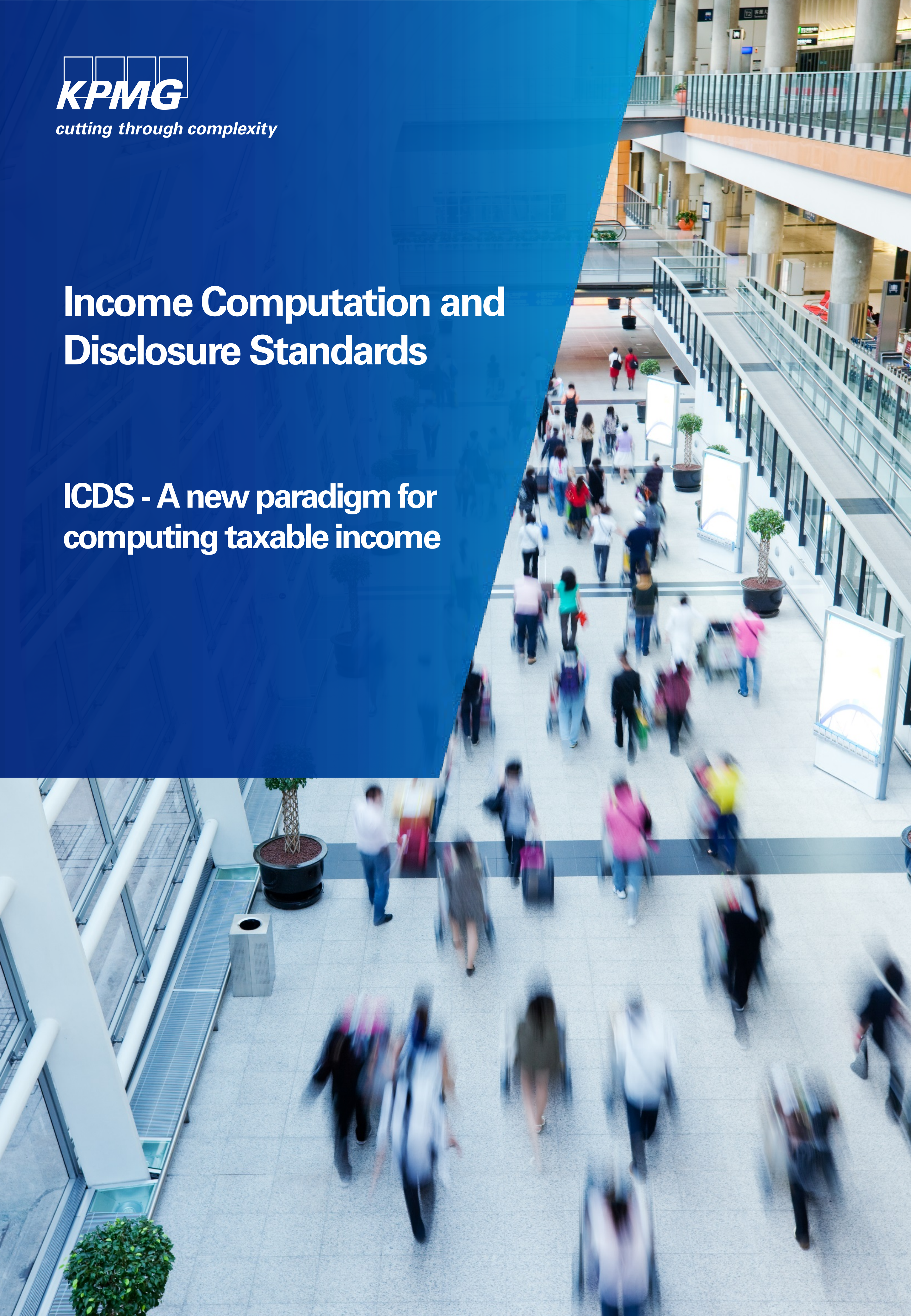
KPMG

cutting through complexity

Income Computation and Disclosure Standards

ICDS - A new paradigm for computing taxable income



The Ministry of Finance has issued ten Income Computation and Disclosure Standards (ICDS), operationalising a new framework for computation of taxable income by all assessees in relation to their income under the heads 'Profit and gains of business or profession' and 'Income from Other Sources'. The Central Board of Direct Taxes (CBDT) notified these standards under Section 145(2) of the Income-tax Act, 1961 (the Act) vide 'Notification No. 33/2015 [F. No. 134/48/2010-TPL] / SO 892(E) dated 31 March 2015'. The notification of these standards comes as a follow up to the announcement made by the Finance Minister in his maiden budget speech in July 2014 of the intent to notify standards for computation of tax.

ICDSs are expected to fill up some gaps that existed in the current taxation set up by bringing in consistency and clarity in computation of taxable income and providing stability in tax treatments of various items. ICDSs also address the significant issue relating to taxability of assessees when companies in India move their financial reporting to Indian Accounting Standards (Ind-AS) that are converged with International Financial Reporting Standards (IFRS) in a phased manner commencing 1 April 2015.

