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Draft Tax Accounting Standards

Background

The Finance Act, 1995, empowered the Central Government to announce Accounting Standards (AS) to be followed when computing income under the head "Profits and gains of business or profession" or "Income from other sources". The purpose of these AS, under the Income-tax Act, 1961 (the Act), is to ensure that income is computed precisely and objectively. In 1996, two AS were announced, relating to disclosure of accounting policies and disclosure of prior period and extraordinary items and changes in accounting policies.

In July 2002, a Committee was constituted to formulate AS to be notified under the Act. This Committee recommended that AS notified by the Institute of Chartered Accountants of India (ICAI) be adopted without any modification, and that there be an amendment to the Act where necessary. In December, 2010, the Central Board of Direct Taxes (CBDT) constituted a Accounting Standard Committee (the Committee) to harmonise the AS issued by the ICAI with the provisions of the Act, and also to suggest amendments to the Act required for the transition to Indian Accounting Standards (Ind AS) / International Financial Reporting Standard (IFRS). The Committee recommended that the AS to be notified under the Act should be made applicable only to the computation of taxable income and that a taxpayer need not maintain separate set of books of account in order to comply with these AS.

The Committee examined the 31 AS issued by the ICAI and noted that Tax Accounting Standards (TAS) need to be notified-only in relation to 14 AS issued by the ICAI, because 17 AS issued by the ICAI only relate to disclosure requirements.

The Committee noted that the proposed TAS, along with the provisions of the Act, will provide a comprehensive framework for computation of income (other than minimum alternate tax (MAT)) even if Ind-AS are made mandatory.

Recommendations of the Committee

On 26 October 2012, the Committee issued its final recommendations announcing 14 TAS to be adopted for income-tax purposes in order to reduce litigation and to provide greater certainty in respect of disputed accounting issues. The TAS drafts are formulated on the following significant issues, and relate to corresponding AS issued by the ICAI in order to harmonise those TAS with the provisions of the Act:

1. Disclosure of Accounting Policies (Corresponding to AS-1)
2. Valuation of Inventories (Corresponding to AS- 2)
3. Events Occurring After the Previous Year (Corresponding to AS-4)
4. Prior Period Expense (Corresponding to AS- 5)
5. Construction Contracts (Corresponding to AS- 7)
6. Revenue Recognition (Corresponding to AS- 9)
7. Accounting for Tangible Fixed Assets (Corresponding to AS- 10)
8. The Effects of Changes in Foreign Exchange Rates (Corresponding to AS-11)
9. Government Grants (Corresponding to AS-12)
10. Securities (Corresponding to AS-13)
11. Borrowing Costs (Corresponding to AS-16)
12. Leases (Corresponding to AS-19)
13. Intangible Assets (Corresponding to AS- 26)
14. Provisions, Contingent Liabilities and Contingent Assets (Corresponding to AS- 29)

Approach

The Committee also made the following recommendations to deal with issues arising from the introduction of the TAS:

- TAS should apply to all taxpayers without any turnover or income threshold.
- TAS should be applicable only to computation of taxable income. Tax payers will not be required to maintain separate set of books of account on the basis of TAS.
- TAS will be applicable only to taxpayers following mercantile system of accounting for tax purposes.
- Where there is a conflict between the Act and TAS, the provisions of the Act will prevail.
- Appropriate modifications will need to be made to the return of income and to Form 3CD so as to ensure compliance with TAS.
- On transition to TAS on a specific date, a situation may arise where income arising from a particular transaction may neither be taxable in the pre-TAS period nor in the post-TAS period or may be taxable in both periods. To address such situations, wherever required, transitional provisions must be introduced, along with TAS.

TAS notified by the Committee

A comparison of some of the key characteristics and distinctive features of the AS notified by the ICAI and TAS are provided below:

Serial No. (AS No.)	Provisions under the AS	Provisions notified under the TAS
1. Disclosure of Accounting Policies (AS – 1)	• Requires recognition of expected losses and anticipated profits • Accounting policies can be changed if this results in a more appropriate presentation of accounts.	• Treatment and presentation of transactions and events shall be governed by their substance and not their legal form • Does not recognise mark-to-market loss or an expected loss unless these are recognised under any other TAS • Accounting policies shall not be changed unless there is a reasonable cause for such a change.
2. Valuation of Inventories (AS-2)	• Does not provide for any method of valuation of inventories in case of service providers • Cost of inventories is to be determined using the standard cost method or the retail method • Method of valuation of inventory can be changed if it results in a more appropriate presentation of accounts • Does not provide the value of inventories to be adopted at the time of dissolution of a partnership firm, association of persons (AOP) or body of individuals (BOI).	• Provides method of valuation of inventories for a service provider based on international practices • Cost of inventories is to be determined using the first-in-first-out (FIFO) method or the weighted average cost method. When these methods are not practicable, the retail trade method is to be adopted • Method of valuation of inventory once adopted cannot be changed, unless there is a reasonable cause for doing so • Provides that the value of inventories shall be the net realisable value on the date of dissolution.
3. Events occurring after the end of the previous year (AS-4)	• Allows adjustments for events occurring between the balance sheet date and the date on which the financial statements are approved • It also provides for requirement of disclosure and adjustment, if any, for material transactions occurring between the date of approval of financial statements and the date of submission of the tax return.	• Allows adjustments for events occurring after the previous year that provide additional information that materially affect the determination of the amounts relating to conditions existing at the end of the relevant previous year.

