Comparison of Indian GAAP (AS-22) and US GAAP (FASB-109)

Comparison of these two GAAPs is based on:-

- Similarities between two GAAPs
- Differences between two GAAPs
- Additional area covered by US GAAP (FASB-109) and not covered by Indian GAAP (AS-22)

Similarities between two GAAPs

Both the GAAPs have laid down similar principles on following areas:-

(1) **Objective and Scope –** tax on income is determined on the principle of accrual concept. According to this concept, tax should be accounted in the period in which corresponding revenue and expenses are accounted, in simple words tax shall be accounted on accrual basis and not on liability to pay basis. Taxes on income include all domestic and foreign taxes, which are based on taxable income.

(2) **Recognition and Measurement -**As the income-tax expense should be treated just like any other expenses on accrual basis irrespective of the timing of payment of tax. Tax expenses for the period to be recognized consist of current tax and deferred tax.

Current Tax- Current tax is the amount of income-tax determined to be payable (recoverable) in respect of the taxable income (tax loss) for a period.

Deferred Tax- Deferred tax is the tax effect of timing difference. Difference between the tax expenses (which is calculated on accrual basis) and current tax liability to be paid for a particular period as per Income-tax Act is called deferred tax (assets/liability). That is why the Tax Expenses = Current Tax + Deferred Tax.

The difference between tax expenses and current tax arises only on account of timing difference and thus creating deferred tax asset/ liability

(3) **Measurement of current and deferred tax**

Current Tax- Current tax should be measured at the amount expected to be paid to (recovered from) taxation authorities using applicable tax rates and tax laws.

Deferred Tax- Deferred tax should be measured using the rates and tax laws that have been enacted or substantially enacted by the balance sheet date.

(4) **Difference in Accounting Profit and Tax Profit-** It is known that profit as shown in accounts differs from the profit (taxable) calculated as per Income-tax. The reasons of difference between two profits are of two types.

Timing Difference/ Temporary Difference*:*- These differences originate in one period and are capable of reversal in one or more subsequent periods. FASB-109 uses the word temporary differences instead of timing difference as used in AS-22. The examples of temporary differences given in FASB-109 are as under:

(i) Unrealized losses or gains on trading securities or available-for sale securities which are recorded for financial reporting purposes (On the tax return, losses or gains are only recognized when the securities are sold.)

(ii) The amortization of goodwill for tax purposes over 15 years but over a different period of years for book purposes

(iii) Use of the equity method for book purposes but the cost method for tax reporting

(iv) Gross profit recognized on the cost recovery method for book purposes but on the cash basis for tax purposes

(v) The use of the capital lease method for book purposes but the operating method for tax reporting

(vi) Amortizing capitalized leases over different time periods for book and tax purposes *(vii)* Gains or losses on fixed assets recognized for book purposes but deferred for tax purposes because of a trade-in on similar fixed assets

(viii) Gains on appreciation in assets distributed associated with a liquidation recognized for financial reporting and on distribution for tax purposes

(ix) The use of different amortization periods for intangible assets for book and tax purposes

(x) The use of cost depletion for financial reporting while using statutory depletion for tax purposes

(xi) A net capital loss recognized in the current year for book purposes but carried forward to offset future capital gains on the tax return

(xii) An excess charitable contribution carried over to future years for tax reporting

(xiii) Deferred compensation accrued for books while employee services are performed but not deductible on the tax return until actually paid

(xiv) The amortization of bond issue costs under the interest method for book purposes but the straight-line method on the tax return

(xv) The accrual of sick or vacation pay as employee services are rendered for book purposes but when paid on the tax return

(xvi) The deferral of intangible drilling costs for book purposes while expensing them on the tax return

(xvii) Interest revenue used to offset capitalized interest on the books but recognized as income on the tax return

(xviii) Inventories valued at the lower of cost or market value for books but at cost for tax reporting

(xix) Loss provision for obsolete inventory for books but not deductible on the tax return until the inventory is available for sale at discounted values or discarded

(xx) Inventory-related costs deducted on the books but capitalized for tax reporting

