Common Errors Found by FRRB in Implementation of AS 22 *Accounting for Taxes on Income*

Financial Statements are the paramount source in hands of the stakeholders to understand the financial well-being of an enterprise. The users are highly reliant on the information depicted in the financial statements and, therefore, the preparers ought to ensure that the information presented in the financial statement is correct, complete, relevant and in adherence to the regulatory requirements. Financial Reporting Review Board (hereinafter referred as FRRB or Board) reviews the General Purpose Financial Statements (GPFS) of enterprises with the view to identify the non-compliances with Accounting and Auditing Standards, CARO, Companies Act, and other statutory requirements applicable in preparation and presentation of the financial statements. The non-compliances observed by the Board are compiled from time to time and published under the name of "Study on Compliance with Financial Reporting Requirement", till date three volumes of the aforesaid publication has been released by the Board. In addition, the Board publishes articles in the 'Journal' of the Institute and also conduct webinar on the non-compliances with various reporting requirements to disseminate the awareness amongst the members as well as general masses. This article deals with the non-compliances, observed by the Board, with disclosure requirements prescribed under Accounting Standard – 22.

Contributed by Financial Reporting Review Board (FRRB) of the ICAI. Comments can be sent to frrb@icai.in

1. Offsetting of DTA and DTL in Consolidated Financial Statement

Case

A company having several subsidiaries, disclosed ***Net Deferred Tax Asset*** in the Consolidated Balance Sheet.

Principle

It may be noted that paragraph 29 of AS 22, Accounting for Taxes on Income, notified under the Companies (Accounting Standard) Rules, 2006 provides that;

"29. An enterprise should offset deferred tax assets and deferred tax liabilities if:

(a) *the enterprise has a legally enforceable right to set off assets against liabilities representing current tax; and*

(b) *the deferred tax assets and the deferred tax liabilities relate to taxes on income levied by the same governing taxation laws."*

Observation

It was noted that as per aforesaid requirement deferred tax liabilities and deferred tax assets can be set off against each other, only when the enterprise has legal enforceable right to set them off against each other. It was noted that in the given case, Net Deferred Tax Assets (DTA) reported in the Consolidated Balance Sheet has been determined by adjusting Deferred Tax Asset (DTA) of one enterprise against Deferred Tax Liabilities (DTL) of another enterprises. It was viewed that **there is no legal enforceable right to set off DTA of one enterprise against DTL of another enterprise.**

Accordingly, it was viewed that reporting such balances on net basis is not in accordance with the requirement of paragraph 29 of AS 22.

2. Presentation of Deferred Tax Liability(DTL) and Deferred Tax Asset (DTA) on the face of Balance Sheet

Case

From the Annual Report of certain companies it was noted that Deferred Tax Liability and Deferred Tax Asset had been presented in the following manner on the face of Balance Sheet:

- DTL as part of Loan Fund
- DTL as part of Note on Provision
- DTA as part of Current Assets
- DTL after Shareholders Fund
- DTL after the head 'Net Current Asset' as a deduction from 'Application of Funds'
- Deferred Tax (net) after the head 'Net Current Asset'

Principle

It may be noted that explanation to paragraph 30 of AS 22, Accounting for Taxes on Income, requires that;

"30. …

Explanation:

Deferred tax assets (net of the deferred tax liabilities, if any, in accordance with paragraph 29) is disclosed on the face of the balance sheet separately after the head 'Investments' and deferred tax liabilities (net of deferred tax assets, if any, in accordance with paragraph 29) is disclosed on the face of the balance sheet separately after the head 'Unsecured Loans'."

Observation

It was noted from the stated requirement that **DTL should be disclosed separately after the head 'unsecured loans' and DTA should be disclosed separately after the head 'Investments'** on the face of Balance Sheet.

Accordingly, it was viewed that the presentation of DTA and DTL in all these cases is not in line with the requirement of paragraph 30 of AS 22.

3. Non-disclosure of major components of DTA and DTL

Case

Certain companies have disclosed the break-up only for deferred tax assets and deferred tax liabilities that have been recognized in Statement of Profit and Loss.

Principle:

It may be noted that Paragraph 31 of AS 22, Accounting for Taxes on Income provides as follows:

"31. The break-up of deferred tax assets and deferred tax liabilities into major components of the respective balances should be disclosed in the notes to accounts."

Observation:

It was noted from the aforesaid requirement that

it requires the break-up of deferred tax assets and deferred tax liabilities ***balances.*** Accordingly, it was viewed that the term **'balances' signify that paragraph 31 requires break up of DTA and DTL as shown in the Balance Sheet** rather than the amount expensed in the Statement of Profit and Loss. However, the companies have disclosed the breakup of only the deferred tax liability/ assets that has been created during the year rather than providing the break-up of entire balance being carried forward in the Balance Sheet from one period to another period.

Accordingly, it was viewed that the requirement of paragraph 31 of AS 22 has not been complied with.

4. Non-recognition of DTA and DTL in case of losses

Case

In the Annual Report of a company, the note relating to provision for taxation read as follows:

'In the absence of book/ tax profits or losses and consequent impact of the timing differences on the same, provision for deferred taxes and current income tax has not been made.'

