Inter-Relationship between Accounting and Taxation

Question 1
How would non-consideration of prudence in selection and application of accounting policies impact the computation of total income under the Income-tax Act, 1961? Give examples of non-consideration of prudence in the Income Computation and Disclosure Standards (ICDSs).

Answer
The concept of prudence requires that provisions should be 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. Non-consideration of prudence in selection and application of accounting policies may have the impact of earlier recognition of income and gains or later recognition of expenses or losses for tax computation.

Examples of non-consideration of prudence in the ICDSs:
(i) The requirement in ICDS VII on Government Grants that recognition of a Government grant shall not be postponed beyond the date of actual receipt, even if conditions attached to the grant are not fulfilled.

(ii) Non-recognition of expected losses on construction contracts and contract costs, recovery of which is not probable, as an expense immediately, in ICDS III on Construction Contracts.

(iii) Non-recognition of provision for loss on onerous contracts.

Question 2
How is inventory on the date of dissolution of a firm to be valued, where the firm’s business is to be continued by one of its partners, in a case where the dissolution has taken place on or after 1.4.2016? What was the manner in which such inventory would have been valued had the dissolution taken place on 31.3.2016?

Answer
Under section 145(1), income chargeable under the heads “Profits and gains of business or profession” or “Income from other sources” shall be computed in accordance with either the
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cash or mercantile system of accounting regularly employed by the assessee. Section 145(2) empowers the Central Government to notify in the Official Gazette from time to time, income computation and disclosure standards to be followed by any class of assesses or in respect of any class of income. Accordingly, the Central Government has, in exercise of the powers conferred under section 145(2), notified ten income computation and disclosure standards (ICDSs) to be followed by all assesses (other than an individual or a Hindu undivided family who is not required to get his accounts of the previous year audited in accordance with the provisions of section 44AB), following the mercantile system of accounting, for the purposes of computation of income chargeable to income-tax under the head “Profit and gains of business or profession” or “Income from other sources”, from A.Y. 2017-18.

In case of dissolution of a partnership firm or association of persons or body of individuals, Paragraph 24 of ICDS II on Valuation of Inventories requires the inventory on the date of dissolution to be valued at the net realisable value, notwithstanding whether business is discontinued or not.

This requirement in ICDS II is in deviation from the Supreme Court ruling in Shakti Trading Co. vs. CIT (2001) 250 ITR 871, where it was held that if the firm is dissolved due to death of a partner and the surviving partners reconstitute the firm and continue the business as before, the firm is entitled to adopt cost or market price, whichever is lower.

Therefore, if the firm was dissolved on 31.3.2016, the valuation of inventory would be governed by the Supreme Court ruling in Shakti Trading Company's case. However, if the dissolution takes place on or after 1.4.2016, it would be governed by ICDS II and the inventory has to be valued at the net realizable value, notwithstanding whether business is discontinued or not.

Question 3

*What are the main differences between the treatment given in AS 7 and ICDS III relating to construction contracts?*

*Answer*

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<tr>
<th>Point of difference</th>
<th>AS 7 vis-à-vis ICDS III</th>
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<tr>
<td>(1) Point in time of recognition of expected loss on construction contracts</td>
<td>AS 7 permits recognition of expected loss on construction contract as well as contract costs, recovery of which is not probable, as an expense immediately. It also permits recognition of expected loss immediately as an expense, when it is probable that total contract costs will exceed total contract revenue. The absence of specific requirement in ICDS III to recognize such expected losses on construction contracts immediately as expense represents a</td>
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significant deviation from AS 7 as well as judicial rulings permitting immediate recognition of such losses as long as the same are in accordance with the accounting standard or justified by the principle of prudence or by the nature and circumstances of the contract.

By implication, such losses are also to be recognized on Percentage of Completion Method as per ICDS III. Consequently, recognition of losses for tax purposes is postponed.

(2) Treatment of penalties arising from delays caused by the contractor in completion of the contract
Paragraph 11 of AS 7 permits decrease in contract revenue as a result of penalties arising from delays caused by the contractor in the completion of the contract. However, ICDS III does not permit such reduction in contract revenue.

Non-recognition of decrease in contract revenue as a result of such penalties would have the effect of inflating the taxable income and consequent tax liability.

(3) Point in time of recognition of retention money
ICDS III requires retention money to be treated as part of contract revenue and recognized on percentage of completion method. As per paragraph 10 of ICDS III, “Contract Revenue” shall comprise of the initial amount of revenue agreed in the contract, including retentions.