(xxi) Use of the accrual basis for book purposes but the cash basis on the tax return

(xxii) The effect of a change from the cash basis to the accrual basis recognized equally over four years for tax purposes

(xxiii) Imputed interest for book purposes that differs from the amount recognized for tax purposes

(xxiv) A reduction in the tax basis of depreciable assets due to tax credits

(xxv) An increase in the tax basis of assets due to indexing whenever the local currency is the functional currency

(xxvi) Tax consequences of differences between the assigned values and the tax bases of assets and liabilities in a purchase business combination

(xxvii) Tax basis adjustments required by the tax law

(xxviii) Items relating to foreign currency denominated assets and liabilities Some items may be considered temporary differences in one case but not in another. For example, the amount by which the cash surrender value of life insurance exceeds insurance premiums paid is a temporary difference if there is anticipation that the cash surrender value will be recovered. It is not a temporary difference if it is anticipated that the cash surrender value will not be recovered when the insured dies.

Permanent Difference: These differences originate in one period and do not reverse subsequently. In other words, the difference always remains and is of permanent nature. For example, expenses is debited in the statement of profit and loss for accounting purpose is not allowed for tax purpose at all in any year or income credited in profit and loss account while calculating the accounting profit is exempted from tax.

(5) Deferred Tax

Deferred tax is tax effect of timing difference/temporary difference.

a. Accounting income is in excess of tax income	Tax on accounting income is more whereas tax payable is less as per income-tax law for the period	Create deferred tax liability by crediting to deferred tax and debit to profit and loss account.
b. Accounting income is less than tax income	Tax on accounting income is less whereas tax payable is more as per income-tax law	Create deferred tax asset by debiting deferred tax
c. There is income as per income-tax but loss as per	Tax on accounting loss is nil but there is liability to pay tax	Create deferred tax assets by debiting deferred tax (subject

accounts		to recoverability /adjustments from future income)
d. Accounting profit but loss as per income-tax law. However MAT is payable as per Indian Income-tax Act.	Tax on accounting profit but tax as per tax law Nil. Carry forward of loss allowed	Create deferred tax liability for the difference.

A deferred tax liability is recognized for temporary differences that will result in taxable amounts in future years. For example, a temporary difference is created between the depreciation as per the books of account and the depreciation claimed under the tax laws which, in initial years, is higher than depreciation claimed as expenses in the financial statements. This would lead to a higher taxable income in future.

Example- Induga Limited prepares its accounts annually on 31st March. On 1st April 2003, its purchases a machine at a cost of Rs. 150,000. 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 the tax purpose, the straight-line method is considered appropriate for accounting purpose. Induga Limited has profits before depreciation and taxes of Rs. 200,000 each year and the corporate tax rate is 40% each year.

The purchase of machine at a cost of Rs. 150,000 in 2003 gives rise to 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 on 31st March, 2003, 2004 and 2005

	2003	2004	2005
Profit before depreciation and taxes	200	200	200
Less: Depreciation for accounting purpose	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 difference			
Reversing during the year			
0.40 (0-50)	-	(20)	(20)
Tax expense	60	60	60
Profit after Tax	90	90	90
Notes:			
Net timing differences	100	50	0
Deferred Tax Liability*	40	20	0

**(To be shown in Balance sheet after the head "Unsecured Loan" as a separate head)*

The following Journal entries will be passed

Year 2003 (Amt. in Rs.)

Profit and Loss A/c	Dr.	20,000	
To Current tax A/c			20,000

(Being the amount of taxes payable for the year 2003 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. 100,000)

Year 2004

Profit and Loss A/c	Dr.	80,000	
To Current tax A/c			80,000

(Being the amount of taxes payable for the year 2004 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 2005

Profit and Loss A/c	Dr.	80,000	
To Current tax A/c			80,000

(Being the amount of taxes payable for the year 2005 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)

A deferred tax asset is recognized for temporary differences that will result in deductible amounts in future years and for carry forwards. For example, a temporary difference is created between the reported amount and the tax basis of a liability for estimated expenses if, for tax purpose, those estimated expenses are not deductible until a future year. Settlement of that liability will result in tax deduction in future years, and a deferred tax asset is recognized in the current year for the reduction in taxes payable in future years.

