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DEFERRED TAX ACCOUNTING FOR SMES: MODIFIED INCOME STATEMENT APPROACH

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Deferred Tax Accounting for SMEs: Modified Income Statement Approach

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Abstract

Purpose: Accounting for income tax under International Financial Reporting Standards ('IFRS') is dealt with in IAS 12 Income Taxes. It is often said that users of financial statements do not find information produced in accordance with IAS 12 useful. This is a serious problem because for many businesses tax is one of the largest expenses. In some cases, preparers find the requirements of IAS 12 difficult to apply in practice. Its requirements are said to be unclear, and preparers sometimes question the relevance and understandability of the information that is provided in accordance with the standard. The IFRS for SMEs currently require use of balance sheet approach for accounting of deferred taxes. In India, the Institute of Chartered Accountants of India (ICAI) – the apex standard-setting body in India, is formulating revised accounting standards for SME's in India. This article examines an alternative to the balance sheet approach which is less complicated and easy to implement.

Methodology: This article proposes a new method i.e. Modified Income Statement Approach. This method is a mix of income statement approach and balance sheet approach, as it requires recognition of deferred taxes using temporary difference approach but calculated using income statement and the other comprehensive income (in effect, Comprehensive income statement). Modified Income Statement Approach requires comparison of tax expense with the underlying related income and expenses so that they are recognized in the same period. In doing so, it also considers income and expenses recognized in the income statement as well as the Other Comprehensive Income. Hence, this approach is more of temporary difference approach but applied by using income statement method. It covers all items of timing differences and most items of temporary differences. The SMEs have less complicated structures and transactions. Also, in many countries, including India, there exists no concept of tax balance sheet. Hence, it would be worthwhile to ease-out the deferred tax accounting for SMEs. The hypothesis is that application of modified income statement approach can result in similar outcome as the balance sheet approach.

Findings: A survey of 50 top companies in India was conducted. The results show that 60% of the companies would have recognized the same deferred tax asset/ liability under both the methods i.e. modified income statement approach and balance sheet approach. Balance 40% had some minor differences, but such transactions may be less frequent for SME. On an average, the impact of using modified income approach as against balance sheet approach is a mere 4%. The only items not covered by the modified income statement approach as against the balance sheet approach are Fair valuation of assets/ liabilities on business combination, Compound financial instrument and the existence of undistributed profits of subsidiaries, branches, associates and joint

arrangements.

Unique contribution to theory, practice and policy: To balance out the cost and benefits of implementing an accounting standard as per the framework, it is critical that SME's use a simpler and less complicated method which is easy to understand and implement. Modified income statement approach is easy to apply and not complicated or technical to understand. In India, companies are used to calculating deferred tax using income statement approach. Hence, this will be a small change from the existing approach, while achieving the objectives of the balance sheet approach. Hence, modified income statement approach seems to be an appropriate method for SMEs.

Keywords: *Accounting, Deferred Tax, Income Statement, Financial Reporting Standards, Income Tax*

INTRODUCTION

Study Overview

Accounting for income tax under International Financial Reporting Standards ('IFRS') is dealt with in IAS 12 Income Taxes. It is complex and controversial. As per the discussion paper on 'Improving the Financial Reporting of Income Tax' by the European Financial Reporting Advisory Group ('EFRAG discussion paper'), It is often said that users of financial statements do not find information produced in accordance with IAS 12 useful. This is a serious problem because for many businesses tax is one of the largest expenses. The complexity of tax makes it difficult to assess its impact and how it has been managed: this requires clear and transparent information, which is not sufficiently provided by financial statements prepared under IAS 12. Although IAS 12 requires extensive disclosures, these tend to focus on accounting technicalities such as temporary differences and their accounting treatment rather than on aspects that are of real concern to users such as tax cash flows and implications for future tax cash flows. In some cases, preparers find the requirements of IAS 12 difficult to apply in practice. Its requirements are said to be unclear, and preparers sometimes question the relevance and understandability of the information that is provided in accordance with the standard. As a result of the 2011 Agenda Consultation, the International Accounting Standards Board (IASB) identified income taxes as one of the three topics for long-term research (Source: IASB Agenda Reference 19A). The IASB identified 3 main causes for the companies and consultants finding it complex or controversial:

Income Approach is better

The current model in IAS 12 produces information that some people consider is not particularly relevant and causes an accounting mismatch. While IAS 12 bases its principles on the 'balance sheet liability approach', a number of people still believe that another approach would reflect the economics of income taxes more faithfully. These people often prefer an 'income approach'. This is probably because, in their view, an income tax liability arises at the time when related income is recognized. In contrast, under the 'balance sheet liability approach', the general view is that a tax liability exists at the point when a recognized asset (or a recognized liability) is measured at an amount that is different from the amount attributed to that asset (or liability) for tax purposes (i.e. its tax base). That difference would give rise to additional tax cash flows if the entity recovers the

asset (or settles the lability) at it carrying amount (i.e. the amount on the balance sheet).

