Accounting Standard 22

Accounting for Taxes on Income

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Course of Study:- Professional Competence Course

Introduction

- **Taxes on Income** – One of the most significant item in the statement of profit and loss of the enterprise.

- Many items of expenses are recognized in the statement of profit and loss on the basis of **Matching Concept.**

- **Appropriate accounting method** - to account for the tax liability in the same year in which expenses are accounted for in books notwithstanding the fact that some items may be considered for tax in different years.

Some Examples:-

- Expenditure of the nature mentioned in section 43B (e.g. taxes, duty, cess, fees, etc.)
- Income credited to the statement on profit and loss but taxed only in subsequent years e.g. conversion of capital asset in stock in trade.
- Where depreciation as per books and depreciation as per the provisions of tax laws differ due to reasons like differences in depreciation rates, differences in method of depreciation i.e. WDV or SLM.

Scope:-

- Includes the determination of the amount of tax expense or saving related to taxes on income in respect of an accounting period and the disclosure of such amount in financial statements.

- Taxes on income include all domestic and foreign taxes which are based on taxable income.

- **Exclusions:-**
  - AS22 does not specify the accounting treatment for taxes that are payable on distribution of dividends and other distributions made by the enterprise.

APPLICABILITY:-

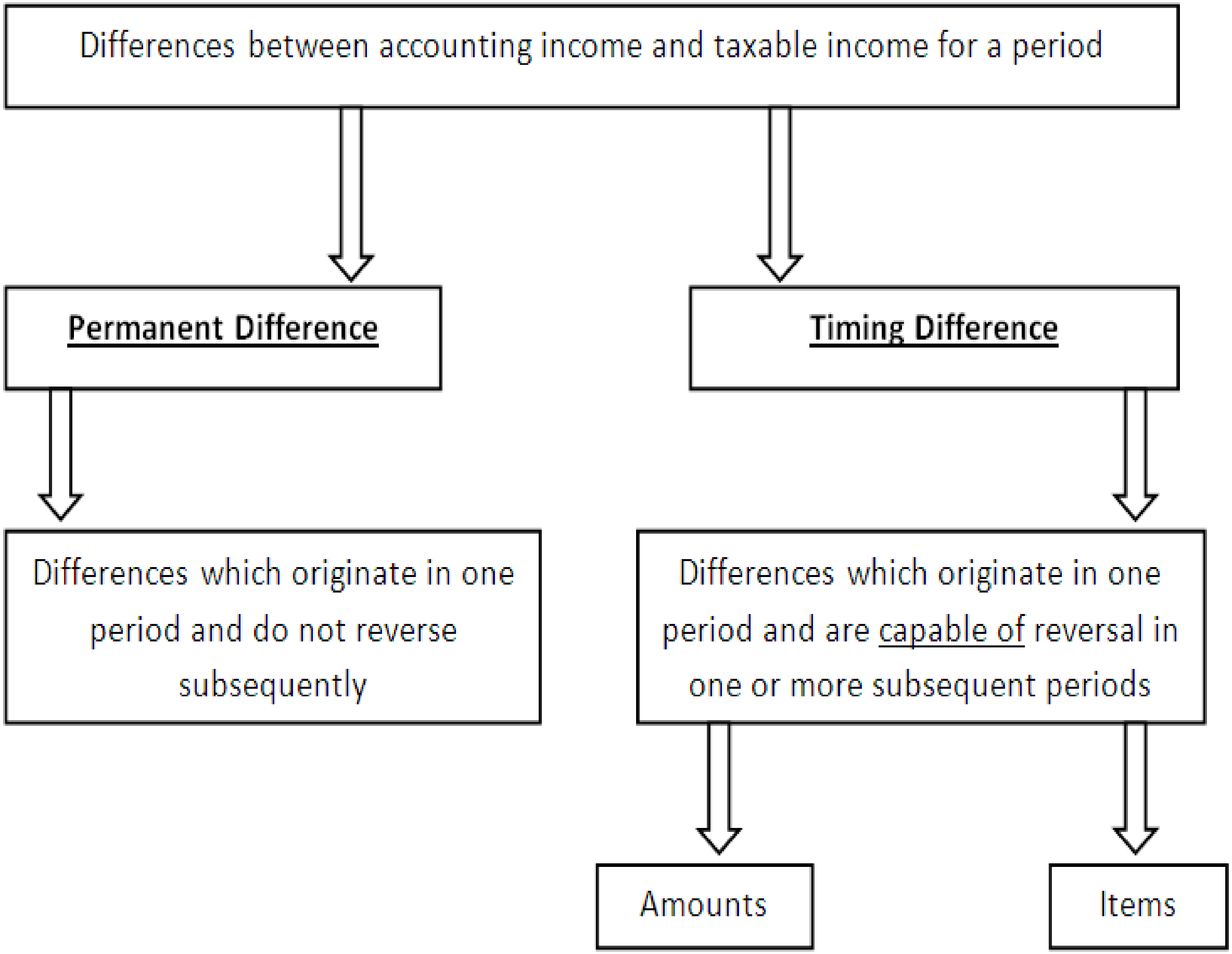
From accounting periods commencing from 01/04/2001	From accounting periods commencing from 01/04/2002	From accounting periods commencing from 01/04/2003
• For existing Listed Companies. • For proposed Listed Companies. • For all enterprises of a parent company (which is a listed company)	• For all other Companies (whose securities are not listed).	• For all other "enterprises", including sole proprietorship, firms or partnerships.

