Extracts of the Supreme Court Decision on Accounting Standard (AS) 22, Accounting for Taxes on Income

CASE NO.:
Appeal (civil) 3761 of 2007

PETITIONER:
J. K. Industries Ltd. & Anr

RESPONDENT:
Union of India & Ors

DATE OF JUDGMENT: 19/11/2007

BENCH:
S.H. Kapadia & B. Sudershan Reddy

JUDGMENT:
J U D G M E N T
With

Civil Appeal Nos.3478/2007, 3479/2007, 3480/2007 and 3482/2007.

KAPADIA, J.

1. A short question which arises for determination in this batch of civil appeals is :

> "Whether Accounting Standard 22 (AS 22) entitled "accounting for taxes on income" insofar as it relates to deferred taxation is inconsistent with and ultra vires the provisions of the Companies Act, 1956 (the Companies Act), the Income-tax Act, 1961 (I.T. Act) and the Constitution of India?"

Finding:

2. For the following reasons we hold that the impugned Rule which adopts AS 22 neither suffers from the vice of excessive delegation nor is the said Rule incongruous/inconsistent with the provisions of the Companies Act, 1956.

Reasons:

(i) Preface:

3. India is an emerging economy. Globalization has helped India to achieve the GDP rate of around 8 to 9 per cent. However, with globalization, India is required to face challenges in various forms. Corporate India has been acquiring companies in India and

abroad. Indian companies are partners in joint ventures. They are part of international consortium. Therefore, Indian Accounting Standards (IAS) have to harmonize and integrate with International Accounting Standards by which harmonization of various accounting policies, practices and principles could take place.

4. In its origin, an accounting standard is the policy document. In matters of recognition of various items of income, expenditure, assets and liabilities, the aim is to achieve standards/norms which would help to reflect "true and fair" view of the accounts of a company. Every Indian and foreign investor/partner before entering into joint venture agreement(s) with its counterpart examines the financial statements and tries to ascertain the real income of the Indian company.

5. With globalization, we have conventional/orthodox system of accounting (recognition, measurement and disclosure) vis-a-vis modern system of advanced accountancy. Therefore, the role of accounting has undergone a revolutionary change with the passage of time. Traditionally, accounting was considered solely a historical description of financial activities. That view is no longer acceptable. Accounting is now considered as a service activity. Its function is to provide quantitative information, primarily of financial nature about the economic entities. Accounting today includes several branches, e.g., Financial Accounting, Management Accounting and Government Accounting. The primary role of accounting is to provide an effective measurement and reporting system. This is possible only when accounting is based on certain coherent set of logical principles that constitute the general frame of reference for evaluation and development of sound accounting practices. That is why, we have different accounting concepts and fundamental accounting assumptions, such as, separate entity concept, going concern concept, accrual concept, matching concept etc.. Therefore, Accounting Standards are based on a number of accounting principles. For example, the Matching Principle and Fair Valuation principle. Historically, matching principles ensured that costs incurred matched with revenues they generated, though they resulted in assets and liabilities in the balance-sheet at other than fair values. Similarly, they resulted in assets, which were not assets in the real sense, e.g., deferred revenue expenditure. However, the matching principles ensured purity of the profit and loss statement. **Therefore, matching principles ensure ascertainment of true income.** Today under Advanced Accountancy, matching principles recognizes not only costs against revenue but also against the relevant time period to determine the Periodic Income. Therefore, matching principle today forms an important component of Accrual Basis of Accounting.

6. On the other hand, Fair Valuation principles are important in the context of valuing derivatives and other investments. If one were to describe one single change in accounting practice over the last few years, it would be the use of Fair Valuation principles. Today, the object behind enactment of A.S., which are now made mandatory under section 211(3A) of the Companies Act, is to shift from historical method of accounting to fair valuation. In the case of mergers and acquisitions, which is common today in the world of globalization, fair valuation principles have important role to play. **Mergers and acquisitions are sometimes undertaken to defer revenue expenditure over future years by invoking the matching concept, which results in putting**

fictitious assets on the balance-sheet. This is one reason why fair valuation principles are accepted.

7. A.S. are established rules relating to recognition, measurement and disclosures thereby ensuring that all enterprises that follow them are comparable and that their financial statements are "true and fair". Measurements and disclosures based on fair value are becoming increasingly important. **Fair valuation is generally used in valuation and disclosure of financial instruments,** derivatives, conversions, auctions in a bond, business combinations, impairment of assets, retirement obligations, transactions involving exchange of assets without monetary consideration, transfer pricing, etc..

8. In conclusion, the importance of the Preface is to show a paradigm shift in the thinking of Accountants all over the world, particularly with the coming-in of the abovementioned new concepts.

(ii) Doctrine of Ultra Vires

9. At the outset, we may state that on account of globalization and socio-economic problems (including income disparities in our economy) the power of Delegation has become a constituent element of legislative power as a whole. However, as held in the case of **Indian Express Newspaper v. Union of India** reported in (1985) 1 SCC 641 at page 689, subordinate legislation does not carry the same degree of immunity which is enjoyed by a statute passed by a competent Legislature. Subordinate legislation may be questioned on any of the grounds on which plenary legislation is questioned. In addition, it may also be questioned on the ground that it does not conform to the statute under which it is made. **It may further be questioned on the ground that it is inconsistent with the provisions of the Act** or that it is contrary to some other statute applicable on the same subject matter. Therefore, it has to yield to plenary legislation. It can also be questioned on the ground that it is manifestly arbitrary and unjust. That, any inquiry into its vires must be confined to the grounds on which plenary legislation may be questioned, to the grounds that it is contrary to the statute under which it is made, to the grounds that it is contrary to other statutory provisions or on the ground that it is so patently arbitrary that it cannot be said to be inconformity with the statute. It can also be challenged on the ground that it violates Article 14 of the Constitution. Subordinate legislation cannot be questioned on the ground of violation of principles of natural justice on which administrative action may be questioned. A distinction must, however, be made between delegation of a legislative function in which case the question of reasonableness cannot be gone into and the investment by the statute to exercise a particular discretionary power. In the latter case, the question may be considered on all grounds on which administrative action may be questioned, such as, non-application of mind, taking irrelevant matters into consideration, failure to take relevant matters into consideration etc.. A subordinate legislation may be struck down as arbitrary or contrary to statute if it fails to take into account vital facts which expressly or by necessary implication are required to be taken into account by the statute or the Constitution. This can be done on the ground that the subordinate legislation does not conform to the statutory or constitutional requirements or that it offends Article 14 or Article 19 of the Constitution. However, it may be noted that, a notification issued under a section of the statute which

requires it to be laid before Parliament does not make any substantial difference as regards the jurisdiction of the Court to pronounce on its validity.

10. Apart from the grounds referred to by this Court in the above judgment in the case of **Indian Express Newspaper,** it is important to bear in mind that where the validity of subordinate legislation is challenged, the question to be asked is whether the power given to the rule making authority (in the present case the Central Government under section 642(1) of the Companies Act) is exercised for the purpose for which it is given. Before reaching the conclusion that the Rule is intra vires (we have to begin with the presumption that the Rule is intra vires), the court has to examine the nature, object and the scheme of the legislation as a whole and in that context, the court has to consider what is the Area over which powers are given by the section under which the Rule Making Authority is to act. However, the court has to start with the presumption that the impugned Rule is intra vires. This approach means that, the Rule has to be read down only to save it from being declared ultra vires if the court finds in a given case that the above presumption stands rebutted.

11. If the impugned rule is a delegated legislation it would follow that the said rule is made in exercise of the power conferred by the statute. Legislature has wide powers of delegation. This, however, is subject to one limitation, namely, it cannot delegate uncontrolled power. Delegation is valid only when it is confined to legislative policy and guidelines.