Doesn't fit well with other Standards issued recently

The current version of IAS 12 may not fit well with more recent IFRS Standards or more recent tax laws across the globe. This is especially the case when the related assets and liabilities are measured at fair value. The current version of IAS 12 was originally published by the International Accounting Standards Committee (IASC), the Board's predecessor, in October 1996, and resulted in a switch from the 'income approach' to the 'balance sheet liability approach'. At that time, only a few IFRS Standards either required, or permitted, subsequent remeasurement or revaluation of assets or liabilities to fair value. Although the IASC provided an exception from deferred tax accounting when an asset or liability was initially recognized, it did not provide an exception for similar cases in subsequent remeasurement or revaluation of assets or liabilities at fair value.

Complex!!

Income taxes are very complex and existing disclosure may be insufficient to explain what drives the amount of income taxes reported. The staff often hear from users of financial statements that tax information is needed to project an entity's after-tax cash flows, as well as to determine an entity's financial soundness (i.e. credit worthiness). However, the way tax information is currently disclosed is often just a mathematical exercise that uses a great deal of technical jargon and, as a result, lacks transparency. Moreover, some users are skeptical about deferred tax accounting because they do not understand what information is provided when this method of accounting is used and they suspect that deferred tax accounting is utilized to manage earnings.

The EFRAG discussion paper mentions, as a starting point, it is important to be clear why accounting for corporate income tax is so complex. At a fundamental level, the objectives of financial reporting and tax reporting differ. Financial reporting is intended to provide financial statement users with useful information for resource allocation decisions; whereas the tax law is designed to achieve various government objectives such as generating revenue and, at times, encouraging what are deemed to be socially beneficial actions, rather than reflecting a purely economic perspective. These different objectives lead to rules that differ in both the scope and timing of which transactions are included in measured income. As a result, deferred taxes are intended to resolve the different application of two sets of reporting rules designed to meet different objectives. Adding to this complexity, many entities operate in more than one tax jurisdiction, and as a result, must deal with tax laws that are not just different from financial reporting requirements but vary by tax jurisdiction. Furthermore, managers usually have incentives to maximize cash flow for shareholders in part by minimizing current tax payments. These efforts have an impact on deferred taxes through the interplay of the differences in the financial reporting requirements and tax planning. This suggests that financial statements should attempt to provide useful information for evaluating this aspect of management's stewardship of the entity's resources.

Despite these challenges, accounting for income tax and the related disclosures are often criticized by users of financial statements as being very complex, incomplete and non- standardized. Users often claim that the information about deferred tax in particular is inadequate and tax remains a 'black box' that makes it difficult to predict future tax cash flows with any degree of precision.

They indicate that it would be helpful to understand an entity's tax strategy and to be provided with clear explanations of why the tax expense for the period is not simply the accounting pro t at the statutory tax rate. That said, users cannot be expected to have the technical accounting knowledge to make sense of complex tax issues and the accounting anomalies that result from the mixed measurement model that underpins the financial statements.The challenges faced by users are typified by the following statement from a group of investment analysts:

...despite their importance, tax issues get very little attention from investors. There are clear reasons behind this. First, there is reluctance on the part of corporates to reveal details of their tax planning strategy beyond what is in the financial statements, thereby restricting the analysis an investor can undertake. Secondly, many users have limited knowledge of the intricacies of tax issues and struggle to use the information that is available.

Addressing these challenges is not straightforward and there are limits to what can be achieved with financial reporting alone. The CFA Institute has noted that: Analysts sometimes analyze corporate performance on a pre- tax basis to avoid the complexity associated with income tax reporting. However, an entity's income tax accounting is too important to be ignored, due to significant cash flow and valuation consequences. Therefore, it is essential to have a clear picture of the effects of the differences between taxable income and financial statement income, including the impact of significant non- recurring transactions. From a user's perspective, unravelling these effects is a difficult and time- consuming task, especially in the absence of transparent disclosures.

