ICDS-VI-Effects of Changes in Foreign Exchange Rates

Introduction:

- Section 145(2) of the Income Tax Act,1961 (“the Act”) grants power to Central Government to notify Income Computation Disclosure Standards.
- So far **10 ICDS** were notified by Central Government on 31st March,2015. However, they are made applicable from the Assessment Year 2017 -18 with a specified deferment period of one year from date of its implementation.
- ICDS are NOT for maintenance of books of accounts, they are only for the purpose of
    - Income Computation **&**
    - Disclosure *(Notification S.O.892(E) dated 31.03.2015)*

Note: *In the case of conflict between* the *provisions of the Act and the ICDS, the provisions of the Act shall prevail to that extent.*

Applicability:

ICDS is applicable to assessees

- ✓ Having income under head ***“Profits and gains of business or profession” or “Income from other sources”*** **AND**
- ✓ Following **mercantile system of accounting.**

But it is not applicable to assessees

- ✓ Who is Individual or HUF and who are not required to get their books get audited u/s 44AB of the Act.
- ✓ Following **cash system of accounting**.

ICDS-VI-Effects of Changes in Foreign Exchange Rates:

This standard discusses about taxation of income earned through foreign currency transactions.

Scope:

1. Treatment of Transactions in foreign currencies.
2. Translating the Financial Statements of foreign operations.
3. Treatment of Foreign currency transactions in nature of forward exchange contract.

Definitions:

- Average rate - The mean of the exchange rates in force during the particular period.
- Closing rate - The exchange rate existing at the last day of the previous year.
- Exchange difference - The difference resulting from converting the **same** number of units of a foreign currency into the reporting currency of a person at **different** exchange rates.
- Exchange rate - The rate at which two currencies are exchanged.
- Foreign currency - Currency other than the reporting currency of a person.
- Reporting currency - ***Indian Currency as per ICDS-VI.***

In order to include the exchange differences in the total income the following classification is to be followed:

- All Assets and Liabilities are *classified into Monetary Items & Non- Monetary Items:*
  - ***Monetary items:*** These are money held and assets to be received or liabilities to be paid in fixed or determinable amounts of money.
    The following are the monetary items:
    - ✓ Money held i.e. cash and cash equivalents held by the entity.
    - ✓ Assets which are receivable in terms of money.
    - ✓ Liabilities which are payable in terms of money.
  - ***Non-monetary items:*** Non-monetary items are those other than monetary items.

  The classification of Assets and Liabilities into Monetary item & Non-monetary items depends upon a question:

Q: If there is a right or obligation to deliver fixed or determinable amounts of currency units?

A: If yes, then it is a monetary item.

Receivable in money or Payable in money=Monetary Item

The words **receivable in money** and **payable in money** are to be focused.
Examples:

Particulars	***Monetary / Non-monetary***	***Reason***
Fixed Assets	Non-monetary	These are held by the entity and these are not receivable or payable to any as on balance sheet date.

Current Assets:

Particulars	***Monetary / Non-monetary***	***Reason***
Cash in hand & Bank	Monetary	It is the money held by the entity
Trade receivables, Bills receivables	Monetary	These are receivable from customers in terms of money

Investments:

Particulars	*Monetary / Non-monetary*	*Reason*
Investments in equity shares	Non-monetary	These are held by the entity and these are not receivable or payable to any as on balance sheet date.
Investment in Debentures, Government Bonds etc.	Monetary	Receivable from issuing entity

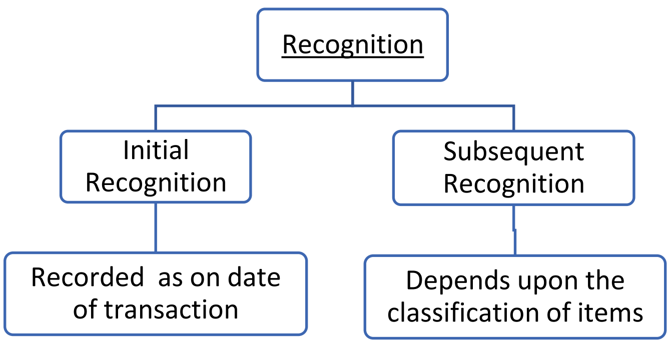
Equity and Liabilities:

