Exposure Draft

Guidance Note on Applicability of AS 25 and Measurement of Income Tax Expense for Interim Financial Results

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EXPOSURE DRAFT

Research Committee
The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)
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Exposure Draft

Guidance Note on Applicability of AS 25 and Measurement of Income Tax Expense for Interim Financial Results

Research Committee of the Institute of Chartered Accountants of India invites comments on any aspect of this Exposure Draft of the 'Guidance Note on Applicability of AS 25 and Measurement of Income Tax Expense for Interim Financial Results'. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, where applicable, provide a suggestion for alternative wording.

Comments should be submitted in writing to the Secretary, Research Committee, The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi – 110 002, to be received not later than ***May 31, 2020.*** *Comments can also be sent by e-mail at* research@icai.in.

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(*The following is the text of the 'Guidance Note on Applicability of AS 25 and Measurement of Income Tax Expense for Interim Financial Results', issued by the Institute of Chartered Accountants of India. Pursuant to the issuance of this, "Guidance Note on Applicability of AS 25 to Interim Financial Results" and "Guidance Note on Measurement of Income Tax Expense for Interim Financial Reporting in the Context of AS 25", stand withdrawn.*)

Introduction

1. This Guidance Note deals with the following issues:
- whether Accounting Standard (AS) 25, Interim Financial Reporting, is applicable to interim financial results presented by an enterprise pursuant to the requirements of a statute/ regulator, for example, quarterly financial results presented under SEBI (Listing Obligations and Disclosure Requirement) Regulations, 2015 entered into between Stock Exchanges and the listed enterprises; and
- the measurement of income tax expense for the purpose of inclusion in the interim financial reports

Applicability of AS 25

2. Accounting Standard (AS) 25, Interim Financial Reporting, issued by the Council of the Institute of Chartered Accountants of India, came into effect in respect of accounting periods commencing on or after 1-4-2002. If any enterprise is required or elects to prepare and present an interim financial report, it should comply with this Standard (applicability paragraph).

3. AS 25 further provides as follows:

"1. This Statement does not mandate which enterprises should be required to present interim financial reports, how frequently, or how soon after the end of an interim period. If an enterprise is required or elects to prepare and present an interim financial report, it should comply with this Statement.

2. A statute governing an enterprise, or a regulator may require an enterprise to prepare and present certain information at an interim date which may be different in form and/or content as required by

this Statement. In such a case, the recognition and measurement principles as laid down in this Statement are applied in respect of such information, unless otherwise specified in the statute or by the regulator."

"4. The following terms are used in this Statement with the meanings specified:

……………

Interim financial report means a financial report containing either a complete set of financial statements or a set of condensed financial statements (as described in this Statement) for an interim period."

Recommendation

4. The presentation and disclosure requirements contained in AS 25 should be applied only if an enterprise prepares and presents an 'interim financial report' as defined in AS 25. Accordingly, presentation and disclosure requirements contained in AS 25 are not required to be applied in respect of interim financial results (which do not meet the definition of 'interim financial report' as per AS 25) presented by an enterprise. For example, quarterly financial results presented under SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 do not meet the definition of 'interim financial report' as per AS 25. However, as per Clause 33 of the said regulations the recognition and measurement principles laid down in AS 25 should be applied for recognition and measurement of items contained in such interim financial results.

Measurement of Income Tax Expense for Interim Financial Reporting in the Context of AS 25

5. The general principles for recognition and measurement have been laid down in AS 25 as below:

"27. An enterprise should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements. However, the frequency of an enterprise's reporting (annual, half yearly, or quarterly) should not affect the measurement of its annual results. To achieve that objective, measurements for interim reporting purposes should be made on a year-to-date basis.

28. Requiring that an enterprise apply the same accounting policies in its interim financial statements as in its annual financial statements may seem to suggest that interim period measurements are made as if each interim period stands alone as an independent reporting period. However, by providing that the frequency of an enterprise's reporting should not affect the measurement of its annual results, paragraph 27 acknowledges that an interim period is a part of a financial year. Year-to-date measurements may involve changes in estimates of amounts reported in prior interim periods of the current financial year. But the principles for recognising assets, liabilities, income, and expenses for interim periods are the same as in annual financial statements."