The IASB staff suggested one of the possible solutions is fundamental change of the main principle i.e. Balance sheet approach. The summary of different alternative approaches identified by the IASB staff is as below:

The current tax approach (also known as the 'flow through approach' or 'tax payable approach'):

Under this approach, only the current tax assessed on profit of the current period was recognized in the financial statements. Deferred tax information needs to be disclosed in the footnotes. There were mixed views as to whether this method met the definitions of a liability under the Conceptual Framework.

The timing difference approach (also known as the 'income approach'):

Under this approach, deferred tax was recognized for timing differences, but not permanent differences. There are two alternatives under this approach:

i. Deferral method: The objective of the deferral method was to match the tax expense with the underlying related income and expenses so that they were recognized in the same period. If current tax effects lead to timing differences that originate in the current period and would reverse in the future, those current tax effects were deferred until the reversal occurred.

ii. Liability method: The objective of the liability method was to recognize as assets and liabilities those tax balances that met the definition of, and the recognition criteria for, assets and liabilities in the Conceptual Framework.

Under the timing difference/ income approach, the tax effect of all timing differences was generally recognized as a deferred tax liability or a deferred tax asset (i.e. Comprehensive Allocation). However, in a variation of this approach, the tax effect was recognized for only some timing differences (i.e. Partial Allocation). In the partial allocation method, deferred tax was recognized only those timing differences that are expected to reverse.

Accruals approach:

Under this approach the reported tax expense reflected the tax effect of all transactions and events that were reported in the period. There was no distinction between current and deferred tax. This difference with this approach and the income approach was that some temporary differences (such as those arising on the initial recognition in a business combination of an asset at an amount in excess of its tax basis) were not timing differences, and accordingly no tax effect is recognized for such items. Tax effects are not recognized under the accruals approach for temporary differences that are not timing differences, for example, on the initial recognition of an asset at an amount in excess of its tax basis in a business combination.

The valuation adjustment approach (also known as the 'net of tax approach'):

This approach is based on the premise that timing differences (or temporary differences) did not give rise to deferred tax assets or deferred tax liabilities but they affected instead the carrying amount of underlying assets or liabilities. For example, when accelerated depreciation was claimed for tax purposes, the right to receive tax benefits was consumed more quickly than the asset's potential to provide service. Consequently, when the entity consumed some of the right to receive tax benefits, the entity should reflect that consumption by reducing the carrying amount of the underlying asset, rather than by recognizing a separate deferred tax liability.

The valuation adjustment approach requires consideration of the tax effects of individual assets and liabilities, and this seems to raise new questions. For example, if part of the cost of an asset is deducted for tax purposes, but the entity is unable to benefit because it makes a tax loss, should the carrying asset be reduced? Clearly, where fair value is used, tax reliefs obtained by the entity in the past and to be obtained in the future are irrelevant (although the tax relief that would be obtained by another market participant may be relevant). Hence the valuation adjustment approach is inconsistent with the use of fair value as a measurement basis.

As can be seen above, every approach has its issues, but balance sheet approach (temporary difference approach) and income statement approach (timing difference approach) are the most acceptable approaches for deferred tax. Under all approaches, it is common that an expense should be reported for the tax that will be assessed on the income of the period and reflected in the statement of financial position as a liability (unless it has been prepaid). It is also common to all the approaches that no adjustment is made to this expense in respect of items that have no tax consequence (that is, items of income that are not assessed to tax, and expenses that are not allowed as a deduction for tax). Such items will cause the tax expense to be a higher or lower proportion of pre-tax profit than the standard rate, but the expense is fairly stated (although there is a case for disclosure of such items in the notes to financial statements).

However, approaches differ markedly in their treatment in respect of income and expense that are taxable, but not for the same period in which they are reflected in the financial statements. These are commonly referred to as timing differences. In India, Accounting Standard 22 ("AS 22") – *Accounting for Taxes on Income* – applies the timing difference approach or the income statement approach. The AS 22 is only applicable for Small and Medium-sized Entities (SME) defined as those having a net worth of less than 250 Crores and not publicly listed. Even IASB has a separate set of standards for SMEs – IFRS for SMEs. The income tax chapter of IFRS for SMEs standards are similar to the full IFRS.