The Genesis of ICDS

In 2010, when Ministry of Corporate Affairs had announced a roadmap for converging Indian financial reporting with IFRS in a phased manner, one of the biggest challenges faced by corporate sector was how this change in financial reporting would impact taxable income, as many companies would report using Ind-AS while others would report using the older Accounting Standards (AS).

In response, the CBDT set up a committee in 2010 to look at the taxation related aspects of Ind-AS implementation. They also recognised it as an opportunity to address certain accounting issues that have been a subject matter of tax litigation due to either diversity in accounting practices or divergence in views between tax payers and tax authorities.

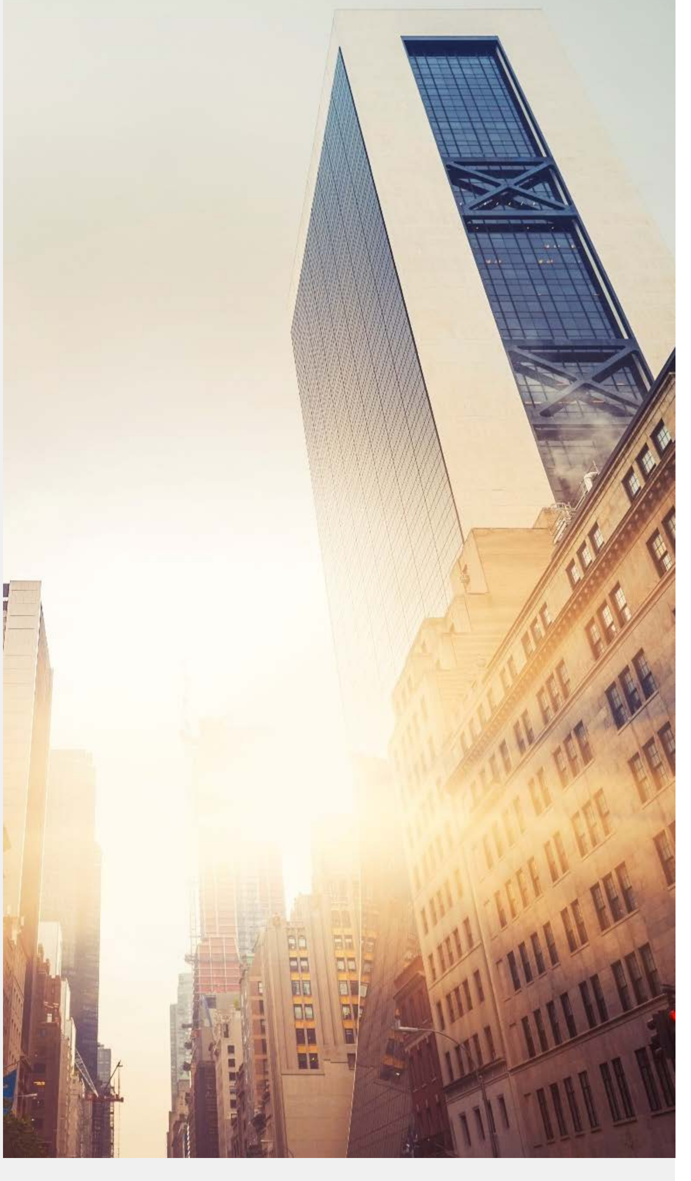
While globally different approaches have been adopted to deal with the tax issues arising from IFRS adoption, the CBDT has chosen to go down the path of prescribing a separate framework for computation of taxable income, which is independent of the financial reporting framework followed by the company.