IMPORTANT TERMS IN AS 22:-

- Accounting Income (Loss)
- Taxable Income (Tax Loss)
- Current Tax
- Deferred Tax
- Tax Expense (Tax Saving)
- Permanent Difference
- Timing Difference

SUBSTANCE OF AS-22:-

- The basic reason due to which rationale of Standard emerges is that "**<u>accounting income differs from taxable income</u>**".
- Taxable income calculated in accordance with the provisions of existing tax laws.
- Requirements of these tax laws to compute taxable income may differ due to the accounting policies applied to determine accounting income.
- **<u>Effect</u>** - The taxable income may differ from accounting income.


Differences between accounting income and taxable income for a period
Permanent Difference
Timing Difference
Differences which originate in one period and do not reverse subsequently
Differences which originate in one period and are capable of reversal in one or more subsequent periods
Amounts
Items

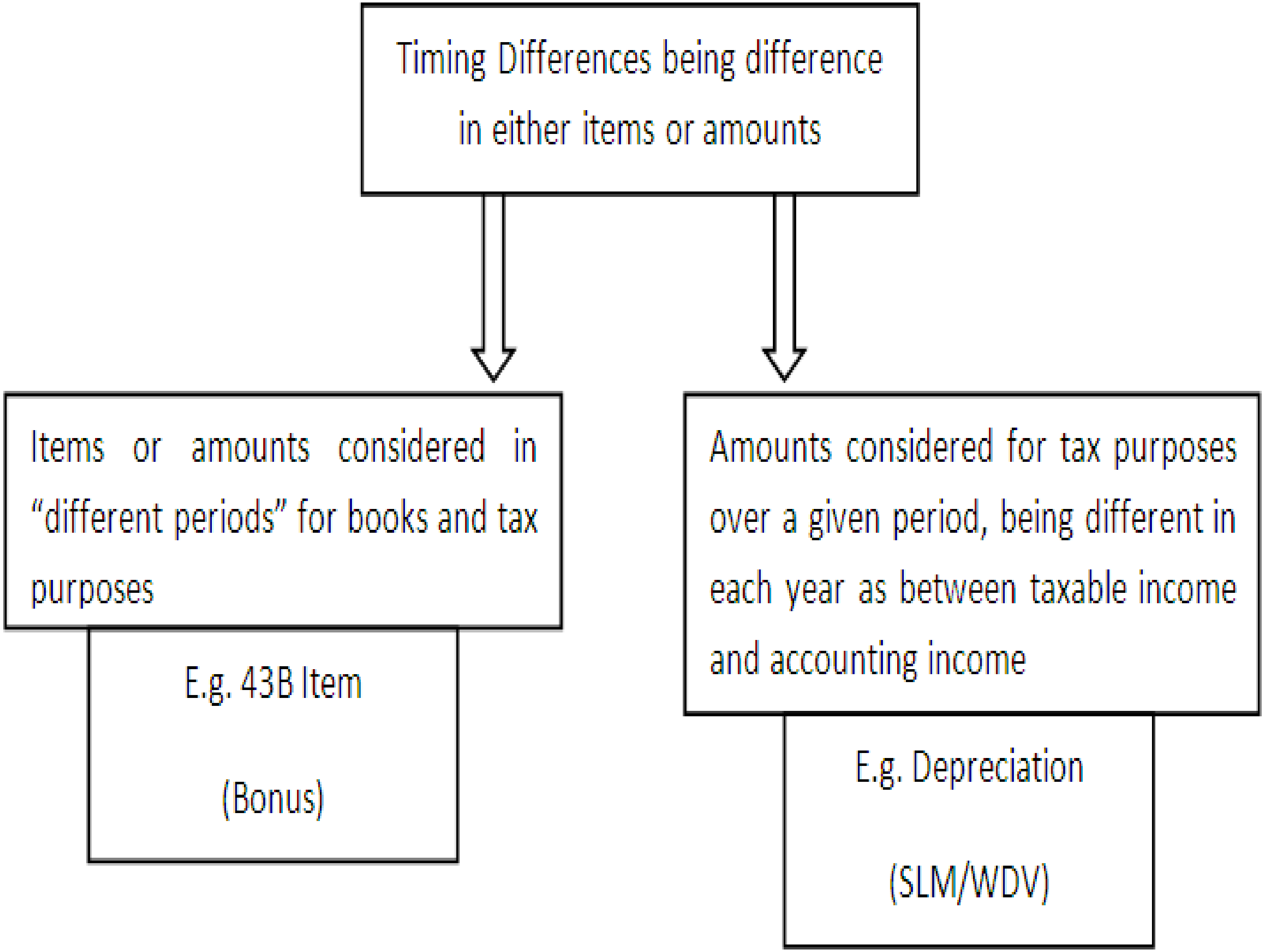
PERMANENT DIFFERENCE:-

- Example of permanent difference include expenses disallowed u/s 40A.
- No such accounting treatment is required for such permanent differences.
- These can be safely excluded from consideration in determining tax expense.

Timing Difference:-

- Timing differences represents those items or amounts, which lead to either saving in tax or payment of tax in current year, in a manner that such saving or payment is nullified in later years.

- This is brought out in the diagram:-


Timing Differences being difference in either items or amounts
Items or amounts considered in "different periods" for books and tax purposes
E.g. 43B Item
(Bonus)
Amounts considered for tax purposes over a given period, being different in each year as between taxable income and accounting income