12. In the present case, abovementioned guideline is provided by **section 211(1), which has brought in a stand-alone concept of "true and fair" accounting. The said concept is the controlling consideration.** As stated above, delegation is valid when it is confined to Legislative Policy and Guidelines which are adequately laid down and the delegate is only empowered to implement such Policy within the Guidelines laid down by the Legislature (see **TISCO v. The Workmen & ors.** reported in AIR 1972 SC 1917)

13. In the present case, we are required to consider the scope of section 642(1), which refers to the power of Central Government (rule making authority) to make rules vis a vis section 641, which states that subject to the provision of the section, the Central Government may, by Notification in the Official Gazette, alter any of the regulations, rules, forms, tables and other provisions contained in any of the Schedules to the Companies Act (including Schedule VI). This aspect is of some importance. Section 642 is in addition to the powers conferred by section 641, therefore, the two sections form part of the same scheme. However, the scope of section 641 is different from the scope of section 642. Power to alter any provision of the Schedules and the power to carry out gap-filling exercise are both entrusted to the Central Government. The expression "in addition" to in section 642 indicates that both the above sections constitute one scheme. However, section 642 enables Central Government to provide details and, therefore, under section 642 the rules contemplated refers to gap-filling exercise.

14. It is well settled that, what is permitted by the concept of "delegation" is delegation of ancillary or subordinate legislative functions or **what is fictionally called**

as "power to fill up the details". The judgments of this Court have laid down that the Legislature may, after laying down the legislative policy, confer discretion on administrative or executive agency like Central Government **to work out details within the framework of the legislative policy laid down in the plenary enactment.** Therefore, power to supplement the existing law is not abdication of essential legislative function. Therefore, power to make subordinate legislation is derived from the enabling Act **and it is fundamental principle of law which is self-evident that the delegate on whom such power is conferred has to act within the limitations of the authority conferred by the Act.** It is equally well settled that, Rules made on matters permitted by the Act in order to supplement the Act and not to supplant the Act, cannot be held to be in violation of the Act. **A delegate cannot override the Act either by exceeding the authority or by making provisions inconsistent with the Act. (See Britnell v. Secretary of State** 1991 (2) AllER 726 at 730)

15. The issue before us in the present batch of civil appeals is whether the Central Government, which is the rule making authority, has overridden the Companies Act, 1956 either by exceeding its authority in adopting AS 22 or by making provisions inconsistent with sections 209 and 211 read with Part I and Part II of Schedule VI to the Companies Act as alleged by the appellants.

16. Since the said issue has two parts, for the sake of convenience, the first point which needs to be decided is as follows:

(a) Whether the impugned Rule adopting AS 22 is in excess of the powers conferred upon Central Government under section 642(1) of the Companies Act, 1956?

17. In the case of **Banarsi Das v. State of M.P.** reported in AIR 1958 SC 909 the State had issued a Notification under section 6(2) of the Central Provinces and Berar Sales Act, 1947 amending Item 33 in Schedule II by substituting for the words "goods sold to or by the State Government" by the words "goods sold by the State Government". As a result of the said Notification, amending the schedule, the assessee who was entitled for exemption from payment of sales tax in respect of goods sold to the State Government could no longer claim such exemption by reason of the said Notification. That Notification was challenged on the ground that it was not open to the Government in exercise of the authority delegated to it under section 6(2) to modify or alter what the Legislature had enacted and, therefore, the said Notification was bad as being unconstitutional delegation of legislative authority. It was argued on behalf of the assessee that earlier they had been granted exemption under section 6(1) of the Act which subsisted when the impugned Notification came to be issued and that in consequences, while an exemption under section 6(1) existed any amendment to the Schedule under section 6(2) was bad as it had the effect of deletion of the exemption which had been granted. Section 6(1) of the Act contemplated exemption to be given by the State Government on certain types of transactions whereas section 6(2) empowered the State Government to amend the schedule. It is in this context that the question arose as to whether the impugned Notification was bad as being an unconstitutional delegation of legislative authority. The said contention was rejected by this Court stating that the two

sub-sections together constituted integral part of a single enactment. We quote hereinbelow para 11 of the said judgment, which reads as follows:

> "11. The contention of the appellant that the notification in question is ultra vires must, in our opinion, fail on another ground. The basic assumption on which the argument of the appellant proceeds is that the power to amend the schedule conferred on the Government under section 6(2) is wholly independent of the grant of exemption under section 6(1) of the Act, and that, in consequence, while an exemption under section 6(1) would stand, an amendment thereof by a notification under section 6(2) might be bad. But that, in our opinion, is not the correct interpretation of the section. <u>The two sub-sections together form integral parts of a single enactment,</u> the object of which is to grant exemption from taxation in respect of such goods and to such extent as may from time to time be determined by the State Government. Section 6(1), therefore, cannot have an operation independent of section 6(2), and an exemption granted thereunder is conditional and subject to any modification that might be issued under section 6(2). In this view, the impugned notification is intra vires and not open to challenge." (emphasis supplied)

Applying the tests laid down in the aforestated judgment to the present case, it may be noted that, in this case, we are concerned only with the existence and the extent of the powers given to the Central Government to make rules, both for altering the Schedules to the Companies Act as well as to fill in details. Power to alter the Schedule as well as power to fill in details are two distinct powers. However, both the powers are entrusted to the same delegate, namely, the Central Government. Further, as stated above, sections 641 and 642 form part of the same scheme, hence, it cannot be said that merely because the impugned Notification has been issued under section 642 and not under section 641 the said Notification is exhaustive of the powers given to the Central Government to frame rules under the aforestated two sections. Moreover, in the present case, section 642(1) begins with the expression "in addition to the powers conferred by section 641", therefore, one has to read section 641 as an additional power given to the Central Government to make Rules, in addition to its power to alter the schedule by making appropriate Rules under section 641. There is one more way of looking at the arguments. The Companies Act has been enacted to consolidate and amend the law relating to companies and certain other associations. Under section 211(3A) Accounting Standards framed by National Advisory Committee on Accounting Standards constituted under section 210A are now made mandatory. Every company has to comply with the said standards. Similarly, under section 227(3)(d), every auditor has to certify whether the P&L a/c and balance-sheet comply with the accounting standards referred to in section 211(3)(c). Similarly, under section 211(1) the company accounts have to reflect "true and fair" view of the state of affairs. Therefore, the object behind insistence on compliance with the A.S. and "true and fair" accrual is the presentation of accounts in a manner which would reflect the true income/profit. One has, therefore, to look at the entire scheme of the Companies Act. In our view, the provisions of the Companies Act together with the Rules framed by the Central Government constitute a complete scheme. Without the Rules, the Companies Act cannot be implemented. The impugned Rules framed under section 642 are a legitimate aid to construction of the Companies Act as contemporanea expositio. Many of the provisions of the Companies Act, like computation of book profit, net profit etc. cannot be put into operation without the rules.

18. In the case of **P. Kasilingam and ors. v. P.S.G. College of Technology and ors.** 1995 Suppl(2) SCC 348 vide para 20 this Court ruled as follows:

> "20. The Rules have been made in exercise of the power conferred by Section 53 of the Act. Under Section 54(2) of the Act every rule made under the Act is required to be placed on the table of both Houses of the Legislature as soon as possible after it is made. It is accepted principle of statutory construction that "rules made under a statute are a legitimate aid to construction of the statute as contemporanea expositio" (See : Craies on Statute Law , 7th Edn., pp. 157-158; Tata Engineering and Locomotive Co. Ltd. v. Gram Panchayat, Pimpri Waghere (1976) 4 SCC 177.) Rule 2(b) and Rule 2(d) defining the expression 'College' and 'Director' can, therefore, be taken into consideration as contemporanea expositio for construing the expression "private college" in Section 2(8) of the Act. <u>Moreover, the Act and the Rules form part of a composite scheme. Many of the provisions of the Act can be put into operation only after the relevant provision or form is prescribed in the Rules.</u> In the absence of the Rules the Act cannot be enforced. If it is held that Rules do not apply to technical educational institutions the provisions of the Act cannot be enforced in respect of such institutions. There is, therefore, no escape from the conclusion that professional and technical educational institutions are excluded from the ambit of the Act and the High Court has rightly taken the said view. Since we agree with the view of the High Court that professional and technical educational institutions are not covered by the Act and the Rules, we do not consider it necessary to go into the question whether the provisions of the Act fall within the ambit of Entry 25 of List III and do not relate to Entry 66 of List I." (emphasis supplied)

19. To the same effect is the judgment of this Court in the case of **TELCO v. Gram Panchayat, Pimpri Waghere** reported in (1976) 4 SCC 177 in which the Court was required to consider the definition of the word "house" under the Rules framed in 1934. It was held that the rules provided internal legitimate aid for the interpretation of the words and phrases used in the main enactment.