(6) Disclosure

- The break-up of deferred tax asset / liability should be disclosed.
- Deferred tax asset and liability should be set off if permissible under the tax laws but to be shown separately if not permissible.

Example: Break-up of deferred tax asset / liability (Indian GAAP)

(Rupees in Millions)

Particulars	*Deferred Tax Liability/ (assets) As at 01.04.2002*	*Current Year*	*Deferred Tax Liability/ (asset) as at 01.03.2003*
Deferred Tax Liability			
(i) Difference between book and tax depreciation	1,487.00	128.00	1,616.00
(ii) Prepaid Expenses	8.00	1.00	8.00
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(A)	1,495.00	129.00	1624.00
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Deferred Tax Assets

(i) Early Separation Scheme	(46.00)	(54.00)	(100.00)
(ii) Wage Provision	(38.00)	8.00	(30.00)
(iii) Provision for doubtful debts & advances	(45.00)	(16.00)	(61.00)
(iv) Disallowances	(5.00)	(1.00)	(6.00)
(v) Provision for leave Salary	---	(33.00)	(33.00)
(vi) Euro Issue Expenses	(1.00)	0.50	(0.50)
(vii) Provision for Retiring Gratuity	(1.00)	(3.00)	(4.00)
(viii) Other Deferred Tax Assets	(1.00)	0.50	(0.50)
(B)	(137.00)	(98.00)	(235.00)
Deferred Tax Liability (Net) (A-B)	1,358.00	31.00	1,389.00

Pursuant to AS-22, the company has recorded a net cumulative deferred tax liability of Rs. 1,358.00 crores up-to 31.03.2002 as reduction in General Reserve. Further, the impact of Deferred Tax Liability of Rs. 31.00 crores for the period ended on 31.03.2003 has been debited to profit and loss account.

Example:-Principal components of deferred tax assets (liabilities) (US GAAP)

	2003	*2002*
Property, plant and equipment and intangibles	$(354.7)	(357.0)
Leveraged leases	(169.7)	(181.0)
Pension	(105.7)	(92.9)
Accrued liabilities	226.4	249.5
Postretirement and post-employment benefits	142.0	145.1
Employee compensation and benefits	112.4	109.1
Other	89.3	81.6
Total deferred tax assets (liabilities)	$ (60.0)	(45.6)

Significant differences between two GAAPs

(1) As per AS-22, deferred tax asset is to be recognized to the extent there is a reasonable or virtual certainty, whereas under US GAAP (FASB-109), a Valuation allowance is made to provide for that portion which is more likely than not realisable.

AS-22 does not talk about **valuation allowance** but it provides that deferred tax asset should be recognized and carried forward only to the extent it is reasonably certain that there will be sufficient future income to recover such deferred tax asset. In case there is no future sufficient income, deferred tax asset should be recognized only to the extent such asset can be recovered by way of tax saving. Further in case of unabsorbed depreciation and carry forward losses recognition of the deferred tax asset should be guided by the concept whether the sufficient profit will be generated within the prescribed time-period. To recognize deferred tax assets on this account there should be convincing evidence that sufficient taxable income will be available against which such deferred tax assets can be realized. In such circumstances, the nature of the evidence supporting its recognition is disclosed.

EXAMPLE -XYZ Company has income before taxes of $1,100,000.The only temporary difference is warranty expense, which is recorded at $100,000 on the books based on sales but is recognized for tax purposes at $30,000 (which is based on the amount paid).The tax rate is 34%. Therefore, the amount of the temporary difference is $70,000 ($100,000 - $30,000). It is concluded that $60,000 of this temporary difference has a greater than 50% probability of being realized, while $10,000 of the temporary difference has a 50% or less probability of being realized. Relevant computations follow:

	Book Income	***Tax Income***
Income before taxes	$1,100,000	$1,100,000
Warranty expense	100,000	30,000
Income	$1,000,000	$1,070,000