The CBDT Committee as part of their report issued in October 2012, also put out fourteen draft tax accounting standards for public comments. Over two years since, and close on the heels of the press release notifying the roadmap for Ind-AS convergence on 2 January 2015, the Ministry of Finance also published a revised set of twelve draft ICDS on 8 January 2015 for final comments. The comment period ended on 8 February 2015. Finally, the notification with ten ICDS has now been issued. With the notification of ICDS, there is certainty on the path that has been chosen by the CBDT.

Facilitates Ind-AS adoption

The notification of these ICDS is quite timely and important, especially considering that the timelines for adoption of Ind-AS have also been notified, which permits voluntary adoption for financial year 2015-16. Providing a tax neutral framework for transition to Ind-AS was a prerequisite for smooth implementation of Ind-AS from this year. With the adoption of ICDS, irrespective of whether the company reports its financial results as per Ind-AS or the existing AS, they would compute their taxable income in accordance with ICDS, ensuring horizontal equity, although not necessarily tax neutrality vis-à-vis the earlier basis.

These standards were developed prior to the notification of Ind-AS and used the existing AS as a base, and included modifications to make them suitable for tax purposes. Now that Ind-AS has been notified, and most large companies would switch to Ind-AS reporting from the year 2016-17, they will find significant differences between the principles used in ICDS and those in Ind-AS. As a result, the resultant computations of taxable income and net income as per financial statements could be significantly different.



Applicability

These standards are applicable for computation of income chargeable under the head 'Profits and Gains of business or profession' or 'Income from other sources' to all assessees following the mercantile system of accounting . These standards are applicable for assessment year 2016-2017 (previous year 2015-2016) i.e. applicable immediately with effect from 1 April 2015.

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 ICDS. Considering that these standards are already effective, it could have an immediate impact on companies, who would need to take this into account when paying their advance taxes for the first quarter of FY 2015-2016 as well as for accounting of tax expense in the quarterly results.

ICDS also provides transitional provisions to facilitate first time adoption and consideration of the resultant impact.

What you need to consider?

The adoption of ICDS could significantly alter the way companies compute their taxable income, as many of the concepts from existing AS have been modified. These ICDS have also been developed with a view to minimising tax related disputes by bringing greater consistency in the application of accounting principles governing the computation of income.

ICDS in general do not have prudence as a fundamental assumption, and accordingly in several situations this would result in earlier recognition of income or gains or later recognition of expenses or losses as compared to that under the accounting standards; this would potentially have a direct impact on the timing of tax related cash outflows.

This special edition of our First Notes provides an overview of key matters and roadmap for implementation of ICDS, along with our brief comments. There are several areas which differ from the current accounting and computation practices followed under existing AS which would require careful consideration.

Key impact areas

Some of these significant impact areas and differences from existing AS are discussed under the following heads:

Borrowing costs

ICDS on borrowing costs prescribes some key changes from the current accounting

- Unlike Accounting Standard (AS) 16, Borrowing Costs, ICDS does not define any minimum period for classification of an asset as a qualifying asset (with the exception of inventories). Borrowing cost, may need to be capitalised even if an asset does not take substantial period of time to construct.
- Unlike, AS 16, exchange differences arising from foreign currency borrowings to the extent they are regarded as interest cost are not considered as borrowing cost under ICDS.
- ICDS has prescribed a new formula for capitalisation of borrowing cost on general borrowings which involves allocating the total general borrowing cost incurred in the ratio of average cost of qualifying assets on the first day and last day of the previous year and the average cost of total assets on the first and last day of the previous year (other than those assets which are directly funded out of specific borrowings). The current formula may require further clarification.
- ICDS states that, in case of a specific borrowing, capitalisation of borrowing cost should commence from the date of the borrowing and in case of general borrowing, from the date of the utilisation of funds.
- Further, ICDS requires capitalisation even if active development of a qualifying asset is interrupted. Also, in case of qualifying assets other than inventories, capitalisation of borrowing cost should cease when the asset is put to use.
- In addition, under ICDS, income from temporary deployment of unutilised borrowed funds would not be deducted from the borrowing cost to be capitalised. Rather, these will be treated as income.

Accounting policies

- ICDS does not recognise the concept of prudence. Hence, it disallows recognition of expected losses or mark-to-market losses unless specifically permitted by any other ICDS. However ICDS is silent on the treatment of mark-to-market unrealised gains.

- Further, the concept of materiality which is an important consideration in preparing financial statements has not been considered under ICDS. This could pose implementation challenges – for instance the treatment of unadjusted audit differences in the financial statements may need to be considered while computing taxable income.
- ICDS does not permit changes in accounting policies without "reasonable cause". ICDS does not define reasonable cause and hence would involve exercise of judgment by management and the tax authorities.

Construction contracts and revenue recognition

- ICDS does not permit accounting under the completed contract method, and mandates that only the percentage of completion method should be applied for recognition of revenue from rendering of services or construction contracts.
- ICDS prescribes non-recognition of margins during the early stages of the contract and thus allowing contract revenue to be recognised only to the extent of costs incurred. It prohibits such deferral if the stage of completion exceeds twenty five per cent.
- ICDS does not contain detailed guidance on recognition of revenue as a principal or agent (gross vs net) which may impact turnover computation under section 44 AB of the Act.
- In addition, ICDS on construction contracts and revenue does not permits the recognition of expected losses on onerous contracts.

- The transitional provisions under notified ICDS provides that ICDS will apply to all open contracts as at 31 March 2015. Cumulative revenue and costs recognised in the prior years has to be considered for revenue recognition of these contracts from the transition date.

Government grants

- ICDS does not permit the capital approach for recording of government grants.

- Accordingly, ICDS requires accounting of all grants either to be reduced from cost of assets or recognised as income either immediately or over a period of time, depending on the nature of grants.
- Initial recognition of government grants cannot be postponed beyond the date of actual receipt even though all the recognition conditions in accordance with AS are not met.

Effects of changes in foreign exchange rates

- ICDS requires premium, discount or exchange difference on forward 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 to be recognised at the time of settlement. This is different from the current practice under existing AS of either recognition of gains and losses on mark to market basis or recognition of only losses in line with the principle of prudence.

- Further, ICDS prescribes that accounting for foreign currency option contracts and other similar contracts should be similar to forward exchange contracts. When these contracts are entered to hedge recognised assets or liabilities, the premium or discount is amortised over the life of the contract and the spot exchange differences are recognised in the computation of taxable income.
- ICDS provides that the exchange differences on translation of non-integral foreign operations to be recognised as an income or expense unlike under existing AS.

Provisions, contingent liabilities and contingent assets

- Unlike existing AS, ICDS requires recognition of provisions only if it is `reasonably certain'. It excludes from its ambit onerous contracts.
- In addition, ICDS also requires recognition of contingent assets when the inflow of economic benefits is reasonably certain.
- These changes are presumably made with the intention to bring in consistency to the tax treatment of losses and gains.

