

Guidance note on measurement of income tax expense for interim financial reporting in the context of AS 25

1. This Guidance Note deals with the measurement of income tax expense for the purpose of inclusion in the interim financial reports.
2. Income tax expense is recognised in each interim period based on the best estimate of the weighted average annual effective tax rate (WAAETR) expected for the full financial year. Amounts accrued for income tax expense in one interim period may have to be adjusted in a subsequent interim period of that financial year if the estimate of the annual income tax rate changes.”
3. The various steps involved in the measurement of income tax expense for the purpose of interim financial reports are as below:
 - i) An enterprise will first have to estimate its annual accounting income. For this purpose, an enterprise would have to take into account all probable events and transactions that are expected to occur during the financial year. Such an estimate would involve, e.g., estimating on prudent basis, the depreciation on expected expenditure on acquisition of fixed assets, profits from sale of fixed assets/investments, etc. Such future events and transactions should be taken into account only if there is a reasonable certainty that the same would take place during the financial year.
 - ii) The enterprise should next estimate its tax liability for the financial year. For this purpose, the enterprise will have to estimate taxable income for the year. By applying the enacted or the substantively enacted tax rate on the taxable income, an estimate of the current tax for the year is arrived at. The enterprise would also have to estimate the deferred tax assets/liabilities by applying the principles of Accounting Standard (AS) 22, ‘Accounting for Taxes on Income’, issued by the Institute of Chartered Accountants of India. Special considerations may have to be applied in certain cases as below:
 - (a) Where brought forward losses exist from the previous financial year (when deferred tax asset was not recognised on considerations of prudence as per AS 22): In such a situation, for estimating the current tax liability, the brought forward losses would have to be deducted from the estimated annual accounting income. Since such carried forward losses will get setoff during the year, these would not have any tax consequence in future periods.
 - (b) Where brought forward losses exist (when deferred tax asset was recognised on the considerations of prudence as per AS 22): In such a situation, current tax would be computed in the same manner as explained in (a) above. However, in the determination of deferred tax, the tax expense arising from the reversal of the deferred tax asset recognised previously, to the extent of reversal of deferred tax asset in the current year, would also be considered.
 - iii) The enterprise would now have to calculate the weighted average annual effective tax rate. This tax rate would be determined by dividing the estimated tax expense as arrived at step (ii) above by the estimated annual accounting income as arrived at step (i) above. Where different tax rates are applicable to different portions of the estimated annual accounting income, e.g., normal tax rate and a different tax rate for capital gains, the weighted average annual effective

tax rate would have to be calculated separately for such portions of estimated annual accounting income.

iv) The weighted average annual effective tax rate arrived at step (iii) would be applied to the accounting income for the interim period for determining the income tax expense to be recognised in the interim financial reports.

4. Accounting for interim period income tax expense as suggested above is based on the approach prescribed in AS 25 that the interim period is part of the whole accounting year (often referred to as the 'integral approach') and, therefore, the said expense should be worked out on the basis of the estimated weighted average annual effective income-tax rate. According to this approach, the said rate is determined on the basis of the taxable income for the whole year, and applied to the accounting income for the interim period in order to determine the amount of tax expense for that interim period. This is in contrast to accounting for certain other expenses such as depreciation which is based on the approach prescribed in AS 25 that the interim period should be considered on stand-alone basis (often referred to as the 'discrete approach') because expenses such as depreciation are worked out on the basis of the period for which a fixed asset was available for use. The aforesaid treatments are, however, consistent with the requirement contained in paragraph 27 of AS 25 that an enterprise should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements.

Guidance Note on Availability of Revaluation Reserve for Issue of Bonus Shares

1. The excess of the revalued amount over the net book value of fixed assets, which is credited to revaluation reserve, is created as a result of a book adjustment only. The revaluation reserve does not result from an arm's length transaction; it represents an expert's perception of value. The revaluation reserve thus does not represent a realised gain.
2. Share capital represents the amount of money or money's worth received from the owners and the capitalisation of earned profits or other gains arising out of an arm's length transaction. It has, therefore, been a cardinal principle that only such profits as are earned or the relevant capital receipts (e.g. share premium), as are realised, can be capitalised.
3. In view of the above, in the opinion of the Institute of Chartered Accountants of India, bonus shares cannot be issued by capitalisation of revaluation reserve. If any company (including a private or a closely held public company) utilises revaluation reserve for issue of bonus shares, the statutory auditor of the company should qualify his audit report.

An illustrative manner of the qualification is given below:

"The company has issued bonus shares for Rs. 10 lakhs, (1 lakh equity shares of Rs.10 each) by capitalising its revaluation reserve. Accordingly, the Paid-up Equity Share Capital of the company stands increased by Rs. 10 lakhs and the revaluation reserve stands reduced by that amount. The issue of bonus shares as aforesaid is contrary to the recommendations of the Institute of Chartered Accountants of India.

4. In this context, it may also be noted that the Securities and Exchange Board of India (SEBI) has prohibited listed companies from issuing bonus shares out of revaluation reserves.

Guidance note on accounting for depreciation in companies

1. The Companies (Amendment) Act, 1988, has amended section 350, as a consequence to which rates of depreciation prescribed in Income-tax Act, 1961, and the Rules made there under are no more relevant as the aforesaid section now provides that the rates of depreciation applicable would be those prescribed in Schedule XIV, which has been inserted in the Act.

