ACCOUNTING STANDARD 22

ACCOUNTING FOR TAXES ON INCOME

1. Background:
   - Usually taxes are paid as per income tax laws.
   - For this purpose, profit is arrived as per income tax laws.
   - But income in our financial statements is determined on the accrual concept.
   - Tax is paid on taxable profit only not on accounting profit.
   - There are many scenarios where taxable profit is not equal to accounting profit.

2. According to this Accounting standard, the income tax expense should be treated just like any other expenses on accrual basis irrespective of the timing of payment of tax.

3. Taxes on income:
   - Domestic taxes on taxable income
   - Foreign taxes on taxable income
   - Exclude tax payable on distributions made by enterprise. (Dividend and other distributions)

4. Accounting income/ loss: Net profit or loss as per Profit and Loss A/c before income tax.

5. Taxable income/ loss: Income or loss determined as per income tax laws.

6. Amount of tax to be credited in the statement of profit and loss is termed as Tax Expenses.

7. Current tax: Tax determined to be payable (recoverable) in respect of taxable income (tax loss) for a period.

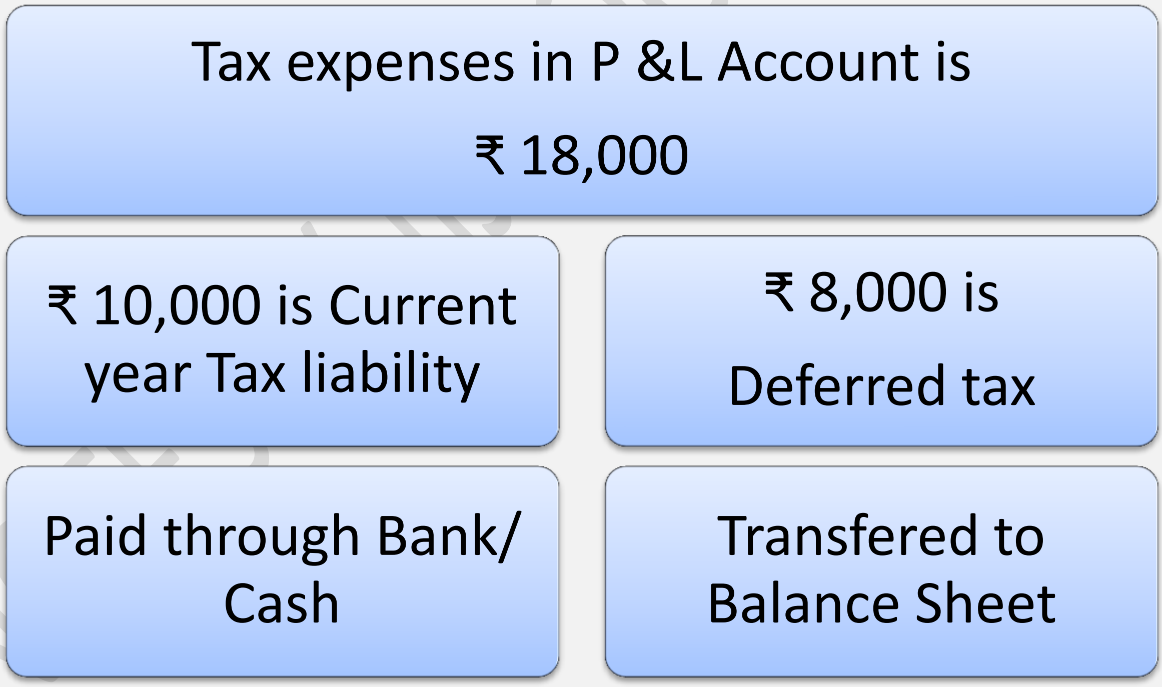
8. Deferred tax: Tax effect of timing difference.

- Suppose Tax expenses calculated on accrual basis is ₹ 18,000. Tax to be paid during the period is ₹ 10,000 as per income tax laws.
  8..1. Current tax = ₹ 10,000.
  8..2. Deferred tax (Balance) = ₹ 8,000.

- So Tax expenses = Current tax + Deferred tax
  8..1. As per our example above, ₹ 18,000 = ₹ 10,000 + ₹ 8,000.

9. How this Deferred tax (extra amount) is shown in Financial statements?
- This is accounted by creating deferred tax asset/ liability.

  Explanation by example:
  We know that enterprise is following double entry system.
  In our example, in the statement of Profit and Loss account tax expenses are shown as ₹ 18,000.



That is:

Income tax payable should be only ₹ 10,000… but we are providing ₹ 18,000 in the Financial statements as expenses.

Actually ₹ 8,000 is also to be paid. But in future we have to pay.

More clarification???

EXAMPLE 1

See the following Trial Balance:

Trial Balance before P&L:

	Debit	Credit
Share Capital		1,00,000
Cash	80,000	
Assets	25,000	
Expenses excluding income tax	20,000	
Income		25,000
Total	1,25,000	1,25,000

Trial Balance after P&L before tax:

	Debit	Credit
Share Capital		1,00,000
Cash	80,000	
Assets	25,000	
P&L		5,000
Total	1,05,000	1,05,000

Let taxable profit as per income tax be 1,000 and taxable profit as per accounting be 1,500.

