Treatment of deferred tax asset in respect of excess provision for doubtful advances and doubtful claims

The following is the brief version of an 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. The accounts of a public sector company are audited by the office of the Principal Director of Commercial Audit and Ex-officio Member, Audit Board. During the audit of the accounts of the company for the financial year 2004-05, certain differences of opinion had arisen between the company and the auditors in respect of Accounting Standard (AS) 22, 'Accounting for Taxes on Income', issued by the Institute of Chartered Accountants of India. The auditors, however, cleared the accounts for the year 2004-05, giving the benefit of doubt and on the commitment made by the company to take opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India.

2. The company has mainly three different businesses controlled by three separate business groups, namely, Petroleum, Explosives and Cryogenics.

3. The querist has separately provided detailed calculation of deferred tax assets/liabilities of the company for the last two years and a copy of the balance sheet as on 31.03.2005 for the perusal of the Committee. According to the querist, the computations show that the company has considered only the provision for doubtful debts against sundry debtors for the purpose of creating deferred tax assets and has not considered provision for doubtful advances, provision for doubtful claims and provision for doubtful deposits for this purpose. The reason given by the querist for the aforesaid treatment is that, from its past experience, the company is reasonably certain in respect of provisions for doubtful advances and doubtful claims that there are remote chances of these resulting into bad debts. The querist has also emphasised that there were no bad debts against these two provisions for the years 2001-02 to 2003-04. As per the querist, the company is consistently following the same method while calculating the deferred tax assets/ liability.

B. Query

4. The querist has sought the opinion of the Expert Advisory Committee as to whether while calculating deferred tax assets/ liability for the company as a whole, provision for doubtful advances and provision for doubtful claims need to be considered for calculation of deferred tax assets.

C. Points considered by the Committee

5. The Committee notes that the basic issue raised by the querist relates to creation of deferred tax asset/liability in respect of provision for doubtful advances and

doubtful claims. Hence, the Committee has considered only this issue and has not examined any other issue arising from the Facts of the Case, for example, creation of provision in respect of doubtful debts against sundry debtors and treatment of deferred tax assets/liabilities in respect thereof, etc.

6. The Committee notes that Part III of Schedule VI to the Companies Act, 1956 states in paragraph 7(2) as below:

   "(2) Where –

   (a) any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, not being an amount written off in relation to fixed assets before the commencement of this Act; or

   (b) any amount retained by way of providing for any known liability;

   is in excess of the amount which in the opinion of the directors is reasonably necessary for the purpose, the excess shall be treated for the purposes of this Schedule as a reserve and not as a provision."

7. The Committee also notes that Schedule VI to the Companies Act, 1956, under 'Instructions in accordance with which assets should be made out' in respect of 'sundry debtors' provides that "The provisions to be shown under this head should not exceed the amount of debts stated to be considered doubtful or bad and any surplus of such provision, if already created, should be shown at every closing under "Reserves and Surplus" (in the Liabilities side) under a separate sub-head "Reserve for Doubtful or Bad Debts"."

8. The Committee further notes that the provision for bad and doubtful claims and advances represents impairment of receivables which is covered by Accounting Standard (AS) 4, 'Contingencies and Events Occurring After the Balance Sheet Date', issued by the Institute of Chartered Accountants of India. In this context, the Committee notes paragraph 10 of AS 4, which states as follows:

   "10. The amount of a contingent loss should be provided for by a charge in the statement of profit and loss if:

   (a) it is probable that future events will confirm that, after taking into account any related probable recovery, an asset has been impaired or a liability has been incurred as at the balance sheet date, and

   (b) a reasonable estimate of the amount of the resulting loss can be made."

   The Committee notes that an event is regarded as 'probable' if the event is more likely than not to occur, i.e., the probability that the event will occur is greater than the probability that it will not.

9. The Committee notes that the querist has stated in paragraph 3 of the Facts of the Case that the chances of advances/claims (against which provisions have been created) becoming bad are very remote and from its past experience, the company is reasonably certain that these debts will be recovered in the future. The Committee also notes from the said paragraph that there were no bad debts against these two provisions during the last two years.

10. From the above paragraphs, the Committee is of the view that creation of provision by the company against advances/claims that are considered to

be recoverable is an error in view of the requirements of the Companies Act, 1956, and AS 4. Hence, the excess amount of provision should be written-back in the financial statements as a 'prior period item'. In this regard, the Committee notes the definition of the term 'prior period items' and paragraphs 15 and 19 of Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', issued by the Institute of Chartered Accountants of India, which state as follows:

"Prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods."

"15. The nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on the current profit or loss can be perceived."

"19. Prior period items are normally included in the determination of net profit or loss for the current period. An alternative approach is to show such items in the statement of profit and loss after determination of current net profit or loss. In either case, the objective is to indicate the effect of such items on the current profit or loss."

11. On the basis of the above, the Committee is of the view that since the creation of provision for doubtful claims and advances was on account of an error in the past years, as discussed in paragraphs 9 and 10 above, it should be written-back in the financial statements of the year in which such a correction is made and should be shown separately in a manner that its impact on the current profit or loss can be perceived. Accordingly, the question of creation of deferred tax assets/liability in respect of provision for doubtful claims and advances would not arise. The Committee is, however, of the view that if the company so desires, the company may create reserve for doubtful claims and doubtful advances as an appropriation of profits.

D. Opinion

12. On the basis of the above, the Committee is of the opinion, on the issue raised in paragraph 4, that in the present case, the provision for doubtful advances and provision for doubtful claims should be written back in the financial statements as a 'prior period item' as explained in paragraph 11 above and hence, the question of treatment of deferred tax asset/liability against such provisions does not arise.

Notes:

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 Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in twenty four volumes which are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.