It was further noted from the note on fixed assets that the depreciation has been provided during the year.

Principle

It may be noted that paragraph 13 of AS 22, Accounting for Taxes on Income, provides as follows:

"13. Deferred tax should be recognised for all the timing differences, subject to the consideration of prudence in respect of deferred tax assets as set out in paragraphs 15-18."

It may further be noted that as per the clarification given in response to Question 9(ii) of Background Material for Seminars on Accounting Standard (AS) 22, Accounting for Taxes on Income, issued by the Institute, states as follows:

"(ii) … It may, however, be added that the deferred tax liability recognised at the balance sheet date will give rise to future taxable income at the time of reversal thereof. Accordingly, in the present case, in respect of tax losses of the company, which can be carried forward at the balance sheet date, deferred tax asset can be recognised to the extent that the reversal of the deferred tax liability will give rise to sufficient future taxable income against which such deferred tax asset can be realised."

Observation

From the aforesaid requirement, it was viewed that deferred tax should be recognised for all the timing differences. The fact that there are no tax profits or book profits does not exempt the company from recognition of deferred taxes. As regards recognition of deferred tax asset, it should be recognised based on principles of prudence stated therein. However, as per the clarification in response to Question 9 (ii), it was viewed that **deferred tax liability recognised at the balance sheet date gives rise to future taxable income at the time of reversal. Hence, deferred tax assets to the extent of deferred tax liability should be recognised.** In the given case, it was viewed that depreciation is giving rise to deferred tax liability. Hence, **the company should have recognised DTL on timing difference related to depreciation, and thereafter, DTA to the extent of DTL,** should have been recognised as per the requirements of AS 22.

Accordingly, it was viewed that in the given case, requirement of AS 22 has not been complied with.

5. Incomplete Accounting Policy for Taxes on Income

Case

From the Annual Report of a company, it has been noted that the company having history of unabsorbed depreciation and carry forward business losses had recognised the deferred tax asset. The accounting policy disclosed by the company with regard to accounting for taxes on income is as under:

"Deferred Tax Asset is recognised, subject to consideration of prudence, on timing differences, being difference between taxable and accounting income/ expenditure that originate in one period and are capable of reversal in one or more subsequent period(s). The management is of the opinion that sufficient future taxable income will be available against which, such deferred tax assets will be realised."

Principle

It may be noted that paragraph 17 of AS 22, Accounting for Taxes on Income, provides as follows:

> *"17. Where an enterprise has unabsorbed depreciation or carry forward of losses under tax laws, deferred tax assets should be recognised only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such deferred tax assets can be realised."*

Observation

It was viewed that as per the stated requirement, if an enterprise has unabsorbed depreciation or carry forward losses, deferred tax assets should be recognised to the extent it is virtually certain supported by convincing evidence that sufficient future taxable income would be available to realise it. It was noted from the stated accounting policy that deferred tax asset was recognised subject to the consideration of prudence. However, **it is not clear whether there exists virtual certainty supported by convincing evidence that future taxable income would be available against which such deferred tax can be realised.**

Accordingly, it was viewed that the accounting policy for the recognition of deferred tax asset is not complete considering the requirements of paragraph 17 of AS 22.

6. Virtual certainty is not supported by convincing evidence

Case

A company has unabsorbed depreciation and carry forward tax losses. The accounting policy given in the Annual Report states that the "Deferred tax assets are recognised only if there is virtual certainty supported by convincing evidence that such deferred tax assets can be realised against future taxable profits." However, under the Notes to the Accounts, it is stated that "based on the future profitability projections, the Company is virtually certain that there would be sufficient taxable income in future, to claim the above tax credit."

Principle

It may be noted that Explanation to paragraph 17 of AS 22, Accounting for Taxes on Income, provides as follows:

"17…

Explanation:

1. *Determination of virtual certainty that sufficient future taxable income will be available is a matter of judgement based on convincing evidence and will have to be evaluated on a case to case basis. Virtual certainty refers to the extent of certainty, which, for all practical purposes, can be considered certain. Virtual certainty cannot be based merely on forecasts of performance such as business plans. Virtual certainty is not a matter of perception and is to be supported by convincing evidence. Evidence is a matter of fact. To be convincing, the evidence should be available at the reporting date in a concrete form, for example, a profitable binding export order, cancellation of which will result in payment of heavy damages by the defaulting party. On the other hand, a projection of the future profits made by an enterprise based on the future capital expenditures or future restructuring etc., submitted even to an outside agency, e.g., to a credit agency for obtaining loans and accepted by that agency cannot, in isolation, be considered as convincing evidence."*

Observation

It was noted that the deferred tax asset was recognised based on virtual certainty ***evident from future profitability projections***. It may be noted that as per the explanation to paragraph 17 of AS 22, a **projection of the future profits made by an enterprise cannot, in isolation, be considered as convincing evidence**. Further, that evidence should be available at the reporting date in a concrete form, for example, a profitable binding export order.

Accordingly, it was viewed that the given policy as adopted for the recognition of deferred tax asset is not in line with the requirements of explanation to paragraph 17 of AS 22. ■