6. Paragraph 29(c) of AS 25 illustrates the application of the general principles for recognition and measurement of tax expense in interim periods, as below:

"29…

(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."

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7. Appendix 3 to AS 25 illustrates the general recognition and measurement principles for the preparation of interim financial reports. Paragraphs 8 to 16 of the Appendix provide guidance on the computation of income-tax expense for the interim period, which are reproduced in Appendix A to this Guidance Note for ready reference. Paragraph 8 of the Appendix states as below:
"8. Interim period income tax expense is accrued using the tax rate that would be applicable to expected total annual earnings, that is, the estimated average annual effective income tax rate applied to the pre-tax income of the interim period."

8. The various steps involved in the measurement of income tax expense for the purpose of interim financial reports are as below:

(i) An enterprise will first have to estimate its annual accounting income. For this purpose, an enterprise would have to take into account all probable events and transactions that are expected to occur during the financial year. Such an estimate would involve, e.g., estimating on prudent basis, the depreciation on expected expenditure on acquisition of fixed assets, profits from sale of fixed assets/investments, etc. Such future events and transactions should be taken into account only if there is a reasonable certainty that the same would take place during the financial year.

(ii) The enterprise should next estimate its tax liability for the financial year. For this purpose, the enterprise will have to estimate taxable income for the year. By applying the enacted for the substantively enacted tax rate on the taxable income, an estimate of the current tax for the year is arrived at. The estimates of tax liability would have to be based on the estimated deductions, allowances, etc., that would be available to the enterprise, provided there is a reasonable certainty for the same. The enterprise would also have to estimate the deferred tax assets/liabilities by applying the principles of Accounting Standard (AS) 22, 'Accounting for Taxes on Income', issued by the Institute of Chartered Accountants of India.

Special considerations may have to be applied in certain cases as below:

(a) Where brought forward losses exist from the previous financial year (when deferred tax asset was not recognised on considerations of prudence as per AS 22): In such a situation, for estimating the current tax liability, the brought forward losses would have to be deducted from the estimated annual accounting income as explained in paragraph 16 of Appendix 3 to AS 25 (reproduced in Appendix A to this Guidance Note). Since such carried forward losses will get set-off during the year, these would not have any tax consequence in future periods.

(b) Where brought forward losses exist (when deferred tax asset was recognised on the considerations of prudence as per AS 22): In such a situation, current tax would be computed in the same manner as explained in (a) above. However, in the determination of deferred tax, the tax expense arising from the reversal of the deferred tax asset recognised previously, to the extent of reversal of deferred tax asset in the current year, would also be considered.

(iii) The enterprise would now have to calculate the weighted average annual effective tax rate. This tax rate would be determined by dividing the estimated tax expense as arrived at step (ii) above by the estimated annual accounting income as arrived at step (i) above. Where different tax rates are applicable to different portions of the estimated annual accounting income, e.g., normal tax rate and a different tax rate for capital gains, the weighted average annual effective tax rate would have to be calculated separately for such portions of estimated annual accounting income.

(iv) The weighted average annual effective tax rate arrived at step (iii) would be applied to the accounting income for the interim period for determining the income tax expense to be recognised in the interim financial reports.

9. Accounting for interim period income-tax expense as suggested above is based on the approach prescribed in AS 25 that the interim period is part of the whole accounting year (often referred to as

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the 'integral approach') and, therefore, the said expense should be worked out on the basis of the estimated weighted average annual effective income-tax rate. According to this approach, the said rate is determined on the basis of the taxable income for the whole year and applied to the accounting income for the interim period in order to determine the amount of tax expense for that interim period. This is in contrast to accounting for certain other expenses such as depreciation which is based on the approach prescribed in AS 25 that the interim period should be considered on stand-alone basis (often referred to as the 'discrete approach') because expenses such as depreciation are worked out on the basis of the period for which a fixed asset was available for use. The aforesaid treatments are, however, consistent with the requirement contained in paragraph 27 of AS 25 that an enterprise should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements.

