

KRISHNAN RETNA & ASSOCIATES

P R E S E N T S

ICDS

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*Understanding ICDS for Better
Tax and Accounting Decisions*

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TAX



ACCOUNTS



INSIGHTS

FROM BOOKS TO TAX: DECODING ICDS AND IND AS

Introduction

Did you know that a company can show a healthy profit in its financial statements but have a completely different profit figure for income tax purposes? This is because of the Income Computation and Disclosure Standards (ICDS). These standards act as a unique "tax bridge" between accounting books and tax returns, and mastering them is essential for any tax professional.

What is ICDS and Why Does It Matter

To understand ICDS, you must first understand what they are *not*. ICDS are not standards for maintaining your day-to-day books of account. Instead, they are strictly tax-computation standards.

They apply to taxpayers who:

- Compute income under "Profits and Gains of Business or Profession" (PGBP) or "Income from Other Sources."
- Follow the mercantile system of accounting.

There is no turnover threshold; if you meet these criteria, ICDS applies. This holds true even if your financial statements are prepared under Ind AS. Crucially, if there is ever a conflict between the Income-tax Act and an ICDS, the Income-tax Act wins.

A very short history

ICDS originated from the CBDT's work on tax accounting standards: a committee was constituted in December 2010 and its final report/draft standards were submitted in August 2012. Ten ICDS were notified in 2015, but after stakeholder representations and the need to align the tax-audit/reporting framework, their effective date was shifted to 1 April 2016 (PY 2016-17 / AY 2017-18).

The 10 notified ICDS are: I Accounting Policies; II Inventories; III Construction Contracts; IV Revenue Recognition; V Tangible Fixed Assets; VI Foreign Exchange; VII Government Grants; VIII Securities; IX Borrowing Costs; X Provisions, Contingent Liabilities and Contingent Assets.

Accounting Policies and Provisions

ICDS I deals with the selection and change of accounting policies. It introduces a major twist by completely ignoring two pillars of traditional accounting: **Prudence** and **Materiality**.

Because the concept of prudence is omitted, you cannot recognize marked-to-market (MTM) losses or expected losses unless specifically allowed by another ICDS.

This raises an important question: does this mean standard provisions like those for warranties, leave encashment, or gratuity are disallowed? Fortunately, judicial precedents help us here. Under Supreme Court rulings (such as *Rotork Controls* and *Bharat Earth Movers*), these provisions are still deductible if they are based on experience, historical trends, and scientific valuation, as they represent accrued liabilities rather than mere contingent/expected losses.

Under ICDS X, a provision is recognized only when a present obligation from a past event is "reasonably certain" to require an outflow of resources. This "reasonably certain" threshold is more restrictive than the "probable" threshold used in standard accounting.

Valuation of Inventories

ICDS II governs inventory valuation. While it shares the familiar "lower of cost or net realizable value (NRV)" rule, it introduces key differences from standard accounting (AS 2):

- **Service WIP:** Service providers must value their work-in-progress (WIP). This means unbilled service hours and directly engaged labour costs are pulled into inventory, bringing unbilled amounts into the tax net early.
- **Allocation of Overheads:** Fixed production overheads must be allocated based on normal capacity. In periods of low production, you cannot increase the overhead rate per unit, which prevents artificial undervaluation of inventory.
- **Partnership Dissolution:** If a partnership firm dissolves, the inventory on the date of dissolution must be valued at NRV, regardless of whether the business actually discontinues. This departs from some historical case laws that allowed book value if the business continued as a reconstituted unit.

Revenue and Construction Contracts

Revenue timing is a frequent source of tax disputes. Under ICDS III (Construction Contracts) and ICDS IV (Revenue Recognition), several rules alter when and how income is recognized:

- **Mandatory Percentage of Completion (POCM):** ICDS IV mandates the use of POCM for all service transactions. Standard accounting (AS 9) allows the "completed service contract method," but ICDS eliminates this option to prevent deferred tax recognition.
- **Early Stages of Contracts:** For construction contracts, if the outcome cannot be reliably estimated in the early stages, revenue is recognized to the extent of costs incurred. However, this "early stage" phase is strictly capped at 25% completion. Once you cross 25%, you must start recognizing profits.
- **Retention Money:** Under ICDS III, contract revenue must include retention money (amounts held back by customers until contract terms are fully met). This directly conflicts with several High Court rulings that held retention money only accrues upon successful completion of the work.

Fixed Assets and Borrowing Costs

Determining the tax base for assets and borrowing costs requires stepping away from book values.

- **Under ICDS V,** the actual cost of a tangible fixed asset excludes taxes and duties that are subsequently recoverable. For assets acquired through exchange, the actual cost is determined based on the fair value of the asset acquired, unlike certain accounting treatments that may consider the fair value of the asset given up. Further, dismantling, removal and restoration costs are not included in the cost of the asset under ICDS V, whereas such costs may be capitalised under Ind AS 16 when they meet the recognition criteria. Also, impairment losses and revaluation gains/losses recognised in the books do not affect taxable profit under ICDS V; they are not recognised for tax computation purposes. ICDS IX (Borrowing Costs) requires borrowing costs directly attributable to a qualifying asset to be capitalized.
- **Qualifying Asset Definition:** For tangible and intangible assets, there is **no minimum period** required for them to be classified as qualifying assets (unlike inventories, which must take 12 months or more). Even off-the-shelf items like laptops could technically require capitalization of proportionate borrowing costs!