2. **Adoption of different methods for different types of assets**

A company may adopt more than one method of depreciation. Thus, it is permissible to follow different methods for different types of assets provided the same methods are consistently adopted from year to year. Also, units in different geographical locations can follow different methods of depreciation provided the same are consistently followed.

3. **Change in the method of providing depreciation**

Such a change should be treated as a change in accounting policy and its effects should be quantified and disclosed.

4. **Relevant rates of depreciation for the purpose of preparation of accounts of a company**

In arriving at the rates at which depreciation should be provided the company must consider the true commercial depreciation, i.e., the rate which is adequate to write off the asset over its normal working life. If the rate so arrived at is higher than the rates prescribed under Schedule XIV the company should provide depreciation at such higher rate but if the rate so arrived at is lower than the rate prescribed in Schedule XIV, then the company should provide depreciation at the rates prescribed in Schedule XIV, since these represent the minimum. rates of depreciation to be provided. Since the determination of commercial life of an asset is a technical matter, the decision of the Board of Directors based on technological evaluation should be accepted by the auditor unless he has reason to believe that such decision results in a charge which does not represent true commercial depreciation. In case a company adopts the higher rates of depreciation as recommended above, the higher depreciation rates, lower lives of the assets must be disclosed as required in Note no. 5 of Schedule XIV to the Companies Act, 1956.

This view is supported by the Department of Company Affairs and it has clarified that the rates as contained in Schedule XIV should be viewed as the minimum rates, and, therefore, a company will not be permitted to charge depreciation at rates lower than those specified in the Schedule in relation to assets purchased after the date of applicability of the Schedule..

Schedule XIV requires that where the concern has worked extra shift, the multiple or extra shift depreciation will have to be provided on the plant and machinery, wherever applicable. In this regard, various units/departments/mills/ factories should be taken as separate concerns. In cases where depreciation has not been provided in respect of extra or multiple shift allowance, it will be necessary for the auditor to qualify his report accordingly.

5. **Pro rata depreciation:**

Where, during any financial year, any addition has been made to any asset, or where any asset has been sold, discards, demolished or destroyed, the depreciation on such assets shall be calculated on a pro rata basis from the date of such addition or, as the case may be, up to the date on which such

asset has been sold, discarded, demolished or destroyed". The Committee is of the view that a company may group additions and disposals in appropriate time period(s), e.g., 15 days, a month, a quarter etc., for the purpose of charging pro rata depreciation in respect of additions and disposal; of its assets keeping in view the materiality of the amounts involved.

Where the financial year of a company is more/less than 12 months, the rates of depreciation as per Schedule XIV should be applied proportionately taking into consideration the duration of the financial year.

6. Depreciation on low value items

Prior to the enforcement of the Companies (Amendment) Act, 1988, many companies used to follow the practice of writing off low value items in the year of acquisition, since such a write off was permitted under the Income-tax Act. The limit for such a write off was Rs. 5,000/-. Schedule XIV is, however, silent on this aspect. The Committee is of the view that the concept of materiality should be kept in mind while deciding the amounts to be written off in this regard. For instance, in small companies, the total write off on this basis may be a substantial figure, it may not, therefore, be proper to charge 100% depreciation on low value items. However, in large companies, where the value of assets is very high, it may be proper to charge 100% depreciation on low value items keeping in view the concept of materiality. The Committee recommends that the accounting policy followed by the company in this regard should be disclosed appropriately in the accounts.

7. Computation of managerial remuneration -- whether SLM rates given in Schedule can be used

The Department of Company Affairs, as per its circular no. 3\19\88-CL V, dated April 13, 1989, has stated that "For the purpose of determining net profits of any financial year the amount of depreciation required to be deducted in pursuance of clause (k) of sub-section (4) of Section 349 read with Section 350 shall be the amount calculated as per the written down value method at the rate specified in Schedule XIV, on the assets as shown by the books of the Company at the end of the relevant financial year" .. The Committee is of the opinion that the language of Section 350 as it stands at present does not permit the use of the Straight Line Method. The aforesaid section makes reference to 'written-down value of the assets; indicating thereby that for the purposes of computation of managerial remuneration, only the WDV method can be used as the SLM rates, by definition, are applicable only to the original cost of the assets and not to the WDV of the assets.

8. Charging of depreciation in case of revaluation of assets

Depreciation is required to be provided with reference to the total value of the fixed assets as appearing in the accounts after revaluation. However, for certain statutory purposes e.g., dividends, managerial remuneration etc., only depreciation relatable to the historical cost of the fixed assets is to be provided out of the current profits of the company. In the circumstance, the additional depreciation relatable to revaluation may be adjusted against "Revaluation Reserve" by transfer to Profit and Loss Account. Such transfer from Revaluation Reserve should be shown in the Profit and Loss Account separately and an appropriate note by way of disclosure would be desirable.

The Revaluation Reserve is not available for payment of dividends. This view is also supported by the Companies (Declaration of Dividend out of Reserves) Rules, 1975. Similarly, accumulated losses or arrears of depreciation should not be set off against Revaluation Reserve.