Now

Trial Balance after P&L after tax:

For transparency the Income tax portion is shown separately (otherwise following trial balance)

	Debit	Credit
Share Capital		1,00,000
Cash	80,000	
Assets	25,000	
P&L		5,000
Income tax expenses	1,500	
Income tax payable		1,000
Deferred tax		500
Total	1,06,500	1,06,500

Now

Trial Balance after P&L.

	Debit	Credit
Share Capital		1,00,000
Cash	80,000	
Assets	25,000	
P&L		***3,500***
Income tax payable		1,000
Deferred tax		500
Total	1,05,000	1,05,000

EXAMPLE 2

See the following Trial Balance:

Trial Balance before P&L:

	Debit	Credit
Share Capital		1,00,000
Cash	80,000	
Assets	25,000	
Expenses excluding income tax	20,000	
Income		25,000
Total	1,25,000	1,25,000

Trial Balance after P&L before tax:

	Debit	Credit
Share Capital		1,00,000
Cash	80,000	
Assets	25,000	
P&L		5,000
Total	1,05,000	1,05,000

Let taxable profit as per income tax be 1,500 and taxable profit as per accounting be 1,000.

Now

Trial Balance after P&L after tax:

For transparency the Income tax portion is shown separately (otherwise following trial balance)

	Debit	Credit
Share Capital		1,00,000
Cash	80,000	
Assets	25,000	
P&L		5,000
Income tax expenses	1,000	
Income tax payable		1,500
Deferred tax	500	
Total	1,06,500	1,06,500

Now

Trial Balance after P&L.

	Debit	Credit
Share Capital		1,00,000
Cash	80,000	
Assets	25,000	
P&L		***4,000***
Income tax payable		1,500
Deferred tax	500	
Total	1,05,500	1,05,500

Deferred Tax	
Deferred tax asset	**Deferred tax liability**
Taxable Profit > Accounting Profit	Accounting Profit > Taxable Profit
Taxable Income > Accounting Income	Accounting income> Taxable income
See Example 1	See Example 2

- Why are there differences in accounting profit and tax profit?

Differences	
Timing difference	**Permanent difference**
Originate in one period; capable of reversing in subsequent periods	Originate in one period; but do not reverse. Always remains.
eg. Expenses debited in P&L for accounting puposes but only allowed for tax purpose in subsequent year.	eg. Expenses debited in P&L for accounting purposes but disallowed for tax purpose.

10.<u>THEREFORE DEFERRED TAX IS TAX EFFECT OF TIMING DIFFERENCE</u>

11. Timing difference that result in future taxable amounts – Deferred tax liability

12. Timing difference that result in deductible amounts and carry forward- Deferred tax asset.

13. All timing differences shall be recognized.

14. Unabsorbed depreciation/ carry forward of losses:

    - Deferred tax should be recognized only to the extent
    - That there is virtual evidence that sufficient future taxable income will be available
    - Against which such deferred assets can be realized.

15. The existence of unabsorbed depreciation or carry forward of losses under tax laws is strong evidence that future taxable income may not available.
    - Therefore the enterprises recognizes deferred tax assets only to the extent it has timing differences
    - the reversal of which will result in sufficient income.
    - or there is other convincing evidence that such income will be available.
    - The nature of such evidence supporting its recognition is disclosed in such circumstances.

16. In cases (other than said in point 14 and 15), if there is reasonable certainty that sufficient taxable income will arise/ available. The deferred tax asset should be recognized to that extent.

17. Every balance sheet date, the unrecognized deferred tax asset should be re-assessed whether such deferred assets can be realized.

18. Simple example showing recognition of deferred tax asset?

    YEAR 1

    Suppose you have taxable profit: ₹ 20,000
    Accounting profit : ₹ 12,000
    Deferred tax asset would become 10% (₹ 20,000 - ₹ 12,000) = ₹ 800 (rate 10% assumed)

    YEAR 2

    Let Tax to be paid as per Year 2 = ₹ 1,000
    Recognition of Deferred tax asset = ₹ 800
    Balance to be paid= ₹ 200.

    Here the deferred tax asset of Year 1 is recognized on Year 2.

19. Review of Deferred tax asset:
- Should be reviewed each balance sheet date.
- If it is evident that the Deferred tax asset is not recoverable because of uncertainty of future income, it should be written down.
- If any written down amount is certain to recovered or it becomes reasonably certain that future taxable amount will be available, the written down amount may be reversed.

20. Disclosure requirements

20..1. Break up of Deferred tax asset/ liability (DTA/DTL) should be disclosed.
20..2. DTA out of unabsorbed depreciation or loss is aroused; evidence supporting recognition should be disclosed.
20..3. DTA/DTL should be disclosed separately form current assets/ liabilities
20..4. DTA should be shown after “Investment”
20..5. DTL should be shown after “Unsecured Loan.”
20..6. DTA and DTL should be set off if permissible under tax laws but to be shown separately if not permissible.

Hi, I hope you enjoyed and clarified some concept…

If so, please hit
“THANKS” @ CACLUBINDIA# jijuoommen…

If you have suggestions or brickbats… comment..

Thank you…