 Unlike AS 16 and Ind AS 23, which deal with both the revenue and capital aspects of borrowing costs, this ICDS primarily deals with the timing and the circumstances under which borrowing costs are to be capitalised. It does not specifically deal with the allowability of borrowing costs as a deduction, which continues to be governed by section 36(1)(iii) of the Act. Finance Act, 2015 amended the Proviso to Section 36(1)(iii) to delete the words “for extension of existing business or profession”.

2.4 This ICDS would need to be considered for the purposes of section 36(1)(iii) of the Act regarding deduction of interest paid in respect of capital

borrowed for the purposes of the business or profession, and explanation 8 to section 43(1) of the Act, regarding interest which cannot be capitalised. It will also apply for the purposes of clause (iii) of section 57 of the Act, for deductibility of interest under the head "Income from Other Sources".

3. Definitions

"2.(1) The following terms are used in this Income Computation and Disclosure Standard with the meanings specified:

- (a) "Borrowing costs" are interest and other costs incurred by a person in connection with the borrowing of funds and include:***
 - (i) commitment charges on borrowings;***
 - (ii) amortised amount of discounts or premiums relating to borrowings;***
 - (iii) amortised amount of ancillary costs incurred in connection with the arrangement of borrowings;***
 - (iv) finance charges in respect of assets acquired under finance leases or under other similar arrangements."***

3.1 Section 36(i)(iv) only refers to interest on capital borrowed. However, this ICDS has enlarged the scope and accordingly borrowing cost would include interest and other costs included in the definition in para 2(1)(a).

3.2 The definition of 'borrowing costs' includes interest. The term "interest", not being defined in the ICDS, would have the same meaning as contained in section 2(28A) of the Act, i.e. "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. However, this term would have to be read in the context of "borrowing of funds", as contained in the definition, and would not apply to interest unrelated to borrowings, such as interest on overdue payments.

3.3 Further, the term "borrowing of funds" would imply that amounts paid for borrowing of stock in trade, or other assets, such as gold, raw material, etc., would not be regarded as interest for the purposes of this ICDS, since no funds are borrowed in such cases.

3.4 The definition has specifically included certain items, which even otherwise, would have been regarded as "interest" as defined, such as

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commitment charges on borrowings, and discounts or premiums related to the borrowings. It needs to be noted that so far as discounts or premiums relating to borrowings, and ancillary costs incurred in connection with the arrangement of borrowings, only the amortised amount is to be considered as borrowing costs, and not the entire amount of discount, premium or ancillary costs. In effect, therefore, the ICDS covers only deferred expenditure for the purposes of capitalisation, if such expenditure is deferred.

3.5 The Supreme Court in the case of *Taparia Tools Ltd v JCIT [2015]372 ITR 605(SC)* has taken a view that one time upfront discounted interest payment on debentures, shown as deferred revenue expenditure in books of account to be written off over a period of five years, was allowable as a deduction in entirety in the initial year of payment itself, since the liability was incurred in that year.

3.6 The related issue which arises is whether the amortised amount is to be considered as amount amortised in the books of account, or amount amortised for income tax purposes. This question would arise where a particular interest expenditure may be amortised on a different basis in the books of account, and on a different basis in the income tax computation. The concept of amortisation is vis-à-vis accounts, and therefore the amortisation referred to in the definition of “borrowing costs” should be amortisation as per books of account.

3.7 This definition also recognises the finance element of finance lease charges as a borrowing cost, and therefore goes by the substance of a finance lease, rather than its form. This is in accordance with the requirement of an accounting policy following the substance rather than the form, as laid down in ICDS 1 - Accounting Policies. Therefore, this ICDS includes finance charges in respect of assets acquired under Finance lease or similar arrangements as borrowing cost.

3.8 So far as bill discounting charges and other similar charges are concerned, question no. 21 and reply thereto from the clarifications on ICDS contained in Circular no. 10/2017, dated 23rd March 2017 issued by the CBDT are reproduced below:

Question 21: *Whether bill discounting charges and other similar charges would fall under the definition of borrowing cost?*

Answer: *The definition of borrowing cost is an inclusive definition. Bill discounting charges and other similar charges are covered as borrowing cost.*

Borrowing Costs

3.9 The answer does not seem to recognise the fact that in most cases of bill discounting, the transaction amounts to a sale of the bill to the bank at a discount. As held by the Delhi High Court in the case of *CIT v Cargill Global Trading Pvt Ltd* [2011]335 ITR 94(Delhi) (SLP rejected by the Supreme Court 21 taxmann.com 496), the discount on sale of bills without recourse does not amount to interest, and the discounting is not a borrowing, but a sale of the bill. Borrowing cost is a broader term than interest; the discount would also not amount to borrowing cost as defined in para 2(1)(a) of the ICDS. The definition refers to other costs incurred in connection with the borrowing of funds. Discounting charges which is not for borrowing of funds may not be included under this definition.

3.10 Unlike AS 16 and IndAS 23, borrowing costs under this ICDS do not include exchange differences arising from foreign currency borrowings to the extent they are regarded as an adjustment to interest costs. ICDS VI deals with effects of changes in foreign exchange rates, and would therefore apply even to fluctuations in foreign exchange rates in respect of such interest.

