

## Revised ICDS VI dealing with forex rates changes - Impact and Open issues!

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### 1. Background:

The Central Government vide section 145 of the Income Tax, 1961 (the Act) is vested with the power to notify Income Computation and Disclosure Standards (ICDS) to be followed by taxpayers in respect of any class of income. In exercise of powers, only 2 Accounting Standards were initially notified. Subsequently, Central Government notified 10 ICDS with effect from FY 2015-16 with an objective to bring about consistency in computation of taxable income, reduce litigation and minimize alternatives provided by the existing Accounting Standards. However, concerns were raised regarding the scope and inconsistency in the treatment accorded as per ICDS vis vis the settled tax principles and the accounting treatment. Accordingly, taking cognizance of the same, the Central Government has deferred the applicability of ICDS to FY 2016-17 and has recently notified the amended ICDS, vide notification dated 29 September.

#### **Following principle issues arise on account of interpretation and applicability of ICDS:**

â-º Whether ICDS shall prevail in case of contradiction with the judgements of the Court(s)?

â-º Whether the method of tax accounting can enlarge/ alter the scope of income and expenditure?

â-º Whether the accounting treatment adopted in respect of the issues not dealt with by the ICDS shall continue to prevail?

The Supreme Court in case of Woodward Governor (312 ITR 254) has made a specific observation that the Central Government has the power to enact such standards and with the legislative sanction, principles of commercial accounting can be modified pursuant to notifications under section 145(2) of the Act. Thus, it can be said that the issues which were addressed by the Court(s) relying on principles of commercial accounting in the absence of specific guidance under the Act shall now have to adhere to ICDS [for e.g. mark to market loss (MTM loss)]. However, ICDS, being in the nature of computational provision, should not have effect in case of contradiction with settled tax principles (viz. Real Income theory, Capital expenditure, etc).

## **2. Scope of ICDS VI and changes:**

The present article, in the following paragraphs, discusses the impact and issues arising on implementation of ICDS VI - Effects of changes in foreign exchange rates. ICDS VI deals with:

- â-º Treatment of transactions in foreign currencies;
- â-º Translating the financial statements of foreign operations; and
- â-º Treatment of foreign currency transactions in the nature of forward exchange contracts.

### **Following are the changes in revised ICDS VI:**

ICDS VI has now done away with the distinction between Integral and Non-Integral Foreign Operations. Accordingly, for tax purposes, ICDS provisions governing the treatment of Non-Integral foreign operations have now been brought at par with that of Integral financial operations.

Additionally, ICDS VI has now clarified that inventory which is carried at the Net Realisable Value (NRV) denominated in foreign currency should be reported using the exchange rate when such value was determined which is in line with reporting requirement prescribed by AS-11 and Ind AS 21.

## **3. Comparative Snapshot:**

Having regard to the above, comprehensive snapshot of the treatment in respect of items/ events is tabulated as follows:

Particulars		AS 11	Ind AS 21/ 109	ICDS - VI
Initial Recognition		Exchange rate on the date of transaction (or) Weekly/ monthly average rate		
<b>Translation on reporting date and its treatment</b>				
		<b>NIFO*</b>	<b>IFO*</b>	
Reporting at Balance Sheet date	Monetary Items (eg. Cash, trade payable, etc.)	Closing rate		
	Non-Monetary Items (eg. Fixed assets, inventory, etc.)	Closing rate	Exchange Rate on the date of transaction/ on the date on which Fair Value was determined	<p>â-° For reporting in presentation currency - Closing Rate</p> <p>â-° For reporting in functional currency - Exchange Rate on the date of transaction/ on the date on which Fair Value is determined</p> <p><b>Exchange rate on transaction date;</b> except in case of inventory valued at NRV - rate on the date on which the NRV is determined</p>
Foreign Exchange difference	Monetary Items	Transfer to FCTR until disposal of the investment <sup>#</sup>	Recognized as income/ expense <sup>#</sup>	<p>Differences arising on functional currency shall be recognised as income/expense in P&amp;L. Changes in presentation currency shall be recognised, as income/ expense in Other Comprehensive Income (OCI)<sup>#</sup></p> <p><b>Recognized as income/ expense,</b> subject to the provisions of section 43A or Rule 115 of the Income Tax Rules, 1962</p>
	Non-Monetary items		Recognized as income/ expense	<p>Difference - on functional currency recognized as income/ expense; on presentation currency recognized in OCI, transferred to P&amp;L on disposal of investment</p> <p><b>Not recognized as income/ expense</b></p>

\*NIFO - Non-Integral foreign operation(s); IFO - Integral foreign operation(s)

<sup>#</sup>Except in case of long term foreign currency monetary items where option under Para 46A of AS- 11 has been exercised