10. The general approach of estimating the effective tax rate for the year should be used even where, for example, an entity's result in the current interim period of the year is expected to be wholly offset by its result in the future interim periods of the year. The consequence of this approach is that, conceptually, even if the overall result for the year was expected to be a breakeven position, an effective tax rate exists that needs to be applied to the interim period. Expected effective tax rates should be applied to interim losses as well as to profits. However, it might be appropriate to adopt a more cautious approach to recognising the deferred tax asset that arises from interim losses where there is no history of equal or larger profits in the subsequent interim periods of the year. That is, if a deferred tax asset arises with respect to a loss in the interim period and this 'relief' is merely the result of applying the expected effective tax rate, this asset should only be recognised if it is probable that the loss will reverse in the foreseeable future. A history of losses in the initial interim quarter of the year, and then equal or larger profits in the subsequent quarters, would support recognising such an asset. On the other hand, if the loss in the initial interim period was unexpected and is not related to an unusual non-recurring transaction or event, this might indicate uncertainty regarding the likely results in the subsequent interim period of the year. Under such circumstances, the deferred tax asset's recoverability is more uncertain, and it might not be appropriate to recognise the asset and the considerations of prudence as per AS 22 should be applied.

Effect of disallowed expenses in computing weighted average annual effective tax rate

11. If there are items that are disallowed for tax purposes, these will increase the effective tax rate. In some cases, the disallowable items might have a distortive effect on the effective tax rate and on the resulting deferred tax asset recognised. In such a case, the disallowable items are not included in determining the effective tax rate but are instead dealt with in the interim periods in which they arise. This is consistent with the approach in paragraph 14 of Appendix 3 to AS 25 for tax benefits that relate to a one-time event.

The accounting treatment in a situation where the disallowable items have a distortive effect on the effective tax rate is illustrated in Example 5 of Appendix B to this Guidance Note.

Effect of Merger or amalgamation subsequent to the interim balance sheet date

12. Sometimes, an acquisition of a subsidiary might impact the expected effective tax rate. For example, if a newly acquired subsidiary has significant tax losses, this might reduce the rate of tax payable by the enlarged group after the acquisition. When a merger or amalgamation occurs in the second half of the year, the question arises at the initial interim period balance sheet date as to whether the acquiring group should assume an expected rate for the full year after taking into account the impact of the merger or amalgamation. Losses attributable to an entity acquired in the second half of the year would not be taken into account in determining the effective average annual tax rate at the interim stage. This is because, AS 14.46 states that when an amalgamation is effected after the balance sheet date but before the issuance of the financial statements of either party to the amalgamation, disclosure is made in accordance with AS 4, 'Contingencies and Events Occurring After the Balance Sheet Date', but the amalgamation is not incorporated in the financial statements.

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To take account of the effect of the losses of the acquired company in the calculation of the tax rate for the interim financial report would effectively be accounting for the effects of the acquisition before it became unconditional. The reporting entity does not control the losses at the interim date. However, as required by AS 25.16, all material events subsequent to the end of the interim period that have not been reflected in the financial statements for the interim period need to be disclosed.

Change in annual effective tax rate

13. When preparing the tax estimate to be included in an interim period, the tax expense is based on the best estimate of the weighted average annual income tax rate expected for the full financial year. Therefore, as for other changes in estimates, amounts accrued for income tax expense in one interim period may have to be adjusted in a subsequent interim period if the estimate of the annual income tax rate changes. The estimated average annual income tax rate would be re-estimated on a year-to-date basis, consistent with AS 25.27. Paragraph 16(d) requires disclosure of a significant change in estimate.

For example, the Taxation Laws (Amendment) Ordinance, 2019 (or 'the Ordinance'), subsequently the Taxation Laws (Amendment) Ordinance, 2019, was promulgated by the President of India, was published in the Gazette of India on 20 September 2019. The Ordinance came into force immediately upon its publication in the Gazette. The Ordinance has brought about significant changes to corporate income-tax rates. The Ordinance provides an option to domestic companies to pay income-tax at a lower rate (22% or 15%, depending on the conditions specified in this behalf) instead of the normal rate of 30%. However, a domestic company can avail of the lower tax rate only if it opts for not availing of certain exemptions or incentives specified in this behalf in the Ordinance. A question that arises is whether a domestic company can give effect to lower tax rate as per the Ordinance while determining current tax and deferred tax assets or liabilities for the purpose of presenting interim financial statements as of 30 September 2019?

