STUDY MATERIAL OF
B.COM PART-II

CORPORATE ACCOUNTING

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Deferred Tax:

• Deferred tax refers to the *tax effect of temporary differences* between accounting income that is calculated by taking into consideration the provisions of Companies Act, 2013 and taxable income that is calculated by taking into consideration the provisions of Income Tax Act, 1961.
• Taxable income is calculated in accordance with tax laws. In some circumstances, *the requirements of these laws to compute taxable income differ from the accounting policies* applied to determine accounting income.

• The effect of such difference is that the *taxable income and accounting income may not be the same.*

• The differences between taxable income and accounting income can be classified into *permanent differences and timing differences.*
Permanent Differences

• **Permanent differences** are those differences between taxable income and accounting income which originate in one period and do not reverse subsequently.

• For instance, if for the purpose of computing taxable income, the tax laws allow only a part of an item of expenditure, the disallowed amount would result in a permanent difference.
Temporary Differences:

• **Timing differences** are the differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods.

• While calculating taxable income, certain expenses debited to Profit or Loss A/c are disallowed in one period and gets reversed in future period in accordance with provisions of the Income-tax Act. In the same manner, certain incomes credited in one period to Profit or Loss A/c form part of the income in future period. Such items are considered as temporary differences.

• Unabsorbed depreciation and carry forward of losses which can be setoff against future taxable income are also considered as timing differences and result in deferred tax assets, subject to consideration of prudence.
• For example:

(i) In case of treatment of *deferred revenue expenditure* (say, advertisement expenses incurred in one year but the benefit of which extends in subsequent years also), the expenditure incurred is amortised over a period of time but as per tax laws, it is allowed wholly in first year in which such deferred revenue expenditure is made.

(ii) In case of advance incomes received (say, advance rent), the disclosure of same is mandatory for the purpose of calculating taxable income. However, this income is recognized in the books of account when actually earned.
(iii) In case of different book and tax depreciation which could arise due to difference in depreciation rates or methods of calculating depreciation i.e. SLM or WDV or differences in composition of actual cost of assets.

(iv) In case of provisions made in anticipation of liabilities where the liability is allowed in the subsequent period when it crystallizes.
Deferred Tax Accounting:

• The accounting, presentation and disclosure of deferred tax is carried out as per the provisions of “Accounting Standard- 22” (i.e., Accounting for Taxes on Income) or “Ind AS- 12” (i.e., Income Taxes).

• Deferred tax asset or deferred tax liability is created by debiting/crediting Statement of Profit and Loss.

• The following table shows different cases where deferred tax asset/liability is required to be created:

<table>
<thead>
<tr>
<th>CASES</th>
<th>DEFERRED TAX ASSET/LIABILITY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Book Profit &gt; Taxable Profit</td>
<td>Deferred Tax Liability</td>
</tr>
<tr>
<td>Book Profit &lt; Taxable Profit</td>
<td>Deferred Tax Asset</td>
</tr>
</tbody>
</table>
Deferred Tax Asset/ liability in case of LOSS:

- Due to differences in income as per financial books and taxable profit as per tax laws, there is a certainty that one book reflects loss and other shows profit. In that case, the following treatment shall be made:

<table>
<thead>
<tr>
<th>CASES</th>
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</tr>
</thead>
<tbody>
<tr>
<td>Loss as per books of accounts and Profit as per tax laws (Subject to the principles of prudence)</td>
<td>Deferred Tax Asset</td>
</tr>
<tr>
<td>Loss as per tax laws and Profit as per books of account (MAT has to be paid)</td>
<td>Deferred Tax Liability</td>
</tr>
</tbody>
</table>
What is a Deferred Tax Asset:

• A deferred tax asset is an asset on a company’s balance sheet that may be used to reduce its taxable income.

• It refers to a situation where a business has overpaid taxes or taxes paid in advance on its balance sheet.

• These taxes are eventually returned to the business in the form of tax relief, and the overpayment is, therefore, an asset for the company.

• A deferred tax asset is the opposite of a deferred tax liability, which can increase the amount of income tax owed by a company.
How Deferred Tax Asset arises:

• The simplest example of a deferred tax asset is the carry-over of losses.

• If a business incurs a loss in a financial year, it usually is entitled to use that loss in order to lower its taxable income in following years. In that sense, the loss is an asset.

• Another scenario where deferred tax assets arise is where there is a difference between accounting rules and tax rules.

• For example, deferred taxes exist when expenses are recognized in the income statement before they are required to be recognized by the tax authorities or when revenue is subject to taxes before it is taxable in the income statement. Essentially, whenever the tax base or tax rules for assets and/or liabilities are different, there is an opportunity for the creation of a deferred tax asset.
What is a Deferred Tax Liability

• A deferred tax liability is a tax that is assessed or is due for the current period but has not yet been paid.

• The deferral comes from the difference in timing between when the tax is accrued and when the tax is paid.

• A deferred tax liability records the fact that the company will, in future, pay more income tax because of a transaction that took place during the current period, such as an instalment sale receivable.
• **For Example:** Revenue recognized when a company sells its products on credit to be paid off in equal amounts in the future.

