

## ***Query No. 20***

***Subject: Treatment of income tax paid for earlier years against the uncontested demand received during the current period.<sup>1</sup>***

### **A. Facts of the Case**

1. A private sector listed company (hereinafter referred to as ‘the company’) is engaged in providing global fluid management solutions and is the largest manufacturer and exporter of centrifugal pumps and valves from India. The core businesses of the company are large infrastructure projects (Water Supply, Power Plants and Irrigation), project and engineered pumps, industrial pumps, agriculture and domestic pumps, valves, motors and hydro turbines.

2. The querist has stated that the company had a survey under section 133A of the Income-tax Act, 1961 during the financial year 2012-13. After the survey, the Income-tax authorities have sent a notice of demand disallowing certain expenses claimed by the company as allowable for earlier financial years for which assessments are pending. To avoid long drawn litigations and expenses, the management has decided not to contest these claims and to pay the income tax for earlier years as per the demand.

3. The management wants to adjust/debit these tax expenses for earlier years directly to general reserve instead of debiting it to the statement of profit and loss for the current period.

4. The management’s argument in support of this accounting treatment is that the accounting treatment is not prohibited as per the provisions of the Companies Act, 1956 and that Accounting Standard (AS) 5, ‘Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies’, notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the ‘Rules’) also does not specifically prohibit such accounting treatment. According to the management, paragraphs 1 and 5 of AS 5 relate to revenue items that are considered to arrive at the profit or loss and the tax expense is of a consequence. The

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<sup>1</sup> Opinion finalised by the Committee on 3.9.2013.

management is also of the view that debiting earlier year's tax expenses to the current year's statement of profit and loss will give a distorted figure of the current year's profit.

5. The estimated profit before tax of the company for the current year is not sufficient to absorb the amount of the income tax paid for earlier years.

6. In the opinion of the statutory auditors of the company, in terms of paragraphs 1 and 5 of AS 5, such accounting treatment is prohibited.

#### **B. Query**

7. From the above background, the querist has sought the opinion of the Expert Advisory Committee whether income tax paid for earlier years against the uncontested demand raised by the Income-tax authorities during the current period can be directly debited to general reserve of the company.

#### **C. Points considered by the Committee**

8. The Committee notes that the basic issue raised in the query relates to whether the income tax paid in respect of earlier years against a demand raised by the Income-tax authorities during this year can be adjusted directly against general reserve of the company. The Committee has, therefore, considered only this issue and has not examined any other issue arising from the Facts of the Case, such as, disclosure of such income tax paid in the financial statements, deferred tax implications due to disallowance of expenses by Income-tax authorities in the subsequent periods, etc. Further, in the absence of the details in respect of the expenses disallowed by the Income-tax authorities, the Committee presumes from the Facts of the Case that these expenses had been correctly charged off to the statement of profit and loss while arriving at the accounting profit for that period. Also, the opinion expressed hereinafter is purely from accounting perspective and not from the angle of interpreting the provisions of any law, such as, Income-tax

Act, 1961 since in view of Rule 2 of the Advisory Service Rules, the Committee is prohibited from such interpretation.

9. The Committee notes paragraph 9 of Accounting Standard (AS) 22, 'Accounting for Taxes on income', notified under the 'Rules', as follows:

***“9. 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.”***

From the above, the Committee is of the view that income tax is an *expense* which is included in the determination of net profit or loss for the period. The Committee also notes paragraph 5 of AS 5, notified under the 'Rules', which inter alia states that all expenses and incomes should be included in the determination of profit or loss. Accordingly, the Committee is of the view that although income tax in the extant case pertains to earlier periods, it is an expense by nature. The Committee is of the view that in respect of an expense which is recognised in the statement of profit and loss, provision relating to it is also recognised in the statement of profit and loss and accordingly, if on actual determination, expenditure against such provision is in excess or short then such excess/short provision is also recognised in the statement of profit and loss. The Committee notes that in the extant case, income tax has arisen in the current year due to short provision of tax which was recognised in the statement of profit and loss of the relevant earlier period(s). Accordingly, after survey under section 133A of the Income-tax Act, 1961, when the Income-tax authorities has determined the final settlement amount of the income-tax obligation, the Committee is of the view that following the above-mentioned principle, the expense arising due to short provisioning of income tax in the earlier years should also be recognised in the statement of profit and loss. In this context, the Committee notes paragraph 9.8.1.6 of the Guidance Note on Revised Schedule VI to the Companies Act, 1956, issued by the Institute of Chartered Accountants of India, under the head 'Current tax', in relation to 'Part II – Statement of Profit and Loss' to the Revised Schedule VI also supports the above treatment while providing that "Excess/Short provision of tax relating to earlier years should be separately disclosed". Accordingly, the Committee is of the view that such tax expense should be separately disclosed in the statement of profit and loss rather than as an adjustment to general reserve.

10. As regards the view of the querist in paragraph 4 above that “AS 5 relate to revenue items that are considered to arrive at the profit or loss and the tax expense is of a consequence”, the Committee is of the view that although tax is estimated on profits, for accounting purposes, it is an expense which is to be included in the determination of profit/loss, as discussed above.

**D. Opinion**

11. On the basis of the above, the Committee is of the opinion that income tax paid for earlier years against the uncontested demand raised by the Income-tax authorities against the company during the current year should not be directly adjusted against the general reserve of the company. Rather it should be charged to the current year’s profit as discussed in paragraphs 9 and 10 above.