Serial No. (AS No.)	Provisions under the AS	Provisions notified under the TAS
4. Prior period expense (AS-5)	• Prior period items are to be disclosed separately • Extraordinary items are to be separately disclosed, together with their impact on current profit or loss.	• Prior period expense shall not be considered as an allowable deduction for a prior year (during which it has been recorded), unless the taxpayer proves that this expense accrued during that previous year • No guidance is provided in relation to recognition of prior period income • No distinction is made between ordinary and extraordinary items.
5. Construction Contracts (AS-7)	• Does not provide for accounting treatment of retention money • Contract revenue already recognised as income is to be reversed if it becomes uncertain • There is no provision for the treatment of borrowing costs relating to construction contracts • There is no provision for the treatment of pre-construction income that is in the nature of interest, dividends or capital gains • Contract costs which relate to future activity shall be recognised as an asset when it is probable that these costs are recoverable • Contract revenues are recognised if it is possible to reliably measure the outcome of a contract • Losses, including the probable / expected losses, shall be recognised fully and not in proportion to the percentage of completion of the contracted work • Revenue shall not be recognised during the early stages of a contract, and which is an uncertain and an undefined concept.	• Provides for recognition of retention money on an accrual basis using the percentage of completion method • Contract revenue already recognised as income is to be written-off as bad debt if the collection of that revenue later becomes uncertain • Provides for inclusion of borrowing costs (computed as per TAS on borrowing costs) in the contract cost • Specifically provides for taxing pre-construction income (like interest, dividend and capital gains) separately under the Act. Such income is not to be subtracted from the construction cost • Contract costs that relate to future activity shall be recognised as an asset. If this asset is not realisable, then the same may be allowed under the provisions of the Act • Losses incurred shall also be allowed only in proportion to the stage of completion. Future or anticipated losses shall not be allowed unless such losses are actually incurred • Revenue shall be recognised only after a contract crosses a 25% proportion of completion.

Serial No. (AS No.)	Provisions under the AS	Provisions notified under the TAS
6. Revenue Recognition (AS-9)	• Revenue for service transactions is to be recognised by using either the proportionate completion method or the completed service contract method • Revenue recognition can be postponed in relation to any claim, where it is not possible to assess the ultimate collection with reasonable certainty.	• Revenue for service transactions is recognised by using the percentage completion method • In view of specific provisions in the Act for bad debts, the postponement of revenue as a result of uncertainty is restricted to claims relating to price escalation and export incentives.
7. Accounting for tangible fixed assets (AS-10)	• Provides for accounting of all fixed assets, except forest assets, wasting assets and livestock • An asset acquired in exchange for another asset, or for shares or securities, shall be recorded at the fair value of the asset given or acquired, whichever is more clearly evident • Expenditure on existing assets which increases the future benefits of those assets is to be capitalised • Provides guidance for revaluation of assets • Provides guidance on retirement and disposal of assets.	• Provides for accounting of all tangible fixed assets which form part of a 'block of assets' under the Act • An asset acquired in exchange for another asset, or for shares or securities, shall be recorded at the lower of the fair value of the asset given up or acquired • In light of judicial pronouncements, it is recommended that expenditure for the purpose of preserving or maintaining an existing tangible fixed asset (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) shall be charged to revenue • There is no concept of revaluation of assets under the TAS, since the Act does not recognise the concept of revaluation of assets • Since the Act contains specific provisions relating to retirement and disposal of tangible fixed assets, these areas are not incorporated in TAS • Prescribes maintenance of a fixed assets register, which must include certain specified disclosures.
8. The effects of changes in foreign exchange rates (AS-11)	• Provides guidance on initial and subsequent recognition of foreign currency transactions and exchange differences in regard to such transactions	• Stipulates that initial recognition, conversion and recognition on settlement, of foreign currency transactions will be subject to section 43A of the Act (provisions relating to consequential changes in the foreign exchange rate) and Rule 115 of the Income-tax Rules, 1962 (which provides

