

Application of paragraph 21 of AS 22

The following is the opinion given by the Expert Advisory Committee of the Institute in response to a query sent by a member. This is being published for the information of readers.

A. Facts of the Case

1. A company is a public limited company listed with recognised stock exchanges, engaged in manufacturing of cementitious material on Pan India basis (hereinafter referred to as the 'company'). The company follows calendar year. In Union Budget for the financial year 2015-16 presented on 28th February 2015, the Government has revised the surcharge on income tax from 5% to 10%, resulting in increase of effective 'Corporate Tax' rate from 33.99% to 34.61%.
2. The querist has stated that as per Accounting Standard (AS) 22, 'Accounting for Taxes on Income', companies are required to recognise deferred tax on its temporary difference between book income and taxable income as per prescribed rate. Paragraph 21 of AS 22 says *"deferred tax should be measured using the tax rates and tax laws that have been enacted or substantively enacted by the balance sheet date."* According to the querist, as per Accounting Standard, it is important to note that the enactment or substantive enactment should have taken place by the balance sheet date. Enactment is when a bill is passed by both houses and receives consent of the President. It is important to note that the enactment or substantive enactment should take place by the balance sheet date, for example, if an enterprise has a December year end, the Finance Bill presented subsequently in February is neither an enactment nor a substantive enactment because it did not occur by the balance sheet date.
3. The querist has stated that the company is in the process of finalisation of its quarterly accounts for the quarter ended March 2015. Its board meeting for consideration and approval of results is scheduled on 29th April 2015. In order to finalise quarterly results for March 2015, the company has to decide the meaning of the word used in AS 22, 'substantive enactment'. What is 'substantive enactment'? At which point of time, substantive enactment should be considered/triggered.

Whether substantive enactment of the Finance Bill 2015 (Budget) took place on the balance sheet date.

4. The querist has explained various stages for approval of Finance Bill as follows:
 - Presenting the Finance Bill on the floor of house.
 - Passing of Finance Bill at Lok Sabha
 - Passing of Finance Bill at Rajya Sabha
 - Passing of Finance Bill at Lok Sabha and Rajya Sabha both + assent of the President is accorded

Further, the querist has also mentioned various possible situations where substantive enactment of Finance Bill may be considered:

- Substantive enactment where the Government is having majority in both the houses:
 - Can substantive enactment be considered by merely introduction of the Finance Bill on the floor of the house or,
 - Can substantive enactment be considered only when Finance Bill is passed by Lok Sabha
 - Can substantive enactment be considered only when Finance Bill is passed by both the houses
- Substantive enactment where the Government is having majority in one house and not in another house, considering Finance Bill need to be compulsory presented in Lok Sabha, first:
 - Government has majority in Lok Sabha but not in Rajya Sabha
Can substantive enactment be considered when Finance Bill is passed by Lok Sabha only and not by Rajya Sabha
 - Government has majority in Rajya Sabha but not in Lok Sabha
Can substantive enactment be considered merely by passing of Finance Bill by Lok Sabha only

The querist has stated that in all above situations, it is assumed that the President's assent will be certain.

5. According to the querist, the following approach, viz., conservative versus aggressive approach, should be considered while deciding on above question:

- Be aggressive in booking of expenses and defer recognition of revenue part
- If there is increase in effective tax rate in Finance Bill, the company should recognise the impact of the same immediately, without considering 'substantive enactment' principles, since there is exposure to that extent and otherwise in case there is decrease in effective tax rate.

6. *Accounting treatment of change in effective tax rate:*

The querist has also raised a question that in case of change in effective tax rate, what treatment should be given to opening deferred tax position, viz., whether it should be taken to free reserves or to the statement of profit and loss. For example, Companies Act, 2013, has made changes and it has changed the way depreciation was charged till date. All the companies need to apply these changes retrospectively. Here option is given to take the impact of depreciation till last year either in the statement of profit and loss of current year or adjust the same in retained earnings.

B. Query

7. In the above background, the querist has sought the opinion of the Expert Advisory Committee on the following issues:

- (i) What is substantive enactment for the purposes of 31st March, 2015 accounts? Is presenting the budget on the floor of the house a substantive enactment? Is passing of the bill by the Lok Sabha (not by Rajya Sabha) a substantive enactment? Is passing of the bill by the Lok Sabha and Rajya Sabha (Presidents consent not yet received) a substantive enactment?
- (ii) In case of change in effective tax rate, what treatment should be given to opening deferred tax position. Should it be taken

to free reserve or to the statement of profit and loss?

C. Points considered by the Committee

8. The Committee notes that the basic issues raised by the querist relate to application of paragraph 21 of AS 22 in relation to meaning of 'substantive enactment' in the context of corporate tax rate, for finalisation of quarterly accounts of the company for quarter ended March 2015 and accounting treatment for effect of change in effective tax rate. Accordingly, the Committee has considered only these issues and has not examined any other issue that may arise from the Facts of the Case, such as, impact of following calendar year as the accounting year, etc. Further, while expressing its opinion, the Committee is laying down the principles to be followed in cases where a revision in tax rates has been announced/introduced but the same has not yet been enacted.

9. The Committee notes from the Facts of the Case that the company follows calendar year as the accounting year for the purpose of preparation of financial statements. Further, in Union Budget for the financial year 2015-16 presented on 28th February 2015, the Government has revised the surcharge on income tax from 5% to 10%, resulting in increase of effective 'Corporate Tax' rate from 33.99% to 34.61%. However, till finalisation of quarterly accounts of March 2015, the revision has not yet been enacted (e.g., President's assent has not yet been accorded). Accordingly, the issue that arises is whether in such situation, can such proposed revision in tax rates be considered as substantively enacted for recognition of deferred taxes as per AS 22. In this regard, the Committee notes the following requirements of AS 22, notified under the Companies (Accounting Standards) Rules, 2006, (hereinafter referred to as the 'Rules') as follows:

AS 22

"21. Deferred tax assets and liabilities should be measured using the tax rates and tax laws that have been enacted or substantively enacted by the balance sheet date.

