

SUPREME COURT OF INDIA

J. K. Industries Ltd.

Vs.

Union of India

C.A.No.3761 of 2007

(S.H.Kapadia and B.S.Reddy JJ.)

19.11.2007

JUDGMENT:

KAPADIA, J.

1. A short question which arises for determination in this batch of civil appeals is :

Whether Accounting Standard 22 (AS 22) entitled accounting for taxes on income insofar as it relates to deferred taxation is inconsistent with and ultra vires the provisions of the Companies Act, 1956 (the Companies Act), the Income-tax Act, 1961 (I.T. Act) and the Constitution of India?

2. M/s. J.K. Industries Ltd. is a public limited company. It was incorporated in 1951. It carries on the business of manufacture and sale of automotive tyres, tubes, sugar and agrigenetics. It has a registered office at Calcutta. It seeks to challenge AS 22 issued by Institute of Chartered Accountants of India (for short, Institute) which has been made mandatory for all companies listed

in Stock Exchanges in India in preparation of their accounts for the financial year 2001-02 onwards.

3. On 7.12.06 the Central Government prescribed AS 22 under Section 211 (3C) of the Companies Act by the Companies (AS) Rules 2006. Before that date, AS 22, when issued in 2001, was challenged in writ petitions filed before Madras, Karnataka, Calcutta and Gujarat High Courts. On transfer petitions, under Section 139A of the Constitution, filed by the Institute, this Court vide order dated 17.2.03 was pleased to transfer the writ petitions filed in various High Courts to the Calcutta High Court. Meaning and purpose of AS:

4. In its origin, Accounting Standard is a policy statement or document framed by Institute. Accounting Standards establishes rules relating to recognition, measurement and disclosures thereby ensuring that all enterprises that follow them are comparable and that their financial statements are true, fair and transparent. Accounting Standards (A.S. for short) are based on a number of accounting principles. They seek to arrive at true accounting income. One such principle is the matching principle. The other is fair value principle. The aim of the Institute is to go for paradigm shift from matching to fair value principle.

5. Today the revised Accounting Standards seeks to arrive at true accounting income. In the age of globalization the attempt is to reconcile the accounts of Indian companies with their joint venture partners abroad. The aim is to harmonise Indian Accounting Standards with International Accounting Standards. With the object of bridging gap between IAS and IFRS, the Institute formulated new A.S. and introduced new concepts, e.g., Deferred Tax Accounting (AS 22 impugned herein), Segment Reporting (AS 17) etc.. However, as a matter of prudence and necessary adjustment, to arrive at real income, Accounting Standards require provision to be made for liabilities payable in future, provision to be made for contingencies, provision to be made for diminution, provision to reflect impairment and so on which have the effect of reducing incomes and were, therefore, not readily accepted by some enterprises and tax authorities.

6. The core of Accountancy is Book-keeping. The rules of Book-keeping are clear. For example, the value of a fixed asset mentioned in a Balance Sheet is based on cost which may involve subjective estimation of the amount to be apportioned. Similarly, the quantum of depreciation is again an estimate, which can vary depending on the persons preparing the accounts as to when and at what stage he wants to record the depreciation. Accounting Standards are an attempt to overcome some of these deficiencies of Accountancy. Accounting Standards involve codification of fundamental accounting rules, rules which explain and standardize the application of the fundamental rules to a variety of uncertain situations like retirement, contingencies, intangibles, consolidation, merger etc. Accounting Standards basically attempt to reduce the subjectivity and lay down rules so as to arrive at the best possible estimates. For example, net assets refer to the difference between total assets less liabilities but the value attributable to each asset and each liability is often subjective. It depends on estimates. This is where the Accounting Standards help. They reduce the subjectivity. Therefore, Accounting Standards help to arrive at the best possible estimates. This estimation/subjectivity is

