Illustration II

Note: This illustration does not form part of the Accounting Standard. Its purpose is to illustrate the application of the Accounting Standard. Extracts from statement of profit and loss are provided to show the effects of the transactions described below.

Illustration 1

A company, ABC Ltd., prepares its accounts annually on 31st March. On 1st April, 20x1, it purchases a machine at a cost of Rs. 1,50,000. The machine has a useful life of three years and an expected scrap value of zero. Although it is eligible for a 100% first year depreciation allowance for tax purposes, the straight-line method is considered appropriate for accounting purposes. ABC Ltd. has profits before depreciation and taxes of Rs. 2,00,000 each year and the corporate tax rate is 40 per cent each year.

The purchase of machine at a cost of Rs. 1,50,000 in 20x1 gives rise to a tax saving of Rs. 60,000. If the cost of the machine is spread over three years of its life for accounting purposes, the amount of the tax saving should also be spread over the same period as shown below:

Statement of Profit and Loss
(for the three years ending 31st March, 20x1, 20x2, 20x3)

(Rupees in thousands)

	20x1	20x2	20x3
Profit before depreciation and taxes	200	200	200
Less: Depreciation for accounting purposes	50	50	50
Profit before taxes	150	150	150
Less: Tax expense			
Current tax			
0.40 (200 – 150)	20		
0.40 (200)		80	80
Deferred tax			
Tax effect of timing differences originating during the year			
0.40 (150 – 50)	40		
Tax effect of timing differences reversing during the year			
0.40 (0 – 50)		(20)	(20)
Tax expense	60	60	60
after tax	90	90	90
Net timing differences	100	50	0
Deferred tax liability	40	20	0

In 20x1, the amount of depreciation allowed for tax purposes exceeds the amount of depreciation charged for accounting purposes by Rs. 1,00,000 and, therefore, taxable income is lower than the accounting income. This gives rise to a deferred tax liability of Rs. 40,000. In 20x2 and 20x3, accounting income is lower than taxable income because the

amount of depreciation charged for accounting purposes exceeds the amount of depreciation allowed for tax purposes by Rs. 50,000 each year. Accordingly, deferred tax liability is reduced by Rs. 20,000 each in both the years. As may be seen, tax expense is based on the accounting income of each period.

In 20x1, the profit and loss account is debited and deferred tax liability account is credited with the amount of tax on the originating timing difference of Rs. 1,00,000 while in each of the following two years, deferred tax liability account is debited and profit and loss account is credited with the amount of tax on the reversing timing difference of Rs. 50,000.

The following Journal entries will be passed:

Year 20x1

Profit and Loss A/c	Dr.	20,000	
To Current tax A/c			20,000
(Being the amount of taxes payable for the year 20x1 provided for)			
Profit and Loss A/c	Dr.	40,000	
To Deferred tax A/c			40,000
(Being the deferred tax liability created for originating timing difference of Rs. 1,00,000)			

Year 20x2

Profit and Loss A/c	Dr.	80,000	
To Current tax A/c			80,000
(Being the amount of taxes payable for the year 20x2 provided for)			
Deferred tax A/c	Dr.	20,000	
To Profit and Loss A/c			20,000
(Being the deferred tax liability adjusted for reversing timing difference of Rs. 50,000)			

Year 20x3

Profit and Loss A/c	Dr.	80,000	
To Current tax A/c			80,000
(Being the amount of taxes payable for the year 20x3 provided for)			
Deferred tax A/c	Dr.	20,000	
To Profit and Loss A/c			20,000
(Being the deferred tax liability adjusted for reversing timing difference of Rs. 50,000)			

In year 20x1, the balance of deferred tax account i.e., Rs. 40,000 would be shown separately from the current tax payable for the year in terms of paragraph 30 of the Standard. In Year 20x2, the balance of deferred tax account would be Rs. 20,000 and be shown separately from the current tax payable for the year as in year 20x1. In Year 20x3, the balance of deferred tax liability account would be nil.