This article suggests an alternative approach i.e. modified income statement approach. The SMEs have less complicated structures and transactions. Also, in many countries, including India, there exists no concept of tax balance sheet. Hence, it would be worthwhile to ease-out the deferred tax accounting for SMEs. The hypothesis is that application of modified income statement approach can result in similar outcome as the balance sheet approach.

MODIFIED INCOME STATEMENT APPROACH

What is the need for a new approach?

While balance sheet approach has its advantages that it reflects the balance sheet position of taxes in appropriate manner i.e. all taxes payable or tax benefits receivable are recognized aptly in balance sheet, it also has its disadvantages of being complicated and too technical. Consequently, some believe, as per IASB's own survey, that being so technical results in lack of transparency. Moreover, some users believe that this method is so complex that they tend to suspect that deferred tax accounting is utilized to manage earnings.

On the other hand, income statement approach is easy to understand, and tax is calculated based on income/ profit. However, not all income is recognized in income statement e.g. revaluation reserve, foreign currency translation reserve, hedge reserve, etc. Hence, a question of completeness arises when income statement method is used to calculate deferred taxes. Moreover, the 'Conceptual Framework for Financial Reporting' issued by the IASB requires application of cost constraint in financial reporting (detailed below) and justifying the same by the benefits of reporting. Hence, in respect of SMEs, implementing such a complex method might be taxing and costly. One must also appreciate that they may not have as complex transactions as in the case of large entities.

The cost constraint on useful financial reporting

As per the 'Conceptual Framework for Financial Reporting' issued by the IASB, Cost is a pervasive constraint on the information that can be provided by financial reporting. Reporting financial information imposes costs, and it is important that those costs are justified by the benefits of reporting that information.

Providers of financial information expend most of the effort involved in collecting, processing, verifying and disseminating financial information, but users ultimately bear those costs in the form of reduced returns. Users of financial information also incur costs of analyzing and interpreting the information provided. If needed information is not provided, users incur additional costs to obtain that information elsewhere or to estimate it.

In applying the cost constraint, the Board assesses whether the benefits of reporting particular information are likely to justify the costs incurred to provide and use that information. When applying the cost constraint in developing a proposed financial reporting standard, the Board seeks information from providers of financial information, users, auditors, academics and others about the expected nature and quantity of the benefits and costs of that standard. In most situations, assessments are based on a combination of quantitative and qualitative information.

What is Other Comprehensive Income (OCI)?

Other comprehensive income comprises items of income and expense (including reclassification adjustments) that are not recognized in profit or loss as required or permitted by other Ind ASs. The components of other comprehensive income include:

(a) changes in revaluation surplus

(b) remeasurements of defined benefit plans

(c) gains and losses arising from translating the financial statements of a foreign operation

(d) gains and losses from investments in equity instruments designated at fair value through other comprehensive income

(da) gains and losses on financial assets measured at fair value through other comprehensive income

(e) the effective portion of gains and losses on hedging instruments in a cash flow hedge and the gains and losses on hedging instruments that hedge investments in equity instruments measured at fair value through other comprehensive income

(f) for particular liabilities designated as at fair value through profit or loss, the amount of the change in fair value that is attributable to changes in the liability's credit risk

(g) changes in the value of the time value of options when separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the changes in the intrinsic value; changes in the value of the forward elements of forward contracts when separating the forward element and spot element of a forward contract and designating as the hedging instrument only the changes in the spot element, and changes in the value of the foreign currency basis spread of a financial instrument when excluding it from the designation of that financial instrument as the hedging instrument.

The Basics of OCI (Source: Ind AS Simplified book published by Wolters Kluwer authored by CA. (Dr.) Anand J. Banka). Under Indian GAAP, there is no concept of OCI. Hence, as required by relevant standards, certain items like *Revaluation Reserve (AS 10, Fixed Assets)*, *Foreign Currency Translation Reserve (AS 11, The Effects of Changes in Foreign Exchange Rates)* are accounted for directly in reserves. Technically, these items are in the nature of income or expense (explained separately below). As per the Framework, all items on income and expenses must be presented in the Statement of Profit or Loss. Hence, to harmonize the requirements of the specific standards with that of the Framework, Ind AS requires such items to be presented in the OCI. As per Ind AS 1, *Presentation of Financial Statements*, OCI comprises items of income and expense (including reclassification adjustments) that are not

recognized in profit or loss as required or permitted by other Ind ASs.