also on account of the conceptual difference between accounting income and taxable income. Accounting income is the real income. Tax laws lay down rules for valuation of inventories, fixed assets, depreciation, bad debts, etc. based on artificial rules and not on the basis of accounting estimates, which results in mismatch between accounting and taxable incomes. For example, a fixed rate of depreciation may, for some companies, result in computing lower than the actual income if the actual erosion in the value of the asset is lower than the depreciation calculated at the fixed rate and higher than actual income for others where assets erode faster. Accounting income is normally used as a relevant measure by most stakeholders. However, on account of artificial set of rules used in computation of taxable income one finds that accounting income differs from taxable income. Looking to these problems, the evolution of Accounting Standards and their greater application is necessary as it results in reducing the need for tax laws to depend upon artificial rules. The object of Accounting Standards is, therefore, to standardize and to narrow down the options. The object of Accounting Standards is to evolve methods by which accounting income is determined. The object behind the Accounting Standards is to evolve methods by which accounting income is determined, made more transparent and leave less and less room for subjective selection of methods and provide for more attention to the quality of estimates used in arriving at accounting income.

7. The main object sought to be achieved by Accounting Standards which is now made mandatory is to see that accounting income is adopted as taxable income and not merely as the basis from which taxable income is to be computed. Thus, if the rules by which inventories are to be valued are laid down in the Accounting Standards and are followed in the determination of accounting income, then tax laws do not need to lay down the rules and the tax authorities do not need to examine the computation of the value of inventories and its effect on computation of income. Similarly, if there is an accounting standard on depreciation which requires estimation of the useful life and prescribes the appropriate method for apportionment of cost of fixed assets over their useful life, it is unnecessary for tax laws to apply an artificial rule to decide the extent of allowance for depreciation.

8. Finally, the adoption of Accounting Standards and of accounting income as taxable income would avoid distortion of accounting income which is the real income. Reasons for introducing AS 22:

9. In the backdrop of globalization and liberalization the world has become an economic village. Today, the capital market all over the world knows no barriers. Fiscal distances and barriers have been removed by developments in transport, communication and e-commerce. In this backdrop, Convergence of Accounting Standards is aimed at removing barriers in the flow of financial information and capital. Based on the above developments in the global economy and the Indian economy, the conceptual differences and consequent deviations in the National Accounting Standards and IFRS have got to be eliminated. For example, exchange difference in respect of unpaid liability for acquisition of an imported asset has been allowed in the past to be adjusted with the carrying costs of the fixed assets instead of recognizing the exchange difference in the profit and loss account.

10. Lastly, it is important to note that Accounting Standards and taxation of income are two independent subjects. The object behind AS is to remove this divergence by making Accounting Income a Taxable Income. Accounting income can never negate True Income.

Relevant provisions of the Companies Act, 1956 and Analysis thereof:

11. Before analyzing the provisions of the Companies Act, we quote hereinbelow the following provisions from the Companies Act which read as follow:

PREAMBLE

The Companies Act, 1956 (ACT 1 OF 1956) [18th January, 1956]

An Act to consolidate and amend the law relating to companies and certain other associations.

Be it enacted by Parliament in the Sixth Year of the Republic of India as follows:-

PRELIMINARY

Section 2(33) "prescribed" means, as respects the provisions of this Act relating to the winding up of companies except sub-section (5) of section 503, sub-section (3) of section 550, section 552 and sub-section (3) of section 555, prescribed by rules made by the Supreme Court in consultation with The Tribunal, and as respects the other provisions of this Act including sub-section (5) of section 503, sub-section (3) of section 550, section 552 and sub-section (3) of section 555, prescribed by rules made by the Central Government;

ACCOUNTS

Section 209. Books of account to be kept by company

(1) Every company shall keep at its registered office proper books of account with respect to- (a) all sums of money received and expended by the company and the matters in respect of which the receipt and expenditure take place; (b) all sales and purchases of goods by the company;

(c) the assets and liabilities of the company; and (d) in the case of a company pertaining to any class of companies engaged in production, processing, manufacturing or mining activities, such particulars relating to utilisation of material or labour or to other items of cost as may be prescribed, if such class of companies is required by the Central Government to include such particulars in the books of account:

Provided that all or any of the books of account aforesaid may be kept at such other place in India as the Board of directors may decide and when the Board of directors so decides, the company shall, within seven days of the decision, file with the Registrar a notice in writing giving the full address of that other place.

