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FIRST NOTES
KPMG in India

The Ministry of Finance issues revised drafts on tax computation standards

14 January 2015

First Notes on:

Financial Reporting
Corporate law updates
Regulatory and other information
Disclosures

Sector:

All
Banking and Insurance
Information, Communication, Entertainment
Consumer and Industrial Markets
Infrastructure and Government

Relevant to:

All
Audit committee
CFO
Others

Transition:

Immediately
Within the next 3 months
Post 3 months but within 6 months
Post 6 months

Background

Currently, the Income-tax Act, 1961 (the Act) notifies two accounting standards: one relating to disclosure of accounting policies and disclosure of prior period and extraordinary items and the other on changes in accounting policies.

The Ministry of Corporate Affairs had earlier announced a roadmap for transition to Indian Accounting Standards (Ind AS) from 1 April 2011. At that time, there was lack of clarity of tax implications on adoption of Ind AS by the companies. Therefore, in December 2010, under the aegis of the Central Board of Direct Taxes (CBDT) a committee was constituted to harmonise the accounting standards issued by the Institute of Chartered Accountants of India (ICAI) with the provisions of the Act.

In August 2012, the committee, after deliberations issued 14 draft accounting standards to be applicable in computation of 'profits and gains of business or profession' or 'income from other sources' for taxpayers following a mercantile system. These accounting standards are now termed as Income Computation and Disclosure Standards (ICDS).

After the release of the draft ICDS (2012) by the CBDT, concerns were raised by various stakeholders since it had significant differences with generally accepted accounting principles. In order to address some of these concerns, the Ministry of Finance (MOF) reworked on the standards on 8 January 2015 issued revised drafts of 12 ICDS (2015) for public comments.

Our First Notes provides an overview of key revisions made in the revised draft ICDS (2015).

Transitional provisions
Draft ICDS (2012) did not specify any transitional provisions which had led to concerns that implementation of draft ICDS (2012) might lead to taxation of a transaction that had already been subjected to tax in prior years. In order to address this concern, the MOF has proposed transitional provisions in all revised draft ICDS (2015) except for the revised draft ICDS on *Securities* (2015) which does not carry any transitional provision.

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Alignment with generally accepted accounting principles

- The draft ICDS on *Revenue Recognition* (2012) provided that in case ultimate collection with reasonable certainty is lacking at the time of raising any claim for price escalation/export incentives, revenue recognition is respect of such claim should be postponed to the extent of uncertainty involved. For other situations draft ICDS on *Revenue Recognition* (2012) did not permit non-recognition of revenue due to uncertainty in collection. Similarly, draft ICDS on *Construction Contracts* (2012) did not permit non-recognition of contract revenue due to uncertainty in collection.

  In order to align with generally accepted accounting principles, it is proposed that revenue (under the revised draft ICDS on *Construction Contracts* (2015) and revised draft ICDS on *Revenue Recognition* (2015)) should be recognised when there is a reasonable certainty of ultimate collection. It carries forward the requirement relating to price escalations/export incentives from the draft ICDS on *Revenue Recognition* (2012).

- The draft ICDS on *The Effects of Changes in Foreign Exchange Rates* (2012) mentioned that foreign currency transactions should be recorded on initial recognition by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the transaction and foreign currency monetary items are converted into reporting currency by applying the closing rate at the last date of the previous year.

  There were concerns that this requirement did not allow practical expedients to use approximate exchange rate between the foreign currency and reporting currency. Therefore, the revised draft ICDS (2015) proposes that average rate for a week or a month that approximates the actual rate at the date of the transaction may be used for recording all foreign currency transactions occurring during that period. If the exchange rate fluctuates significantly, then the actual rate at the date of the transaction should be used.

  Additionally, in the situations:
  – foreign currency monetary item has a restriction on remittances, or
  – the closing rate is unrealistic and it is not possible to effect an exchange of currencies at that rate
  then the relevant monetary item should be reported in the reporting currency at the amount which is likely to be realised from or required to be disbursed at the last date of the previous year.