Are these items an item of income/expense?

Income is increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants. For example – revaluation reserve is increase in economic benefits in form of increase in property, plant and equipment that result in increase in equity, which is not relating to contributions from equity participants. Similar is the case with FCTR, hedge reserve, FVOCI reserve, etc.

Is the list given in Ind AS 1 exhaustive?

No, the list is inclusive and not exhaustive. Any other item that fits into the definition of an OCI item will be presented in OCI. For example, as per Ind AS 103, *Business Combinations*, "*in extremely rare circumstances, an acquirer will make a bargain purchase in a business combination in which the amount in paragraph 32(b) exceeds the aggregate of the amounts specified in paragraph 32(a). If that excess remains after applying the requirements in paragraph 36, the acquirer shall recognize the resulting gain in other comprehensive income on the acquisition date and accumulate the same in equity as capital reserve. The gain shall be attributed to the acquirer.*" Hence, in these circumstances, bargain purchase would be presented in OCI, though this item has not been mentioned in the list given in Ind AS 1. (Note: Ind AS 1 is similar to IAS 1).

What is Modified Income Statement Approach?

Modified Income Statement Approach is a mix of income statement approach and balance sheet approach, as it requires recognition of deferred taxes using temporary difference approach but calculated using income statement and the other comprehensive income (in effect, Comprehensive income statement).

Modified Income Statement Approach compares the tax expense with the underlying related income and expenses so that they are recognized in the same period. In doing so, it also considers income and expenses recognized in the income statement as well as the Other Comprehensive Income. Hence, this approach is more of temporary difference approach but applied by using income statement method.

This approach believes that an income tax liability arises at the time when related income is recognized, whether the same is recognized in income statement or in other comprehensive income. This approach covers all items of timing differences and most items of temporary differences.

What all can it cover additionally as compared to the income statement approach?

Modified Income Statement approach will cover all items covered by the income statement approach. It will also cover most of the items covered by the balance sheet approach. Below is a list of items comparing modified income statement approach to income statement approach:

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Table 1: Income statement approach Vs. Modified income statement approach

Sr. No.	Particulars	Covered by Income statement approach?	Covered by Modified Income Statement approach?
1	Revaluation/ fair valuation of assets/ liabilities	✕	✓
2	Other items recognized in Equity through OCI e.g. Hedge reserve, fair value through OCI of equity and debt instruments, etc.	✕	✓
3	Goodwill on business combination	✕	✓ , to the extent it does not arise from the initial recognition of goodwill
4	Difference on initial recognition of assets/ liabilities	✕	✓ , if it affects either accounting profit or tax profit
5	The carrying amount of investments in subsidiaries, branches and associates or interests in joint arrangements in separate and consolidated financial statements: (1) the existence of undistributed profits of subsidiaries, branches, associates and joint arrangements; (2) changes in foreign exchange rates when a parent and its subsidiary are based in different countries; and a reduction in the carrying amount of an investment in an associate to its recoverable amount.	✕, except for (3) reduction in the carrying amount of an investment in an associate to its recoverable amount	✓ , except for (1) the existence of undistributed profits of subsidiaries, branches, associates and joint arrangements

What all will it cover less as compared to the balance sheet approach?

Modified Income Statement approach will cover all items covered by the income statement approach. It will also cover most of the items covered by the balance sheet approach. Below is a list of items comparing modified income statement approach to balance sheet approach:

Table 2: Modified income statement approach Vs. Balance sheet approach

Sr. No.	Particulars	Covered by Modified Income statement approach?	Covered by Balance sheet approach?	Whether any exemption/ prohibition as per IAS 12?
1	Fair valuation of assets/ liabilities on business combination	✕	✔	No
2	Goodwill on business combination	✔, to the extent it does not arise from the initial recognition of goodwill	✔	Yes, IAS 12 prohibits recognition of deferred tax on initial recognition of goodwill on business combination.
3	Difference on initial recognition of assets/ liabilities	✔, if it affects either accounting profit or tax profit	✔	IAS 12 prohibits recognition of deferred tax on difference arising on initial recognition of assets/ liabilities if the transaction is not a business combination, and affects neither accounting profit nor taxable profit.
4	Compound financial instrument	✕	✔	No
5	The carrying amount of investments in subsidiaries, branches and associates or interests in joint arrangements in separate and consolidated financial statements: (1) the existence of undistributed profits of subsidiaries, branches, associates and joint arrangements; (2) changes in foreign exchange rates when a parent and its subsidiary are based in different countries; and (3) a reduction in the carrying amount of an investment in an associate to its recoverable amount.	✔, except for (1) the existence of undistributed profits of subsidiaries, branches, associates and joint arrangements	✔	Yes, if both of the following conditions are satisfied: (1) the parent, investor, joint venturer or joint operator is able to control the timing of the reversal of the temporary difference; and (2) it is probable that the temporary difference will not reverse in the foreseeable future.