“(b) “Qualifying asset” means:

- (i) land, building, machinery, plant or furniture, being tangible assets;**
- (ii) know-how, patents, copyrights, trade marks, licences, franchises or any other business or commercial rights of similar nature, being intangible assets;**
- (iii) inventories that require a period of twelve months or more to bring them to a saleable condition.**

(2) Words and expressions used and not defined in this Income Computation and Disclosure Standard but defined in the Act shall have the meaning assigned to them in the Act.”

3.11 Unlike AS 16 and Ind AS 23, where an asset that necessarily takes a substantial period of time to get ready for its intended use or sale alone is a qualifying asset, under ICDS IX, all tangible assets and intangible assets referred to in the definition, irrespective of the period of time to get ready for their intended use, are qualifying assets. It is only in the case of inventories that ICDS IX requires a qualifying period of at least twelve months, in order to fall within the definition of a qualifying asset.

3.12 Since specific categories of tangible assets and intangible assets are referred to, a question which arises is whether any other tangible asset or

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intangible asset not specifically referred to in the definition, can be treated as qualifying assets. The controversy may arise as to whether goodwill is a business or commercial right of similar nature, and therefore whether it is a qualifying asset or not. The Supreme Court, in the case of *CIT v Smifs Securities Ltd [2012] 348 ITR 302 (SC)*, in the context of the term “intangible assets” used in the definition of “block of assets” contained in section 2(11), where the language used is similar, has held that goodwill arising on an amalgamation is also an intangible asset. Therefore, goodwill would be regarded as an intangible asset for this purpose as well.

3.13 Inventory, for example, in the case of real estate developers would also be qualifying asset under this ICDS.

Operative Portion

3.14 The operative portion consists of four parts – recognition, borrowing costs eligible for capitalisation, commencement of capitalisation and cessation of capitalisation, besides transitional provisions and disclosures.

4. Recognition

“3. Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset shall be capitalised as part of the cost of that asset. The amount of borrowing costs eligible for capitalisation shall be determined in accordance with this Income Computation and Disclosure Standard. Other borrowing costs shall be recognised in accordance with the provisions of the Act.

4. For the purposes of this Income Computation and Disclosure Standard, "capitalisation" in the context of inventory referred to in item (iii) of clause (b) of sub-paragraph (1) of paragraph 2 means addition of borrowing cost to the cost of inventory.”

4.1 Paragraph 3 requires capitalisation of borrowing costs that are directly attributable to acquisition, construction or production of a qualifying asset as part of the cost of that asset till the asset is put to use. The quantum of borrowing costs to be capitalised is to be determined in accordance with this ICDS. Explanation 8 to section 43(1) provides that borrowing costs incurred for acquisition of an asset, which are relatable to periods after the asset is put to use, cannot be capitalised as part of the cost of the asset.

4.2 Borrowing costs which are allowable as a deduction are not governed by this ICDS, but are governed either by section 36(1)(iii), or by section 57(iii), as the case may be. Therefore, the deductibility of such expenditure

Borrowing Costs

would depend upon the provisions of the respective sections, and would not be governed by the provisions contained in this ICDS.

4.3 In the context of inventories, it is clarified in paragraph 4, that capitalisation would mean addition of the borrowing cost to the cost of the inventory.

4.4 This treatment is also in accordance with paragraph 11 of ICDS II - Valuation of Inventories, which provides that, interest and other borrowing costs shall not be included in the cost of inventories, unless they meet the criteria for recognition of interest as a component of the cost as specified in the ICDS on borrowing costs.

4.5 A question does arise as to whether the requirement of capitalisation of borrowing costs to inventory as per the ICDS is in conflict with section 36(1)(iii). While section 36(1)(iii) provides that interest paid in respect of capital borrowed for the purposes of the business or profession is an allowable deduction, the proviso to this clause prohibits deduction only in respect of capital borrowed for acquisition of an asset till the date the asset is first put to use. The term "asset" used in this proviso, has to be construed as "capital asset", given similar usage of the term in section 43(1), as well as section 43A. The proviso therefore applies only to capital assets acquired, and not to stock-in-trade. This has been confirmed by the Bombay High Court in the case of *CIT v Lokhandwala Construction Industries (2003) 260 ITR 579 (Bom)*. Therefore, the provisions of the ICDS are in conflict with section 36(1)(iii). In such an event, in accordance with the ICDS, the provisions of section 36(1)(iii), being a part of the Act, would prevail over the provisions of the ICDS requiring capitalisation of interest on borrowings for the purpose of acquiring stock-in-trade which takes more than 12 months to be ready for sale.

5. Borrowing Costs Eligible for Capitalisation

"5. Subject to paragraph 8, the extent to which funds are borrowed specifically for the purposes of acquisition, construction or production of a qualifying asset, the amount of borrowing costs to be capitalised on that asset shall be the actual borrowing costs incurred during the period on the funds so borrowed.