20. In the present case also even under the Rules impugned herein AS 22, which is made mandatory, provides an internal legitimate aid to the meaning of the words in the Companies Act, including Schedule VI, namely, liability, provision for taxes on income, book profit, net profit, depreciation, amortization etc.. Therefore, it cannot be said that the impugned Rules framed under section 642(1) constitute an act on the part of the rule making authority, namely, the Central Government, in excess of its powers under section 642(1) of the Companies Act. In our view, the impugned Rule/Notification is valid. It has nexus with the matters entrusted to the Central Government to be covered by appropriate

rules. Therefore, in our view, the impugned Rule is valid as it has nexus with statutory functions entrusted to Central Government which is the rule making authority under the Act. It is important to bear in mind that the power to regulate a business or profession implies the power to prescribe and enforce all such proper reasonable rules as may be deemed necessary to conduct business/profession in a proper and orderly manner and the power includes the power to prescribe conditions under which business/profession can be carried on. (See **Deepak Theatre, Dhuri v. State of Punjab and ors.** AIR 1992 SC 1519 at page 1521). The Scheme of the Companies Act indicates that Accounting Standards are made mandatory. They have to be followed by the auditors. They have to be followed by the companies. The Accounting Standards provide discipline. They provide harmonization of concepts. They provide harmonization of accounting principles. In the past, when Accounting Standards were not mandatory, various companies used to follow alternate system of accounting. This led to overstatement of profits. Therefore, the said Standards have now been made mandatory. In our view, it is the statutory function given to the Central Government to frame Accounting Standards in consultation with the National Advisory Committee on Accounting Standards (NAC) under section 211(3C). It is not necessary for the Central Government to adopt in every case the Accounting Standards issued by the Institute. Nothing prevents the Central Government from enacting its own Accounting Standards which may not be in consonance with the Standards prescribed by the Institute. Similarly, nothing prevents the Central Government from adopting the Standards issued by that Institute as is the case in the present matter. Therefore, in our view, the impugned Rule is valid as it has nexus with the statutory functions entrusted to the Rule making authority, namely, the Central Government.

(b) Whether the impugned Rule is incongruous/contrary to sections 209 and 211 read with the provisions of Part I and Part II of Schedule VI to the Companies Act, 1956 and whether the said Rule seeks to modify the essential features of the Companies Act ?

(A) <u>Concepts</u>

21. To answer the above question, we need to examine the following concepts prevalent in Accounting.

<u>Accrual System of Accounting</u>

22. In the conventional sense, amounts which become receivables/recoverable are shown as income actually received and the liabilities incurred are shown as amounts actually **disbursed in a given year.** Therefore, under the aforestated system of accounting, entries are posted in the books of accounts on the date of the transaction, i.e., on the date on which rights accrue or liabilities are incurred, **irrespective of the date of payment.** In such cases, a company has to account for its income or loss as per the above system and not otherwise, if that company has adopted mercantile system of accounting which is also known as accrual system of accounting. However, accrual does not mean confinement of items of revenue/expenditure to a given year. **As stated above, mergers and acquisitions are undertaken to defer revenue expenditure over future years by invoking matching principles.** Therefore, the said principle forms an important part of accrual accounting.

Taxes on Income (TOI)

23. It is an important item of P&L a/c. Taxes on income are considered as expenses incurred by a company in earning revenues. **It is an expense which is recognized in the same period as revenue and expense to which they relate. This is called as matching principle. Such matching, results in what is called as Timing Differences. Tax effects of Timing Differences are included as tax expense in the statement of profit and loss and as deferred tax asset (DTA) or as deferred tax liability (DTL) in the balance-sheet. In short, deferred tax should be recognized for timing differences.** This is the basic mandate of AS 22. This mandate is based on an important principle of accounting, namely, that **every transaction has a tax effect**. However, DTA is subject to the principle of prudence and certainty that in future the company will have adequate income. This principle of prudence states that DTAs are recognized and carried forward only to the extent of their being a reasonable certainty of their realization, i.e., in future there would be taxable income. Therefore, under the rule of prudence, DTAs are to be recognized only to the extent of their being timing differences, the reversal whereof will result in sufficient taxable income in future against which they can be realized. On the other hand, DTL is to be recognized as liability under the said standard as it results in future cash outflow in the form of payments to the Income tax Department in the case of TOIs.

Current Tax

24. Current tax has to be measured by using the applicable tax rates. This is because current tax has to be **measured** at the amount expected to be paid to the Income tax Department by way of tax. Not only the tax rates, but also tax laws constitute the basis for measuring the amount of tax expected to be paid to the Income tax Department. It is important to note that while measuring current tax, companies have to go by the balance-sheet date. The company has to examine the tax rates and the tax laws on that date.

Timing Differences

25. **They are differences which arises because the period in which some items of revenue and expenses are included in the taxable income do not tally with the period in which items are considered to compute the Accounting Income.** In other words, it recognizes expenses against the relevant time period to determine the periodic income. This concept has been brought in after the amendment to section 211(1) of the Companies Act which emphasizes that after 2001 the companies shall prepare their accounts so as to reflect "true and fair" view of the State of Affairs and **to obliterate the difference between Accounting and Taxable Income.** This concept bridges the gap between accounting income and taxable income. **Deferred tax is the tax effect of such differences** which are now required to be accounted for. As stated above, Accounting Standards today constitute a paradigm shift from the conventional system of accounting based on Historical Costs Method towards Fair Valuation Principles. Similarly, in the past, companies used to follow alternate system of accounting. The Accounting Standards today are trying to harmonize different accounting concepts and principles and, therefore, timing differences play an important role in harmonizing the matching principle under accrual system of accounting with the Fair Valuation Principles. The object is to achieve

proper presentation of balance-sheet and P&L a/c. The object is to present before the investors, shareholders and other stake-holders the book profits (real income) of the company. **The tax effect of timing difference under AS 22 has to be included in the tax expenses in the P&L a/c as DTA or DTL in the balance-sheet.** Therefore, **timing difference is the tax effect which forms part of tax expense in the P&L a/c.** The primary object of AS 22 adopted by the impugned Rule is to prescribe an accounting treatment for TOI. In accordance with the matching concept, TOIs are recognized in the same period as revenue and expenses to which they relate. Matching of TOI against revenue for a period poses problems due to the effect that in a number of cases, taxable income is different from accounting income. This difference arises for two reasons. Firstly, there are differences between **items** of revenue and expenses in the P&L a/c and items considered as revenue expenses or taken for tax purposes. Secondly, there are differences between the **amount** in respect of a particular item of revenue or expenses as recognized in the P&L a/c and the **corresponding amount** which is recognized for computing taxable income.

<u>Tax Expense</u>

26. As stated above, current tax is the amount of income tax determined to be payable in respect of taxable income for a period. On the other hand, **deferred tax is the tax effect of Timing Differences.** As stated above, Timing Differences are differences between taxable income and accounting income for a given period. **Timing Difference originates in one period, but it is capable of reversal in one or more subsequent period(s).** As stated above, **every transaction has a tax effect, therefore, tax expense is the sum total of current tax + deferred tax charged or credited to the statement of profit and loss for the given period.** Therefore, tax expense for that period has to be included in the Net Profit. Therefore, we see no inconsistency between liability as understood in the conventional sense and DTL as submitted on behalf of the appellants.

<u>Assets</u>

27. **Assets represent expenditure.** When an expenditure is written off for accounting purposes in the year in which it is incurred but is admissible as deduction for tax purposes **over a period of time** then in such cases, the asset representing expenditure would have a balance **only for tax purposes but not for accounting purposes. The difference between the balance of the assets for tax purposes and the balance for accounting purposes would be a timing difference which will reverse in future when the expenditure would be allowed for tax purposes.** In such a case, DTA would be recognized in respect of the timing difference, subject to the principle of prudence. This concept is important while deciding the question as to whether para 33 of AS 22 (transitional provision) is or is not inconsistent with the provisions of Schedule VI to the Companies Act.