E.g. Depreciation
(SLM/WDV)

Timing Difference:-

- Timing difference can be on account of two reasons:
  - Due to Reversal Time Difference.
  - Due to difference in Method of Accounting.

- Special accounting treatment is Required.

- Tax effect of such timing differences ought to be recognized in determination of tax expenses.

IMPACT OF TIMING DIFFERENCES:-

- Timing difference may lead either:
  - Tax of initial years being higher and subsequent years being lower. (Pay tax now, Save tax later).
    - Leads to creation of **<u>Deferred Tax Asset.</u>**
  - Tax of initial years being lower and subsequent years being higher. (Save tax now, Pay tax later).
    - Leads to creation of **<u>Deferred Tax Liability.</u>**
- This is the essence of AS-22.

Deferred Tax:-

- Deferment of the difference between tax liability according to taxable income and tax liability according to accounting income.
- If tax as per tax laws is more than the tax payable as per accounting income, then it results in **Deferred Tax Asset**.
- If tax as per accounting income is more than the tax payable as per tax laws, then it results in **Deferred Tax Liability.**

DEFERRED TAX ASSETS:-

- Deferred Tax Assets should be recognized and carried forward by considering the **Concept of Prudence**.
- General items e.g. items falling u/s 43B of IT Act, 1961 –

  There should be **"Reasonable Certainty"** that sufficient taxable income would be available in future, to set off deferred tax assets.
- Specific items i.e. unabsorbed depreciation and carry forward of losses–

  There should be **"Virtual Certainty"** that sufficient taxable income would be available in future, to set off deferred tax assets.

