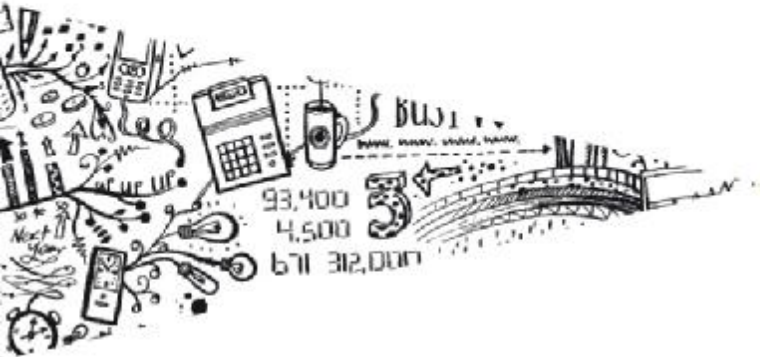


20 October 2011

EY Tax Alert

Central Government issues Discussion Paper on Tax Accounting Standards



Executive summary

This Tax Alert summarizes the Discussion Paper on Tax Accounting Standards (Tax AS) issued by the Central Government (CG) on 17 October 2011.

Section 145 of the Indian Tax Laws (ITL) gives power to the CG to notify Tax AS to be followed by any class of taxpayers or in respect of any income. So far, the CG has notified two Tax AS in 1996 viz., (a) Accounting Standard I, relating to disclosure of accounting policies. (b) Accounting Standard II, relating to disclosure of Prior Period and Extraordinary Items and changes in accounting policies.

In view of significant developments on convergence to International Financial Reporting Standards (IFRS), the CG constituted a new Accounting Standards Committee (new Committee) in December 2010, comprising officials of the Tax Authority and professionals. The terms of reference of the new Committee was to study the harmonization of accounting standards issued by the Institute of Chartered Accountants of India^[1] (ICAI AS) with the ITL and to suggest accounting standards for tax compliance under the ITL and also to deal with the issue of the tax impact of convergence to IFRS.

The new Committee has recommended a notification of separate Tax AS for compliance with the ITL on the issue of harmonization of ICAI AS with the ITL and has provided drafts of two Tax AS viz., (i) Construction Contracts (ii) Government Grants. Drafts of other Tax AS will be issued in due course. However, it has recommended that the taxpayers should not be

burdened with the maintenance of two sets of books for corporate law and tax purposes, in accordance with the respective accounting standards. The compliance of Tax AS can be made by preparing a reconciliation statement between the income as per financial statements and income as per application of Tax AS.

The CG has invited comments/suggestions on the recommendations of the new Committee and draft Tax AS by 11 November 2011.

Background

Section 145 of the ITL provides that the taxable income of the taxpayer under the heads 'Profit and gains of business or profession' (Business head) or 'Income from other sources' (Other sources head) shall be computed in accordance with either cash or mercantile system of accounting that is regularly employed by the taxpayer. It further provides that the CG may notify in the Official Gazette, from time to time, (Tax AS to be followed by any class of taxpayers or in respect of any income. If the Tax Authority is not satisfied about the correctness or completeness of the taxpayer's accounts or if the method of accounting (viz., cash or mercantile) or Tax AS has not been regularly followed by the taxpayer, the Tax Authority can make an assessment to the best of its judgment, in terms of other provisions of the ITL.

The object behind introducing a provision to notify separate Tax AS was that ICAI AS provide flexibility of alternative accounting treatments, which make it possible for a taxpayer to avoid payment of correct taxes by choosing a particular system. Therefore, an urgent need was felt to standardize one or more of the

alternatives in various standards so that income for tax purposes could be computed precisely and objectively.

Since the introduction of this provision in the ITL, the CG has notified two Tax AS in 1996^[2] viz., (a) Accounting Standard I, relating to disclosure of accounting policies (b) Accounting Standard II, relating to disclosure of Prior Period and Extraordinary Items and changes in accounting policies. These standards are largely comparable to AS-1 and AS-5 of the ICAI, respectively.

