



Income Computation and Disclosure Standards (ICDS)

A comprehensive technical framework for of tax-specific income computation under the Income-tax Act, 1961

TAX ACCOUNTING

CA-LEVEL TRAINING

Agenda

What We Cover Today

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Foundation

Legislative genesis, philosophy, and structural framework of ICDS

03

ICDS VI–X

Forex, Government Grants, Securities, Borrowing Costs, Provisions

02

ICDS I–V

Accounting Policies, Inventories, Construction Contracts, Revenue Recognition, Fixed Assets

04

Audit & Practice

Tax audit obligations, litigation areas, and practical implications



What Is ICDS?

A **tax-specific computation framework** notified by the Central Government under **Section 145(2)** of the Income-tax Act, 1961. ICDS standardizes income computation under **Profits & Gains of Business or Profession** and **Income from Other Sources** — not for preparation of financial statements.

Accrual-Based Taxation

Systematic recognition irrespective of receipt

Certainty of Collection

Reduces timing arbitrage and deferment

Uniformity

Standardized recognition across assesseees

Minimal Subjectivity

Restricts conservative accounting choices

Legislative Genesis: Section 145

Section 145(1)

Income chargeable under PGBP or IFOS shall be computed in accordance with either the **cash system** or the **mercantile system** of accounting regularly employed by the assessee.

- ① ICDS supplements the computation methodology — it does not govern maintenance of books of account.

Section 145(2)

Empowers the Central Government to notify **Income Computation and Disclosure Standards** to be followed by assesseees.

Notified via **CBDT Notification No. 32/2015** dated 31 March 2015, initially as Tax Accounting Standards (TAS), later formalized as ICDS.

Fundamental Philosophy

"Taxability over Conservatism"

Financial Reporting Prioritizes

- True and fair view for stakeholders
- Prudence and conservatism
- Recognition of anticipated losses

ICDS Prioritizes

- Certainty of taxation revenue
- Accelerated accrual recognition
- Restriction of anticipated loss provisions

The 10 ICDS Standards

ICDS	Subject	AS Equivalent
I	Accounting Policies	AS-1
II	Valuation of Inventories	AS-2
III	Construction Contracts	AS-7
IV	Revenue Recognition	AS-9
V	Tangible Fixed Assets	AS-10
VI	Effects of Changes in Foreign Exchange Rates	AS-11
VII	Government Grants	AS-12
VIII	Securities	AS-13 (partial)
IX	Borrowing Costs	AS-16
X	Provisions, Contingent Liabilities & Assets	AS-29

Books vs. ICDS: A Critical Distinction

Book Profit \neq Taxable Profit. This gap is the core of ICDS compliance and drives tax audit obligations.

Area	Books (AS / Ind AS)	ICDS Computation
Objective	True & Fair View	Tax Computation
Prudence	High	Restricted
Materiality	Fundamental	Omitted
Expected Losses	Often recognized	Generally disallowed
MTM Losses	Wider recognition	Restricted
Revenue Deferment	Possible	Limited

 Differences lead to ICDS adjustments, deferred tax implications, and mandatory disclosures in Form 3CD – Clause 13(d).

Constitutional Validity & Judicial Position

"ICDS cannot override the Income-tax Act or binding Supreme Court judgments — but remains constitutionally valid as a computation mechanism."

— Delhi High Court, *Chamber of Tax Consultants v. Union of India*

Practical Hierarchy



- 1 ICDS
Computation framework
- 2 Judicial Precedents
Binding on ICDS application
- 3 Income-tax Act, 1961
Supreme authority

ICDS I

Accounting Policies

ICDS I is **foundational** — all other ICDS operate subject to its principles. It standardizes accounting policy application for tax purposes, restricts excessive prudence, and aligns taxable income with statutory accrual principles.



ICDS I: Three Fundamental Assumptions



Going Concern

Assets and liabilities valued assuming continuing operations, not liquidation or forced sale basis.



Consistency

Accounting policies followed consistently year to year. Prevents opportunistic method changes to reduce tax.



Accrual

Income and expenditure recognized when accrued — not merely when received or paid. Interest accrued but unpaid is taxable.

❏ If these assumptions are followed, no disclosure is required. Non-compliance mandates disclosure in Form 3CD.