Virtual Certainty:-

- refers to the extent of certainty, which for all practical purposes can be considered certain.
- cannot be based merely on forecasts of performance such as business plans (ASI 9).
- can be taken to exist only when the evidence gathered establish beyond doubt that the enterprise will be able to generate adequate future taxable income.

Accounting Standard Interpretation 9

Virtual Certainty Supported by Convincing Evidence

ACCOUNTING FOR DEFERRED TAX:-

- **Stages for accounting for deferred Tax:-**
  - Stage I:- Recognition.
  - Stage II:- Measurement of Tax Expense.
  - Stage III:- Periodical Review.
  - Stage IV:- Presentation and Disclosure.

RECOGNITION:-

- **Tax Expense = Current Tax + Deferred Tax**
- Tax expense for the period, comprising current tax and deferred tax, should be included in the determination of profit or loss for the period.
- Deferred Tax should be recognized for all Timing Differences, subject to consideration of prudence in respect of Deferred Tax Assets.

RECOGNITION OF DEFERRED TAX ASSETS:-

- Deferred tax assets should be recognized and carried forward to the extent that there is **Reasonable Certainty** that sufficient taxable income would be available in future, against which deferred tax assets can be realized.
- In case of specific items i.e. **Unabsorbed Depreciation and Carry forward of losses**, a deferred tax asset can be recognized and carried forward only to the extent that there is **Virtual Certainty** that sufficient taxable income would be available in future, against which deferred tax assets can be realized.

Measurement:-

- Measurement means "**<u>Quantification</u>**".

- Determine the amount of Current Tax, i.e. tax payable as per Tax Laws for the current period.

- Determine Deferred Tax, i.e. tax liability or tax asset arising on account of Timing Differences.

- Deferred Tax should not be discounted to present value.

Periodical Review:-

- AS 22 lays down – There should be a periodical (annual) review of "Deferred Tax Assets" as on Balance Sheet Date.
- Carrying amount of deferred tax asset should be written–down to the extent that there is no longer reasonable or virtual certainty that sufficient future taxable income will be available against which deferred tax asset can be realized.

<table>
<tr><td rowspan="2">Where a Deferred Tax Asset (DTA) stands previously recognized

(Reversal of Timing Difference)</td><td>Conditions underlying reasonable certainty or virtual certainty are reviewed and found to be valid, and continuing</td><td>In such a situation, DTA can be carried forward</td></tr>
<tr><td>Conditions underlying reasonable certainty or virtual certainty are reviewed and found to be NOT VALID, conditions ceases to exist</td><td>If it ceases to exist, write down the DTA to the extent of reversing timing differences (to the extent ceased)</td></tr>
<tr><td rowspan="4">Deferred Tax Asset (DTA) has not been previously recognized

(Originating Timing Difference)</td><td rowspan="2">Does the item belong to the category, where determination of reasonable certainty, of taxable income is adequate?</td><td>If reasonable certainty does not exist, DO NOT RECOGNIZE DTA</td></tr>
<tr><td>If reasonable certainty exists, recognize DTA.</td></tr>
<tr><td rowspan="2">Does the item belong to the category, where determination of virtual certainty, of taxable income is necessary? (Carry forward losses, accumulated depreciation)</td><td>If virtual certainty does not exist, DO NOT RECOGNIZE DTA</td></tr>
<tr><td>If virtual certainty exists, recognize DTA.</td></tr>
</table>

PRESENTATION AND DISCLOSURE:-

- Deferred tax assets and liabilities should be distinguished from assets and liabilities representing current tax for the period.
- Deferred tax assets and liabilities should be disclosed under a separate heading in the balance sheet of the enterprise, separately from current assets and current liabilities.

PRESENTATION AND DISCLOSURE:-

- The break-up of deferred tax assets and deferred tax liabilities into major components of the respective balances should be disclosed in the notes to accounts.
- The nature of the evidence supporting the recognition of deferred tax assets should be disclosed, if an enterprise has unabsorbed depreciation or carry forward of losses under tax laws.