Particulars	*Monetary / Non-monetary*	*Reason*
Debentures	Monetary	Payable in terms of money
Convertible Debentures	Non-monetary	Entity issues shares and is not liable to pay money
Share Capital	Non-monetary	It is held by the entity
Trade payables, Bills payables	Monetary	Payable in terms of money
Provisions for income tax	Monetary	Payable in terms of money

Treatment of Foreign currency Transactions directly entered by the entity:

- What is a "Foreign currency transaction"?
- It is a transaction which is denominated in (or) requires settlement in a foreign currency. It includes the following:
  - ✓ buying or selling of goods or services,
  - ✓ borrowing or lending of funds,
  - ✓ becomes a party to an unperformed forward exchange contract,
  - ✓ acquisition or disposal of assets,
  - ✓ incurs or settles liabilities, denominated in a foreign currency.

Recognition and Measurement of Assets and Liabilities is divided into two phases as below:

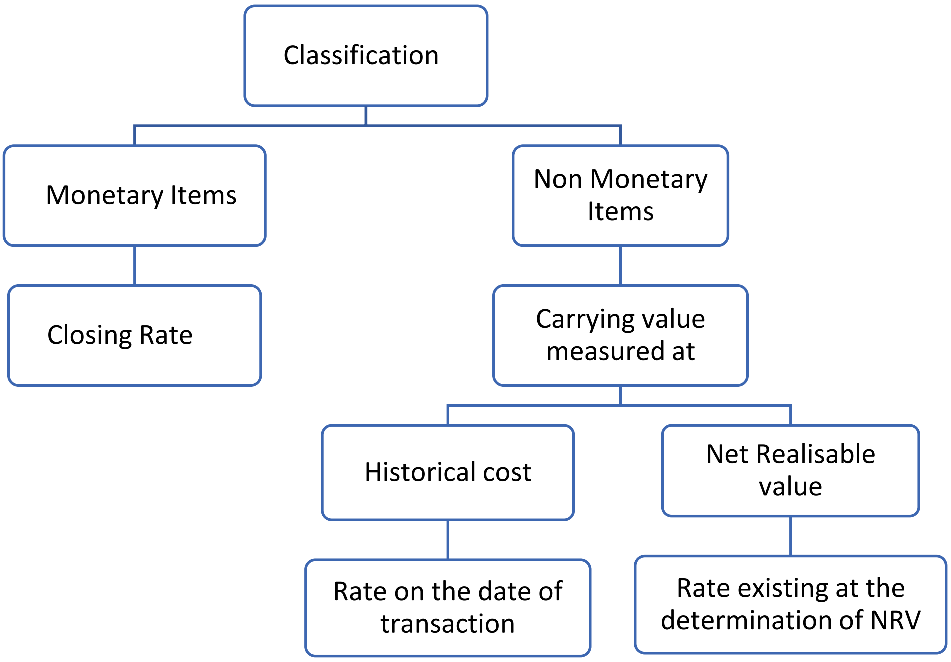


Initial Recognition:

- A Foreign Currency Transaction *(FCT)* is initially recorded using the exchange rate on the date of transaction.
    - Example: X ltd purchased goods of $500 from Y ltd of Canada on 02-12-2018.The exchange rate is 1$= Rs60. Describe recognition.
    - Answer: As per this ICDS all the transactions are initially recorded using the rate on the date of transaction. So the purchases are to be recorded at Rs.30,000.
- In case a person is dealing with number of FCT's the average rate of week or month shall be taken.
- If there is a significant fluctuation in the exchange rates the actual rate on the date of transaction shall be taken**.**

Subsequent Recognition:

- If any Asset or Liability continues till the Balance sheet date, then assessee should revalue i.e. remeasure its value on the Balance sheet date.
- However, its remeasurement depends upon the classification of items as follows:



Examples of Non-Monetary items that can be measured at fair value or NRV:

Inventory:

- As per AS-2 "Valuation of Inventories" inventory is to be measured at **cost or NRV** whichever is lower.
- If inventory is to be measured at cost- use the rate on date of transaction.
- If inventory is to be measured at NRV – use the rate on date of valuation (i.e. Closing rate). Since inventory is valued on balance sheet date, the rate existing on the balance sheet date is to be used.