Other areas

The key areas of differences for the other notified ICDS standards are summarised below:

- Existing AS states that techniques for the measurement of the cost of the inventories such as the standard cost method may be used for convenience if the results approximate to the actual cost. However, ICDS does not permit use of the standard cost method.
- Existing AS permits capitalisation of foreign exchange differences along with the underlying asset under certain circumstances. ICDS reiterates the fact that capitalisation of exchange differences relating to fixed assets shall be in accordance with Section 43A and other similar provisions of the Act.
- Unlike existing AS, ICDS only covers securities held as stock - in- trade. ICDS requires the comparison of cost and net realisable value for securities held as stock-in-trade to be assessed category wise and not for each individual security. ICDS also provides that securities that are not quoted or are quoted irregularly shall be valued at cost. This could also represent a change in practice for some entities.

There could be many other areas of differences for specific transactions and may vary from assessees to assessees.

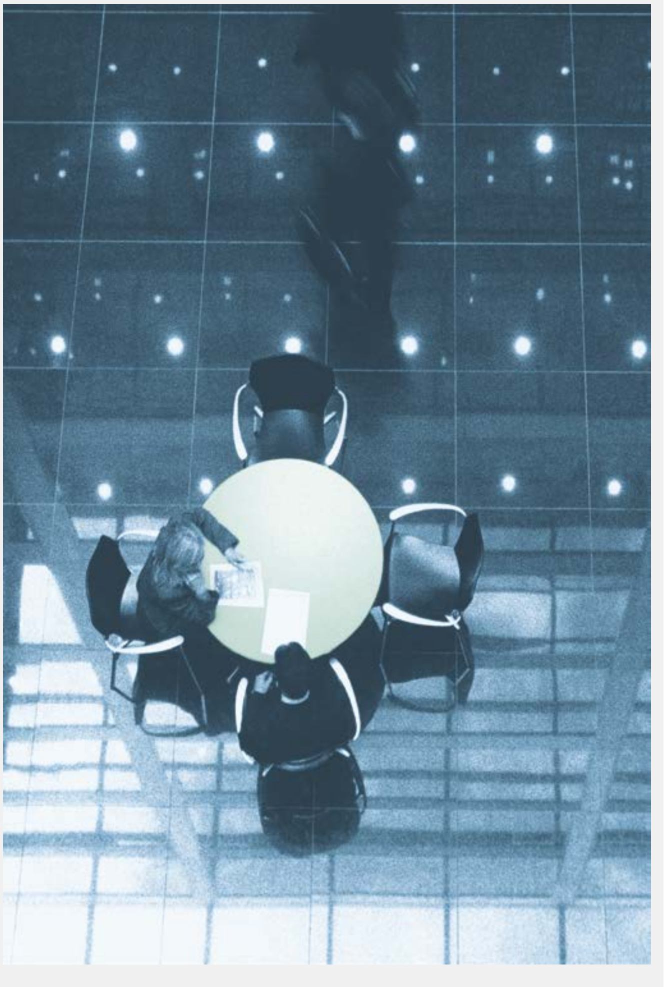
Transitional provisions

The overarching principles of the transitional provisions are that no income would escape taxation nor would it suffer double taxation as a result of the transition to this new framework. As per the transitional provisions, the assessees will 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.

Our views

The much awaited ICDS is now a reality, and India Inc. needs to gear up for this change.