(2) Where a company has a branch office, whether in or outside India, the company shall be deemed to have complied with the provisions of sub-section (1), if proper books of account relating to the transactions effected at the branch office are kept at that office and proper summarised returns, made up to dates at intervals of not more than three months, are sent by the branch office to the company at its registered office or the other place referred to in sub-section (1).

(3) For the purposes of sub-sections (1) and (2), proper books of account shall not be deemed to be kept with respect to the matters specified therein,- (a) if there are not kept such books as are necessary to give a true and fair view of the state of the affairs of the company or branch office, as the case may be, and to explain its transactions; and (b) If such books are not kept on accrual basis and according to the double entry system of accounting. (4) The books of account and other books and papers shall be open to inspection by any director during business hours.

(4A) The books of account of every company relating to a period of not less than eight years immediately preceding the current year together with the vouchers relevant to any entry in such books of account shall be preserved in good order : Provided that in the case of a company incorporated less than eight years before the current year, the books of account for the entire period preceding the current year together with the vouchers relevant to any entry in such books of account shall be so preserved.

(5) If any of the persons referred to in sub-section (6) fails to take all reasonable steps to secure compliance by the company with the requirements of this section, or has by his own wilful act been the cause of any default by the company thereunder, he shall, in respect of each offence, be

punishable with imprisonment for a term which may extend to six months, or with fine which may extend to ten thousand rupees, or with both : Provided that in any proceedings against a person in respect of an offence under this section consisting of a failure to take reasonable steps to secure compliance by the company with the requirements of this section, it shall be a defence to prove that a competent and reliable person was charged with the duty of seeing that those requirements were complied with and was in a position to discharge that duty :

Provided further that no person shall be sentenced to imprisonment for any such offence, unless it was committed wilfully.

(6) The persons referred to in sub-section (5) are the following namely :-

(a) where the company has a managing director or manager, such managing director or manager and all officers and other employees of the company; and;

(d) where the company has neither a managing director nor manager, every director of the company;

Section 210. Annual accounts and balance sheet (1) At every annual general meeting of a company held in pursuance of section 166, the Board of directors of the company shall lay before the company-

(a) a balance sheet as at the end of the period specified in sub-section (3); and

(b) a profit and loss account for that period. (2) In the case of a company not carrying on business for profit, an income and expenditure account shall be laid before the company at its annual general meeting instead of a profit and loss account, and all references to "profit and loss account", "profit" and "loss" in this section and elsewhere in this Act, shall be construed, in relation to such a company, as references respectively to the "income and expenditure account", "the excess of income over expenditure", and "the excess of expenditure over income".

(3) The profit and loss account shall relate- (a) in the case of the first annual general meeting of the company, to the period beginning with the incorporation of the company and ending with a day which shall not precede the day of the meeting by more than nine months; and

(b) in the case of any subsequent annual general meeting of the company, to the period beginning with the day immediately after the period for which the account was last submitted and ending with a day which shall not precede the day of the meeting by more than six months, or in cases where an extension of time has been granted for holding the meeting under the second proviso to sub-section (1) of section 166, by more than six months and the extension so granted.

(4) The period to which the account aforesaid relates is referred to in this Act as a "financial year" and it may be less or more than a calendar year, but it shall not exceed fifteen months :

Provided that it may extend to eighteen months where special permission has been granted in that behalf by the Registrar.