The 2002 Committee recommendations

In July 2002, the CG constituted a committee on formulation of Tax AS (2002 Committee), which submitted its final report in November 2003. The main recommendations of the 2002 Committee were:

- (i) To avoid putting compliance burden on the taxpayer to follow two different sets of accounting standards, ICAI AS should be notified under the ITL without any modifications.
- (ii) Appropriate legislative amendments should be made in the ITL to prevent scope for leakage of revenue on account of adoption of ICAI AS for tax purpose.

The CG could not implement the recommendations of the 2002 Committee on account of the following:

^[1] Apex accounting regulatory body in India

^[2] Notification No. 9949 dated 25 January 1996

a. The implementation of the 2002 Committee recommendations involved extensive amendments to the ITL, leading to complexity and litigation and, thus, negating the very object of achieving certainty by notifying separate Tax AS.

b. Since ICAI AS keep evolving/changing by way of issue of new accounting standards, it would be cumbersome for the CG to keep track of all changes in ICAI AS and move simultaneous amendments in the ITL.

Significant developments since the 2002 Committee recommendations

Furthermore, post the issue of the 2002 Committee report, there were certain significant developments, as follows:

i. The CG notified 28 ICAI AS under the Indian Corporate Laws (ICL) for the purpose of compliance by companies. It is mandatory for companies to adopt these standards while preparing their financial statements in compliance with the ICL.

ii. The CG decided to converge ICAI AS with IFRS and placed 35 converged accounting standards (IND AS) on its website.

iii. In the absence of ITL-specific accounting standards, uncertainty and litigation continue on various accounting-related issues, such as

accounting for construction contracts, foreign exchange fluctuations and Government grants.

Constitution of the new Committee

Therefore, vide an Order^[3] dated 20 December 2010, the CG constituted a new Committee, comprising officials of the Tax Authority and professionals, with the following terms of reference:

i. To study the harmonization of ICAI AS with the ITL and to suggest accounting standards for tax compliance under the ITL, with relevant modifications.

ii. To suggest a method for determination of tax base (book profit) for the purpose of Minimum Alternate Tax in case of companies migrating to IND AS in the initial year of adoption and thereafter.

iii. To suggest appropriate amendments to the ITL in view of transition to IND AS regime.

Interim Report of the new Committee

The new Committee submitted its interim report in August 2011. Its main recommendations with regard

^[3] Order No. 134/48/2010-SO(TPL)

to the first term of reference viz., harmonization of ICAI AS with the ITL and suggestion of accounting standards for tax compliance were as follows:

1. ICAI AS cannot be notified without modification for the purpose of tax compliance since they are not in harmony with the ITL. Hence, separate Tax AS should be notified which should provide specific rules enabling computation of income with certainty and clarity. To ensure horizontal equity and uniformity, Tax AS should eliminate alternatives for differing accounting treatment, as far as possible.

2. It would be burdensome for the taxpayer to maintain two separate books of account for corporate law and tax compliance purposes, in accordance with the respective accounting standards. Accordingly, Tax AS should be made applicable only for computation of taxable income and the taxpayer should not be required to maintain books of account on the basis of Tax AS.

3. Two different sets of accounting standards may cause confusion for the taxpayers and other stakeholders. Accordingly, Tax AS should be termed as 'Tax Accounting Standards' to distinguish them from ICAI AS or accounting standards relevant for compliance with the ICL.

4. Since Tax AS are based on the mercantile system of accounting, they should be applicable to those taxpayers following mercantile system of accounting only and should not be applicable to those taxpayers following cash system of accounting.

5. Since Tax AS are intended to be in harmony with the ITL, they should, specifically, provide that, in case of conflict between the ITL provisions and Tax AS, the ITL provisions shall prevail.

6. Currently, the starting point for computation of taxable income under Business head or Other sources head is the income as per financial statements. Since Tax AS may not correspond with accounting standards used for preparation of financial statements, reconciliation between income as per financial statements and income computed as per Tax AS should be presented.

Draft Tax AS on Construction Contracts and Government Grants

Drafts of Tax AS on Construction Contracts and Government Grants, as recommended by the new Committee, are annexed to the Discussion Paper. Drafts of other Tax AS will be issued in due course. The CG has invited comments/suggestions on the recommendations of the new Committee and draft Tax AS by 11 November 2011, which may be mailed to dirtpl3@nic.in.