6. Subject to Para 8, in respect of borrowing other than those referred to in Para 5, if any, the amount of borrowing costs to be capitalised shall be computed in accordance with the following formula namely : -

$$A \times \frac{B}{C}$$

Where

A = *borrowing costs incurred during the previous year except on borrowings referred to in para 5 above;*

B = (i) *the average of costs of qualifying asset as appearing in the balance sheet of a person on the first day and the last day of the previous year;*

(ii) *in case the qualifying asset does not appear in the balance sheet of a person on the first day, half of the cost of qualifying asset;*

(iii) *in case the qualifying asset does not appear in the balance sheet of a person on the last day of previous year, the average of the costs of qualifying asset as appearing in the balance sheet of a person on the first day of the previous year and on the date of put to use or completion, as the case may be, excluding the extent to which the qualifying assets are directly funded out of specific borrowings;*

C = *the average of the amount of total assets as appearing in the balance sheet of a person on the first day and the last day of the previous year, other than assets to the extent they are directly funded out of specific borrowings;*

Explanation – *For the purpose of this paragraph, a qualifying asset shall be such asset that necessarily require a period of twelve months or more for its acquisition, construction or production.”*

5.1 Paragraph 5 provides that actual borrowing costs incurred during the period, on funds borrowed specifically for the purposes of acquisition, construction or production of a qualifying asset, are to be capitalised.

5.2 Paragraph 6 deals with borrowing costs on general borrowings. In respect of general borrowings utilised for the purposes of acquisition, construction or production of a qualifying asset, the amount of borrowing costs to be capitalised are to be computed in accordance with the formula specified therein.

Borrowing Costs

5.3 The ICDS also provides a formula for computing borrowing costs on general borrowings. It presumes that qualifying assets are acquired in the middle of the year, for the purposes of computing the borrowing costs attributable to such qualifying assets.

5.4 For the purposes of computation of capitalisation of general borrowing costs, not all tangible and intangible assets are qualifying assets, as is the case for capitalisation of specific borrowing costs, but only those assets which necessarily require a period of 12 months or more for its acquisition, construction or production. In other words, unless the qualifying asset (tangible and intangible asset) necessarily require a period of twelve months or more for its acquisition, construction or production, general borrowing is not required to be capitalised.

5.5 One has to find out the total amount of general borrowing cost to be capitalised by using this formula. The formula uses the term “qualifying asset” in singular. Paragraph 6 is subject to paragraph 8, which provides for the date of cessation of capitalisation, which is different for each asset. It therefore appears that the formula for computation of general interest to be capitalised to the cost of the asset has to be vis-à-vis each qualifying asset, and not to be applied to the aggregate of all qualifying assets acquired during the year.

5.6 In this respect, one may also refer to the clarifications on ICDS contained in Circular no. 10/2017, dated 23rd March 2017 issued by the CBDT. Question no. 22 and answer thereto are reproduced below:

Question 22: *How to allocate borrowing costs relating to general borrowing as computed in accordance with formula provided under Para 6 of ICDS-IX to different qualifying assets?*

Answer: *The capitalization of general borrowing cost under ICDS-IX shall be done on asset-by-asset basis.*

5.7 One also needs to understand various terms used in the formula. The amount of borrowing costs would have to be taken as defined in the ICDS, and may therefore vary slightly from the figure of interest as per the Profit & Loss Account.

5.8 Further, only borrowing costs which are otherwise allowable as deduction are to be considered, and not borrowing costs disallowed under sections 43B, 40A(2), etc. In this respect, one may refer to the clarifications on ICDS contained in the Circular no. 10/2017, dated 23rd March 2017

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issued by the CBDT. Question no. 20 and answer thereto are reproduced below:

Question 20: *There are specific provisions in the Act read with Rules under which a portion of borrowing cost may get disallowed under sections like 14A, 438, 40(a)(i), 40(a)(ia), 40A(2)(b), etc of the Act. Whether borrowing costs to be capitalized under ICDS-IX should exclude portion of borrowing costs which gets disallowed under such specific provisions?*

Answer: *Since specific provisions of the Act override the provisions of ICDS, it is clarified that borrowing costs to be considered for capitalization under ICDS IX shall exclude those borrowing costs which are disallowed under specific provisions of the Act. Capitalization of borrowing cost shall apply for that portion of the borrowing cost which is otherwise allowable as deduction under the Act.*

5.9 While computing borrowing costs to be considered in (A) of the formula, as per the ICDS, only borrowing costs referred to in paragraph 5 are to be reduced, i.e. only borrowing costs attributable to loans taken for acquisition of qualifying assets. Does this mean that borrowing costs on loans taken specifically for acquisition of other assets are not to be reduced, and are to be considered as part of A? The purpose of the formula is to capitalise general borrowing costs. Logically, therefore, all borrowing costs specifically incurred for acquisition of assets should be excluded, irrespective of whether the assets are qualifying assets or not. Again, this is irrespective of whether the period of interest is before the date when the asset was put to use, or after the date when the asset was put to use. Also, while taking total assets in (C), all assets to the extent funded by specific borrowings are to be excluded. A natural corollary is that borrowing costs on such specific borrowings are also to be excluded. This is also evident for the definition of "A" in the formula.

5.10 The amount of total assets has to be taken as appearing in the balance sheet. This would include all assets at balance sheet values. This would imply taking the assets at written down values as per the balance sheet, net of depreciation. In taking total assets, should one take net current assets (net of provisions and current liabilities) or the gross current assets? Since one has to compare like with like, the better view is that it is the gross assets that have to be taken, and not the net assets.

Borrowing Costs

5.11 The cost of qualifying asset has also to be taken as appearing in the balance sheet. Does an asset cease to be a qualifying asset once it is put to use? Though the ICDS does not expressly state so, the intention seems to be that after the date the asset is put to use, the asset would cease to be a qualifying asset. This can be inferred from the fact that paragraph 6 is subject to paragraph 8, the date of cessation of capitalisation. Obviously, once an asset is put to use, the formula would no longer apply in respect of such asset. Also, in (B)(iii) of the formula, there is a reference to taking the average of the opening cost and the cost on the date when the qualifying asset was put to use. This also indicates that once the asset is put to use, there is no requirement of further capitalisation of general borrowing costs.