Accounting Standard 22, 'Accounting for Taxes on Income' states as follows:

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

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."

The Ordinance came into force on 20 September 2019. Thus, the lower tax rate has been "enacted" by the interim reporting date of 30 September 2019. However, considering the requirements of above paragraphs of Ind AS 12, the lower tax rates as per the Ordinance should be applied by a company for measurement of current and deferred taxes only if it expects to opt for the lower rates.

14. Accordingly, if a company's intention to opt for lower tax rate is appropriately evidenced, lower tax rate as per the Ordinance should be given effect to while determining the current tax and deferred tax assets or liabilities for the purpose of weighted average annual income tax rate expected for the full financial year in interim financial statements for the quarter/half-year ended 30 September 2019. Where a company expects to avail of the lower tax rate only from a later financial year (say, from financial year 2020-21), it should apply the lower tax rate in measurement of deferred taxes only to the extent that the deferred tax assets are expected to be realised or deferred tax liabilities are expected to be settled in the periods during which the company expects to be subject to lower tax rate. To the extent deferred tax assets are expected to be realised or deferred tax liabilities are expected to be settled in earlier periods, the normal tax rate should be applied.

15. Appendix B contains examples of computing weighted average annual effective tax rate.

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Appendix A

Extracts from Appendix 3 to Accounting Standard (AS) 25, Interim Financial Reporting

Measuring Income Tax Expense for Interim Period

16. Interim period income tax expense is accrued using the tax rate that would be applicable to expected total annual earnings, that is, the estimated average annual effective income tax rate applied to the pre-tax income of the interim period.

17. This is consistent with the basic concept set out in paragraph 27 that the same accounting recognition and measurement principles should be applied in an interim financial report as are applied in annual financial statements. Income taxes are assessed on an annual basis. Therefore, interim period income tax expense is calculated by applying, to an interim period's pre-tax income, the tax rate that would be applicable to expected total annual earnings, that is, the estimated average effective annual income tax rate. That estimated average annual income tax rate would reflect the tax rate structure expected to be applicable to the full year's earnings including enacted or substantively enacted changes in the income tax rates scheduled to take effect later in the financial year. The estimated average annual income tax rate would be re-estimated on a year-to-date basis, consistent with paragraph 27 of this Statement. Paragraph 16(d) requires disclosure of a significant change in estimate.

18. To the extent practicable, a separate estimated average annual effective income tax rate is determined for each governing taxation law and applied individually to the interim period pre-tax income under such laws. Similarly, if different income tax rates apply to different categories of income (such as capital gains or income earned in particular industries), to the extent practicable a separate rate is applied to each individual category of interim period pre-tax income. While that degree of precision is desirable, it may not be achievable in all cases, and a weighted average of rates across such governing taxation laws or across categories of income is used if it is a reasonable approximation of the effect of using more specific rates.

19. As illustration, an enterprise reports quarterly, earns Rs. 150 lakhs pre-tax profit in the first quarter but expects to incur losses of Rs 50 lakhs in each of the three remaining quarters (thus having zero income for the year), and is governed by taxation laws according to which its estimated average annual income tax rate is expected to be 35 per cent. The following table shows the amount of income tax expense that is reported in each quarter:

(Amount in Rs. lakhs)					
	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Annual
Tax expense	52.5	(17.5)	(17.5)	(17.5)	0

Difference in Financial Reporting Year and Tax Year

20. If the financial reporting year and the income tax year differ, income tax expense for the interim periods of that financial reporting year is measured using separate weighted average estimated effective tax rates for each of the income tax years applied to the portion of pre-tax income earned in each of those income tax years.

21. To illustrate, an enterprise's financial reporting year ends 30 September and it reports quarterly. Its year as per taxation laws ends 31 March. For the financial year that begins 1 October, Year 1 ends 30 September of Year 2, the enterprise earns Rs 100 lakhs pre-tax each quarter. The estimated weighted average annual income tax rate is 30 per cent in Year 1 and 40 per cent in Year 2.