Serial No. (AS No.)	Provisions under the AS	Provisions notified under the TAS
	• Stipulates that exchange differences arising from the translation of financial statements of non-integral foreign operations should be accumulated in a foreign currency translation reserve in the balance sheet • Where there are foreign currency options and forward contracts, mark-to-market losses are to be determined and the resultant exchange differences recorded in the profit and loss account.	for a rate of exchange for conversion of foreign currency) • Does not distinguish between integral and non-integral foreign operations • Stipulates that exchange differences on the translation of financial statements shall be recognised for the purpose of computation of income • Losses on foreign currency and forward contracts are to be recognised only on settlement. This would have the effect of overruling the Supreme Court (SC) judgment in the case of Woodward Governor India Pvt Ltd [2009] 312 ITR 254 (SC) • Premium, discount or exchange differences on contracts that are intended for trading or speculation purposes, or that are entered into to hedge the foreign currency risks of a firm commitment or a highly probable forecast transaction, shall be recognised at the time of settlement.
9. Government grants (AS-12)	• Provides two approaches for treatment of grants: capital approach (treating grants as a part of shareholders' funds) and income approach (treating grants as income) • Stipulates that grants should be recognised on fulfilment of attached conditions and irrespective of whether the grant is received • Grants relating to non-depreciable assets should be deducted from the carrying value of the asset.	• To be treated either as revenue receipt or reduced from cost of fixed assets, depending on the purpose for which the grant or subsidy is given • Should not be recognised until there is reasonable assurance that all conditions are complied with. However, recognition should not be postponed beyond the actual date on which a grant is received • Grant relating to a non-depreciable asset, which requires the fulfillment of certain obligations, shall be recognised as income in the same period in which the cost of meeting those obligations is charged to revenue.
10. Accounting for investments (AS -13)	• 'Investment' covers current investments, long-term investments, and property, but excludes shares, debentures or other securities held as stock-in-trade • Where an asset is acquired in exchange for any other asset, the cost of the new asset would be the fair market value of the consideration paid.	• Only deals with securities held as stock-in-trade • Where a security is acquired in exchange for any other security, the cost shall be recognised as the lower of the fair value of the security acquired the security exchanged • Securities held as stock-in-trade shall be valued at year-end, at actual cost as initially recognised or net realisable value, whichever is lower • Valuation of securities at year-end should be done by comparing cost and

Serial No. (AS No.)	Provisions under the AS	Provisions notified under the TAS
		net realisable value by each category of security (shares, debentures, convertible securities or other securities) and not by valuing each individual security • In respect of securities not listed on a recognised stock exchange (or listed but not regularly quoted), valuation shall be done with reference to initially recognised actual cost • Where the actual cost initially recognised is not ascertainable with reference to specific identification, the cost shall be determined using the FIFO method.
11. Borrowing Costs (AS-16)	• Borrowing cost includes exchange differences arising from foreign currency borrowings to the extent of interest cost adjustments • Defines a qualifying asset as an asset where a substantial period of time (more than 12 months) is needed to prepare that asset for use or sale • Capitalisation of borrowing costs is only allowed where it is probable that these costs will result in future economic benefits and where they are reliably measurable • Income from temporary investments is to be deducted from borrowing costs • Where development activities are interrupted, capitalisation of borrowing costs is to be suspended • Capitalisation of borrowing costs is to be done only on: incurrence of expenditure on capital (qualifying) asset; incurrence of borrowing cost;	• Since treatment of exchange differences arising from foreign currency borrowings is specifically covered by the provisions of the Act, this is not included in TAS • Provides for capitalisation of borrowing costs in respect of an asset, irrespective of the related construction period (except for inventories, for which it is the same as is stated in the AS – i.e. more than 12 months) • Provision relating to capitalisation of borrowing costs being related to the probability that these costs will result in future economic benefits, does not appear in TAS • Income earned from temporary investments, shall be taxable as income under the provisions of the Act • Borrowing costs are to be capitalised even where active development of a capital asset is interrupted • Capitalisation of borrowing costs should commence from the date on which funds are borrowed • Borrowing costs in cases of general borrowings, should be apportioned in proportion to the ratio of the average carrying value of the qualifying asset to the average total assets value (specific purpose borrowing cost and assets funded out of specific borrowings is to be excluded).