However, as per paragraph 10 of AS 7, contract revenue should comprise the initial amount of revenue agreed in the contract. While there is a specific requirement in paragraph 10 of ICDS III to include retentions, there is no such requirement in paragraph 10 of AS 7.

**Question 4**

*The conditions for recognition of provisions and contingent assets are more stringent in ICDS X as compared to AS 29* - Elucidate.

**Answer**

**Condition for recognition of Provision**

AS 29 requires recognition of a provision when it is *probable* that an outflow of resources embodying economic benefits will be required to settle the obligation.

ICDS X requires recognition of a provision only when it is *reasonably certain* that an outflow of resources embodying economic benefits will be required to settle the obligation.

The requirement of “reasonable certainty” in ICDS X to recognize a provision is more stringent as compared to the requirement of “probability” in AS 29. This may have the
effect of postponing the recognition of provision for tax purposes and consequently, result in earlier payment of taxes.

Condition for recognition of Contingent Asset

Both AS 29 and ICDS X provide that a contingent asset should not be recognized. Further, both AS 29 and ICDS X require contingent assets to be assessed continually. Thereafter, recognition of contingent assets and related income is required in –

AS 29, if inflow of economic benefits is “virtually certain”;

ICDS X, if inflow of economic benefits is “reasonably certain”.

The requirement of “reasonable certainty” in ICDS X to recognize a contingent asset and the related income is more stringent as compared to the requirement of “virtual certainty” in AS 29. This deviation between AS 29 and ICDS X may have the effect of advancing recognition of income for tax purposes and consequently, result in earlier payment of taxes.

Exercise

1. Distinguish between “Permanent difference” and “Timing difference”, with the help of examples.
2. When does a deferred tax asset and deferred tax liability arise? Explain giving examples.
3. What are the criteria for recognizing a deferred tax asset?
4. What are the accounting entries to be passed for recognition and reversal of a deferred tax asset and deferred tax liability?

Annexure

Income Computation and Disclosure Standards

Section 145 of the Income-tax Act, 1961 provides for the method of accounting. Section 145(1) requires income chargeable under the head “Profits and gains of business or profession” or “Income from other sources” to be computed in accordance with either the cash or mercantile system of accounting regularly employed by the assessee, subject to the provisions of section 145(2). Under section 145(2), the Central Government is empowered to notify in the Official Gazette from time to time, income computation and disclosure standards (ICDSs) to be followed by any class of assessees or in respect of any class of income.

Accordingly, the Central Government had, vide Notification No.S.O.892(E) dated 31.3.2015, in exercise of the powers conferred by section 145(2), notified ten income computation and disclosure standards (ICDSs) to be followed by all assessees, following the mercantile system of accounting, for the purposes of computation of income chargeable to income-tax under the head “Profit and gains of business or profession” or “Income from other sources”. This notification was to come into force with effect from 1st April, 2015, to be applicable from A.Y. 2016-17.
However, the Central Government has, vide Notification No.S.O.3078(E) dated 29.9.2016, rescinded Notification No.S.O.892(E) dated 31.3.2015. Simultaneously, vide Notification No.S.O.3079(E) dated 29.9.2016, the Central Government has notified ten new ICDSs to be applicable from A.Y.2017-18. The newly notified ICDSs have to be followed by all assessees (other than an individual or a Hindu undivided family who is not required to get his accounts of the previous year audited in accordance with the provisions of section 44AB) following the 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”, from A.Y.2017-18.

[A.Y.2017-18 is the assessment year relevant for May, 2017 and November, 2017 examinations. Therefore, the ICDSs notified on 29.9.2016 to be applicable from A.Y.2017-18 are relevant for students appearing in May, 2017 and November, 2017 examinations. The text of the ICDSs notified on 29.9.2016 is given as Annexure at the end of this Practice Manual. The significant changes in the ICDSs notified on 29.9.2016 vis-à-vis ICDSs initially notified on 31.3.2015 (since rescinded) have been briefed hereunder.]

Significant changes made in the ICDSs notified on 29.9.2016 (newly notified ICDSs) vis-à-vis ICDSs initially notified on 31.3.2015 (since rescinded)

There are no changes in ICDS I: Accounting Policies, ICDS VII: Government Grants and ICDS X : Provisions, Contingent Liabilities and Contingent Assets. The significant changes in the other ICDSs are briefed hereunder. The transitional provisions, however, have been revised in all ICDSs in line with the new implementation date.