- The taxable income now might be visibly delinked from the accounting income as both will be computed under different set of standards and principles. The areas of significant differences between the existing AS and the corresponding tax positions would be the key areas that assessees would need to consider while implementing ICDS.
- ICDS has been drafted keeping the existing AS as a base. There are significant differences between Ind-AS and existing AS. With Indian companies moving into Ind-AS in phases from 1 April 2015 onwards, there would be additional adjustments required to be made to the accounting profit calculated using Ind-AS to arrive at the taxable income as per the Act.
- ICDS has not adequately addressed certain areas such as financial instruments, share based payments, etc., which are quite prevalent in today's business environment. The standards have generally excluded those topics where there is specific guidance under the income tax law. However, if there is a conflict between the provisions of the Act and ICDS, then the provisions of the Act would prevail. The interplay between judicial precedents and the requirements of these standards needs to be seen, and there could be several instances, where there are conflicting positions.
- In addition, some of the judicial pronouncements which were in favour of the assessees might no longer be operative. Suitable amendments would also be required to the Act to provide certainty on some of these issues.
- ICDS has only considered the existing AS currently. For accounting purposes, companies have also been relying upon numerous other pieces of literature issued by the Institute of Chartered Accountants of India such as Guidance Notes, Accounting Standard Interpretations, etc.. These areas needs to be carefully evaluated as it has significant impacts on reporting of numbers for covered entities. They may impact computation of taxable income going forward.
- Considering the current status and divergent practices that are in existence, the implementation of new standards could result in significant variations in tax outflow. In many cases, the timing of taxable income under the new standards would differ from the timing of recognition under accounting standards.
- Appropriate modifications needs to be made to the Income tax return and Form 3CD to determine taxable income computed as per provision of ICDS.
- Another area that needs the regulator's attention are the Minimum Alternate Tax (MAT) provisions. Once Ind-AS comes in, some companies would report based on Ind-AS whereas others would report based on existing Indian GAAP; therefore the accounting profits based on which MAT is to be calculated would need to be clarified, and may require consideration of suitable adjustments to Ind-AS accounting profit. The CBDT Committee did not address this issue in its Final Report released in October 2012, citing uncertainty around the implementation date for Ind-AS. The Committee had earlier recommended that transition to Ind AS should be closely monitored and appropriate amendments relating to MAT should be considered in the future based on these developments. Regulators would need to address this matter shortly.
- While standard setters have clarified that additional set of books of accounts will not be required for ICDS, there would be several additional records which might need to be prepared and kept available going forward. The differences between the two standards may give rise to additional computations and reconciliations, which in essence could result in the need for maintaining additional set of records especially for large and multi-location companies.
- Considering the magnitude of the changes involved, all the stakeholders including assessees, management and regulatory officers would need to be trained and educated on the new framework. This is important to ensure that there is a fair process of assessment, and the objective of minimising tax disputes is met.



Summary of major changes in notified ICDS vis-à-vis Draft ICDS

The notified ICDS has certain changes as compared to the draft issued in January 2015. We have summarised some of the significant changes below –

- ICDS on Leases and Intangible assets which were earlier issued has now been excluded from the final list of notified ICDS. This would come as a big relief for many assessees. The draft ICDS on leases was in line with the current accounting practice as per Accounting Standard (AS) 19, Leases. ICDS proposed that the depreciation on finance leases to be claimed by the lessee as against by the legal owner of the asset. Similarly, the draft ICDS on intangible assets has not been notified. The existing Act already contains guidance on intangible assets and this exclusion should not impact assessees in a big way. The treatment of leases and intangible assets would continue to be as per the current Act.
- Another major relief has been provided in the notified ICDS on tangible assets. The draft ICDS required a Fixed Asset Register (FAR) to be maintained for all assets for all years. That would have required additional records to be maintained by assessees for Income tax purposes and to keep ready a reconciliation of FAR per ICDS requirements with previous submissions to IT departments. This requirement has been removed in the notified ICDS and would be a welcome change for the assessees.
- Some changes in ICDS on Securities have been made for making it consistent with other ICDSs. These are exchange of securities (in line with ICDS on Tangible Assets) and valuation of securities held as stock-in-trade for business commenced during the previous year (in line with ICDS on Valuation of inventories).
- One more change in the notified ICDS has been made in ICDS relating to Borrowing Costs. The earlier draft of ICDS appeared to have missed out borrowings for the purposes of construction or production of qualifying asset in para 5 and para 6 of ICDS which dealt with measurement of specific and general borrowing cost eligible for capitalisation.

There are similar inconsistencies which have been rectified in the notified ICDS.

Making it 'business as usual'

From a corporate perspective, as a first step, companies should carry out an impact assessment. The impact assessment would provide clarity on both the extent of impact on taxable income, as well as the system and process changes that would be required to compute taxable income each period in an efficient manner. A thorough impact assessment would then serve as a blue print and drive the plan for implementation.