If all the exceptions/ exemptions as per IAS 12 are considered, following are the items covered by

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balance sheet approach but not by modified income statement approach:

1. Fair valuation of assets/ liabilities on business combination
2. Compound financial instrument
3. The existence of undistributed profits of subsidiaries, branches, associates and joint arrangements

Why Modified Income Statement Approach?

As mentioned above, modified income statement approach requires recognition of deferred taxes using temporary difference approach but calculated using income statement and the other comprehensive income (in effect, Comprehensive income statement). Under the approach, one compares the tax expense with the underlying related income and expenses so that they are recognized in the same period. In doing so, it also considers income and expenses recognized in the income statement as well as the Other Comprehensive Income. Hence, this approach is more of temporary difference approach but applied by using income statement method.

This approach takes the advantages of both the income statement approach and the balance sheet approach. It is easy to apply and not complicated or technical to understand. In India, companies are used to calculating deferred tax using income statement approach. Hence, this will be a small change from the existing approach, while achieving the objectives of the balance sheet approach. The only items not covered by the modified income statement approach as against the balance sheet approach results are as below:

1. Fair valuation of assets/ liabilities on business combination
2. Compound financial instrument
3. The existence of undistributed profits of subsidiaries, branches, associates and joint arrangements

The above items do not materially affect even the top companies in India (refer survey results). Such transactions are not as frequent in SMEs and hence the impact would be further insignificant in these entities. Consequently, application of modified income statement approach will result in similar accounting as balance sheet approach, but with ease of calculation and understanding. A detailed discussion on these items and results of survey in respect of these items is mentioned under Survey and Main Findings.

RESEARCH METHODS

The research methods are designed to examine whether most common items of deferred taxes are covered by both balance sheet method and modified income statement approach or not. IAS 12 requires entities to disclose major components of deferred taxes. A Survey of top 50 companies in India was conducted to study their deferred tax components. These components were analyzed to ascertain whether these are covered under modified income statement approach as well or not and the impact of those components on the gross deferred tax assets/ liabilities. Further, the Standard requires only major components to be disclosed. Hence, the non-major components could not be

analyzed further. However, these are non-major components and the impact of these items would also not be material (these components had an average impact of less than 8% of the gross deferred tax assets/ liabilities).

Objective of Survey

The Survey was conducted to understand the components of the deferred tax assets and liabilities and the impact those components have on the gross deferred tax assets and liabilities. The ultimate result from survey would be to understand what would have been the impact on companies had they adopted modified income statement approach instead of balance sheet approach.

Survey Methodology

IAS 12 requires entities to disclose major components of deferred taxes. These components were analyzed to ascertain whether these are covered under modified income statement approach as well or not. Also, the Survey was conducted to determine how many companies have recognized deferred taxes on components that are not covered by the modified income statement approach and the impact of those components on the gross deferred tax assets/ liabilities. Further, the Standard requires only major components to be disclosed. Hence, the non-major components could not be analyzed further. However, these are non-major components and the impact of these items would also not be material (these components had an average impact of less than 8% of the gross deferred tax assets/ liabilities).