Illustration 2

In the above illustration, the corporate tax rate has been assumed to be same in each of the three years. If the rate of tax changes, it would be necessary for the enterprise to adjust the amount of deferred tax liability carried forward by applying the tax rate that has been enacted or substantively enacted by the balance sheet date on accumulated timing differences at the end of the accounting year (see paragraphs 21 and 22). For example, if in Illustration 1, the

substantively enacted tax rates for 20x1, 20x2 and 20x3 are 40%, 35% and 38% respectively, the amount of deferred tax liability would be computed as follows:

The deferred tax liability carried forward each year would appear in the balance sheet as under:

31st March, 20x1 = 0.40 (1,00,000)= Rs. 40,000

31st March, 20x2 = 0.35 (50,000) = Rs. 17,500

31st March, 20x3 = 0.38 (Zero) = Rs. Zero

Accordingly, the amount debited/(credited) to the profit and loss account (with corresponding credit or debit to deferred tax liability) for each year would be as under:

31st March, 20x1 Debit = Rs. 40,000

31st March, 20x2 (Credit) = Rs. (22,500)

31st March, 20x3 (Credit) = Rs. (17,500)

Illustration 3

A company, ABC Ltd., prepares its accounts annually on 31st March. The company has incurred a loss of Rs. 1,00,000 in the year 20x1 and made profits of Rs. 50,000 and 60,000 in year 20x2 and year 20x3 respectively. It is assumed that under the tax laws, loss can be carried forward for 8 years and tax rate is 40% and at the end of year 20x1, it was virtually certain, supported by convincing evidence, that the company would have sufficient taxable income in the future years against which unabsorbed depreciation and carry forward of losses can be set-off. It is also assumed that there is no difference between taxable income and accounting income except that set- off of loss is allowed in years 20x2 and 20x3 for tax purposes.

Statement of Profit and Loss
(for the three years ending 31st March, 20x1, 20x2, 20x3)

(Rupees in thousands)

	20x1	20x2	20x3
Profit (loss)	(100)	50	60
Less: Current tax	—	—	(4)
Deferred tax:			
Tax effect of timing differences originating during the year	40		
Tax effect of timing differences reversing during the year	___	(20)	(20)
Profit (loss) after tax effect	(60)	30	36

Illustration 4

Note: The purpose of this illustration is to assist in clarifying the meaning of the explanation to paragraph 13 of the Standard.

Facts:

1. The income before depreciation and tax of an enterprise for 15 years is Rs. 1000 lakhs per year, both as per the books of account and for income-tax purposes.

2. The enterprise is subject to 100 percent tax-holiday for the first 10 years under section 80-IA. Tax rate is assumed to be 30 percent.

3. At the beginning of year 1, the enterprise has purchased one machine for Rs. 1500 lakhs. Residual value is assumed to be nil.

4. For accounting purposes, the enterprise follows an accounting policy to provide depreciation on the machine over 15 years on straight-line basis.

5. For tax purposes, the depreciation rate relevant to the machine is 25% on written down value basis.

The following computations will be made, ignoring the provisions of section 115JB (MAT), in this regard:

Table 1
Computation of depreciation on the machine for accounting purposes and tax purposes
(Amounts in Rs. lakhs)

Year	Depreciation for accounting purposes	Depreciation for tax purposes
1	100	375
2	100	281
3	100	211
4	100	158
5	100	119
6	100	89
7	100	67
8	100	50
9	100	38
10	100	28
11	100	21
12	100	16
13	100	12
14	100	9
15	100	7

At the end of the 15th year, the carrying amount of the machinery for accounting purposes would be nil whereas for tax purposes, the carrying amount is Rs. 19 lakhs which is eligible to be allowed in subsequent years.