ICDS I: The Prudence Controversy

Traditional Accounting

"Anticipate losses, do not anticipate profits" — prudence is a fundamental pillar of financial reporting under AS and Ind AS.

ICDS I Position

Prudence is **substantially restricted**. Expected losses and mark-to-market (MTM) losses are **not recognized** unless expressly permitted under another ICDS.

- Contingent provisions generally disallowed
- MTM losses controlled (permitted only if ICDS VI allows)
- Materiality concept **deliberately omitted**

Valuation of Inventories



Core Principle

Inventory shall be valued at the **lower of Cost or Net Realisable Value (NRV)**.

Cost includes:

- Cost of purchase (net of recoverable taxes)
- Cost of conversion (direct labour + systematic overhead allocation)
- Other directly attributable costs



Abnormal wastage, idle capacity losses, and selling costs are **excluded** from inventory cost.

ICDS II: Key Technical Points

Permitted Cost Formulas

FIFO, Weighted Average, Standard Cost (if approximate), Retail Method. LIFO is **not permitted**.

Normal Capacity Overheads

Fixed production overheads allocated based on **normal capacity**. Unabsorbed overheads due to low actual production are expensed — not capitalized.

Inventory on Dissolution

Valued at **NRV** regardless of whether business is discontinued — overriding the earlier Shakti Trading Co. judicial position for tax computation.

Section 145A Interaction

Non-recoverable taxes, duties, and cess are **included** in inventory cost. Recoverable GST (ITC available) is excluded.



ICDS III

Construction Contracts

ICDS III mandates the **Percentage of Completion Method (POCM)** for all construction contracts. The **completed contract method is not permitted** — ensuring progressive, accrual-based taxation of long-term projects.

ICDS III: POCM Mechanics & Early Stage Rule

Stage of Completion

Typically computed as:

$$\text{Costs Incurred} \div \text{Total Estimated Costs} \times 100$$

Alternative methods (surveys, physical completion, technical certification) are permitted where appropriate.

- ① Contract revenue includes initial amount, approved variations, claims (when crystallization is reasonably certain), and incentive payments.

Critical: <25% Threshold

Where stage of completion is below 25%, revenue is recognized only to the extent of costs incurred — **no profit is recognized.**

Stage	Treatment
Below 25%	Revenue = Costs only; Profit = Nil
25% and above	Normal POCM profit recognition

ICDS III: Foreseeable Losses — A Critical Departure

AS-7 Position

Expected / foreseeable losses on construction contracts are recognized **immediately** in the period they are identified — prudence prevails.

ICDS III Position

Foreseeable and expected losses are **NOT allowed as a deduction** unless they are actually incurred. Only costs actually incurred during the year are deductible — no prospective provisioning permitted.

- ⊗ This is the most significant practical deviation between AS-7 and ICDS III, generating recurring litigation for EPC, infrastructure, and real estate contractors.

Revenue Recognition



Sale of Goods

Recognized when significant risks & rewards transfer and no significant uncertainty exists in collection.



Rendering of Services

Mandatory **POCM** (except contracts ≤ 90 days or indeterminate acts). $< 25\%$ threshold applies here too.



Interest

Recognized on **time proportion** basis — accrues with passage of time irrespective of receipt or invoicing.



Royalty & Dividend

Royalty recognized per agreement terms on accrual. Dividend recognized when right to receive is established.

ICDS IV: Revenue Recognition — Practical Issues

Area	ICDS IV	AS-9 / Ind AS 115
Services methodology	Mandatory POCM	Flexible / Performance obligations
Early-stage profits	Restricted (<25%)	No such restriction
Revenue reversal	Discouraged	Permitted in some cases
Prudence	Restricted	Significant
Variable consideration	Simplified	Extensive / Detailed

⚠ Interest on NPAs remains a contested area — ICDS IV does not expressly override RBI prudential norms or the real income doctrine (UCO Bank v. CIT).

Tangible Fixed Assets



Core Principle: Actual Cost

Tangible fixed assets recorded at **actual cost** — comprising purchase price, import duties, non-refundable taxes, freight, installation, site preparation, and directly attributable costs to bring the asset to working condition.