Current Investments:

- As per AS-13 “Accounting for Investments” current investments are measured at cost or fair value whichever is lower.
- If current investment is valued at Cost- consider the rate on date of transaction. If current investment is measured at Fair value – use the rate on date of valuation.

Particulars	***Net realisable value/ Fair value***	***Cost***
Inventory	Closing Rate	Rate on date of transaction
Current Investments	Closing Rate	Rate on date of transaction

- Exchange Differences arising as result of conversion or settlement of:
  - ✓ Monetary items shall be recorded as income(gain) or expense(loss) in the Previous Year.
  - ✓ Non-Monetary Items shall not be recorded as income or expense in the Previous Year.

Financial Statements of Foreign Operation:

- Foreign operation of a person refers to **overseas Branch of such person** whose activities are conducted in a country other than India.

Foreign Operation =
Overseas Branch

- The same principles (as stated in classification) shall be applied for conversion of Financial Statements of a foreign operation (i.e. Branch) as if the transactions of operation had been those of the person himself.
- The Assets and liabilities of such branch shall be classified into Monetary items and Non - Monetary Items and the resulting difference (gain or loss) shall be recognised in the profit and loss account as income or expense.

Forward Exchange Contract:

- Forward exchange contract is an agreement to buy or sell the foreign currency at a pre-determined rate (i.e. Forward Rate) on a specified date.
- This Forward exchange contract also includes buying or selling of:
  a) Foreign Currency
  b) Foreign Currency Option
  c) A Financial Instrument
- Forward rate is the rate agreed in forward exchange contract to exchange the two currencies, options or financial instruments at a specified date.
- These contracts are entered for any of the following purposes:
  - ✓ *Hedging*: This transaction is entered to minimize the loss that may occur due to changes in exchange rates.

    Example: Swift Ltd. Purchased goods from Switzerland on 25-07-2018 for $6000 with a credit period of one month i.e. on 25-08-2018.No one is aware about exchange rate on date of payment. If the dollar rate increases the liability also increases. So, in order to avoid those losses, the entity enters into a contract called Forward exchange contract.

- ✓ *Trading or speculation purposes*: The main objective of this activity is to grab the advantage of changes in exchange rates.

  Example: In continuation to the above example If Swift Ltd. expects that dollar rate rises to Rs.65 the entity will enter into Forward exchange contract today where dollar rate is Rs.62 to sell the units either at end of credit period or on any day whenever it is profitable to the entity.

- ✓ *Other than above two* (as per ICDS highly probable forecast transaction)

- The premium or discount in this contract is measured by the difference between the exchange rate on the date of transaction and forward rate agreed in the contract.
- The exchange difference of the contract is the difference between closing rate or settlement rate (if settled) and inception rate of contract or opening rate whichever is later.
- The premium or discount shall be recognised on the **Date of Settlement**.

Comparisons:

S.no	Points of comparison	ICDS-VI	AS- 11
1	Applicability	As stated above	Applicable to level 1,2and 3 entities
2	Foreign Operation includes	Only Branch	Branch, Associate, Subsidiary
3	Types of Foreign Operation	It does not specify the types	Foreign operations are divided into: – Integral Non – Integral
4	Forward Exchange Contract includes	foreign currency, foreign options, other financial instruments	only foreign currency
5	Disclosure	No disclosure requirements	The amount of exchange differences included in Net profit to be disclosed