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(Amount in Rs. lakhs)					
	Quarter Ending 31 Dec Year 1	Quarter Ending 31 March Year 1	Quarter Ending 30 June Year 2	Quarter Ending 30 Sep Year 2	Year ending 30 Sep Year 2
Tax Expense	30	30	40	40	140

Tax Deductions/Exemptions

22. Tax statutes may provide deductions/exemptions in computation of income for determining tax payable. Anticipated tax benefits of this type for the full year are generally reflected in computing the estimated annual effective income tax rate, because these deductions/exemptions are calculated on an annual basis under the usual provisions of tax statutes. On the other hand, tax benefits that relate to a one-time event are recognised in computing income tax expense in that interim period, in the same way that special tax rates applicable to particular categories of income are not blended into a single effective annual tax rate.

Tax Loss Carry forwards

23. A deferred tax asset should be recognised in respect of carry forward tax losses to the extent that it is virtually certain, supported by convincing evidence, that future taxable income will be available against which the deferred tax assets can be realised. The criteria are to be applied at the end of each interim period and, if they are met, the effect of the tax loss carry forward is reflected in the computation of the estimated average annual
effective income tax rate.

24. To illustrate, an enterprise that reports quarterly has an operating loss carry forward of Rs 100 lakhs for income tax purposes at the start of the current financial year for which a deferred tax asset has not been recognised.

The enterprise earns Rs 100 lakhs in the first quarter of the current year and expects to earn Rs 100 lakhs in each of the three remaining quarters. Excluding the loss carry forward, the estimated average annual income tax rate is expected to be 40 per cent. The estimated payment of the annual tax on Rs. 400 lakhs of earnings for the current year would be Rs. 120 lakhs {(Rs. 400 lakhs - Rs. 100 lakhs) x 40%}. Considering the loss carry forward, the estimated average annual effective income tax rate would be 30% {(Rs. 120 lakhs/Rs. 400 lakhs) x 100}. This average annual effective income tax rate would be applied to earnings of each quarter. Accordingly, tax expense would be as follows:

(Amount in Rs. lakhs)					
	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Annual
Tax Expense	30.00	30.00	30.00	30.00	120.00

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Appendix B

Examples of Computation of Weighted Average Annual Effective Tax Rate

Example 1: When deferred tax asset was not recognised for carried forward losses from earlier accounting periods.

	Quarter I	Quarter II	Quarter III	Quarter IV	Total
Estimated Pre-tax Income (after considering estimated depreciation on the probable acquisition of fixed assets during the year)	(25)	175	(25)	50	175
Carried forward losses from earlier accounting periods, the deferred tax asset in respect of which was not recognised as it did not meet the requirements of prudence laid down in AS 22. During this year, in view of the expected taxable income, this loss is expected to be set off there against. Therefore, it will not have any tax effect on future periods.					(25)
Additional estimated depreciation as per tax laws as compared to the accounting depreciation after considering depreciation on probable capital expenditure on acquisition of fixed assets during the year.					(50)
Estimated taxable income on which tax payable.					100
Applicable tax rate (say)					30%
Estimated current tax expense for the year.					30
Estimated deferred tax expense for the year (50×30/100)					15
Weighted Average Annual Effective Tax Rate (current tax)					30/175 × 100 = 17.14%
Weighted Average Annual Effective Tax Rate (deferred tax)					15/175 ×100 = 8.57%
Tax expense for the interim period					
Current tax	(4.29)	30	(4.29)	8.57	29.99
Deferred tax	(2.14)	15	(2.14)	4.29	15.01
Total	(6.43)	45	(6.43)	12.86	45.00

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(a) The above calculation needs to be done for every interim period for which recognition and measurement of tax expense is required.
(b) It is presumed that there are no other differences between accounting income and taxable income.