Serial No. (AS No.)	Provisions under the AS	Provisions notified under the TAS
	and, on activities that are necessary to prepare the asset for its intended use or sale • Borrowing costs relating to general borrowings are eligible for capitalisation and are computed by applying the weighted average rate of the borrowing cost to the cost of the asset(s) funded by non-specific borrowing.	
12. Accounting for Leases (AS-19)	• Does not provide for uniform classification of leases into operating and finance leases in the books of the lessor and the lessee • Includes provisions relating to sale and lease-back transactions • Requires cumulative fulfilment of specified indicators, in order to be classified as a finance lease • The lessor should recognise the asset as a receivable equal to net investment in lease. Finance income should be based on pattern reflecting a constant periodic return on net investment in lease	• Requires uniformity in classification of leases, to be demonstrated by a joint confirmation by the lessor and the lessee • Does not cover sale and lease-back transactions since these are specifically covered by the Act • In the case of the finance lease, the lessor is not entitled to depreciation and only the finance income component is to be treated as taxable income • Fulfilment of any one of certain specified indicators is sufficient to classify a lease as a finance lease. The indicators *inter alia* include ownership being transferred to a lessee at the end of the lease period, a lease term that is for the major part of the economic life, where the initial present value of lease payments substantially constitutes fair value, the lease is a specialised lease which is designed only for the use of the lessee, etc. • Minimum lease payments include only the residual value guaranteed by the lessee and not the value guaranteed by any third party.

Serial No. (AS No.)	Provisions under the AS	Provisions notified under the TAS
13. Intangible assets (AS-26)	• Intangible asset acquired in exchange for another asset, or for shares or other securities, shall be recorded at the fair market value of the asset/securities given up or at the fair value of the asset acquired, whichever is more clearly evident • Sets out treatment of amortisation, retirement and disposal of intangible assets, and intangible assets acquired on amalgamation • Includes goodwill arising on acquisition of a group of assets that constitute a business (e.g. in a slump sale) • Capitalisation of development costs is to be carried out only if the company establishes the commercial feasibility of the project • Stipulates that where the development phase of a project cannot be distinguished from the research phase, the entire costs are to be recognised as part of the research phase and are to be consequently charged as expense.	• To be recorded at lower of fair value of the asset/securities given up/acquired • Does not contain provisions on intangible assets acquired on amalgamation since this is specifically covered by the provisions of the Act • Excludes goodwill from the definition of intangible assets. While goodwill is excluded from the definition of intangible assets, it would need to be considered and examined as to whether the observations of the SC in the case of Smifs Securities Ltd [2012] 348 ITR 302 (SC) on availability of depreciation on goodwill acquired in the process of amalgamation be impacted. This would need to be considered and examined • For determining capitalisation of development cost, it is not necessary to establish commercial feasibility of the project • There is no provision which distinguishes a project's development phase from its research phase (unlike the AS where the entire costs are to be recognised in the research phase). The taxpayer would need to establish clearly whether the costs relate to the research phase or to the development phase.

Serial No. (AS No.)	Provisions under the AS	Provisions notified under the TAS
14. Provisions, contingent liabilities and contingent assets (AS-29)	• 'Provision' is to be recognised only when it is 'probable' that an outflow of economic resources will be required to settle an obligation • Recognition of a contingent asset is to be made only when its realisation is 'virtually certain' • Provides for recognising losses on onerous executory contracts (i.e. when neither party has performed any of its obligations, or when both the parties have partially performed their obligations in equal proportion).	• A provision would be recognised only when: a person has a present obligation as a result of a past event; it is reasonably certain that an outflow of resources embodying economic benefits will be required to settle the obligation; and a reliable estimate can be made of the amount of the obligation • Recognition of a contingent asset takes place in the year when it becomes reasonably certain that inflow of economic benefit will arise • Excludes all executory contracts and onerous contracts.

PwC Comments

While the intention of the TAS, according to its preamble, is to provide an independent and comprehensive frame work, to bring uniformity to the computation of taxable income under the Act, the fact that the TAS stipulates a different treatment for different items of income and expense from the AS, would give rise to additional computations and reconciliations for tax provisions and liabilities. While the draft TAS would undergo a public consultation process, it would need to be examined as to whether the recommendations are the only alternative and similarly under the Direct Taxes Code.

The TAS provides clarification on many tax positions and its implementation is therefore likely to reduce litigation in various significant areas, as has been stated by the Government.

It is also to be considered whether TAS has overturned recent judicial precedents of the SC in the cases of Woodward Governor India Pvt Ltd [2009] 312 ITR 254 (SC) (page no. 6 herein) and Smifs Securities Ltd [2012] 348 ITR 302 (SC) (page no. 9 herein). The requirement to maintain a fixed asset register by all assessees with business income may be an unintended hardship.

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