Data Collection and Sampling Technique:

Data for this research was collected from primary sources. Annual reports of top 50 listed companies in India was studied and analyzed for deferred tax impacts. These companies appear in top indices of stock exchanges in India (e.g. NIFTY50, BSE100). These 50 companies had prepared their financial statements in accordance with Indian Accounting Standards (Ind AS). Banks and financial institutions that had not adopted Ind AS were excluded from the sample. The top 50 companies in these indices, according to their market capitalization, were selected as samples for this research. The list of companies included in our sample is as below:

Table 3: List of companies

Sr. No	Company Name
1	Adani Ports & Special Economic Zone
2	Limited
3	Asian Paints Limited
4	Aurobindo Pharma Limited
5	Avenue Supermarts Limited
6	Bajaj Auto Limited
7	Berger Paints India Limited
8	Bharat Petroleum Corporation Limited
9	Bharti Airtel Limited
10	Bharti Infratel Limited

11	Bosch Limited
12	Britannia Industries Limited
13	Cipla Limited
14	Coal India Limited
15	Dabur India Limited
16	Dr. Reddys Laboratories Limited
17	Eicher Motors Limited
18	GAIL (India) Limited
19	Godrej Consumer Products Limited
20	Grasim Industries Limited
21	HCL Technologies Limited
22	Hero MotoCorp Limited
23	Hindalco Industries Limited
24	Hindustan Unilever Limited
25	Hindustan Zinc Limited
26	Indian Oil Corporation Limited
27	Infosys Limited
28	ITC Limited
29	JSW Steel Limited
30	Larsen & Toubro Limited
31	Lupin Limited
32	Mahindra & Mahindra Limited
33	Marico Limited
34	Nestle India Limited
35	NTPC Limited
36	Oil & Natural Gas Corporation Limited
37	Pidilite Industries Limited
38	Power Grid Corporation of India Limited
39	Reliance Industries Limited
40	Shree Cement Limited
41	Sun Pharmaceuticals Limited
42	Tata Consultancy Services Limited
43	Tata Motors Limited
44	Tata Steel Limited
45	Tech Mahindra Limited
46	Titan Company Limited
47	Ultratech Cement Limited
48	UPL Limited
49	Vedanta Limited

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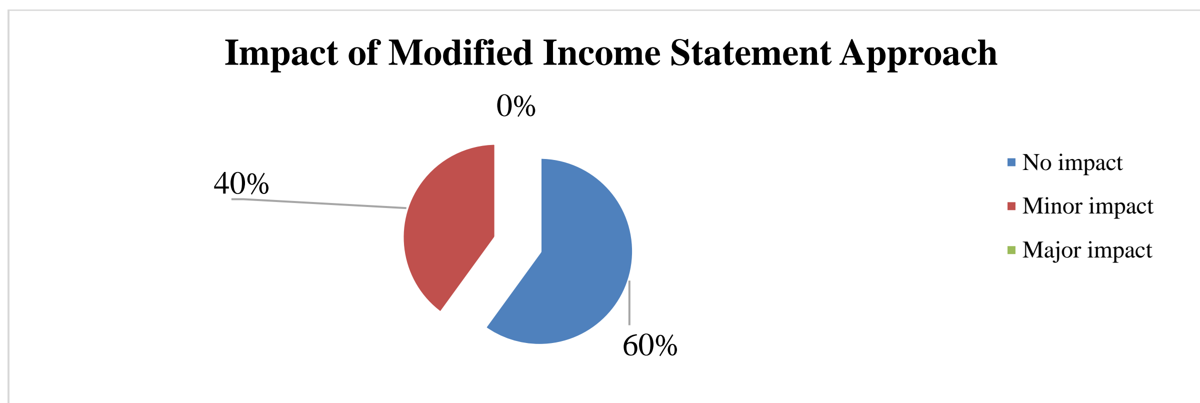
50	Wipro Limited
51	Zee Entertainment Enterprises Limited

FINDINGS



The results show that 60% of the companies would have recognized the same deferred tax asset/ liability under both the methods i.e. modified income statement approach and balance sheet approach. Balance 40% had some minor differences, but such transactions may be less frequent for SME. On an average, the impact of using modified income approach as against balance sheet approach is a mere 4%. The only items not covered by the modified income statement approach as against the balance sheet approach results are as below:

1. Fair valuation of assets/ liabilities on business combination

Only 9 out of 50 companies had entered into a transaction wherein deferred tax was created on fair valuation of assets/ liabilities in a business combination. The average impact of the deferred tax in those 9 companies relating to Fair valuation of assets/ liabilities on business combination was merely 1% of the gross deferred tax assets/ liabilities. Hence, though this is a point of difference between the balance sheet approach and modified income statement approach, the impact is insignificant. Further, such transactions would be even less frequent in a SME.