Accounting Standard Interpretation 7

Disclosure of deferred tax assets and deferred tax liabilities in the balance sheet of a company

ACCOUNTING STANDARD INTERPRETATION 7:-

- In case of a company,
  - Deferred tax assets should be disclosed on the face of the balance sheet separately after the head 'Investments' and
  - Deferred tax liabilities should be disclosed on the face of the balance sheet separately after the head 'Unsecured Loans'.

ILLUSTRATION

- Profit for Year 1 and Year 2. = Rs. 100 Lacs each.
- Provision for interest on Loan from Financial Institutions in Year 1 and Year 2.

  (Deduction is allowed on payment basis.) = Rs. 10 Lacs paid in year 2
- Rates of Tax. = 50%

SOLUTION

- **Provision for Tax:-**

Rs. *in Lacs*

Particulars	Year 1	Year 2
Profit Before Tax	100	100
Add:- Provision for Interest	10	Nil
	110	100
Less:-Interest of previous year now eligible on payment basis	Nil	(10)
Taxable Income	110	90
Tax at 50%	55	45

Solution

- **Deferred Tax Asset:-**

Rs. *in Lacs*

Particulars	Year 1	Year 2
Interest considered in books	10	Nil
Interest considered for taxation	Nil	10
Originating Timing Difference	10	Nil
Reversal of Timing Difference	Nil	10
Tax on above	5	5
	↓ Recognize Deferred Tax Asset	↓ Write off Deferred Tax Asset

Solution

- **Statement of Profit:-**

Rs. *in Lacs*

Particulars	Year 1	Year 2
Profit before Tax	100	100
Less:- Provision for Tax	(55)	(45)
Profit after Tax	45	55
Add:- Deferred Tax Asset	5	Nil
Less:- Write off Deferred Tax Asset	Nil	(5)
Profit available to Shareholders	50	50

Screenshots

1. Presentation of Deferred Tax Assets in the Balance Sheet of Infosys Annual Report 2008-09.
2. Disclosure of Deferred Tax given in the notes to accounts.

B. Financial condition

A summary of our financial position as at March 31, 2009 and 2008 is as follows :

in Rs. crore

	2009	%	2008	%	Growth %
Sources of funds					
Shareholders' funds					
Share capital	286	1.6	286	2.1	–
Reserves and surplus	17,523	98.4	13,204	97.9	32.7
	17,809	100.0	13,490	100.0	32.0
Application of funds					
Fixed assets					
Original cost	5,986	33.6	4,508	33.4	32.8
Depreciation	(2,187)	(12.3)	(1,837)	(13.6)	19.1
Net book value	3,799	21.3	2,671	19.8	42.2
Capital work-in-progress	615	3.5	1,260	9.3	(51.2)
	4,414	24.8	3,931	29.1	12.3

Financial condition (contd.) :

in Rs. crore

	2009	%	2008	%	Growth %
Investments	1,005	5.6	964	7.2	4.3
Deferred tax assets	102	0.6	99	0.7	3.0
Current assets, loans and advances					
Sundry debtors	3,390	19.0	3,093	22.9	9.6
Cash and bank balances	9,039	50.8	6,429	47.7	40.6
Loans and advances	3,164	17.8	2,705	20.1	17.0
	15,593	87.6	12,227	90.7	27.5
Current liabilities	(1,507)	(8.5)	(1,334)	(9.9)	13.0
Provisions	(1,798)	(10.1)	(2,397)	(17.8)	(25.0)
	(3,305)	(18.6)	(3,731)	(27.7)	(11.4)
Net current assets	12,288	69.0	8,496	63.0	44.6
	17,809	100.0	13,490	100.0	32.0

Infosys Annual Report 2008-09

5. Deferred tax assets

We recorded net deferred tax assets of Rs. 102 crore as at March 31, 2009 (Rs. 99 crore as at March 31, 2008). Deferred tax assets represent timing differences in the financial and tax books arising from depreciation on assets and provision for sundry debtors.

We assess the likelihood that our deferred tax assets will be recovered from future taxable income. We believe it is more likely than not that we will realize the benefits of these deductible differences.

Thank You