It might be appropriate to adopt a more cautious approach to recognising the income tax asset that arises from interim loss in Quarter I. Particularly, where there is no history of equal or larger profits in the subsequent interim periods of the year. A history of losses in the initial interim quarter of the year, and then equal or larger profits in the subsequent quarters, would support recognising such an asset. On the other hand, if the loss in the initial interim period was unexpected and is not related to an unusual non-recurring transaction or event, this might indicate uncertainty regarding the likely results in the subsequent interim period of the year. Under such circumstances, the deferred tax asset's recoverability is more uncertain, and it might not be appropriate to recognise the asset and the considerations of prudence as per AS 22 should be applied.

Example 2: When deferred tax asset was recognised for carried forward losses from earlier accounting periods.

	Quarter I	**Quarter II**	**Quarter III**	**Quarter IV**	**Total**
	Rs.	Rs.	Rs.	Rs.	Rs.
Estimated Pre-tax Income (after considering estimated depreciation on the probable acquisition of fixed assets during the year)	(25)	175	(25)	50	175
Carried forward losses from earlier accounting periods, the deferred tax asset in respect of which was recognised on the basis of considerations of AS 22. During this year, in view of the expected taxable income, this loss is expected to be set off there against. This will result in reversal of the deferred tax asset in the current year.					(25)
Additional estimated depreciation as per tax laws as compared to the accounting depreciation after considering depreciation on probable capital expenditure on acquisition of fixed assets during the year.					(50)
Estimated taxable income on which tax payable.					100
Applicable tax rate (say)					30%
Estimated current tax expense for the year.					30
Estimated deferred tax expense for the year: (i) Deferred tax liability on account of timing difference in depreciation (50×30/100) 15					22.5

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(ii) Reversal of deferred tax asset (25×30/100) 7.5					
Weighted Average Annual Effective Tax Rate (Current tax)					30/175 × 100 =17.14%
Weighted Average Annual Effective Tax Rate (Deferred tax) Tax expense for the interim period					22.5/175 ×100 = 12.86%
Tax expense for the interim period					
Current tax	(4.29)	30.0	(4.29)	8.57	29.99
Deferred tax	(3.21)	22.5	(3.21)	6.43	22.51
Total	(7.50)	52.5	(7.50)	15.00	52.50

(a) The above calculation needs to be done for every interim period for which recognition and measurement of tax expense is required.
(b) It is presumed that there are no other differences between accounting income and taxable income.

Example 3: When progressive rates of tax are applicable under the Indian tax system, the tax rates for corporates and firms are not progressive (i.e., based on levels of income), but are flat rates. Therefore, the tax rate to be applied in the interim period would be the normal rate applicable to the entity. However, the calculation of weighted average annual effective tax rate can be illustrated as below where the tax rates are progressive:

Estimated annual income Rs.1 Lakh

Assumed Tax Rates:
On first Rs. 40,000 30%
On the balance income 40%
Tax expense: 30% of Rs. 40,000 + 40% of Rs. 60,000 = Rs. 36,000
Weighted average annual effective tax rate = 36,000/1,00,000 × 100 = 36%

Supposing the estimated income of each quarter is Rs. 25,000, the tax expense of Rs. 9,000 (36% of Rs. 25,000) would be recognised in each of the quarterly financial reports.

Example 4: When different rates of tax are applicable to different portions of the estimated annual accounting income (refer para5 (iii)) Estimated annual income Rs. 1 lakh (inclusive of Estimated Capital Gains
(earned in Quarter II) Rs. 20,000
Assumed Tax Rates:
On Capital Gains 10%
On other income:
First Rs. 40,000 30%
Balance income 40%
Assuming there is no difference between the estimated taxable income and the estimated accounting income,
Tax Expense:
On Capital Gains portion of annual income:
10% of Rs. 20,000 Rs. 2,000
On other income: 30% of Rs. 40,000 + 40% of
Rs.40,000 Rs. 28,000
Total: Rs.30,000

Weighted Average Annual Effective Tax Rate:

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On Capital Gains portion of annual income: 2,000/20,000× 100 = 10%
On other income: 28,000/80,000 × 100 = 35%

Supposing the estimated income of each quarter is Rs.25,000, when income of Rs.25,000 for 2nd Quarter includes capital gains of Rs.20,000, the tax expense for each quarter will be calculated as below:

	Income	Tax Expense
Quarter I:	Rs. 25,000	35% of Rs. 25,000 = Rs. 8,750
Quarter II:		
Capital Gains:	Rs. 20,000	10% of Rs. 20,000 = Rs. 2,000
Other:	Rs. 5,000	35% of Rs. 5,000 = Rs. 1,750
		Rs. 3,750
Quarter III: Rs. 25,000 35% of Rs. 25,000 =		Rs. 8,750
Quarter IV: Rs. 25,000 35% of Rs. 25,000 =		Rs. 8,750
Total tax expense for the year		= Rs. 30,000

Example 5: An entity makes a loss in the first two quarters of the year of Rs.250,000, and it expects to make a profit in the third and fourth quarter of Rs.275,000 each (overall profit: Rs.50,000 for the year).

The interim results include expenditure of 70,000 each in the first two quarters that is disallowed for tax purposes. The expected profit in the second half of the year includes expected disallowable expenditure of Rs.80, 000 each.

The applicable tax rate is 30%.
The taxable profits for the year and the related tax are as follows:

	Q1	Q2	Q3	Q4	Full Year
	Rs.000	Rs.000	Rs.000	Rs.000	Rs.000
(Loss)/profit before tax	(250)	(250)	275	275	50
Disallowable expenditure	70	70	80	80	300
Taxable (loss)/profit	(180)	(180)	355	355	350
Tax (charge)/credit @ 30%					(105)

Note: It is presumed that there are no other differences between accounting income and taxable income.

If an effective tax rate including the effect of the disallowable expenditure is calculated, this is 105,000/50,000 or 210%. Applying this to the results in the interim periods gives the following:

	Q1	Q2	Q3	Q4	Full Year
	Rs.000	Rs.000	Rs.000	Rs.000	Rs.000
(Loss)/profit before tax	(250)	(250)	275	275	50
Tax (charge)/credit @ 210%	525	525	(577.5)	(577.5)	(105)
Profit/(loss) after tax	275	275	(302.5)	(302.5)	(55)
Effective rate of tax credit/ (charge)	210%	210%	210%	210%	210%

Subject to recoverability, a deferred tax asset of 525,000 would be recognised in each of the first two quarters. When the tax rate of 210% is then applied to the profits made in the second half of the year, a tax charge of Rs.577, 500 would be generated in each of the third and fourth quarters, giving a net

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tax charge of Rs.105, 000 for the full year. However, it can be argued that applying a tax rate of 210% has a distortive effect and overstates the tax asset.

If the effective tax rate is calculated excluding the effect of the disallowable items, this is 105,000/350,000 or 30%. Applying this to the results in the interim periods, and dealing with the disallowable items separately in the interim periods in which they arise, gives the following:

	Q1	Q2	Q3	Q4	Full Year
	Rs.000	Rs.000	Rs.000	Rs.000	Rs.000
Taxable (loss)/profit	(180)	(180)	355	355	350
Tax (charge)/credit @ 30%	54	54	(106.5)	(106.5)	(105)
Disallowable expenditure	(70)	(70)	(80)	(80)	(300)
Tax credit @ 0%	-	-	-	-	-
(Loss)/profit before tax	(250)	(250)	275	275	50
Tax credit/(charge)	54	54	106.5	106.5	(105)
(Loss)/profit after tax	(196)	(196)	168.5	168.5	(55)

As noted in above, the disallowable items are not included in determining the effective tax rate, but they are instead dealt with in the interim periods in which they arise, consistent with the approach in paragraph 10 of Appendix A to AS 25 for categories of income with different tax rates. Disallowable expenditure is effectively taxed at a zero rate.

Under this approach, subject to recoverability, a deferred tax asset of Rs.54,000 is recognised in each of the first two quarters. When the tax rate of 30% is applied to the profits made in the second half of the year, a tax charge of Rs.106,500 is generated in each of the third and fourth quarters, giving a net tax charge of Rs.105,000 for the full year. This approach is appropriate where, as in this example, the disallowable items have a distortive effect on the effective tax rate and on the resulting tax credit and deferred tax asset recognised. This might be the case where a loss in one interim period becomes income (or vice versa) in the next, or where there is a concentration of a significant amount of disallowable expenses in one interim period and not in the other.

EXPOSURE DRAFT