2. Compound financial instrument

Only 1 out 50 companies had mentioned this as a major component of deferred taxes i.e. either they do not have such instrument, or the impact is immaterial for other companies. For that 1 company, the impact of deferred tax on compound financial instrument was less than 4% of the gross deferred tax asset/ liability. Hence, though this is a point of difference between the balance sheet approach and modified income statement approach, the impact is insignificant. Further, such transactions would be even less frequent in a SME.

3. The existence of undistributed profits of subsidiaries, branches, associates and joint arrangements

Only 12 out of 50 companies had entered into a transaction wherein deferred tax was created on undistributed profits of subsidiaries, branches, associates and joint arrangements. This may also be because IAS 12 gives an exemption to companies in case they satisfy both the below mentioned

conditions:

a. the parent, investor, joint venturer or joint operator is able to control the timing of the reversal of the temporary difference; and
b. it is probable that the temporary difference will not reverse in the foreseeable future.

The average impact of the deferred tax in those 12 companies relating to undistributed profits of subsidiaries, branches, associates and joint arrangements was 16% of the gross deferred tax assets/ liabilities. Hence, though this is a point of difference between the balance sheet approach and modified income statement approach, only 24% companies actually recognized deferred tax due to such a transaction/ event. Further, IAS 12 provides exemption to companies on satisfaction of certain conditions. Also, such transactions would be even less frequent in a SME.

To balance out the cost and benefits of implementing an accounting standard as per the framework, it is critical that SME's use a simpler and less complicated method which is easy to understand and implement. Hence, modified income statement approach seems to be an appropriate method for SMEs. It covers almost all temporary differences that a balance sheet approach does while being easy to apply.

CONCLUSION

The IASB has undertaken research on income taxes, addressing concerns that IAS 12 may cause accounting mismatches. The IASB research suggests that one option is to fundamentally change the main principle of IAS 12 from the balance sheet method to another method. Four deferred tax methods are suggested:

(1) the taxes payable method

(2) the comprehensive basis under the income statement method

(3) the partial basis under the income statement method or

(4) the balance sheet method (the method currently in use by the IASB)

In India, the Accounting Standard 22 *Taxes on Income* requires use of income statement method for SMEs. Indian Accounting Standards (Ind AS) 12 *Income Taxes*, based on IAS 12, requires use of balance sheet method for public interest entities. Neither accounting standard allows the taxes payable method. Furthermore, in India, there is no concept of preparation of Tax balance sheet. SMEs in India are used to accounting for deferred tax using the income statement approach. However, income statement approach has its own disadvantages – mainly being it does not consider income and expenses recognized in the balance sheet through the other comprehensive income or directly in equity.

Hence, this article suggests an alternative method i.e. the Modified income statement approach. This method is a mix of income statement approach and balance sheet approach, as it requires recognition of deferred taxes using temporary difference approach but calculated using income statement and the other comprehensive income (in effect, Comprehensive income statement).

Modified Income Statement Approach requires comparison of tax expense with the underlying

related income and expenses so that they are recognized in the same period. In doing so, it also considers income and expenses recognized in the income statement as well as the Other Comprehensive Income. Hence, this approach is more of temporary difference approach but applied by using income statement method.

This approach covers all items of timing differences and most items of temporary differences. The SMEs have less complicated structures and transactions. Also, in many countries, including India, there exists no concept of tax balance sheet. Hence, it would be worthwhile to ease-out the deferred tax accounting for SMEs. The hypothesis is that application of modified income statement approach can result in similar outcome as the balance sheet approach.

Modified income statement approach takes the advantages of both the income statement approach and the balance sheet approach. It is easy to apply and not complicated or technical to understand. In India, companies are used to calculating deferred tax using income statement approach. Hence, this will be a small change from the existing approach, while achieving the objectives of the balance sheet approach. The only items not covered by the modified income statement approach as against the balance sheet approach results are Fair valuation of assets/ liabilities on business combination, Compound financial instrument and the existence of undistributed profits of subsidiaries, branches, associates and joint arrangements.

A survey of 50 top companies in India was conducted and the results show that 60% of the companies would have recognized the same deferred tax asset/ liability under both the methods i.e. modified income statement approach and balance sheet approach. Balance 40% had some minor differences, but such transactions may be less frequent for SME. On an average, the impact of using modified income approach as against balance sheet approach is a mere 4%. To balance out the cost and benefits of implementing an accounting standard as per the framework, it is critical that SME's use a simpler and less complicated method which is easy to understand and implement. Hence, modified income statement approach seems to be an appropriate method for SMEs.

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