..."

“22. Deferred tax assets and liabilities are usually measured using the tax rates and tax laws that have been enacted. However, certain announcements of tax rates and tax laws by the government may have the substantive effect of actual enactment. In these circumstances, deferred tax assets and liabilities are measured using such announced tax rate and tax laws.”

From the above, the Committee notes that in case certain changes are proposed in tax rates, the term ‘substantively enacted’ should be construed as the tax rate that has the substantive effect of actual enactment. In other words, the process of enactment is substantively complete. The Committee is of the view that whether the process of enactment is substantively complete is a matter of judgement, which should be determined considering the facts and circumstances and various factors, such as, whether or not the remaining stages of the enactment process in past have affected the outcome (i.e., enactment of surcharge in the extant case) and are likely to do so in the present situation, viz., the process remaining to be executed for enactment is more of a procedural formality and is not expected to affect the outcome, etc. For example, in most cases, a tax rate for the purposes of AS 22 is regarded as having been substantively enacted if the Bill containing such changed tax rate has been passed by the Lok Sabha and is awaiting passage through the Rajya Sabha and the President’s assent. The Committee is also of the view that adequate and appropriate disclosures should be made regarding the tax rate adopted while recognising deferred tax assets and liabilities and the basis for such adoption in the notes to accounts.

10. With regard to accounting impact of changes in effective tax rates in the next reporting period resulting into any increase or decrease in the recognised deferred tax assets or liabilities, the Committee notes the requirements of Accounting Standard (AS) 25, ‘Interim Financial Reporting’ and Accounting Standard (AS) 5, ‘Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting

Policies’, notified under the Rules, as reproduced below:

AS 25

“29. To illustrate:

...

- (c) income tax expense is recognised in each interim period based on the best estimate of the weighted average annual income tax rate 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.”

“16. An enterprise should include the following information, as a minimum, in the notes to its interim financial statements, if material and if not disclosed elsewhere in the interim financial report:

...

- (d) the nature and amount of changes in estimates of amounts reported in prior interim periods of the current financial year or changes in estimates of amounts reported in prior financial years, if those changes have a material effect in the current interim period;**

...”

“25. If an estimate of an amount reported in an interim period is changed significantly during the final interim period of the financial year but a separate financial report is not prepared and presented for that final interim period, the nature and amount of that change in estimate should be disclosed in a note to the annual financial statements for that financial year.

26. Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies, requires disclosure, in financial statements, of the nature and (if practicable) the amount of a change in an accounting estimate which has a material effect in the current

period, or which is expected to have a material effect in subsequent periods. Paragraph 16(d) of this Standard requires similar disclosure in an interim financial report. Examples include changes in estimate in the final interim period relating to inventory write-downs, restructurings, or impairment losses that were reported in an earlier interim period of the financial year. The disclosure required by the preceding paragraph is consistent with AS 5 requirements and is intended to be restricted in scope so as to relate only to the change in estimates. An enterprise is not required to include additional interim period financial information in its annual financial statements.”

AS 5

“5. All items of income and expense which are recognised in a period should be included in the determination of net profit or loss for the period unless an Accounting Standard requires or permits otherwise.

6. Normally, all items of income and expense which are recognised in a period are included in the determination of the net profit or loss for the period. This includes extraordinary items and the effects of changes in accounting estimates.”

From the above, the Committee is of the view that the income tax rate applied in an interim period is an accounting estimate and effects of any change in such estimates resulting into income or expenses in another reporting period should be recognised in the statement of profit and loss. Further, paragraphs 16(d), 25 and 26 of AS 25 also requires disclosure in the interim financial report or financial statements (for final interim period in case separate financial report is not prepared for that period) of the nature and amount of changes in estimates of amounts reported in prior interim periods of the current financial year if such changes have material effects in the current interim period. In this regard, the Committee also wishes to point out that any adjustment to free reserves or retained earnings is possible only if there is any specific requirement in the accounting standard(s) or law to do so.

D. Opinion

11. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 7 above:

- (a) The term ‘substantively enacted’ should be construed as the tax rate that has the substantive effect of actual enactment. In other words, the process of enactment is substantively complete and whether the process of enactment is substantively complete is a matter of judgement, which should be determined considering the facts and circumstances and various factors as discussed in paragraph 9 above.
- (b) Effects of changes in effective tax rates in the next reporting period resulting into any increase or decrease in the recognised deferred tax assets or liabilities should be recognised in the statement of profit and loss and not in free reserves, as discussed in paragraph 10 above.

1	The Opinion is only that of the Expert Advisory Committee and does not necessarily represent the Opinion of the Council of the Institute.
2	The Opinion is based on the facts supplied and in the specific circumstances of the querist. The Committee finalised the Opinion on February 1, 2016. The Opinion must, therefore, be read in the light of any amendments and/or other developments subsequent to the issuance of Opinion by the Committee.
3	The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in thirty four volumes. A CD of Compendium of Opinions containing thirty four volume has also been released by the Committee. These are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.
4	Recent opinions of the Committee are available on the website of the Institute under the head ‘Resources’.
5	Opinions can be obtained from EAC as per its Advisory Service Rules which are available on the website of the ICAI, under the head ‘Resources’. For further information, write to eac@icai.in .