A comparison of the significant features of the draft Tax AS on Construction Contracts and Government Grants, IND AS and ICAI AS is annexed in Appendix A to this Tax Alert.

On Construction Contracts, the Tax AS deviates from IND AS (Ind AS-11) and ICAI AS (AS-7) in the matter of

recognition of expected loss on construction contracts, by not permitting recognition of such loss. Tax AS provides a quantitative threshold of 25% for determining early stage of a contract, whereas IND AS and ICAI AS do not lay down any such quantitative threshold. Tax AS is silent on its applicability to real estate developers and infrastructure service concession agreements.

On Government grants, Tax AS is more aligned to ICAI AS (AS-12), subject to certain deviations. Tax AS requires capital Government grants, not directly relatable to any assets, to be reduced from the actual cost or written-down value (WDV) of the assets on pro-rata basis, which is in line with the specific provision of the ITL, unlike ICAI AS which requires it to be credited to capital reserve. Furthermore, Tax AS does not expressly permit grants in the nature of promoter's contribution to be credited to capital reserve and they are required to be recognized as income on a systematic basis over a period matching with related costs.

Comments

The tax impact of convergence to IFRS is one of the principal issues occupying the attention of the CG. One of the reasons for keeping the implementation of IND AS in abeyance, despite the CG's earlier commitment^[4] to converge from 1 April 2011, is reportedly the ambiguity surrounding the approach to be adopted for computation of taxable income from financial statements prepared on the basis of IND AS which

^[4]Press Release of Ministry of Corporate Affairs in May 2008

requires fair valuation of significant items of assets and liabilities.

On 13 December 2010, the ICAI made a recommendation in the form of a Position Paper to the CG suggesting four alternative approaches for resolution of the issue, in the light of the object of achieving tax neutrality of the convergence process. The constitution of the new Committee represents another attempt of the CG to search for an acceptable alternative which matches the competing considerations of clarity, certainty and ease of compliance for the taxpayers and protection of revenue base for the Tax Authority.

It needs to be noted that the recommendations covered by the present Discussion Paper and the draft Tax AS are in the context of the first term of reference of the new Committee viz., harmonization of ICAI AS with the ITL and suggestion of accounting standards for tax compliance. As it appears, the resolution of the issue of convergence to IFRS is still under consideration of the new Committee.

The recommendation of the new Committee of not burdening the taxpayers with the maintenance of two sets of books for corporate law and tax compliance purposes will be welcomed by the taxpayers. The areas of concern will, however, be the differences between ICAI AS, IND AS and Tax AS, which will increase the compliance burden of the taxpayers by way of preparation of a reconciliation statement. Also, the impact of such a requirement on small taxpayers needs to be looked into.

Appendix A

Comparison statement between Ind AS, ICAI Accounting Standard (ICAI AS) and Tax Accounting Standards (Tax AS) on (i) Construction Contracts (ii) Government Grants

This comparison does not attempt to capture all the differences between Ind AS, ICAI AS and Tax AS or the impact on transition to either Tax AS or Ind AS, that exist or that may be material to a particular entity's financial statements. Our focus is on differences or impacts that are commonly found in practice. The existence of any differences, and their materiality to an entity's financial statements, depends on a variety of specific factors, including, among others, the nature of the entity, an entity's interpretation of the more general Ind AS or ICAI AS principles, industry practices and accounting policy elections required under either ICAI AS or Ind AS. Accordingly, we recommend that readers seek appropriate advice regarding any specific issues that they encounter. This comparative statement should not be relied on as a substitute for reading Ind AS, ICAI AS or Tax AS. Before reaching any conclusion as to how your specific company may be affected by a change to Ind AS or Tax AS, you should consider your specific facts and circumstances and then consult with professional advisors familiar with your particular factual situation for advice.

This comparison does not cover differences arising from the ICAI's Expert Advisory Committee opinions, regulatory and practice-related differences.