**ICDS II: Valuation of Inventories**

**Recognition of standard cost method for measuring cost of inventories:** Whereas AS 2 permits standard cost method as one of the techniques for the measurement of the cost of inventories, for convenience if the results approximate the actual cost, there was no enabling clause or para in the initially notified ICDS II permitting adoption of standard cost as a technique for measurement of the cost of inventories.

The newly notified ICDS II permits techniques for the measurement of the cost of inventories, such as the standard cost method or the retail method, to be used for convenience if the results approximate the actual cost. New ICDS II goes on to explain that standard costs take into account normal levels of consumption of materials and supplies, labour, efficiency and capacity utilization. They are regularly reviewed and, if necessary, revised in the light of the current conditions.

Further, 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 have to be disclosed.

**ICDS III: Construction contracts**

**Recognition of contract revenue and contract costs, associated with construction contracts in progress as on 31.3.2016, on the basis of method regularly followed:** The newly notified ICDS III permits contract revenue and contract costs associated with the construction contract, which commenced on or before 31.3.2016 but not completed by the said date, to be recognised based on the method regularly followed by the person prior to the previous year 2016-17. As per the initially notified ICDSs, such contract revenue and costs in respect of construction contracts in progress as on 31.3.2015 had to be recognized only in accordance with the provisions of the standard.
Revenue recognition in case of rendering of services: Revenue from service transactions is required to be recognized on the basis of percentage completion method as per ICDS IV. The newly notified ICDS IV, however, permits revenue to be recognized on a straight line basis over a specific period of time, when services are provided by an indeterminate number of acts over such period.

As per the initially notified ICDS IV, “reasonable certainty for ultimate collection” was not a criterion for recognition of revenue from rendering of services. However, the newly notified ICDS IV permits revenue from service contracts with duration of not more than 90 days to be recognized when the rendering of services under that contract is completed or substantially completed.

Point in time when interest would be treated as income chargeable to tax: As per ICDS IV, interest shall accrue on the time basis determined by the amount outstanding and the rate applicable. However, the newly notified ICDS IV goes on to provide that 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.

Requirement to mention details of jointly owned tangible fixed assets separately in the tangible fixed assets register dispensed with: The initially notified ICDS V contained a requirement to indicate separately in the tangible fixed assets register, the details of jointly owned tangible fixed assets. However, the requirement to mention these details separately has been dispensed with in the newly notified ICDS V.

Conversion at last day of the previous year - Non-monetary item being inventory carried at NRV denominated in foreign currency: As per the newly notified ICDS VI, at last day of each previous year, 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.

In the newly notified ICDS VIII, there are two parts. Part A deals with securities held as stock-in-trade. Part B 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 or the Companies Act, 2013. Part B has been inserted in the newly notified ICDS VIII.

Scope of definition of “securities” in Part A expanded: The definition of “securities” in Part A of the newly notified ICDS VIII has been expanded to specifically include share of a company in which public are not substantially interested.

Use of “Weighted Average Cost” formula permitted for subsequent measurement of securities held as stock-in-trade (other than unlisted or unquoted securities) referred to in Part A: As per the newly notified ICDS VIII, in a case 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. In the initially notified ICDS VIII, only FIFO method was permitted to be used for determining the cost of such security.

**Securities referred to in Part B to be classified, recognized and measured in accordance with the extant guidelines issued by RBI:** Securities referred to in Part B to be classified, recognised and measured in accordance with the extant guidelines issued by the RBI in this regard. Any claim for deduction in excess of the said guidelines will not be taken into account. To this extent, the provisions of ICDS VI on the effect of changes in foreign exchange rates relating to forward exchange contracts would not apply.

**ICDS IX: Borrowing Costs**

**Specification of minimum period for treating an asset as a qualifying asset for the purpose of computing the amount of borrowing costs to be capitalised:** The initially notified ICDS IX did not provide any minimum period for treating an asset as a qualifying asset (except in the case of inventories). This concern has been partially addressed in the newly notified ICDS IX. *Explanation* to paragraph 6 clarifies that, for the purpose of computing the amount of borrowing costs to be capitalized, in a case where the funds are not borrowed specifically for the purposes of acquisition, construction or production of a qualifying asset, a qualifying asset would be such asset that necessarily require a period of 12 months or more for its acquisition, construction or production.