- **No Reduction for Temporary Income:** Unlike AS 16, any income earned from temporarily investing borrowed funds cannot be used to reduce the borrowing costs eligible for capitalization. You must capitalize the gross borrowing costs.

Forex and Government Grants

Both foreign exchange fluctuations and government grants can drastically impact your tax liability depending on how they are recognized.

- Under ICDS VI (Foreign Exchange Changes), foreign currency transactions are recorded initially using the transaction date's exchange rate. At year-end, monetary items (like cash, receivables, and payables) must be translated using the closing rate, and any exchange differences are recognized immediately in the P&L. Non-monetary items (like fixed assets and inventory) remain at their historical transaction rate. This translation is always subject to the overriding rules of Section 43A of the Income-tax Act.
- Under ICDS VII (Government Grants), grants cannot be recognized until there is reasonable assurance of compliance and receipt. Crucially, recognition **cannot be postponed beyond the date of actual receipt**.
- Furthermore, ICDS VII rejects the "capital approach" allowed in accounting (AS 12), where certain grants are credited directly to capital reserves. Under ICDS, grants must either be deducted from the cost of the depreciable asset or recognized directly as income.

Valuation of Securities

ICDS VIII deals specifically with securities held as stock-in-trade (not as long-term investments).

While standard accounting (AS 13) recommends comparing cost and NRV for each *individual* security, ICDS VIII mandates a **category-wise** comparison. Securities must be grouped into four distinct buckets:

1. Shares
2. Debt securities
3. Convertible securities
4. Any other securities

The comparison of actual cost and NRV is done on the total value of each category. However, this category-wise valuation does not apply to unlisted securities or securities that are not regularly quoted on a recognized stock exchange; these must be valued strictly at actual cost.

The Auditor's Working Paper Approach

For a tax auditor, the key to handling ICDS is establishing a robust, repeatable workflow. You are creating a "tax bridge" from book profit to taxable profit.

Here is the step-by-step working-paper approach:

1. **Confirm Applicability:** Ensure the client uses the mercantile system and computes income under PGBP or Income from Other Sources.
2. **Identify and assess relevant transactions:** Identify the transactions and items appearing in the financial statements that are covered by ICDS I to X, and evaluate their tax treatment in accordance with the applicable ICDS.

3. **Quantify Adjustments:** Identify book-to-tax differences for each standard and calculate the variance.
4. **Track Reversals:** Determine if an adjustment is temporary (timing-based, like construction contract revenue) or permanent, and track how it reverses in future years.
5. **Verify and Disclose:** Ensure disclosures are properly filled out in Form 3CD and the ICDS schedule of the Income Tax Return (ITR).
6. **Retain Evidence:** Keep clear documentation, including valuation reports, grant letters, Foreign Exchange schedules, and loan statements.

Summary

ICDS	Subject	Closest AS / Ind AS	Practical focus
I	Accounting Policies	AS 1 / broadly Ind AS 1	Watch for consistency, accrual, fundamental assumptions and changes in accounting policy. ICDS is for tax computation, not books.
II	Valuation of Inventories	AS 2 / Ind AS 2	Inventory cost and NRV can create tax adjustments. Standard cost/retail method is allowed if it approximates actual cost.
III	Construction Contracts	AS 7 / Ind AS 115	Percentage-of-completion is central. Identify contract revenue/cost, expected losses, advances, retentions and stage of completion.
IV	Revenue Recognition	AS 9 / Ind AS 115	Revenue timing can differ from book recognition. Check sale of goods, services, interest, royalty and dividend separately.
V	Tangible Fixed Assets	AS 10 / Ind AS 16	Tax base may differ from book carrying amount. Focus on actual cost, exclusions from cost and capitalization/depreciation implications.
VI	Effects of FX Changes	AS 11 / Ind AS 21	Identify monetary items, year-end translation and treatment of exchange differences. Reconcile tax treatment with books.
VII	Government Grants	AS 12 / Ind AS 20	Grant timing and whether it is capital- or revenue-related can affect taxable income/cost. Track grants against assets and income.
VIII	Securities	AS 13 / Ind AS 109	Tax valuation rules for securities can differ from

			Ind AS fair-value accounting. Check classification, valuation and interest/dividend recognition.
IX	Borrowing Costs	AS 16 / Ind AS 23	Capitalization can materially affect taxable profit. ICDS scope and qualifying-asset rules should be checked independently of book accounting.
X	Provisions, Contingent Liabilities & Assets	AS 29 / Ind AS 37	Provision recognition for tax is more restrictive than merely booking an accounting provision. Test certainty/measurement and tax deductibility.

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