Ind AS	ICAI AS	Tax AS
Construction Contracts		
1. Contract revenue		
Contract revenue is measured at the fair value of the consideration received or receivable.	AS-7 explains contract revenue. Contract revenue is measured at the consideration received or receivable. In other words, there is no need to measure contract revenue at fair value in this case.	Contract revenue measurement in Tax AS is similar to that under AS-7. However, Tax AS doesn't contain additional guidance that is provided under AS-7 on issues such as contract variation, customer claims and incentive payments. In addition, Tax AS clarifies that, where contract revenue already recognized as income is, subsequently, written off when they are uncollectible, it shall be recognized as expense, rather than as an adjustment to contract revenue.
2. Conditions when outcome of construction contract can be estimated reliably		
Ind AS-11 requires certain conditions to be satisfied for the outcome of fixed price contracts and cost	AS-7 is similar to Ind AS-11.	Tax AS does not lay down any such conditions.

plus contracts to be estimated reliably.		
3. Expected loss on construction contracts		
Ind AS-11 states that, when it is probable that total contract cost will exceed total contract revenue, the expected loss should be immediately recognized as an expense.	AS-7 is similar to Ind AS-11.	Tax AS does not require or permit expense recognition of such expected loss.
4. Early stage/when outcome of a contract cannot be reliably measured		
Under Ind AS-11, when the outcome of a construction contract cannot be estimated reliably: a) Revenue shall be recognized only to the extent of contract costs incurred that it is probable will be recoverable. b) Contract costs shall be recognized as an expense in the period in which they are incurred. There is no quantitative threshold laid down for	AS-7 is similar to Ind AS-11.	Tax AS states that during early stages of a contract, where outcome of construction contract cannot be reliably measured, contract revenue is recognized only to the extent of cost incurred. Furthermore, it states that the early stage of a contract shall not extend beyond 25% of the stage of completion.

determining the stage of completion until when the outcome of a contract cannot be reliably measured.		
5.Other specific issues		
i) Real estate		
Ind AS-11, specifically, applies to accounting in the financial statements of real estate developers. Consequently, they will need to recognize revenue by reference to the stage of completion of the real estate project in cases where an agreement for sale of real estate has been entered into before the construction is complete.	AS-7 does not deal with recognition of revenue by real estate developer. There is a separate Guidance Note issued by the ICAI on this subject.	Tax AS states that it is applied in determination of income for construction of a contractor. The standard is silent on whether it applies to real estate developer.
ii) Service concession arrangements		
Appendix A to Ind AS-11, regarding service concession arrangement, applies to accounting by operators for public-to-private service concession arrangements. Appendix B to Ind AS-11 addresses	AS-7 does not contain any specific guidance on accounting for service concession arrangements. The ICAI had earlier issued an exposure draft of the 'Guidance Note on	Tax AS is silent on whether it applies to service concession arrangements.

additional disclosures for service concession arrangements. It should, however, be noted that notification of Appendix A and Appendix B to Ind AS-11 has been deferred. The effective date for their implementation will be announced separately.	Accounting for Service Concession Arrangements' which laid similar accounting and disclosures for service concession arrangements as in Appendix A and Appendix B to Ind AS-11. However, the Exposure Draft has not been issued as a final Guidance Note. Consequently, Indian infrastructure entities may be following varying practices with regard to accounting for such arrangements.	
Accounting for Government Grants		
1.Government assistance		
Ind AS-20 deals with disclosure of Government assistance. It requires an entity to give an indication of the Government assistance (other than in the form of Government grants) from which it has directly benefited.	AS-12 does not deal with the accounting for Government assistance other than in the form of Government grants.	Tax AS also does not deal with the accounting for Government assistance other than in the form of Government grants.

2.Recognition of Government grants		
Ind AS-20 states that Government grants shall not be recognized until there is reasonable assurance that the entity will comply with the conditions attached to them and the grants will be received. Grant recognition does not depend on actual receipt.	The recognition criteria under AS-12 are similar to those under Ind AS-20.	The recognition criteria under Tax AS are similar to those under AS-7. The Standard further states that recognition shall not be postponed beyond the date of actual receipt.
3.Grants related to assets		
Ind AS-20 requires a depreciable asset-related grant to be presented in the balance sheet by setting up the grant as deferred income. The grant set up as deferred income is recognized in the profit or loss on a systematic basis over the useful life of the asset. Grants related to non-depreciable assets, which require the fulfillment of certain obligations, are recognized in	Government grants related to specific depreciable fixed assets should be presented in the balance sheet by showing the grant as a deduction from the gross value of the assets concerned in arriving at their book value. Where the grant related to a specific fixed asset equals the whole, or virtually the whole, of the cost of the asset, the asset should be shown in the	Grants related to depreciable assets are required to be deducted from cost of the asset(s) or from the WDV of block of assets to which concerned asset(s) belong. Grants related to non-depreciable asset(s), which require the fulfillment of certain obligations, are recognized as income over the same periods over which the cost of meeting the obligations is