- Trial run expenses (net of trial run revenue) — **capitalized**
- Staff training costs — **revenue expenditure**
- Recoverable GST (ITC available) — **excluded**
- Revaluation increments — **ignored for tax purposes**

ICDS V: Capital vs. Revenue — The Core Test

Capitalize If

Increases future economic benefits or capacity

Improves efficiency or extends useful life

Borrowing costs on qualifying assets (ICDS IX)

Revenue Deduction If

Merely maintains existing efficiency

Restores original condition without improvement

General administration overheads not directly attributable

i Judicial principles — enduring benefit test (Empire Jute Co.), commercial expediency — continue to apply alongside ICDS V.

ICDS VI

Effects of Changes in Foreign Exchange Rates

ICDS VI governs foreign currency transactions, translation of foreign operations, and forward exchange contracts for tax computation. The fundamental distinction is between **monetary items** (translated at closing rate) and **non-monetary items** (retained at historical cost).



	USD - EUR	EUR - CUPY	LEM - GKTYR	ORVER - SIOP	EUR - CRV
USD/EUR	1.0945	1.0945	1.0844	1.0945	0.8720
USD/GBP	1.0945	1.2743	1.2644	1.0943	0.0921
USD/GBP	1.5525	1.2743	1.5723	1.2746	0.5724
USD/GBP	1.0943	1.2643	1.2624	0.0644	1.0961
USD/JPY	1.0945	1.2744	1.5624	1.2843	1.0945
EUR/SUR	1.0845	1.2743	1.3324	0.3344	1.2751
EUR/JPY	1.0925	1.2755	1.2424	0.0951	0.0984
EUR/GBP	1.0945	1.2743	1.0723	1.3676	1.2724
EUR/GBP	1.0374	1.8743	1.5624	0.0641	2.0731
EUR/CDY	0.2745	1.0545	1.2424	0.2721	0.8721



ICDS VI: Monetary vs. Non-Monetary Items

Monetary Items → Closing Rate

Items receivable/payable in fixed or determinable money: debtors, creditors, loans, bank balances.

Year-end exchange difference: Mandatorily recognized as income or expense — accelerating MTM adjustment for monetary items.

- ✔ MTM adjustment on monetary items is mandatory — codifying the Woodward Governor principle.

Non-Monetary Items → Historical Rate

Fixed assets, inventory at historical cost, equity investments — **not restated** at year-end closing rate.

Item	Rate Applied
Foreign debtor	Closing rate
Imported machinery	Historical rate
Foreign currency loan	Closing rate
Inventory (historical)	Historical rate

Government Grants



Recognition Threshold

Government grants are recognized only when there is **reasonable certainty** that conditions will be complied with **and** the grant will be received. Accrual, not receipt, governs timing.

Grant Type	Tax Treatment
Depreciable asset grant	Reduce actual cost / WDV
Revenue grant	Income matched with related cost
Promoter contribution	Capital receipt — no cost reduction
Compensation grant	Recognize immediately when receivable

ICDS VII: The Purpose Test

The landmark **Ponni Sugars (Supreme Court)** ruling established the purpose test — still relevant alongside ICDS VII:

Capital Receipt


Subsidy granted to assist in **setting up or establishing** the industry / total investment. Not linked to operational performance.

Example: Promoter contribution grants

Revenue Receipt

Subsidy granted to assist in **operations, profits, or ongoing costs**. Compensates for revenue expenditure incurred.

Example: Salary reimbursement grants, power subsidies

 Interaction with Explanation 10 to Section 43(1) — where subsidy directly relates to asset acquisition, it **must reduce** the actual cost for depreciation purposes.

ICDS VIII

Securities Held as Stock-in-Trade

ICDS VIII applies only to securities held as stock-in-trade (inventory) — not to capital asset investments. Valuation follows FIFO cost method with year-end comparison at the category-wise lower of cost or NRV.



ICDS VIII: Category-wise Valuation — The Critical Mechanism

Why Category-wise?

ICDS VIII deliberately prevents scrip-wise prudence — losses in one security are offset by gains in another within the same category before any write-down is recognized.

- ⊗ This is a significant anti-avoidance measure — selective booking of unrealized losses to reduce taxable income is prohibited.