<u>Matching Principle</u>

28. **Matching Concept is based on the accounting period concept.** The paramount object of running a business is to earn profit. In order to ascertain the profit made by the

business during a period, it is necessary that :revenues: of the period should be matched with the costs (expenses) of that period. In other words, income made by the business during a period can be measured only with the revenue earned during a period is compared with the expenditure incurred for earning that revenue. However, in cases of mergers and acquisitions, companies sometimes undertake to defer revenue expenditure over future years which brings in the concept of Deferred Tax Accounting. Therefore, today it cannot be said that the concept of accrual is limited to one year.

29. **It is a principle of recognizing costs** (expenses) against revenues or **against the relevant time period** in order to determine the periodic income. This principle is an important component of accrual basis of accounting. As stated above, the object of AS 22 is to reconcile the matching principle with the Fair Valuation Principles. It may be noted that **recognition, measurement and disclosure of various items of income, expenses, assets and liabilities is done only by Accounting Standards and not by provisions of the Companies Act.**

Depreciation

30. As stated above, timing difference is the difference between taxable income and accounting income for a period. Depreciation is one of the important items in computation of income, be it taxable income or accounting income. According to *Pickles Accountancy, fourth edn.*, at page 0518, depreciation is the inherent decline in the value of an asset from any cause whatsoever. The wearing out of a machine is a simple example of depreciation. In double-entry system of accounting, there has to be complete double-entry for depreciation adjustment. The required entry under that system of Depreciation Adjustment is debit Trading and Profit & Loss account and credit the asset in respect of which depreciation is being recorded. Such an entry conforms with the principles enunciated, namely, that, the debit to Trading and Profit & Loss account is necessary because **the amount written-off represents an expense and the credit to the asset is required, as the asset has, pro tanto, reduced in value.** Therefore, from the above point of view in the principles of accountancy, even distribution in certain cases is treated as expenditure paid out over the years. The object of providing for such distribution is to spread the expenditure incurred in acquiring the assets over its effective lifetime. The amount of provision to be made in respect of the accounting period is intended to represent the portion of such expenditure which has expired during the period. Therefore, in that sense, it is money expended which is spread out over the effective life of an asset. Even under the Income tax Act, Parliament has used the expression “allowances and depreciation” in several sections in Chapter IV within which section 44A appears. In this connection, reference may be made to section 37 which enjoins that, any expenditure not falling in sections 30 to 36 expended wholly and exclusively or laid out for business purposes should be allowed in computing the business income. Therefore, depreciation and allowances have been dealt with in section 32 and the expression “any expenditure” in section 37 covers both, allowances and depreciation. [See **Commissioner of Income-tax v. Indian Jute Mills Association** (1982) 134 ITR 68 (Cal)]. **Depreciation under Income tax Act is an incentive/allowance. However, in commercial accountancy, it is reduction/deduction from the value of an asset on the balance-sheet.**

Reserves & Provisions

31. **In State Bank of Patiala v. CIT** reported in (1996) 219 ITR 706 substantial amounts were set apart by the assessee-bank as reserves. No amount of bad debt was actually written off or adjusted against the amounts claimed as reserves. No claim for any deduction by way of bad debts was made during the relevant assessment years. The assessee never appropriated any amount against any "bad and doubtful" debts. The amount remained in the account of the assessee by way of capital and the assessee treated the said amount as "reserves" and not as "provisions" designed to meet any liability, contingency, commitment or diminution in the value of assets known to exist on the date of the balance-sheet.

32. The question which arose for consideration by this Court was whether amounts set apart in the balance-sheet are "provisions" or "reserves". The matter arose under the provisions of Companies (Profits) Surtax Act, 1964 which levied a charge on every company for every assessment year called as surtax, insofar as the chargeable profits of the previous year exceeded the statutory deduction at the rates mentioned in the Third Schedule. Rule (1) of Schedule II stipulated mandatory that the capital of the company shall be the total of the amounts including reserves. The assessee contended that the amounts set apart in the balance-sheet are reserves. The Department contended that the said amounts were provisions. The assessee succeeded. However, the reasoning given in the judgment is important. It was held by this Court, after referring to the relevant provisions of the Companies Act regarding the form of balance-sheet wherein the words "reserves and surplus" and "current liabilities and provisions" are dealt with, that if any retention or appropriation falls within the definition of "provision" it can never be a reserve but it does not follow that if the retention or appropriation is not a provision it is automatically a reserve. That question has to be decided having regard to the true nature and character of the sum so retained depending on several factors including the intention with which and the purpose for which such retention has been made because the substance of the matter is to be recorded. In the said judgment, it has been further held that if any retention is made to meet depreciation, renewal or diminution in value of asset, the same is not a reserve.

33. In that case, one of the other questions which arose for determination was whether a fund created or a sum of money set apart by assessee-bank to meet any liability which the assessee-bank can reasonably anticipate on the balance-sheet date is equivalent to the case where the liability has actually arisen. The High Court took the view that since the assessee is the banking company, it would be reasonable and legitimate to assume that the bank was in a position to anticipate any liability by way of bad debt on the balance-sheet date. This Court held that the aforestated assumption made by the High Court was unjustified. According to this Court, **the question to be asked in such cases is whether the liability was known or anticipated on the date when the balance-sheet was prepared** and not whether the assessee can anticipate on the balance-sheet date the debt and doubtful debts.

34. Applying this test to the facts of the present case, the tax effect of the timing difference was known on the date when the balance-sheet was prepared and, therefore, AS 22 is right in stipulating that the **tax effect of such timing differences should be included in the tax expense in the statement of profit and loss** as DTA/DTL in the balance-sheet.

35. Depreciation in accounting sense is similar to bad and doubtful debts. **Provision for** bad and doubtful debt like **depreciation is not a provision for liability but it is a provision for diminution in value of assets. Where such provision is made and if that provision is not excessive or unreasonable, it is not a reserve, however, any amount in excess of the requirement can be considered to be a reserve.** Thus, provision can be made for depreciation, renewal, diminution in the value of an asset or for any known liability. In this case, we are concerned with depreciation mainly because in 99 per cent of the cases the difference between tax depreciation and accounting depreciation results in timing differences.

36. The provision for bad and doubtful debt is always made with reference to debt receivable where there is doubt about full realization of debt. The provision is made in order to cover up the probable diminution in the value of an asset, i.e., debt which is amount receivable. For example, if the receivable is Rs. 1 crore and the assessee is of the opinion that Rs. One crore might not be realized and that only 90 per cent of the debt would be realized and, therefore, he makes a provision for Rs. 10 lacs for bad debts. By making the provision, the assessee is valuing his asset, namely, debt, which is the amount receivable, at Rs. 90 lacs as against the book figure of Rs. 1 crore. Thus, the provision for bad and doubtful debt is the provision for diminution in the value of asset, i.e., debt. Such provision is not a provision for liability, because even if a debt is not recovered, no liability would be fastened upon the assessee. The debt is the amount receivable by the assessee. It is not any liability payable by the assessee. Therefore, any provision towards irrecoverability of debt cannot be said to be provision for liability. It is the provision for diminution in the value of assets. The expression “reserve” has been defined in a negative manner by clause 7(1)(b) of Part III of Schedule VI to the Companies Act and it only says that the reserve shall not include any amount written off or retained by way of provision for depreciation, renewal, diminution in value of asset or by way of provision for any known liability. Thus, if the provision made by the assessee for depreciation, (diminution in value of the asset) is in excess of the amount which is reasonably necessary for the purpose for which the provision is made, the excess shall be treated as a reserve and not a provision. This aspect is important because the question as to whether the provision made is in excess of the requirement would depend on the facts of each case. This aspect is important also because it has been vehemently argued on behalf of the assessee that AS 22 requires the assessee to make provision for DTL which, in fact, should have been treated as a reserve and not as a provision. Reserve is not a charge to be deducted before arriving at the profit for the period under review. It is appropriation of profit. The “reserve account” is credited as a result of a debit to the appropriation account and not to the P&L a/c or revenue account. In a broad sense, all allocations to reserve represent additions to capital. In the case of a provision, unlike reserves, the charge is created as a result of debit to the P&L a/c and not a debit to the appropriation account.