- Under the draft ICDS on *Inventories* (2012), inventory of a service provider was required to be valued at cost. The revised draft ICDS (2015) proposes to align with the general inventory valuation principle i.e. at cost or net realisable value, whichever is lower.

Formula for capitalising borrowing cost revised

The draft ICDS on *Borrowing Costs* (2012) mentioned the following formula for capitalising borrowing costs on general borrowings and utilised for acquiring a qualifying asset:

Borrowing costs incurred during the previous year except on borrowings directly relatable to specific purposes (A) X

Average of cost of qualifying asset appearing in the balance sheet on the first day and the last day of the previous year, other than those qualifying assets directly funded out of specific borrowings (B)
____
Average of total assets (other than assets directly funded out of specific borrowings) as appearing in the balance sheet on the first day and the last day of the previous year (C)

In the revised draft ICDS (2015), the above formula has been proposed to be revised to envisage a situation when the qualifying assets (capital work-in-progress) do not appear in the balance sheet either on the first day/last day, or both on the first and last day in the previous year. The formula in the revised ICDS (2015) now proposes that:

When the qualifying asset does not appear in the balance sheet on the	*The numerator (B) of the above formula would be*
First day or both on the first and the last day of the previous year	The half of the cost of the qualifying asset (other than those qualifying assets directly funded out of specific borrowings)
Last day of the previous year	Average of cost of qualifying asset (other than those qualifying assets directly funded out of specific borrowings) as on the first day of the previous year and on the date of completion

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Recognition and initial measurement requirements modified

The draft ICDS on *Tangible Fixed Assets* (2012), *Intangible Assets* (2012) and *Securities* (2012) mentioned following requirements when an item is acquired in exchange for another asset/shares/securities:

– A tangible fixed asset acquired in exchange for another asset/shares/securities, the cost of the tangible fixed asset should be recognised at lower of:
  - fair market value of the tangible fixed asset acquired, or
  - fair market value of the assets/securities given up/issued.

– An intangible asset acquired in exchange for another asset/shares/securities, the cost of the intangible asset should be recognised at the fair value of:
  - asset given up if it is acquired in exchange for another asset
  - securities issued if it is acquired in exchange for shares or other securities.

– The cost of a security acquired in exchange for another asset should be recognised at lower of:
  - fair value of the security acquired, or
  - fair market value of the asset given up.

The revised draft ICDS (2015) on above topics propose that actual cost of a tangible fixed asset/intangible asset/security acquired in the above cases would be recognised at the value of the asset acquired. Therefore, the revised draft ICDS (2015) requires the use of value of the asset acquired and not the value of the asset given up.

Other key revisions

- Under the draft ICDS on *Tangible Fixed Assets* (2012) machinery spares should be charged to revenue when consumed for the purpose of preserving or maintaining an already existing tangible fixed asset and which does not bring a new asset into existence or does not result into a new or different advantage that increases the future benefits from the existing asset.

  The revised draft ICDS (2015) proposes that the machinery spares should be charged to revenue 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 should be capitalised.

- The revised draft ICDS on *Intangible Assets* (2015) proposes to include exchange fluctuations as an adjustment to cost of an intangible asset subsequent to its acquisition.

Draft ICDS (2012) not re-issued

Following draft ICDS (2012) have not been issued as revised drafts (2015):
- Events occurring after the previous year
- Prior period expense.