5.12 Similarly, borrowing cost capitalised as per Accounting Standard, also needs to be reduced from the total assets, otherwise it may amount to capitalisation of interest on interest.

5.13 Similarly, capital work-in-progress outstanding on balance sheet date and capitalised in subsequent year, also needs to be included in total assets only in the year in which cost is incurred, otherwise it may get included twice.

5.14 The reduction from qualifying asset as well as total assets is only to the extent that they are funded directly out of specific borrowings.

5.15 Assessee would also need to keep evidence as to what is the actual date of put to use in respect of each tangible or intangible asset acquired, in cases where the acquisition of the asset has been funded by specific borrowings, so as to compute the borrowing costs to be capitalised in respect of that particular asset. However, in cases where there is only a general borrowing, and the acquisition of the assets are not funded by any specific borrowings, the date of put to use of each asset would be required only where the asset requires a period of 12 months or more for its acquisition, construction or production.

5.16 Unlike Ind AS 23, the ICDS does not provide for reduction of interest earned on temporary investment of borrowed funds pending the expenditure on the qualifying asset from the borrowing costs.

6. Commencement of Capitalisation

“7. The capitalisation of borrowing costs shall commence:

- (a) in a case referred to in paragraph 5, from the date on which funds were borrowed;***
- (b) in a case referred to in paragraph 6, from the date on which funds were utilised.”***

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6.1 In case of borrowing costs specifically related to acquisition of assets, the period from which borrowing costs are to be counted begins with the date on which funds are borrowed. Borrowing of funds would mean actual drawing of funds. Disbursement of loans for acquisition of specific assets would normally be directly linked to the payments for the assets. Therefore, borrowing costs on loans utilised for payment of advances for acquisition of assets would need to be added to the cost of assets commencing from the date of borrowing, which may be before the date of acquisition of the asset, up to the date of asset being first put to use. There could also be a time lag between the date of borrowing and the date of utilisation of funds for acquisition of the asset. Borrowing costs for such time period would also need to be capitalised in the case of specific borrowings. This provision is in harmony with the proviso to section 36(1)(iii), which now provides that interest paid in respect of capital borrowed for acquisition of an asset for any period beginning from the date on which the capital was borrowed for acquisition of the asset to the date on which such asset was first put to use shall not be allowed as a deduction.

6.2 Interest payable on borrowings taken for acquisition of a qualifying asset relating to the period after the date of put to use of the asset would be allowable as a deduction under section 36(1)(iii).

6.3 The provision relating to general borrowings seems to be inconsistent with the formula provided in paragraph 6 of the ICDS, since the formula requires the entire interest for the year to be taken and pro-rated by taking an average. The formula therefore does not take into consideration the actual date of utilisation of funds. The actual interest, which is part of the formula takes into consideration the date of borrowing of funds, and not the date of utilisation of the funds, since interest is levied on the number of days that the borrowing has been outstanding.

6.4 In case of general borrowings, the interest to be capitalised is to be considered from the date of utilisation of the funds borrowed. There could therefore be a period between the date of borrowing and the date of utilisation, in respect of which period the borrowing costs are not to be capitalised as per the ICDS.

7. Cessation of Capitalisation

“8. Capitalisation of borrowing costs shall cease:

- (a) in case of a qualifying asset referred to in item (i) and (ii) of clause (b) of sub-paragraph (1) of paragraph 2, when such asset is first put to use;***

- (b) in case of inventory referred to in item (iii) of clause (b) of sub-paragraph (1) of paragraph 2, when substantially all the activities necessary to prepare such inventory for its intended sale are complete.**

9. When the construction of a qualifying asset is completed in parts and a completed part is capable of being used while construction continues for the other parts, capitalisation of borrowing costs in relation to a part shall cease: -

- (a) in case of part of a qualifying asset referred to in item (i) and (ii) of clause (b) of sub-paragraph (1) of paragraph 2, when such part of a qualifying asset is first put to use;**
- (b) in case of part of inventory referred to in item (iii) of clause (b) of sub-paragraph (1) of paragraph 2, when substantially all the activities necessary to prepare such part of inventory for its intended sale are complete.”**

7.1 For tangible and intangible assets, borrowing costs up to the date when the asset is first put to use are to be added to the cost of the assets. In case of inventories, which require 12 months or more to bring them to a saleable condition, the date of completion of substantially all the activities necessary to prepare the inventory for its intended sale is the date up to which borrowing costs are to be added to the cost of inventories.

7.2 Paragraph 8 would apply not only to specific borrowings for acquisition of assets, but also to general borrowings, since the capitalisation of general borrowings on the basis of the formula set out in paragraph 6 is subject to paragraph 8.

7.3 The ICDS does not clarify the exact meaning of the term “substantially all the activities necessary to prepare such inventory for its intended sale”. This would therefore be a subjective judgement, depending upon the facts of each case.

7.4 The activities necessary to prepare inventory for its intended sale would normally include all processes necessary to make the inventory fully functional for its intended use, as well as those processes necessary to render the inventory saleable. It would include processes such as quality control, which indicate whether the inventory is fit for its intended use, and therefore fit for sale. It will also include the process of primary packing of inventory, where the inventory is normally sold in a packed condition.