Tax Base

37. **The tax base of an asset or liability is the amount attributed to that asset or liability for tax purpose.** As stated above, **deferred tax has to be recognized for all timing differences.** This is based on the principle that financial statements for a given period should recognize the tax effect, whether current or deferred, of all transactions occurring in a given period. One more principle needs to be noted that assets represent expenditure.

Concept of DTL/DTA

38. **DTL/DTA is recognized for all timing differences.** AS 22 requires the companies to make a provision for Deferred Tax Accounting with reference to the difference between accounting income and taxable income. In our view, matching principle is an important component of Accrual Accounting. The said principle is not in conflict with accrual accounting as vehemently submitted on behalf of the appellants. Accrual Accounting is the concept recognized by sections 205, 209, 211 and Schedule VI to the Companies Act. However, the said provisions of the Companies Act nowhere lays down as to which asset should be recognized as an investment and the method of valuing investments. That exercise is left to the accounting standards. Similarly, the Companies Act nowhere lays down as to how and when income or expenditure should be measured/recognized. That exercise is left to the accounting standards. AS 22 proceeds on the basis that a benefit obtained in one year could be reversed in the subsequent year and, therefore, it has to be recognized as a liability. One more concept needs to be mentioned. Deferred tax is the same as timing difference. It arises on account of the difference between taxable and accounting incomes. This difference arises between items of revenue and expenses as comparing in P & L a/c vis-`-vis items considered as revenue, expenses or deduction for tax purposes. Secondly, difference also arises between the amount in respect of an item of revenue or expenses as recognized in the P & L a/c and the corresponding amount required in the computation of taxable income. It is the **tax effect of time difference** which is required to be included in Tax Expense in the P & L a/c and as DTA/DTL in the balance-sheet. Timing difference originates in the year in which difference arises between the tax depreciation and accounting depreciation. Therefore, it is a known liability for the current year, though payable in future period(s). Therefore, tax effect of timing difference is a real liability for which a provision is required to be made in the P & L a/c as well as DTL in the balance-sheet. As stated above, deferred tax is the tax effect of timing difference. It has been vehemently submitted that a provision for **Matching Tax** is required to be made in respect of accounting income only for accounting period. The emphasis is on the words "only for accounting period". In our view, even under accrual system of accounting, the accounting period need not be confined to one year alone. As stated hereinabove, mergers and acquisitions today are sometimes undertaken by companies to defer revenue expenditure over future period(s) by invoking the matching concept. Historically, it may also be stated that prior to the introduction of AS 22, the companies used to follow what is called as **Tax Payable Method.** They were put to notice by the Institute that in future the

companies shall have to follow what is called as Tax Effect Accounting method. **AS 22 introduces tax effect accounting method.**

39. Before us, it has been vehemently urged on behalf of the appellants that, unlike U.K., in India, rates of depreciation are statutorily prescribed under the Companies Act and under the Income-tax Act, 1961. According to the appellants, rates of depreciation are not prescribed statutorily in U.K.. Therefore, in U.K. the tax payer is at liberty to adopt any rate of depreciation and, therefore, there could be justification for invoking the matching principle and for applying **AS 22 for deferred taxation.** We find no merit in this argument. In our view, on the contrary, since in India we have two separate rates of depreciation statutorily prescribed under two different Acts, introduction of matching principle becomes relevant. Ultimately, AS 22 is for deferred taxation. It brings out for the information of shareholders, investors and stake-holders the hidden liability which earlier could not be brought out. Today, we are living in the world of globalization in which, apart from merger, acquisitions play an important role. The buyer wants to know the income and liabilities of a company. He wants to know the real income of the company, which he proposes to buy. Because of the difference in the rates of depreciation statutorily prescribed under the Income-tax Act and the Companies Act, the concept of deferred taxation has been introduced in order to obliterate the difference between accounting depreciation and tax depreciation.

(B) Application of above Concepts:

40. As stated above, the power to alter the Schedule is distinct and separate from the power to fill in the details, though both together form part of the same scheme. In the present case, under section 641, the Central Government is empowered vide the Notification to alter any of the Regulations, Rules, Forms and other provisions contained in any of the Schedules except Schedules XI and XII. Under section 641(2), any alteration notified under sub-section (1) has the effect as if the notified alteration stood enacted in the parent Act and shall come into force on the date of the Notification, unless the Notification directs otherwise. In the present case, we are concerned with the provision of section 641(2) which is not there in section 642. However, as stated above, section 642 begins with the expression “in addition to the powers conferred by section 641”. The point which we would like to stress is that though the Central Government is vested with both the powers, namely, to amend the Schedule and to fill in details, the nature of the rules framed under section 641(2) continuous to have the status of the rules despite the phraseology used in section 641(2) which, as stated above, says that “any alteration notified under sub-section (1) of section 641 **shall have effect** as if enacted in the Companies Act”. To this extent, we are in agreement with the submission made on behalf of the appellants. Our view is supported by the judgment of this Court in the case of **Chief Inspector of Mines v. Karam Chand Thapar** AIR 1961 SC 838. We quote hereinbelow para 20 of the said judgment, which read as follows:

> “20. The true position appears to be that the Rules and Regulations do not lose their character as rules and regulations, even though they are to be of the same effect as if contained in the Act. They continue to be rules subordinate to the Act, and though for certain purposes, including the purpose of construction, they are to

be treated as if contained in the Act, their true nature as subordinate rule is not lost. Therefore, with regard to the effect of a repeal of the Act, they continue to be subject to the operation of Section 24 of the General Clauses Act."

Therefore, in our view, Rules framed under section 641 followed by Rules framed under section 642(1) shall continue to be Rules subordinate to the Companies Act though for the purposes of construction, they are to be treated as forming part of the same scheme.

41. In the present case, the most important question, which we have to decide is whether the impugned Rule adopted AS 22 is contrary to or inconsistent with the provisions of the Companies Act and in that connection our judgment proceeds on the basis that the impugned Rule is an example of subordinate legislation.

42. As stated above, tax expense or tax income represents total amount included in the determination of net profit or loss for the period in respect of current tax and deferred tax.

43. DTL is a tax payable in future period(s) which arises out of taxable temporary differences.

44. DTA is the tax recoverable in future period(s) which arises out of deductible temporary difference, carry forward of unused tax losses and carry forward of unused tax credits.

45. Temporary difference is the difference between the carrying amount of an asset or liability in the balance-sheet and its tax base, which is an amount attributable for tax purpose.

46. Taxable temporary difference will result in future period(s) when carrying amount of the asset or liability is recovered. It will arise when the tax base of an asset/liability is lower than the balance-sheet amount. Tax base of an asset gets reduced by over-charge of depreciation as per the tax law. The tax base of a liability gets reduced by over-charge of a liability which is to be written back as income in the future period(s).

(C) Whether AS 22 is contrary to or inconsistent with the provisions of the Companies Act.

47. In the case of **C.I.T. v. Duncan Brothers & Co. Ltd.** reported in (1996) 8 SCC 31 the assessee company submitted that provision for taxation made by it for assessment years 1963-64 and 1964-65 should be treated as a fund and, therefore, it should be deducted from the cost of asset required to be excluded under Rule 1(ii) of Schedule II to the Super Tax Act, 1963 and Rule 2(ii) of Schedule II to the Companies (Profits) Super Tax Act, 1964 respectively. This contention was rejected. This Court held that since Schedule II to both the Acts pertained to computation of capital, the terms used in Schedule II should be interpreted in the context of the balance-sheet of a company and its

P&L a/c which will have to be looked at to ascertain the company's capital and its profits. It was held that a provision for taxation of the kind in question was not a fund etymologically in accounting parlance. **It was observed that words of accounting language should be interpreted as understood in accounting practice.**

48. Applying the above test to the present case, we are now required to interpret the words "the amount of charge for Indian Income tax on profits" in clause 3(vi) in Part II of Schedule VI to the Companies Act. Similarly, we are required to interpret the words "current liabilities and provisions" in the form of balance-sheet in Part I of Schedule VI to the Companies Act. Part III of the said Schedule defines the words "provision" as well as "reserve".