The journal entry to record the temporary difference is:

Income tax expense	(.34 x $1,000,000)	340,000
Deferred tax asset	(.34 x $70,000)	23,800
Income tax payable	(.34 x $1,070,000)	363,800

The entry to record the valuation allowance is:

Income tax expense	(.34 x $10,000)	3,400
Valuation allowance	(.34 x $10,000)	3,400

The balance sheet presentation follows:

Gross deferred tax asset	(.34 x $70,000) $23,800
Less: Valuation allowance	(.34 x $10,000) 3,400
Net deferred tax asset	(.34 x $60,000) $20,400

The valuation allowance for a particular tax jurisdiction should be allocated proportionately (pro rata) between the current and non-current deferred tax assets for that jurisdiction.

(2) As per AS-22, deferred tax assets and liabilities should be measured using tax rates that have been enacted by balance sheet date. Under US GAAP (FASB-109), deferred tax liabilities and assets are adjusted in the period of enacted change in tax laws or rates.

(3) AS per AS-22, deferred tax assets and liabilities should be disclosed separately from current assets and current liability. Under US GAAP (FASB-109), classification as current or non-current is based on the classification of related non-tax asset or liability.

FASB Statement Number 37 (US GAAP) deals with balance sheet classification of deferred income taxes. In the balance sheet, deferred tax assets are offset against deferred tax liabilities and shown as (1) net current or (2) net non-current. However, you cannot offset a current account against a non-current account. Further, you cannot offset (net) current or non-current accounts for different tax-paying components or for different tax jurisdictions (e.g., federal versus local) because offsetting is prohibited unless there is a legal right of setoff. Deferred tax assets or deferred tax liabilities are classified based on the related asset or liability they apply to.

For example, a deferred tax liability due to depreciation on a fixed asset would be presented as non-current. A deferred tax asset related to accounts receivable would be classified as current. Deferred taxes not related to specific assets or liabilities are classified as current or non-current depending on the anticipated reversal dates of the temporary differences. Temporary differences reversing within one year are current, but those reversing after one year are non-current. In some cases, a given temporary difference may be a mix of current and non-current, such as a three-year warranty in which the first year is shown as a current account while years 2 and 3 are presented as a non-current account. Other examples are deferred tax assets related to a loss carry forward, and deferred tax liabilities arising when a long-term contract is accounted for by the percentage-of-completion method for financial reporting and by the completed contract method for tax purposes. Under the latter circumstances, the temporary difference becomes taxable when the contract is completed. If a valuation allowance account exists as a reduction of a gross deferred tax asset, there must be a pro rata division of the valuation allowance between current and non-current relative to the classification of the gross deferred tax asset.

Additional areas covered by US GAAP (FASB-109) and not covered by AS-22

FASB-109 explains some additional areas which are not covered by AS-22, in fact the need of coverage of these areas under US GAAP arises because differences in tax laws between US and India. The Institute of Chartered Accountant of India which issues the accounting standard covers these additional areas by issuing accounting standard interpretation. The ICAI has issued four accounting standard interpretation numbering ASI-3 to ASI-6 till today. Some of the additional areas which are covered by US GAAP (FASB-109) are explained as under:-

(1) **Loss Carry backs -**Tax effects of net operating loss carry backs are allocated to the loss period (the current year).A company may carry back a net operating loss three years and receive a tax refund for taxes paid in profitable years. The tax benefit is recognized as a receivable for the refundable amount. Further, the tax benefit reduces the current year's tax expense, but the amount is based on the tax rate(s) in effect in the carry back period. The loss is first applied to the earliest year, with any remaining loss carried forward. (A company may elect to forgo the carry back). The presentation of a loss carries back with recognition of the refund during the loss year follows:

Loss before refundable income taxes	$120,000
Refund of prior years' income taxes arising from carry back of operating loss	40,000
Net loss	$ 80,000

Note: The refund should be computed at the amount actually refundable regardless of current tax rates.