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7.5 The term “substantially” qualifies “all the activities”. Therefore, the major part of the activities necessary to manufacture and prepare the inventory for sale would need to be completed, for the capitalisation of interest costs to cease.

7.6 Paragraph 23 of Ind AS 23 clarifies that an asset is normally ready for its intended use or sale when the physical construction of the asset is complete, even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the purchaser's or user's specification are all that are outstanding, it would indicate that substantially all the activities are complete.

7.7 One possible situation could be where the manufacture of the inventory has been completed, to the extent that it is fit for its intended use, but only certain processes to render it fit for sale, such as painting or packaging, are pending.

7.8 Paragraph 25 of Ind AS 23 also gives an example of a situation where construction of a qualifying asset is completed in parts, each part of which can be used separately. The example is that of a business park comprising several buildings, each of which can be used individually, while construction may continue on other parts. An illustration is also given of a qualifying asset that needs to be complete before any part can be used - an industrial plant involving several processes which are carried out in sequence and different parts of the plant within the same site, such as a steel mill.

8. Transitional Provisions

“10. All the borrowing costs incurred on or after 1st day of April, 2016 shall be capitalised for the previous year commencing on or after 1st day of April, 2016 in accordance with the provisions of this standard after taking into account the amount of borrowing costs capitalised, if any, for the same borrowing for any previous year ending on or before 31st day of March, 2016.”

8.1 These transitional provisions ensure that all borrowing costs incurred on or after 1st April 2016 which are required to be capitalised in accordance with this ICDS are capitalised, while at the same time, there is no capitalisation of borrowing costs already capitalised. This could however result in a situation where, for a particular asset, the borrowing costs incurred for the assessment year 2016-17 are treated as expenditure in accordance with the law prevalent in that year, while the borrowing costs for the same asset incurred in the subsequent year are capitalised.

9. Disclosures

“11. The following disclosure shall be made in respect of borrowing costs, namely: -

- (a) the accounting policy adopted for borrowing costs; and***
- (b) the amount of borrowing costs capitalised during the previous year.”***

9.1 The accounting policy required to be disclosed in respect of borrowing costs would be the policy followed as per ICDS I.

9.2 The ICDS requirement of disclosure of the amount of borrowing costs capitalised during the previous year does not state whether such details are required to be given block -wise or whether such disclosure has to be given in aggregate. A disclosure of the aggregate amount should suffice. It is, however, necessary to keep the details of block -wise, capitalisation of borrowing costs to tally the total figure with the additions to the respective blocks of assets.

Chapter 11

ICDS X : Provisions, Contingent Liabilities & Contingent Assets

1. Preamble

“This Income Computation and Disclosure Standard is applicable for computation of income chargeable under the head “Profits and gains of business or profession” or “Income from other sources” and not for the purpose of maintenance of books of accounts.

In the case of conflict between the provisions of the Income-tax Act, 1961 (‘the Act’) and this Income Computation and Disclosure Standard, the provisions of the Act shall prevail to that extent.”

2. Scope

“1. This Income Computation and Disclosure Standard deals with provisions, contingent liabilities and contingent assets, except those:

- (a) resulting from financial instruments;*
- (b) resulting from executory contracts;*
- (c) arising in insurance business from contracts with policyholders; and*
- (d) covered by another Income Computation and Disclosure Standard.*

2. This Income Computation and Disclosure Standard does not deal with the recognition of revenue which is dealt with by Income Computation and Disclosure Standard - Revenue Recognition.

3. The term 'provision' is also used in the context of items such as depreciation, impairment of assets and doubtful debts which are adjustments to the carrying amounts of assets and are not addressed in this Income Computation and Disclosure Standard.”

2.1 This ICDS corresponds to AS 29 and Ind AS 37, which also deal with Provisions, Contingent Liabilities and Contingent Assets. The language of this ICDS is however closer to that of AS 29, and significantly different from that of Ind AS 37.

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2.2 This ICDS specifically excludes provisions, contingent liabilities and contingent assets resulting from financial instruments, executory contracts and insurance business from contracts with policyholders. It also excludes such transactions from financial instruments, irrespective of whether the financial instruments are held as investments or as stock-in-trade. Since it also excludes provisions, contingent liabilities and contingent assets governed by other ICDSs, some other items excluded by this ICDS would be:

- (a) Construction Contracts governed by ICDS III;
- (b) Foreign Currency Transactions governed by ICDS VI; and
- (c) Securities transactions governed by ICDS VIII.

2.3 It also excludes all executory contracts, and not just executory contracts which are not onerous, unlike AS 29 and Ind AS 37.

2.4 This ICDS would not affect revenue recognition, which is governed by ICDS IV. Ind AS 37 gives an example of a guarantee, which may be recognized as a provision under the Standard, where the recognition of the income from fees charged for the guarantee would be governed by the Revenue Recognition Standard. This ICDS would however impact recognition of expenditure, in as much as the point of recognition of a provision or treatment of an item as a contingent liability, may impact the year of allowability of the corresponding expenditure, since a contingent liability would not be allowed as an expenditure, while a provision would generally be allowable.