Considering the extent of differences between Ind-AS and ICDS, most large corporate would need to consider the process and system changes that may be warranted to implement ICDS and maintain records as per these two sets of standards. Considering that the information computed using ICDS would be subject to audit through the tax audit process, it becomes all the more important for companies to maintain information in a manner that provides an audit trail.

ICDS is now a reality, and certainly a step in the right direction to enable smooth implementation of Ind-AS, and reduce tax litigation in the medium term. As with any new framework, its implementation is expected to throw up challenges. With the extent of changes in financial, corporate and tax reporting regulations, corporates in India, certainly have their task cut out for 2015.

How KPMG can assist

KPMG is a global network of professional firms providing Audit, Tax and Advisory services. We operate in 152 countries and have 145,000 people working in member firms around the world. The independent member firms of the KPMG network are affiliated with KPMG International Cooperative (KPMG International), a Swiss entity. Each KPMG firm is a legally distinct and separate entity and describes itself as such.

KPMG in India, a professional services firm, was established in September 1993. KPMG in India has offices at Delhi, Chandigarh, Ahmedabad, Mumbai, Pune, Bangalore, Chennai, Kochi, Hyderabad, and Kolkata.

Our Accounting Advisory Services (AAS) practice in India provides accounting advisory services to a number of clients across different sectors. We have assisted various companies in diverse areas such as implementation of IFRS and Ind-AS, Capital market reporting, restatement services, transaction and deal reporting, learning solutions, financial reporting process advisory and other accounting and reporting projects.

Our Tax practice provides a comprehensive range of corporate tax planning, compliance, regulatory and litigation services both relating to direct tax as well as indirect tax. The team also provides advisory services which includes tax due diligence and structuring/restructuring assistance.

Professionals at KPMG have been involved with various initiatives relating to the issuance of ICDS. Based on this experience and our experience in tax, accounting, reporting and auditing matters, we can assist in the following areas:

Diagnostic and Impact assessment

- Analysing and identifying the differences between the current tax computation and the requirements of ICDS
- Impact assessment vis-à-vis Ind-AS
- Realign financial reporting with ICDS based measures
- Impact on tax computations, tax positions, Technology platforms
- Plan an implementation road map

Implementation

- Implementation of changes in accounting and reporting policies and computation methodologies
- Computation of impacts (Tax expenses and deferred taxation)
- Transactions recording, data flows for ongoing requirements
- Disclosure requirements
- Transition methodology
- Thought leadership and knowledge updates

System and Processes

- Plan and implement both 'quick fixes' and ensure that systems implemented would enable sustained ICDS reporting
- Determine approach for parallel run (multi GAAP reporting) including ICDS information for tax filing, Ind-AS or Indian GAAP and group reporting, where applicable
- Identify sources of additional information required as per ICDS requirements
- Process changes and implementation

Business and People

- Impact on existing processes and changes
- Knowledge management and trainings
- Impact on current transaction/contract structures and advise including items such as
  - Tax expenses
  - Key business contracts such as acquisitions, capitalisations, derivatives, borrowing costs and others
  - Future contracts and business transactions
  - Impact on EPS, business ratios, budgets etc..

Appendix

List of ICDSs

ICDS #	Income Computation Disclosure Standards	Accounting Standard
ICDS I	Accounting Policies	(Corresponding to AS-1)
ICDS II	Valuation of Inventories	(Corresponding to AS- 2)
ICDS III	Construction Contracts	(Corresponding to AS- 7)
ICDS IV	Revenue Recognition	(Corresponding to AS- 9)
ICDS V	Tangible Fixed Assets	(Corresponding to AS- 10)
ICDS VI	The Effects of Changes in Foreign Exchange Rates	(Corresponding to AS- 11)
ICDS VII	Government Grants	(Corresponding to AS-12)
ICDS VIII	Securities	(Corresponding to AS-13)
ICDS IX	Borrowing Costs	(Corresponding to AS-16)
ICDS X	Provisions, Contingent Liabilities and Contingent Assets	(Corresponding to AS- 29)

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