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Our comments

- The MOF has issued a revised draft of the ICDS (2015) as a follow up to the announcement in this year's budget that these standards may be notified separately. The publication of the revised draft ICDS (2015) is quite timely and important, especially considering that the timelines for adoption of Ind AS have also just been announced. Providing clarity on tax position to Ind AS can be critical for the successful implementation of the new financial reporting framework from the next financial year.
- The introduction of ICDS may significantly alter the way companies compute their taxable income, irrespective of whether the company reports its financial results as per Ind AS or existing accounting standards, they would compute their taxable income in accordance with ICDS.
- The revised draft ICDS has incorporated the transitional provisions according to which, the companies may be required to do a retrospective catch up at the date of transition in certain cases, whereas in certain other cases, the provisions apply only on a prospective basis.
- It can be important to note that since the Act does not recognise the concept of materiality for the purpose of computation of taxable income, the same has not been incorporated in the revised draft ICDS. This may pose a significant challenge to taxpayers deriving income from 'profits and gains of business or profession' or 'income from other sources' and to the auditors (where required under section 44AB of the Act) in preparation and verification of the tax computation, respectively.
- The revised draft ICDS (2015) seem to be based on the current accounting standards issued by the ICAI. From 1 April 2016, certain specified companies would be required to follow Ind AS. For those companies, accounting policies under Ind AS could be significantly different from ICDS, notably in the areas of revenue recognition, securities, borrowing costs, leases, etc.
- Though there is no requirement under the Act to maintain separate books of accounts for tax purposes, the effect of implementation of ICDS is expected to be pervasive on the taxpayers deriving income from 'profits and gains of business or profession' or 'income from other sources'. Therefore, an entity may need to have systems and processes in place to capture the relevant information for application of the ICDS.
- As a corollary, it is expected that the ICDS could also entail appropriate modification in the Return of Income and the Form No. 3CD.

The bottom line

- The revised draft ICDS (2015) in general does not emphasise prudence as a fundamental assumption, and accordingly in several situations this could result in earlier recognition of income or gains or later recognition of expenses as compared to that under the accounting standards. This could potentially have a direct impact on the timing of tax related cash outflows.
- Considering that one month of comment period is available, it could be important that the taxpayers actively participate in the comment process to help ensure that ICDS that get finalised and notified are the ones that are fair and reasonable to the interests of both the taxpayers and the tax authorities.
- For an overview of the significant impact areas due to introduction on draft ICDS (2012) you can reach us at aaupdate@kpmg.com.

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Introducing IFRS Notes

IFRS convergence: Government announces roadmap for implementation of Ind AS

The new year heralds an important update; on 2 January 2015 the Ministry of Corporate Affairs (MCA) issued a press release announcing a revised roadmap for implementation of Indian Accounting Standards (Ind AS), converged with International Financial Reporting Standards (IFRS). This roadmap is applicable to companies other than banking companies, insurance companies and non-banking finance companies.

This roadmap was developed after consultations with various stakeholders and regulators. It comes as a follow up to the announcement by the Finance Minister in his budget speech that Ind AS will be made mandatory from the financial year 2016-2017.

In this issue of IFRS Notes we have provided an overview of the revised roadmap of implementation of Ind AS along with our points of view.

Missed an issue of Accounting and Auditing Update or First Notes?

December 2014

The December 2014 edition of the Accounting and Auditing Update contains an anthology of our articles, on the key aspects of the Companies Act, 2013. These articles have been updated to include clarifications and implementation related insights that have been gained as companies have sought to apply in practice this landmark legislation.

As is the case each month, we covered key regulatory developments during the recent past as well as highlight the salient aspects of the recently issued guidance note by the Institute of Chartered Accountants of India on the area of internal financial controls.

The Union Cabinet proposes certain amendments to the Companies Act, 2013

The Companies Act, 2013 (the Act) is largely operationalised from 1 April 2014. The MCA has been issuing various amendments and clarifications to the Act and the corresponding Rules in order to address the implementation challenges faced by corporates and professionals.

Continuing with the endeavour for effective implementation of the Act, the Union Cabinet, on 2 December 2014 introduced the Companies (Amendment) Bill, 2014 in the Parliament to make certain amendments to the Act. Changes proposed include approval process of related party transactions, fraud reporting by auditors, areas where the Rules overreached the Act, and other procedural relaxations.

This issue of First Notes provides a list of the amendments proposed in the Act.

KPMG in India is pleased to present Voices on Reporting – a monthly series of knowledge sharing calls to discuss current and emerging issues relating to financial reporting.

On 20 November 2014, we covered following three topics:

(1) Roadmap for IFRS convergence in India

(2) Exposure draft on Ind AS 101, First-time Adoption of Indian Accounting Standards

(3) An overview on the Ind AS convergence process.

Feedback/Queries can be sent to aaupdate@kpmg.com

Back issues are available to download from: www.kpmg.com/in

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