3. Definitions

“4(1) The following terms are used in this Income Computation and Disclosure Standard with the meanings specified:

- (a) ***"Provision" is a liability which can be measured only by using a substantial degree of estimation.***
- (b) ***"Liability" is a present obligation of the person arising from past events, the settlement of which is expected to result in an outflow from the person of resources embodying economic benefits.***
- (c) ***"Obligating event" is an event that creates an obligation that results in a person having no realistic alternative to settling that obligation.***

- (d) **"Contingent liability" is:**
 - (i) **a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the person; or**
 - (ii) **a present obligation that arises from past events but is not recognised because:**
 - (A) **it is not reasonably certain that an outflow of resources embodying economic benefits will be required to settle the obligation; or**
 - (B) **a reliable estimate of the amount of the obligation cannot be made.**
- (e) **"Contingent asset" is a possible asset that arises from past events the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the person.**
- (f) **"Executory contracts" are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent.**
- (g) **"Present obligation" is an obligation if, based on the evidence available, its existence at the end of the previous year is considered reasonably certain.**

4(2) Words and expressions used and not defined in this Income Computation and Disclosure Standard but defined in the Act shall have the meaning respectively assigned to them in the Act."

3.1 The Supreme Court, in the case of *Rotork Controls India (P) Ltd v CIT* [2009]314 ITR 62(SC), had analysed the meanings of the terms "provision", "liability", "obligating event" and when a provision can be recognized. The Supreme Court observed:

"10. What is a provision? This is the question which needs to be answered. A provision is a liability which can be measured only by using a substantial degree of estimation. A provision is recognized

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when: (a) an enterprise has a present obligation as a result of a past event; (b) it is probable that an outflow of resources will be required to settle the obligation; and (c) a reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision can be recognized.

11. Liability is defined as a present obligation arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

12. A past event that leads to a present obligation is called as an obligating event. The obligating event is an event that creates an obligation which results in an outflow of resources. It is only those obligations arising from past events existing independently of the future conduct of the business of the enterprise that is recognized as provision. For a liability to qualify for recognition there must be not only present obligation but also the probability of an outflow of resources to settle that obligation.”

3.2 The definition of “provision” in the ICDS is identical to that considered by the Supreme Court in this case, and as contained in AS 29, and significantly different from that contained in Ind AS 37. The definition in Ind AS 37 is – “a provision is a liability of uncertain timing or amount”. The emphasis in the Supreme Court decision, AS 29 and in the ICDS is therefore more on the degree of estimation involved with regard to the future expenditure required in settlement, rather than on the uncertainty involved in the timing or amount. As clarified by AS 29 and Ind AS 37, in contrast to a provision, trade payables are liabilities which have been invoiced or formally agreed with the supplier and accruals are liabilities that have not been paid, invoiced or formally agreed with the supplier, including amounts due to employees. Though it may be at times necessary to estimate the amount of accruals, the degree of estimation is generally much less than that required for provisions. Accruals are therefore treated as liabilities.

3.3 The definition of “liability” is also identical to that considered by the Supreme Court in Rotork Controls’ case, and to that in AS 29, besides being identical to that contained in Ind AS 37.

3.4 The definition of “obligating event” is again identical to the definition contained in AS 29. Ind AS 37 has a slightly modified definition as it qualifies the term “obligation” with the term “legal or constructive”. In Ind AS 37 therefore, an obligating event occurs not only when a legal obligation arises,

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but also in a case where a constructive obligation arises. The definition of “contingent liability” is consistent with the definition of the term in both AS 29 as well as Ind AS 37. This definition assumes importance under ICDS X, given the fact that a contingent liability would not be an allowable deduction for the purposes of the computation of the income under the heads “Income from business or profession” and “income from other sources”, as held by the Supreme Court in the case of *Indian Molasses Company (P) Ltd v CIT* [1959]37 ITR 66(SC).

3.5 The definition of “contingent asset” is also identical to the definition of the term contained in AS 29 and in Ind AS 37.

3.6 The definition of the term “executory contract” is identical to the definition of the term used in paragraph 3 of AS 29 as well as paragraph 3 of Ind AS 37. However, both those Accounting Standards provide that they do not apply to executory contracts unless they are onerous. However, while ICDS X uses the same definition, it excludes all executory contracts from its purview, even though they may not be onerous.

3.7 The definition of ‘present obligation’ in ICDSX is substantially the same as contained in AS 29. While AS 29 uses the phrase “probable, i.e. more likely than not”, ICDSX uses the phrase “reasonably certain”. In substance, the meaning of ‘present obligation’ under ICDS would to be the same as contained in AS 29.

4. Recognition Provisions

“5. A provision shall be recognised when:

- (a) a person has a present obligation as a result of a past event;***
- (b) it is reasonably certain that an outflow of resources embodying economic benefits will be required to settle the obligation; and***
- (c) a reliable estimate can be made of the amount of the obligation.***

If these conditions are not met, no provision shall be recognised.

6. No provision shall be recognised for costs that need to be incurred to operate in the future.

7. It is only those obligations arising from past events existing independently of a person's future actions, that is the future conduct of its business, that are recognised as provisions.

8. Where details of a proposed new law have yet to be finalised, an obligation arises only when the legislation is enacted.”

4.1 The main recognition provision is similar to that contained in AS 29. While AS 29 requires that it is probable that an outflow of resources would be required to settle the obligation [with a similar view, having been taken by the Supreme Court in the case of *Rotork Controls (supra)*], ICDS uses the terminology ‘probable event’ with reasonable certainty. In substance, the meaning of both the terminology would be same.. Ind AS 37, which has similar recognition provision, also requires that it is probable that an outflow of resources is required. However, under Ind AS 37, the present obligation could be legal or constructive.