• Under accounting rules, the company is allowed to recognize full income from the instalment sale of general merchandise, while tax laws require companies to recognize the income when instalment payments are made.

• This creates a temporary positive difference between the company's accounting earnings and taxable income, as well as a deferred tax liability.
Accounting Treatment:

- **Deferred Tax Computation Rate:** The deferred tax asset/liability is calculated at the normal rate of tax.

- **Deferred Tax Asset Accounting:** Deferred Tax Asset account is created by crediting Profit & Loss Account.

- The following journal entry is required to be passed.
  
  Deferred Tax Asset A/C……… Dr
  
  To Profit & Loss A/C………

- **Deferred Tax Liability Accounting:** Deferred Tax Liability account is created by debiting Profit & Loss Account.

- The following journal entry is required to be passed.
  
  Profit & Loss A/C ……. Dr
  
  To Deferred Tax Liability A/C ……….
Accounting for deferred taxes

- Deferred tax expense is the net change in the deferred tax liabilities and assets of a business during a reporting period.
- The amount of deferred taxes is compiled for each tax-paying component of a business that provides a consolidated tax return.

The accounting for deferred taxes requires that a business complete the following steps:

- Identify the existing temporary differences and carry forwards.
- Determine the deferred tax liability amount for those temporary differences that are taxable, using the applicable tax rate.
• Determine the deferred tax asset amount for those temporary differences that are deductible, as well as any operating loss carry forwards, using the applicable tax rate.

• Determine the deferred tax asset amount for any carry forwards involving tax credits.

• Create a valuation allowance for the deferred tax assets if there is a more than 50% probability that the company will not realize some portion of these assets. Any changes to this allowance are to be recorded within income from continuing operations on the income statement. The need for a valuation allowance is especially likely if a business has a history of letting various carry forwards expire unused, or it expects to incur losses in the next few years.
Illustration:

- Suppose, one company purchases a machine costing Rs. 300000/- on 1\textsuperscript{st} April. The salvage value is assumed as zero. The working life is assumed to be 3 years. The company uses straight line method for depreciation in books of accounts but this machine is of that type which can be depreciated fully in the first year for tax purpose. Suppose tax rate is 30\% for 3 years and profit before depreciation and tax is assumed at Rs.500000. \textit{Calculate Deferred Tax Asset and Liability.}
Illustration:

- X Ltd. was incorporated on 1\textsuperscript{st} May, 2015 to acquire a business as on January 01, 2015. The first accounts were closed on 30\textsuperscript{th} September, 2015.

- The gross profit for the period is Rs 42,000. Details of other expenses:
  The general expenses are Rs 7,200;
  Directors’ remuneration Rs 12,000 p.a.;
  Preliminary expenses Rs, 2,000;
  Rent up to 30\textsuperscript{th} June is Rs 6,000 p.a., after which it is increased by 40%;
  Salary of the manager, who on formation of the company had become a whole time director, is Rs 5,100 p.a. His remuneration thereafter is included in the above figure of remuneration to directors.

- The company earned a uniform profit. The sales up to September 30, 2015 were Rs 98,000. The monthly average of sales for the first four months of the year was one-half of that of the remaining period. Show the Profit and loss Account showing pre-and post-incorporation profits. Interest and tax may be ignored.
**Illustration:**

- The capital structure of a company consists of 20,000 Equity Shares of Rs 10 each fully paid up and 1,000 8% Redeemable Preference shares of Rs 100 each fully paid up.

- Undistributed reserve and surplus stood as; General Reserve Rs 80,000; Profit and Loss Account Rs 10,000; Investment Allowance Reserve (out of which Rs 5,000, not free for distribution as dividend) Rs 10,000; Securities Premium Rs 12,000. Cash at bank amounted to Rs 98,000.

- Preference shares are to be redeemed at premium of 10% and for the purpose of redemption, the directors are empowered to make fresh issue of Equity shares at par after utilising the undistributed reserve and surplus, subject to the condition that a sum of Rs 20,000 shall be retained in general reserve and which should not be utilised. Pass Journal Entries to give effect to the above arrangements.
Illustration:

- The books of S.B. Ltd showed the following balance on 31st Dec, 2016:
  30,000 Equity Shares of Rs 10 each fully paid up;
  18,000 12% Redeemable Preference shares of Rs 10 each fully paid;
  4,000 10% Redeemable Preference shares of Rs 10 each, Rs 8 paid up;
- Undistributed reserve and surplus stood as; General Reserve Rs 120,000; Profit and Loss Account Rs 80,000; Securities Premium Rs 15,000. Capital Reserve Rs 21,000.
- Preference shares are redeemed on 1st January, 2017 at a premium of Rs 2 per share. The whereabouts of the holders of 100 shares of Rs 10 each fully paid are not known.
- For redemption 3000 equity shares of Rs 10 each are issued at 10% premium. At the same time, a bonus issue of equity share was made at par two shares being issued for every five held on that date out of the Capital Redemption Reserve Account. Show the necessary Journal Entries to record the transactions.
Thanks.....!

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