Particulars	AS 11	Ind AS 21/ 109	ICDS - VI
<b>Treatment in respect of Forward Contracts</b>			
Other than Trading/ Speculation/ Contracts	â-° Premium/discount; amortized over the life of	Accounted for in terms of Ind AS 109; Following is	â-° Premium/discount; amortized over the life of

hedge foreign currency risk on firm commitments or a highly probable forecast transaction	the contract â-º Foreign exchange difference on the contract to be recognised in the year in which exchange rate changes â-º Gain or loss on cancellation and renewal recognized as income/expense of that year	the generic treatment subject to satisfaction of fair value hedge conditions MTM gains/ losses recognized as income/expense in P&L	the contract â-º Foreign exchange difference on the contract to be recognised in the year in which exchange rate changes â-º Gain or loss on cancellation and renewal recognized as income/expense of that year
Meant for Trading/ Speculation purposes	Premium/ discount on the contract is ignored; and at each balance sheet date, the value of the contract is marked to its current market value and gains or loss on the contract is recognised	MTM gains/ losses recognized as income/expense in P&L	Premium/ discount/ exchange differences accounted for <b>on settlement basis</b>
To hedge foreign currency risk on firm commitments or a highly probable forecast transaction	MTM losses are accounted and MTM gains are ignored	Generally regarded as cash flow hedge: MTM gains/ losses recognized as income/expense in OCI	Premium/ discount/ exchange differences accounted for <b>on settlement basis</b>

### Thus, broadly difference between existing AS vis vis ICDS arises on account of the following:

â-º Exchange difference on monetary items relating to NIFO is recognized as income or expense as per ICDS; whereas such difference in books is recorded in FCTR and recognized as income or expense in the year of disposal of investment;

â-º Exchange difference on non-monetary items relating to NIFO is recognized as income or expense as per books of account in the year of disposal; whereas such difference is not recognized under ICDS;

â-º Exchange difference on Non-Monetary assets of IFO is recognized as income/ expense in the Profit & Loss Account; whereas such difference is not recognized under ICDS; and

â-º MTM gains/ loss on forward contracts in the nature of firm commitments and highly probable forecast transactions and trading/ speculation contracts shall be allowed on a settlement basis under ICDS; whereas allowed on MTM basis under AS.

### 4. Key open issues:

â-º **No distinction between capital and revenue items:**

Section 43A of the Act provides for adjustment to the written down value (WDV) of realized foreign exchange loss/ gain arising on account of repayment of loan/ creditor including interest thereon raised for purchase of assets from outside India. The effect is that any such exchange difference in the Profit & Loss Account is excluded from taxable profits by way of adjustment in tax computation and is adjusted in

the WDV of such assets. While section 43A only covers adjustment on account of imported assets, as a matter of principle any such exchange difference even arising on account of loan or interest or creditor repayment for indigenous asset is also excluded from taxable profits but no adjustment is made in the WDV of the asset in absence of applicability of section 43A.

While applicability of ICDS VI is subject to section 43A, it remains silent on the treatment of exchange differences which can be regarded as capital in nature.

#### â-º **MTM loss on derivative contracts:**

ICDS VI does not provide for any specific treatment of MTM gains/ loss on derivative contracts like cross currency swaps, futures, interest rate swaps, etc. However, ICDS I states that MTM loss or expected loss shall not be allowed except as provided in any other ICDS.

#### â-º **Treatment of balance in the FCTR maintained in respect of NIFO under AS 11 as on 31 March 2016:**

ICDS VI, applicable post 1 April 2016, specifically provides for treating exchange difference relating to monetary items as income/ expense in the Profit and Loss Account, irrespective of whether it relates to IFO/ NIFO.

Until 31 March 2016, the taxpayer would have accounted such exchange difference in the FCTR relating to NIFO. The transitional provision in this regard states that exchange differences arising in respect of monetary or nonmonetary items, on settlement during FY 2016-17 or conversion as on last day from FY 2016-17 onwards, shall be recognised in accordance with provisions of this standard after taking into account the amount recognised as on 31 March 2016. Logically, since ICDS is applicable prospectively from FY 2016-17 onwards, the accumulated amount in FCTR until 31 March 2016 should not be taxed during FY 2016-17. However, considering the language it remains ambiguous whether such accumulated amount should not be treated as income/ expense for FY 2016-17 (especially considering the language in transitional provision relating to forward contracts).

The response of the CBDT in deferring the applicability of ICDS by one year, taking into consideration the concerns of the taxpayer and coming out with amended ICDS is much appreciated. Amongst the changes noted above, removal of distinction between Integral and Non-integral foreign operations reduces subjectivity.

However, it is to be seen if the above issues will also be clarified in due course. The applicability and specific reporting of differences in Tax Audit Report necessitates capturing appropriate information in the current system especially in case of large corporates and maintaining reconciliation for differences to capture consequential impact in subsequent years.