4.2 AS 29 (in paragraph 17), Ind AS 37 (in paragraph 18) as well as ICDS X provide that no provision needs to be made for costs that need to be incurred to operate in future. This is on account of the fact that financial statements deal with the financial position of the entity as at the end of the reporting period, and not its possible position in the future. Therefore, the only liabilities recognised are those that exist at the end of the reporting period.

4.3 Paragraph 7 of ICDS X is identical to the provisions contained in paragraph 18 of AS 29 and paragraph 19 of Ind AS 37. Therefore, the examples contained in those Accounting Standards would apply (penalties or cleanup costs for unlawful environmental damage, decommissioning costs of an oil installation or a nuclear power station).

4.4 Paragraph 8 significantly differs from the corresponding provisions contained in paragraph 21 of AS 29 and paragraph 22 of Ind AS 37. While the two Accounting Standards require that it should be virtually certain that the new law will be enacted for an obligation to arise, ICDS X requires that the law should be enacted for an obligation to arise.

4.5 The Supreme Court in relation to warranty provision in the case of *Rotork Controls*, had observed as under:

“Where there are a number of obligations (e.g. product warranties or similar contracts) the probability that an outflow will be required in settlement, is determined by considering the said obligations as a whole. In this connection, it may be noted that in the case of a

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manufacture and sale of one single item the provision for warranty could constitute a contingent liability not entitled to deduction under Section 37 of the said Act. However, when there is manufacture and sale of an army of items running into thousands of units of sophisticated goods, the past event of defects being detected in some of such items leads to a present obligation which results in an enterprise having no alternative to settling that obligation.”

4.6 Further, in the case before the Supreme Court, the sale price included the element of warranty, and the provision was based on the past trend of expenditure on warranties. In that case, it was further held:

“The principle which emerges from these decisions is that if the historical trend indicates that large number of sophisticated goods were being manufactured in the past and in the past if the facts established show that defects existed in some of the items manufactured and sold then the provision made for warranty in respect of the army of such sophisticated goods would be entitled to deduction from the gross receipts under Section 37 of the 1961 Act. It would all depend on the data systematically maintained by the assessee.”

4.7 Under such circumstances, the Supreme Court had taken the view that there was an expectation of outflow of resources to meet the obligation. The circumstances of that case would indicate that where a provision for warranties is based on past trends and experience in respect of a large number of goods sold, there would be a reasonable certainty that the expenditure would be incurred on such warranties. Therefore, even under the provisions of ICDS X, provision for warranties would meet the requirement of recognition as a liability if it is in relation to a large number of goods and based on past trends and experience.

4.8 The Act contains specific provisions for dealing with certain expenditure. Allowability of such expenditure is governed by relevant sections, e.g. provision for contribution to provident fund, gratuity etc. Provision for expenses other than expenses governed by specific section in the Act will be governed by this ICDS. In this respect, a reference may be made to clarifications on ICDS contained in Circular no. 10/2017, dated 23rd March 2017 issued by the CBDT. Question no. 24 and answer thereto are reproduced below:

Question 24: *Expenditure on most post-retirement benefits like provident fund, gratuity, etc. are covered by specific provisions. There*

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are other post-retirement benefits offered by companies like medical benefits. Such benefits are covered by AS-15 for which no parallel ICDS has been notified. Whether provision for these liabilities are excluded from scope of ICDS X?

Answer: *It is clarified that provisioning for employee benefit which are otherwise covered by AS 15 shall continue to be governed by specific provisions of the Act and are not dealt with by ICDS-X.*

5. Contingent Liabilities

“9. A person shall not recognise a contingent liability.”

5.1 This provision is identical to paragraph 26 of AS 29 and paragraph 27 of Ind AS 37. This provision is also consistent with the tax position that a contingent liability is not deductible in computing the total income.

6. Contingent Assets

“10. A person shall not recognise a contingent asset.

11. Contingent assets are assessed continually and when it becomes reasonably certain that inflow of economic benefit will arise, the asset and related income are recognised in the previous year in which the change occurs.”

6.1 The requirement of not recognising a contingent asset is consistent with AS 29 and Ind AS 37. However, subsequent recognition of a contingent asset as an asset and its related income require a lesser degree of certainty under ICDS X, which requires reasonable certainty of inflow of economic benefits, as against the two Accounting Standards, both of which require virtual certainty of inflow of economic benefits. Therefore, under ICDS X, the recognition of a contingent asset as an asset with the corresponding income would be sooner than that under Accounting Standards.

6.2 Under ICDS, reasonable certainty would normally mean that there has to be degree of certainty required for recognition of contingent asset and in case of uncertainty there is no need to recognize contingent asset.

7. Measurement

Best Estimate

“12. The amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the end of

the previous year. The amount of a provision shall not be discounted to its present value.

13. The amount recognised as asset and related income shall be the best estimate of the value of economic benefit arising at the end of the previous year. The amount and related income shall not be discounted to its present value."

7.1 Paragraph 12 of ICDS X is similar to paragraph 35 of AS 29. Both require that a provision is not to be discounted to its present value. This prohibition on discounting to present value is absent in Ind AS 37. In fact, paragraph 45 of Ind AS 37 requires discounting to the present value where the effect of the time value of money is material.