49. As stated above, the form of balance-sheet is prescribed by Part I of Schedule VI. The Act does not prescribe a proforma of P&L a/c. However, Part II of Schedule VI prescribes the particulars which must be furnished in a P&L a/c. As far as possible, the P&L a/c must be drawn up according to the requirements of Part II of Schedule VI. As stated above, section 211(1) emphasizes "true and fair" view in place of "true and correct" view of accounting. As stated above, the legislative policy is to obliterate the difference between the accounting income and the taxable income. As stated above, the accounting income/book profit is the real income. Therefore, section 211(1) emphasizes the concept of "true and fair" view. As stated above, it is a stand-alone consideration. It is the controlling element underlying the scheme of sections 209, 211 and 227. However, as stated above, the Companies Ac does not deal with Recognition, Measurement and Disclosure. As stated above, how much amount should be recognized in respect of a specific matter is not covered by section 209(3)(b). Recognition, measurement and disclosure are the three items which can only be done by way of Accounting Standards and not by the provisions of the Companies Act. This aspect is important because under section 642(1) the Central Government is empowered to carry out ancillary/subordinate legislative functions which is also fictionally called as power to fill-up the details. Under section 211(1) Parliament has laid down the controlling consideration in presentation of balance-sheet and P&L a/c by companies and it has thereafter conferred discretion on Central Government to work out details within the framework of that Policy. Presentation of balance-sheet and P&L a/c is different from recognition, measurement and disclosure of various items of revenue, expenses, assets, liabilities etc.. That part has been left to the Central Government which is empowered to enact Accounting Standards in consultation with National Advisory Committee on Accounting Standards (NAC), which committee is to be established and which has been established under section 210A(1). As stated above, the Central Government is the rule making authority. As stated above, it is not bound to go by the recommendations of the Institute in the matter of framing of accounting standards. Generally, it follows such recommendations. However, in law nothing prevents the Central Government from enacting accounting standards in consultation with NAC which are in variance from the Standards prescribed by the Institute. In the present case, we are concerned with the accounting standards prescribed by Central Government in consultation with NAC under section 642(1) of the Companies Act.

50. In the present case, the main objection of the appellants is against paragraphs 9 and 33 of AS 22. Para 9 reads as under:

> ***"Tax expense for the period, comprising current tax and deferred tax, should be included in the determination of the net profit or loss for the period."***

51. Para 33 of AS 22 reads as under:

> "On the first occasion that the taxes on income are accounted for in accordance with this Statement, the enterprise should recognise, in the financial statements, the deferred tax balance that has accumulated prior to the adoption of this Statement as deferred tax asset/liability with a corresponding credit/charge to the revenue reserves, subject to the consideration of prudence in case of deferred tax assets (see paragraphs 15-18). The amount so credited/charged to the revenue reserves should be the same as that which would have resulted if this Statement had been in effect from the beginning."

52. As regards para 9, the appellants had no objection to the disclosure of DTL/DTA in their financial statements. They object to a charge being created qua P&L a/c for DTL mainly because it results in reduction of reserves and net profits. Therefore, the main contention is that the DTL is a notional concept. According to the appellants, DTL is not a liability. Therefore, according to the appellants, there cannot be a charge for DTL to the P&L a/c of the company. According to the appellants, DTL distorts their financial statements. According to the appellants, Schedule VI forms part of the Companies Act. According to the appellants Part II of Schedule VI contains clause 3(vi). According to the appellants, the said clause 3(vi) refers to the amount of charge for income tax on the profits. According to the appellants when AS 22 states that tax expense for the period shall consist of current tax and deferred tax and that such tax expense should be included in the determination of net profit or loss, it amounts to alteration of clause 3(vi) of Schedule VI to the Companies Act which is the part thereof. According to the appellants, Rules framed by the Central Government as a delegate under section 642 cannot alter the provisions of the Companies Act including Schedule VI. We have dealt with this aspect in the earlier paragraphs. However, the appellants have further contended that para 9 of AS 22 is inconsistent with the provisions of the Companies Act including Schedule VI and, therefore, void. It is also contended on behalf of the appellants that section 211 deals with P&L a/c and balance-sheet. That, para 9 only refers to filling in the details qua items in P&L a/c and balance-sheet. According to the appellants, P&L a/c and balance-sheet do not constitute primary books of accounts. According to the appellants, deferred taxation do not form part of accrual system of accounting. According to the appellants para 9 of AS 22 requires the company to make provision for liability for taxation in the balance-sheet and P&L a/c, further, according to the appellants P&L a/c and balance-sheet do not constitute books of accounts and, therefore, according to the appellants, such a standard brings about inconsistency between maintenance of books of accounts which are primary documents on one hand and balance-sheet an P&L a/c on the other hand. According to the appellants, para 9 of AS 22 does not touch the subject "maintenance of books of accounts". That, it only touches the presentation of balance-sheet and P&L a/c.

According to the appellants, books of accounts constitute primary documents and if para 9 does not apply to the maintenance of books of accounts, para 9 cannot be made applicable only to balance-sheet and P&L a/c because if it is so permitted it would bring about inconsistency between "maintenance of books of accounts" under section 209 vis-`-vis presentation of financial statements under section 211. In short, according to the appellants para 9 and para 33 of AS 22 are inconsistent with the provisions of the Companies Act including Schedule VI.

53. We do not find any merit in the arguments of the appellants on the point of inconsistency.

54. As stated above, recognition and measurements bring in the concept of fair value. When a financial instrument is measured at fair value it brings transparency in financial reporting. Today, companies undertake multifarious activities which warrants segment reporting. For example in RIL we have three segments, namely, refining, industry and infrastructure. Similarly, in the case of Sterlite Industries (India) Ltd., it has different segments. Each segment earns its own revenue. For example, revenue from copper, revenue from aluminium and revenue from others. Under clause 3(vi) of Part II non-provision for taxation would amount to contravention of the provisions of sections 209 and 211 of the Companies Act. Accordingly, it is necessary for the auditor to say in what manner the accounts do not disclose a "true and fair" view of the state of affairs of the company and the P&L a/c of the company. AS 22 is mandatory. Therefore, it is the duty of the members of the Institute to examine whether the accounting standard is complied with the said standard in the presentation of financial statement. [see also section 227(3)(d)]

55. In our view, para 9 only provides for details which are necessary for giving effect to the concept of true and fair accrual of accounts contemplated by section 211(1). As stated above, the concept of "true and correct" accrual is different from the concept of "true and fair" accrual. Both the concepts fall under accrual system of accounting. However, there is a difference. Under "true and correct" accrual, the matching principle was always recognized. However, fair valuation principle is the concept which brings out the real income of the company. Para 9 has been enacted, as stated above, to obliterate the difference between the accounting income and taxable income. Para 9 aims to present the real income to the investors, shareholders and stake-holders in the company. As stated above, there is also a difference between accounting depreciation and tax depreciation. In order to harmonize these differences, para 9 has been enacted. As stated above, true and fair view is the basic requirement in the matter of presentation of balance-sheet and P&L a/c. Therefore, in order to bring out the true income of a company, one has to read the provisions of the Companies Act with the accounting standards adopted by the impugned Notification. As held in the judgment of **P. Kasilingam** (supra) there are statute under which the rules provide an internal aid to the construction of the words used in the parent Act. The Companies Act uses the words like, provision, reserve, liability etc. in the accounting sense and as held in the case of **Duncan Brothers** (supra) the words of accounting language should be interpreted as understood in accounting practice.

Therefore, in our view, para 9 of AS 22 merely provides for details in the matter of provision for liability for taxation.