profit or loss over the periods that bear the cost of meeting the obligations.	balance sheet at a nominal value. Alternatively, Government grants related to depreciable fixed assets may be treated as deferred income, which should be recognized in the profit or loss on a systematic and rational basis over the useful life of the asset. Grants related to non-depreciable assets are credited to capital reserve. However, if a grant related to a non-depreciable asset requires the fulfillment of certain obligations, the grant should be credited to income over the same period over which the cost of meeting such obligations is charged to income.	charged to income. Where the grant is of such a nature that it cannot be directly relatable to the asset acquired, so much of the amount which bears to the total grant, the same proportion as such asset bears to all the assets in respect of or with reference to which the grant is so received, shall be deducted from the actual cost of the asset or shall be reduced from the WDV of the block of assets to which the asset or assets belonged to.
4.Revenue Grants		
Grants related to income are presented in the statement of profit and loss, either separately	Government grants related to revenue are recognized on a systematic basis in the	Grants other than those related to assets or those receivable as compensation

or under a general heading such as 'Other income'. Alternatively, they are deducted in reporting the related expense.	profit and loss statement over the periods necessary to match them with the related costs which they are intended to compensate. Such grants are either shown separately under 'Other income' or deducted in reporting the related expense.	for expense or losses or for the purpose of giving immediate financial support to the person with no further related cost, shall be recognized as income over the periods necessary to match them with the related costs which they intend to compensate.
5.Grants in the form of non-monetary assets		
Ind AS-20 requires entities to account for Government grants in the form of non-monetary assets at their fair value.	AS-12 requires Government grants in the form of non-monetary assets, given at a concessional rate, to be accounted for on the basis of their acquisition cost only. If a non-monetary asset is given free of cost, it should be recorded at a nominal value.	Tax AS requires Government grants in the form of non-monetary assets, given at a concessional rate, to be accounted for on the basis of their acquisition cost only.
6.Grants in the nature of promoter's contribution		
Ind AS-20 does not recognize the concept of	AS-12 requires certain grants viz., grants in the	Tax AS does not contain guidance

recognizing grants directly in reserves. Government grants will be recognized as income over the periods necessary to match them with the related costs which they are intended to compensate, on a systematic basis. They cannot be credited directly to shareholders' interests.	nature of promoter's contribution and grants related to non-depreciable assets, which do not have any conditions attached to them, to be recognized directly in 'capital reserve' which is a part of the 'shareholders' funds'.	requiring recognition of grants directly in reserves. Government grants will be recognized as income over the periods necessary to match them with the related costs which they are intended to compensate, on a systematic basis. They cannot be credited directly to shareholders' interests.
7. Refund of asset-related grants		
Repayment of a grant related to an asset shall be recognized by reducing the deferred income balance by the amount repayable.	The amount refundable in respect of a grant related to a specific fixed asset should be recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred income balance, as appropriate, by the amount refundable. In the first alternative i.e., where the book value of the	The amount refundable in respect of a grant related to asset(s) should be recorded by increasing the actual cost or WDV of block of assets by the amount refundable. Where actual cost of the asset is increased, depreciation on the revised actual cost or WDV shall be

	asset is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset.	provided prospectively at prescribed rates.
8. Disclosures		
Ind AS-20 requires additional disclosure of unfulfilled conditions and other contingencies attached to Government assistance that have been recognized. It also requires an indication of other forms of Government assistance from which the entity has directly benefited to be disclosed in the financial statements.	AS-12 does not require any such additional disclosure.	Tax AS does not require such additional disclosure. However, it additionally requires disclosure of nature and extent of grants not recognized during a year.

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