Illustration

Security	Cost	NRV
Share A	₹5 lakh	₹4 lakh
Share B	₹5 lakh	₹7 lakh
Category Total	₹10 lakh	₹11 lakh

Since category NRV (₹11L) > Cost (₹10L), closing stock = ₹10 lakh. The ₹1 lakh decline in Share A is ignored.

Borrowing Costs



Core Rule

Borrowing costs **directly attributable** to acquisition, construction, or production of a **qualifying asset** must be capitalized.

Qualifying Asset

An asset requiring **substantial time** to become ready for use or sale — including inventories taking **≥12 months** to reach saleable condition (broader than AS-16).

- ❗ Unlike AS-16, ICDS IX does **not permit reduction** of capitalized borrowing costs for income earned on temporary investment of borrowed funds.

ICDS IX: Specific vs. General Borrowings

Specific Borrowings

Entire actual borrowing cost capitalized during the construction / production period. Temporary investment income does **not** reduce capitalization (major ICDS departure).



General Borrowings

Borrowing cost capitalized using **weighted average borrowing cost rate** applied to expenditure on qualifying asset.

Rate = Total Interest / Average General Borrowings

- ❏ Capitalization commences when all three conditions are met: expenditure incurred, borrowing cost incurred, and preparatory activities in progress. Cessation occurs when the asset is substantially complete.



ICDS X

Provisions, Contingent Liabilities & Contingent Assets

ICDS X governs recognition of uncertain obligations and probable inflows — adopting a stricter "reasonably certain" threshold compared to the "probable" standard in AS-29, significantly restricting prudence-based provisioning.

ICDS X: Recognition Framework

Element	Threshold	Treatment
Provision	Reasonably certain outflow + reliable estimate	Recognized; measured at best estimate (undiscounted)
Contingent Liability	Obligation uncertain / amount not estimable	NOT recognized — disclosed only
Contingent Asset	Realization reasonably certain	Recognized (earlier than AS-29's "virtually certain")

Key ICDS X Differences

Discounting of provisions **generally not permitted**.
Contingent assets recognized earlier — accelerating taxation. Mere management intent without obligating event is insufficient for provision recognition.

Section 43B Interaction

Even if a provision is recognized under ICDS X, deductions for bonus, leave encashment, and gratuity are subject to **actual payment** requirements under Section 43B — ICDS does not override this.

Tax Audit Obligations: Form 3CD

Clause 13(d) — Mandatory Disclosure

The Chartered Accountant must disclose in Form 3CD:

1. Whether taxable income is computed in accordance with each applicable ICDS
2. Every deviation from ICDS in computation
3. The **quantified income impact** of each such deviation

⊗ ICDS non-compliance is a direct audit risk area. Inadequate disclosure can attract penalty and scrutiny.

High-Risk Disclosure Areas

- Expected loss provisions (ICDS III, X)
- Service contract POCM adjustments (ICDS IV)
- Forex MTM on monetary items (ICDS VI)
- Subsidy / grant treatment vs. books (ICDS VII)
- Category-wise securities valuation (ICDS VIII)
- Borrowing cost capitalization differences (ICDS IX)

ICDS vs. Ind AS: Key Interaction Areas

ICDS and Ind AS operate **independently and simultaneously**. An assessee maintains Ind AS books while computing taxable income under ICDS — generating systematic timing differences.

Area	Ind AS	ICDS
Revenue (services)	Performance obligations (Ind AS 115)	Mandatory POCM
ECL provisions	Mandatory (Ind AS 109)	Restricted recognition
Fair value	Core principle	Minimal adoption
Lease accounting	Ind AS 116 — ROU assets	Not specifically addressed
Forex (OCI)	FCTR via OCI	P&L recognition only
Borrowing costs	Effective interest; investment income reduces	Wider capitalization; no such reduction

ⓘ These differences create **deferred tax liabilities / assets** and require careful MAT reconciliation for companies subject to Section 115JB.

Major Litigation Landscape



POCM vs. Completed Contract

EPC contractors, consultants, and software companies disputing mandatory POCM applicability under ICDS III and IV.



Provisions & Expected Losses

Warranty, derivative, and contract loss provisions disallowed under ICDS — Rotork Controls and Bharat Earth Movers principles tested.