7.2 There is no provision under both Accounting Standards corresponding to paragraph 13 of ICDS X, which deals with amount recognised as asset and the related income. This provision needs to be read in the context of the fact that ICDS X deals with contingent assets, and therefore the applicability of this provision arises only when a contingent asset is to be recognised as an asset, with corresponding recognition of the related income.

Reimbursements

"14. Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement shall be recognised when it is reasonably certain that reimbursement will be received if the person settles the obligation. The amount recognised for the reimbursement shall not exceed the amount of the provision.

15. 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.

16. 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."

7.3 As opposed to the virtual certainty of receipt of reimbursement required by both Accounting Standards for recognition of reimbursements, ICDSX requires reasonable certainty. Therefore, under ICDSX, reimbursement would be required to be recognised once there is reasonable certainty.

7.4 Paragraphs 15 and 16 of ICDSX are identical to the corresponding paragraphs 57 and 58 of Ind AS 37 and paragraphs 50 and 51 of AS 29.

Review

“17. 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.

18. An asset and related income recognised as provided in para 11 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.”

7.5 Paragraph 17 of ICDS X corresponds to paragraph 52 of AS 29 and paragraph 59 of Ind AS 37. While the two Accounting Standards use the term “no longer probable” as the trigger for reversal of the provision, ICDS X uses the term “no longer reasonably certain”. This would again mean that reversal of a provision would be made when the provision is not required based on reasonable certainty. This is also consistent with the requirement of recognition of a liability contained in paragraph 5.

7.6 Paragraph 18 has no corresponding paragraph under the two Accounting Standards, as those two Accounting Standards do not deal with measurement of recognition of an asset and the related income. The issue that arises is whether reversal of an asset and the related income would mean that the entry which was originally passed for recognition of the asset and the income should be reversed, or whether the asset should be written off as a bad debt under section 36(1)(vii), read with the second proviso to that section. Since the ICDS provides that the provisions of the Income-tax Act would prevail over the provisions of ICDS in case of conflict between the two, the provisions of section 36(1)(vii) should apply.

Use of Provisions

“19. A provision shall be used only for expenditures for which the provision was originally recognised.”

7.7 This provision is consistent with paragraph 53 of AS 29 and paragraph 61 of Ind AS 37. As clarified in the Accounting Standards, only expenditures relating to the original provisions should be set off against the provisions, and any expenditure should not be set off against a provision recognised for another purpose, as that would conceal the impact of two different events.

Transitional Provisions

“20. All the provisions or assets and related income shall be recognised for the previous year commencing on or after 1st day of April, 2016 in accordance with the provisions of this standard after taking into account the amount recognised, if any, for the same for any previous year ending on or before 31st day of March, 2016.”

7.8 These transitional provisions would imply that at the end of the first year in which ICDS is applicable, i.e. the financial year 2016-17, the entity would need to review all past events to see whether any provision is to be recognised or derecognised, and whether any asset is to be recognised or derecognised, in relation to such past events, in accordance with the provisions of this ICDS.

7.9 A reference may be made to the clarifications on ICDS contained in Circular no. 10/2017, dated 23rd March, 2017 issued by the CBDT. Question no. 23 and answer thereto deal with the impact of the transitional provision of the ICDS. The same are reproduced below:

Question 23: What is the impact of Para 20 of ICDS X containing transitional provisions?

Answer: Para 20 of ICDS X provides that all the provisions or assets and related income shall be recognised for the previous year commencing on or after 1st day of April 2016 in accordance with the provisions of this standard after taking into account the amount recognised, if any, for the same for any previous year ending on or before 31st day of March, 2016.

The intent of transitional provision is that there is neither “double taxation” of income due to application of ICDS nor there should be escape of any income due to application of ICDS from a particular date. This is explained as under-

Provision required as per ICDS on 31 March 2017 for items brought forward from 31st day of March 2016 ... (A)	INR 3 Crores
Provisions as per ICDS for FY 2016-17 ... (B)	INR 5 Crores
Total gross provision ... (C) = (A) + (B)	INR 8 Crores
Less: Provision already recognised for computation of taxable income in FY 2016-17 or earlier ... (D)	INR 2 Crores
Net provisions as per ICDS in FY 2016-17 to be recognised as per transition provision... (E) = (C) - (D)	INR 6 Crores

Disclosure

“21(1) Following disclosure shall be made in respect of each class of provision, namely:-

- (a) a brief description of the nature of the obligation;***
- (b) the carrying amount at the beginning and end of the previous year;***
- (c) additional provisions made during the previous year, including increases to existing provisions;***
- (d) amounts used, that is incurred and charged against the provision, during the previous year;***
- (e) unused amounts reversed during the previous year; and***
- (f) the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.***

21(2) Following disclosure shall be made in respect of each class of asset and related income recognised as provided in para 11, namely: -

- (a) a brief description of the nature of the asset and related income;***
- (b) the carrying amount of asset at the beginning and end of the previous year;***
- (c) additional amount of asset and related income recognised during the year, including increases to assets and related income already recognised; and***
- (d) amount of asset and related income reversed during the previous year.”***

7.10 The disclosures under this ICDS are fairly extensive, and need to be made for each class of provision and asset. They are however similar to the disclosures required under AS 29 and under Ind AS 37. The reference in relation to assets and related income should be considered only in relation to recognition of contingent assets as assets, and not to all assets, since the ICDS deals only with contingent assets. The reference to paragraph 11 also supports this view.