Table 2
Computation of Timing differences

(Amounts in Rs. lakhs)

1	2	3	4	5	6	7	8	9
Year	Income before Depreciation and tax (both for accounting purposes and tax purposes)	Accounting Income after depreciation	Gross Total Income (after deducting depreciation under tax laws)	Deduction under section 80-IA	Taxable Income (4-5)	Total Difference between accounting income and taxable income (3-6)	Permanent Difference (deduction pursuant to section 80-IA)	Timing Difference(due to different amounts of depreciation for accounting purposes and tax purposes) (O= Originating and R=Reversing)
1	1000	900	625	625	Nil	900	625	275 (O)
2	1000	900	719	719	Nil	900	719	181 (O)
3	1000	900	789	789	Nil	900	789	111 (O)
4	1000	900	842	842	Nil	900	842	58 (O)
5	1000	900	881	881	Nil	900	881	19(O)
6	1000	900	911	911	Nil	900	911	11 (R)
7	1000	900	933	933	Nil	900	933	33 (R)
8	1000	900	950	950	Nil	900	950	50 (R)
9	1000	900	962	962	Nil	900	962	62 (R)
10	1000	900	972	972	Nil	900	972	72 (R)
11	1000	900	979	Nil	979	-79	Nil	79 (R)
12	1000	900	984	Nil	984	-84	Nil	84 (R)
13	1000	900	988	Nil	988	-88	Nil	88 (R)
14	1000	900	991	Nil	991	-91	Nil	91 (R)
15	1000	900	993	Nil	993	-93	Nil	74 (R) 19 (O)

Notes:

1. Timing differences originating during the tax holiday period are Rs.644 lakhs, out of which Rs. 228 lakhs are reversing during the tax holiday period and Rs. 416 lakhs are reversing after the tax holiday period. Timing difference of Rs. 19 lakhs is originating in the 15th year which would reverse in subsequent years when for accounting purposes depreciation would be nil but for tax purposes the written down value of the machinery of Rs. 19 lakhs would be eligible to be allowed as depreciation.

2. As per the Standard, deferred tax on timing differences which reverse during the tax holiday period should not be recognised. For this purpose, timing differences which originate first are considered to reverse first. Therefore, the reversal of timing difference of Rs. 228 lakhs during the tax holiday period, would be considered to be out of the timing difference which originated in year 1. The rest of the timing difference originating in year 1 and timing differences originating in years 2 to 5 would be considered to be reversing after the tax holiday period. Therefore, in year 1, deferred tax would be recognised on the timing difference of Rs. 47 lakhs (Rs. 275 lakhs - Rs. 228 lakhs) which would reverse after the tax holiday period. Similar computations would be made for the subsequent years. The deferred tax assets/liabilities to be recognised during different years would be computed as per the following Table.

Table 3
Computation of current tax and deferred tax

(Amounts in Rs. lakhs)

Year	Current tax (Taxable Income x 30%)	Deferred tax (Timing difference x 30%)	Accumulated Deferred tax (L= Liability and A = Asset)	Tax expense
1	Nil	47 × 30%= 14 (see note 2 above)	14 (L)	14
2	Nil	181 × 30%=54	68 (L)	54
3	Nil	111× 30%=33	101 (L)	33
4	Nil	58 × 30%= 17	118 (L)	17
5	Nil	19 × 30%=6	124 (L)	6
6	Nil	Nil[1]	124 (L)	Nil
7	Nil	Nil[1]	124 (L)	Nil
8	Nil	Nil[1]	124 (L)	Nil
9	Nil	Nil[1]	124 (L)	Nil
10	Nil	Nil[1]	124 (L)	Nil
11	294	–79 × 30%= -24	100 (L)	270
12	295	–84 × 30%= -25	75 (L)	270
13	296	–88 × 30%= -26	49 (L)	270
14	297	–91 × 30%= -27	22 (L)	270
15	298	–74 × 30%= -22	Nil	270
		–19 × 30%= -6	6(A)[2]	

[1.] No deferred tax is recognised since in respect of timing differences reversing during the tax holiday period, no deferred tax was recognised at their origination.

[2.] Deferred tax asset of Rs. 6 lakhs would be recognised at the end of year 15 subject to consideration of prudence as per AS 22. If it is so recognised, the said deferred tax asset would be realized in subsequent periods when for tax purposes depreciation would be allowed but for accounting purposes no depreciation would be recognised.