56. The word "tax expense" in para 9 under conservative system of accounting was confined to current tax. However, with para 9 of AS 22 coming into force, the word "tax expense" now includes both, current tax and deferred tax. This inclusion became necessary because of developments not only in concepts but also in accounting practices. This inclusion becomes necessary if one has to go by paradigm shift from historical costs accounting to fair value principles. In our view, with the insertion of the words "true and fair" view in section 211, which is the requirement in the matter of presentation of balance-sheet and P&L a/c the rule making authority was entitled to include the concept of "deferred tax" in tax expense. It may be stated that under clause 3(vi) of Part II, Schedule VI the charge for tax on profit is contemplated. Provision for liability for taxation is contemplated by the said clause. Para 9 of AS 22 merely provides for a liability which arises on account of timing difference as explained hereinabove. As stated above, it is known on the balance-sheet date. One has to therefore consider matching principle and fair valuation principles as important concepts in Accrual Accounting. Further, as stated above, recognition and measurement is not covered by the provisions of the Companies Act, therefore, one has to read the presentation of balance-sheet and P&L a/c together with recognition and measurements. Therefore, one has to read the provisions of the Companies Act along with the impugned Rule which adopts AS 22 as recommended by the Institute. The matching principle recognizes cost against revenue or against the relevant time period to determine the periodic income. Therefore, the said principle constitutes an important component of the accrual basis of accounting. The concept of accrual, in case of mergers and acquisition, is not limited to one year. DTL/DTA arises out of timing differences. Therefore, such differences have got to be reflected in Deferred Tax Accounting. DTL in most cases arises on account of the difference between tax depreciation and accounting depreciation. When on account of over-charging of depreciation under the Income-tax Rules, the taxable income falls below the accounting income, DTL emerges. This is because the rates of tax depreciation are incentive rates whereas accounting depreciation is based on the useful life of the asset. Thus, an asset under Income tax Act would be charged over a much shorter period as compared to the useful life of the asset. If the useful life of the asset is 10 years, for tax purposes it should be written off fully in 4 years. Thus, in the first year in which tax depreciation is higher than the accounting depreciation, the taxable income would be less than the accounting income, which would give rise to DTL on account of the difference between the amount of depreciation, i.e., the timing difference, which arises as it relates to the depreciation amounts for that particular year. It would become payable in future years when the timing difference reverses, i.e., when the taxable income becomes higher than the accounting income. Therefore, it is called as DTL. It is so called because it results in future cash outflow on account of the timing difference.

57. Hereinbelow, we are required to give illustrations to indicate the application of Fair Valuation principles in advanced accounting.

Illustration- (Application of "Fair Value Principles")

58. A convertible debenture is normally presented in the financial statements as a liability, while it has two components; a liability and an option to convert loan into equity. Appropriate accounting principle requires separate accounting for rights and obligations. Each component has to be separately accounted for. In the past, many of those rights and obligations were shown as off-balance-sheet items. Only recently, on account of accounting standards, the number of such items stand reduced. The issuer of a financial instrument is required to classify convertible debentures (financial instrument) as liability or as equity depending on the terms of the contract. A convertible debenture is a compound instrument. In case of such instrument, having different components, one has to present such components in financial statements either as equity or as liability based on the terms of the contract. As a general principle, a contract that will be settled by an entity receiving a fixed number of its own shares is an equity instrument. For example, when an enterprise issues shares in consideration of cash or some other asset/service, the transaction does not result in any cash outflow. For example, a redeemable preference share should be classified as liability and not as equity because it gives rise to an obligation to deliver cash. This example is given to show that DTL is a liability because it results in cash outflow in future on account of timing differences.

59. A company has an option to designate a financial asset at fair value through profit or loss. A financial asset held for trading should be classified as an asset at fair value through profit or loss. The difference in the fair value of financial asset at the beginning of the period and at the end of the period is generally recognized as profit or loss in the P&L a/c. Similarly, loans and receivables are carried at amortized cost unless the company intends to sell the same immediately. Similarly, there are certain assets like Held-to-maturity-investments which are required to be carried in the balance-sheet at the amortized cost. In all such cases, the company will now have to classify such assets or liabilities at fair value through profit or loss. Therefore, fair value under the new A.S. has become the basis for measurement of financial assets. Application of new standards will require a change in the mind-set. At present, non-financial companies carry current investments at cost or market value, whichever is lower. However, they carry long term investments at cost. They provide for permanent diminution in value of long term investment.

60. In our view, para 9 of AS 22 merely represents gap-filling exercise, therefore, there is no merit in the contention advanced on behalf of the appellants that AS 22 is inconsistent with the provisions of the Companies Act including Schedule VI. It proceeds on the principle that every transaction has a tax effect. The words "true and fair" view in section 211(1) connotes the widest law making powers and, in that context, we hold that that impugned Rule adopting AS 22 is intra vires as the said Rule is incidental and/or supplementary to the specific powers given to the Central Government to make Rules, particularly when such power is given to fill-in details. The word "supplementary" means something added to what is there in the Act, to fill-in details for which the Act itself does not provide. It is something in the sense that is required to implement what is there in the Act. [See **Daymond v. South West Water Authority** (1976) 1 All ER 39]. There is no merit in the contention advanced on behalf of the appellants that the impugned Rule seeks

to modify the essential features of the Companies Act. Rules made on matters permitted by the Act to supplement the Act cannot be held to be in violation of the Act. [See **Britnell v. Secretary of State** (supra)]. When the power to make rules is limited to particular topics and if that rule falls within the ambit of that topic, namely, taxes on income in the present case, it cannot be said that the rule is inconsistent with the provisions of the Act. As stated above, the Act and the Rules form part of the composite scheme. The provisions of sections 205, 209 and 211 can be put into operation only if the Act and the Rules are read together. In the present case, in our view, the impugned Rule constitutes a legitimate aid to construction of the provisions of the Companies Act. Further, as stated above, the Central Government is the rule making authority under section 211(3C). As rule making authority, the Central Government is empowered to enact accounting standards in consultation with NAC which may be at variance with the Standards issued by the Institute.

61. In the case of **Union of India and anr. v. Cynamide India Ltd. and anr.** reported in (1987) 2 SCC 720 one of the arguments advanced on behalf of the company was that, in calculating the "net worth" the cost of works-in-progress and the amount invested outside business were excluded from "free reserves" and that such exclusion could not be justified on any known principle of commercial accountancy (See para 33). The matter related to price fixation. In the Control Order vide para 2(g) the word "free reserve" was defined. Similarly, in the Form prescribed in the Fourth Schedule, several items like bonus, bad debts and provisions, loss/gain on sale of assets etc. were required to be excluded from the cost of production. Therefore, it was argued that such exclusion was not warranted by principles of commercial accountancy. This argument was rejected by this Court on the ground that it was open to the subordinate body to prescribe and adopt its own mode of ascertaining the cost of production. That the said body was under no obligation to adopt the method indicated under the Income tax Act in allowing expenses for the purposes of ascertaining income. It was further held that so long as the method prescribed and adopted by the subordinate legislating body is not opposite to the principle statutory provisions and so long as the method prescribed is ancillary to the provisions of the parent Act, it cannot be legitimately questioned. In the present case, as stated above, measurement and recognition methods are not the items under the Companies Act. Methods of recognition and measurements are talked about by the provisions of the Companies Act. Recognition and measurement of various items of revenue expenses etc. stand covered only by the accounting standards. Therefore, it cannot be said that the said standards are contrary to the provisions of the Companies Act. We also do not find any merit in the argument advanced on behalf of the appellants that the impugned Rule does not touch upon maintenance of books of accounts to be kept by the company. Under section 209(3)(b) every company is required to keep its books of accounts on accrual basis and according to double-entry system of accounting. Under section 209(3)(a) every company is required to maintain books of accounts necessary to provide a true and fair view of the state of affairs of the company and its accounts. In our view, books of accounts do not include balance-sheet and P&L a/c. However, as stated above, there is a difference between "true and correct" accrual and "true and fair" accrual. In the past, what prevailed was true and correct accrual. At that time, it was noticed in several cases that profits were overstated and, therefore, the Legislature

inserted what is called as “true and fair” accrual concept. The said concept is wider than the concept of true and correct accrual. **When section 209(3) refers to maintenance of books of accounts on accrual basis it means “true and fair” accrual,** which would include not only matching principles but also fair valuation principles. These principles do not contravene accrual system of accounting. Moreover, we are concerned with presentation of balance-sheet and P&L a/c. These are financial statements. An investor, shareholder or stake-holder is entitled to know the real income which the company has earned during the year. Provision for diminution in value of an asset results in emergence of liability. In the past, when timing difference concept was not there, in many cases, profits were overstated, particularly because provision for DTL (deferred taxation) was not recognized. With the introduction of the timing difference concept, it cannot be said that the accrual system of accounting is violated. As stated above, it is the concept of “timing difference” which obliterates the difference between accounting and tax incomes. Ultimately, the object is to obliterate the difference between accounting income and taxable income. Accounting income is the real income, therefore, in our view, para 9 of AS 22 is not inconsistent with the provisions of the Companies Act, including Schedule VI.