Forex MTM Losses

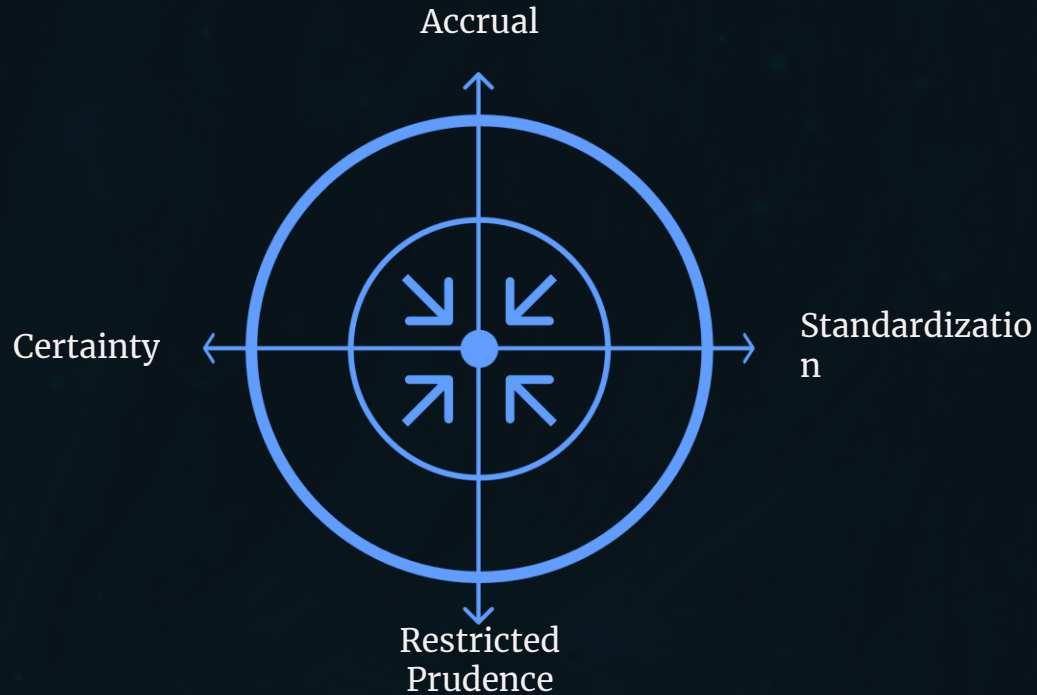
Whether year-end MTM on monetary items constitutes accrued income/loss or contingent adjustment — ongoing post-ICDS VI.



Capital vs. Revenue Subsidy

Purpose test (Ponni Sugars) applied to industrial incentive packages — ICDS VII recognition timing and asset cost impact disputes.

Conceptual Summary: The ICDS Framework



These four pillars define the entire ICDS regime — every standard is an expression of this underlying philosophy in a specific domain of income computation.

Key Takeaways for CA Practice

1

ICDS ≠ Accounting Standard

It is a tax normalization mechanism — books and ICDS computation run in parallel. Differences require explicit Form 3CD disclosure.

2

ICDS Cannot Override the Act

ICDS is subordinate legislation. The Income-tax Act and binding judicial precedents prevail — Delhi HC in Chamber of Tax Consultants confirmed this.

3

POCM is Non-Negotiable

Construction contracts (ICDS III) and service contracts (ICDS IV) must use POCM for tax. Completed contract method is impermissible.

4

Prudence is Restricted, Not Eliminated

Lower of cost or NRV is retained for inventory and securities, but expected losses, MTM provisions, and contingent liabilities are significantly controlled.

"ICDS is a tax-specific accrual framework designed to standardize timing of income recognition while restricting prudence-based deferment and anticipated loss recognition."

Technical Memory Framework

Accrual + Standardization – Prudence – Flexibility

This four-element equation is the conceptual foundation of the entire ICDS regime. Apply it as the first filter in every ICDS analysis.

ICDS I

Accrual + Consistency – Prudence – Materiality

ICDS II

Lower of Cost or NRV | Cost = Purchase + Conversion

ICDS III & IV

Mandatory POCM + No Anticipated Losses

ICDS VI

Monetary → Closing Rate | Non-Monetary → Historical

ICDS VIII

FIFO + Category-wise Lower of Cost or NRV

ICDS IX

Qualifying Asset + Borrowing Nexus = Capitalise

THANK YOU

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