EXAMPLE -In 2005, a net loss of $100,000 occurred. In the prior years the net incomes were $250,000 in 2002, $60,000 in 2003, and $80,000 in 2004.The tax rates over the years were 2002 30%, 2003 31%, 2004 33%, and in 2005 32%. The 2005 net loss may be carried back starting in 2002.The loss carry back of $100,000 can be used in 2002 because the net profit that year was higher. The tax benefit of the carry back is calculated based on the 2002 tax rate of 30% since 2002 was when the tax was paid. The amount of the tax benefit is $30,000 ($100,000 x 30%).The journal entry in 2005 to recognize the loss carry back benefit is Receivable from the IRS 30,000 Income tax expense 30,000

EXAMPLE - Assume the same facts as in the previous example except that the net income in 2002 was $75,000. In that case, the tax benefit of the carry back loss is first applied to 2002, with the balance ($25,000) in 2003.
The relevant computations follow:

2002, $75,000 x 30%	=	$22,500
2003, $25,000 x 31%	=	7,750
Total		$30,250

The journal entry in 2005 to reflect the loss carry back benefit is Receivable from the IRS 30,250
Income tax expense 30,250

(2) **Multiple Tax Jurisdictions -**The determination of tax liability for federal reporting purposes may differ from that of state and/or city reporting requirements. As a consequence, temporary differences, permanent differences, and loss carry backs or carry forwards may be different between federal and local reporting. If the temporary differences are significant, separate deferred tax calculations and recording will be required. If temporary differences are treated the same for federal and local reporting purposes, a combined tax rate may be used in determining deferred taxes. The combined tax rate equals Federal tax rate x (1 -state tax rate) + state tax rate

(3) **Tax Credits -** According to Emerging Issues Task Force Consensus Summary Number 95–10 (*Accounting for Tax Credits Related to Dividend Payments in Accordance with FASB Statement No. 109*), if a company pays a dividend, any tax credit associated with it acts to reduce income tax expense.

(4) **Tax Status Changes -** The effect of any change in tax status affecting a company requires an immediate adjustment to deferred tax liabilities (or assets) and to income tax expense. For example, if a company changes to S corporation status, a tax advantage generally arises, resulting in a reduction in both the deferred tax liability and income tax expense. Another example of a tax status change requiring an adjustment on the accounts is a company electing C corporation status. There should be a footnote explaining the nature of the status change and its affect on the accounts. If an entity's tax status changes from nontaxable to taxable, a deferred tax asset or liability should be recorded for any temporary differences at the time the status changes. On the other hand, if the status change is from taxable to nontaxable, any deferred tax asset or liability should be eliminated.

(5) **Business Investments -** If the cost method is used to account for an investment in the common stock of other companies, no temporary difference arises. However, if the equity method is used to account for an investment in another company, a temporary difference arises because, the investor recognizes in its earnings the profit of the investee but recognizes for tax purposes the dividends received from the investee. As a result, the investor's book income exceeds its tax income because profit is usually in excess of dividends. In consequence, a deferred tax liability will likely arise.

(6) **Intra-period Tax Allocation –** Income-tax expenses or benefit for the year shall be allocated among continuing operations, discontinuing operations, extra-ordinary items, and items charged or credited directly to shareholders' equity.

(7) **Separate Financial Statements of a Subsidiary –** The allocation of income-taxes among the members of group of entities that files a consolidated tax return must be based on a method that in systematic, rational and consistent with the broad principles established in FAS-109, although FAS-109 does not require a single allocation method. A method that allocates current and deferred taxes to members of the group by applying FAS-109 to each member as if it were a separate tax-payer meets those criteria. Example of the methods that are not consistent with the broad principles of FAS-109 include (FAS-109, Para 40):-

- A method that allocates only current taxes payable to a member of the group that has taxable temporary differences.
- A method that allocates deferred taxes to a member of the group using a method fundamentally different from the asset and liability method.
- A method that allocates no current or deferred tax expenses to member of the group that has taxable income because the consolidated group has no current or deferred tax expense.

<u>Sources:</u>

(i) Accounting Standards (AS-22) issued by ICAI, New Delhi
(ii) www.fasb.org (Site of Financial Accounting Standards Board)

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