62. In the case of **Bharat Hari Singhania and ors. V. Commissioner of Wealth-tax (Central) and ors.** reported in AIR 1994 SC 1355 valuation of unquoted equity shares based on the break-up method was challenged. That challenge was rejected on the ground that the break-up method leads to appropriate market value and, therefore, the said method adopted by Rule 1-D of Wealth-tax Rules was neither ultra vires nor inconsistent with section 7 of the Wealth tax Act. We quote hereinbelow paras 13, 14 and 21 of the said judgment which held that it is always open to the rule-making authority to prescribe an appropriate method of valuation out of several methods of valuing an asset. And since the break-up method adopted by the rule-making authority was a known method in the relevant circles, it cannot be said that the method adopted was an impermissible method. Paras 13, 14 and 21 read as under:

> “13. We may first take up the question whether Rule 1-D is void for being inconsistent with the Act or for the reason that it is beyond the rule-making authority conferred by the Act. Section 7(1) indeed defines the expression "value of an asset." It is "the price which in the opinion of the Wealth Tax Officer it would fetch if sold in the open market on the valuation date", but this is made expressly subject to the Rule made in that behalf. No.guidance is furnished by the Act to the rule-making authority except to say that the Rule made must lead to ascertainment of the value of the asset (unquoted equity share) as defined in Section 7. It is thus left to the rule-making authority to prescribe an appropriate method for the purpose. Now, there may be several method of valuing an asset or for that method an unquoted equity share. The rule-making authority cannot obviously prescribe all of them together. It has to choose one of them which according to it is more appropriate. The rule-making authority has in this case chosen the break-up method, which is undoubtedly one of the recognised methods of valuing unquoted equity shares. Even if it is assumed that there was another method available which was more appropriate, still the method chosen cannot be

faulted so long as the method chosen is one of the recognised methods, though less popular. One probable reason why yield method or dividend method was not adopted in the case of unquoted equity shares was that bulk of these companies are private limited companies where the divided declared does not represent the correct state of affairs and to estimate the probable yield is no simple exercise. The dividends in these companies is declared to suit the purposes of the persons controlling the companies. Maintainable profits rather than the dividends declared represent the correct index of the value of their shares. The break-up method based upon the balance-sheet of the company, incorporated in Rule 1-D, is a fairly simple one. Indeed, no serious objection can also be taken to this course since the basis of the Rule is the balance-sheet of the company prepared by the company itself - subject, of course, to certain modifications provided in Explanation-II.

"14. We are not satisfied that the break-up method adopted by Rule 1-D does not lead to proper determination of the market value of the unquoted shares. The argument to this effect, advanced by the learned Counsel for the assessees, is based upon the assumption/premise that the value determined by applying the yield method is the correct market value. We do not see any basis for this assumption. No empirical data is placed before us in support of this submission or assumption. It may be more advantageous to the assessees but that is not saying the same thing that it alone represents the true market value. It cannot be stated as a principle that only the method that leads to lesser value is the correct method. The idea is to find out the true market value and not the value more favourable to the assessee. Accordingly, the contention that rule 1-D is inconsistent with Section 7(1) or that it travels beyond that purview of Section 7 is rejected."

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"21. The statement of law in the decision would thus establish that it does not purport to "lay down any hard and fast rule." It recognises that various factors in each case will have to be taken into account to determine the method of valuation to be applied in that case. The dividend yield method is not the only method indicated in the case of a going concern; there is the 'earning method' and then a combination of both methods. The several qualifications added to the above rules, as already stated, make them highly cumbersome and time-consuming. The Wealth Tax Officer has to examine the facts and circumstances of each case including the nature of the business, prospects of profitability and similar other considerations before finally determining whether to apply the dividend method, yield method or whether the break-up method should be followed. There may be cases where an assessee may be holding shares of a large number of private companies or other public limited companies whose shares are not quoted. Compared to them, the break-up method incorporated in Rule 1-D is far simpler and far less time-consuming. It prescribes a simple uniform method to be followed in all cases. All that the Wealth Tax Officer has to do is to take the balance-sheet, delete some items from the columns relating to assets and liabilities as directed by Explanation-II, and then apply the formula contained in the Rule.

He need not have to look into the profitability, the earning capacity and the various other factors mentioned in propositions (2), (3) and (4) of the decision. The decision, it bears repetition, recognises that break-up method "nonetheless is one of the methods." In the circumstances, it is difficult to agree with the learned Counsel for the assessees either that break-up method is not a recognised method or that yield method is the only permissible method for valuing the unquoted equity shares. It is not as if the rule-making authority has adopted a method unknown in the relevant circles or has devised an impermissible method. There is no empirical data produced before us to show that break-up method does not lead to the determination of market value of the shares. Merely because yield method may be more advantageous from the assessee's point of view, it does not follow that it alone leads to the ascertainment of true market value and that all other methods are erroneous or misleading. This aspect we have emphasised hereinbefore too."

Validity of Para 33 of AS 22

63. We have already quoted hereinabove para 33. The said para is challenged on the ground that a subordinate legislation cannot be retrospective unless there is provision to that effect in the parent Act. Therefore, the short question which we have to decide is whether the said para is retrospective.

64. To decide the said question, we have to analyse the scope of para 33. For the purpose of determining accumulated deferred tax in the period in which the Standard is applied for the first time, the opening balances of assets and liabilities for accounting purposes and for tax purposes are to be compared and the differences, if any, are to be determined. The tax effect of these differences have got to be recognized as DTA or DTL, if such differences are timing differences. For example, in the year in which a company adopts AS 22, the opening balance of a fixed asset is, let's say, Rs. 100 for accounting purposes and Rs. 60 for tax purposes. This difference is because the company applied written down value method of depreciation for calculating taxable income, whereas for calculating accounting income it adopts straight-line method. This difference will reverse in future when depreciation for tax purposes will be allowed as compared to depreciation for accounting purposes. In this example, let's assume that the tax rate is 40 per cent and that there are no other timing differences then, DTL would be [Rs. 100 - Rs. 60] x 40/100 = Rs. 16

65. Once we are required to take into account the concept of opening balance of a fixed asset in para 33, it cannot be said that the said para is retrospective. In fact, it is a transitional provision. Let's say that there is an expenditure which is written off for accounting purposes in the year in which it is incurred but is admissible for deduction under Income-tax Act over a period of time. In such a case, the asset representing expenditure would have a Balance only for tax purposes and not for accounting purposes. Therefore, the difference between the Balance of the asset for tax purposes and balance for accounting purposes, which is nil, would give rise to a timing difference which will reverse in future when expenditure would be allowed for tax purposes. In such a case,

DTA would be recognized in respect of difference, subject to the principle of prudence. In the circumstances, it cannot be said that para 33 is retrospective.

Conclusion:

66. For the aforestated reasons, we are of the view that the impugned Notification/Rule is neither ultra vires nor inconsistent with the provisions of the Companies Act, including Schedule VI.

67. To sum up, deferred tax is nothing but accrual of tax due to divergence between accounting profit and tax profit. This difference arises on two counts, namely, different treatment of items of revenue/expense as per profit and loss account and as per the tax law. It also arises on account of the difference between the amount of revenue/expense as per profit and loss account and the corresponding amount considered for tax purposes, e.g., depreciation.

68. For the aforestated reasons, we find no infirmity in the impugned judgment of the High Court and, accordingly, the civil appeals filed by the various companies stand dismissed with no order as to costs.