(5) If any person, being a director of a company, fails to take all reasonable steps to comply with the provisions of this section, he shall, in respect of each offence, be punishable with imprisonment for a term which may extend to six months, or with fine which may extend to ten thousand rupees, or with both :

Provided that in any proceedings against a person in respect of an offence under this section, it shall be a defence to prove that a competent and reliable person was charged with the duty of seeing that the provisions of this section were complied with and was in a position to discharge that duty :

Provided further that no person shall be sentenced to imprisonment for any such offence unless it was committed wilfully.

(6) If any person, not being a director of the company, having been charged by the Board of directors with the duty of seeing that the provisions of this section are complied with, makes default in doing so, he shall, in respect of each offence, be punishable with imprisonment for a term which may extend to six months, or with fine which may extend to ten thousand rupees, or with both :
Provided that no person shall be sentenced to imprisonment for any such offence unless it was committed wilfully.

Section 210A. Constitution of National Advisory Committee on Accounting Standards

(1) The Central Government may, by notification in the Official Gazette, constitute an Advisory

Committee to be called the National Advisory Committee on Accounting Standards (hereafter in this section referred to as the "Advisory Committee") to advise the Central Government on the formulation and laying down of accounting policies and accounting standards for adoption by companies or class of companies under this Act. (2) The Advisory Committee shall consist of the following members, namely :-

(a) a Chairperson who shall be a person of eminence well versed in accountancy, finance, business administration, business law, economics or similar discipline;

(b) one member each nominated by the Institute of Chartered Accountants of India constituted under the Chartered Accountants Act, 1949, the Institute of Cost and Works Accountants of India constituted under the Cost and Works Accountants Act, 1959 and the Institute of Company Secretaries of India constituted under the Company Secretaries Act, 1980;

(c) one representative of the Central Government to be nominated by it;

(d) one representative of the Reserve Bank of India to be nominated by it;

(e) one representative of the Comptroller and Auditor-General of India to be nominated by him; (f) a person who holds or has held the office of professor in accountancy, finance or business management in any university or deemed university;

(g) the Chairman of the Central Board of Direct Taxes constituted under the Central Boards of Revenue Act, 1963 or his nominee;

(h) two members to represent the chambers of commerce and industry to be nominated by the Central Government, and

(i) one representative of the Securities and Exchange Board of India to be nominated by it. (3) The Advisory Committee shall give its recommendations to the Central Government on such matters of accounting policies and standards and auditing as may be referred to it for advice from time to time.

(4) The members of the Advisory Committee shall hold office for such terms as may be determined

by the Central Government at the time of their appointment and any vacancy in the membership in the Committee shall be filled by the Central Government in the same manner as the member whose vacancy occurred was filled. (5) The non-official members of the Advisory Committee shall be entitled to such fees, travelling, conveyance and other allowances as are admissible to the officers of the Central Government of the highest rank.

Section 211. Form and contents of balance sheet and profit and loss account

(1) Every balance sheet of a company shall give a true and fair view of the state of affairs of the company as at the end of the financial year and shall, subject to the provisions of this section, be in the form set out in Part I of Schedule VI, or as near thereto as circumstances admit or in such other form as may be approved by the Central Government either generally or in any particular case; and in preparing the balance sheet due regard shall be had, as far as may be, to the general instructions for preparation of balance sheet under the heading "Notes" at the end of that Part : Provided that nothing contained in this sub-section shall apply to any insurance or banking company or any company engaged in the generation or supply of electricity, or to any other class of company for which a form of balance sheet has been specified in or under the Act governing such class of company. (2) Every profit and loss account of a company shall give a true and fair view of the profit or loss of the company for the financial year and shall, subject as aforesaid, comply with the requirements of Part II of Schedule VI, so far as they are applicable thereto : Provided that nothing contained in this sub-section shall apply to any insurance or banking company or any company engaged in the generation or supply of electricity, or to any other class of company for which a form of profit and loss account has been specified in or under the Act governing such class of company.

(3) The Central Government may, by notification in the Official Gazette, exempt any class of companies from compliance with any of the requirements in Schedule VI if, in its opinion, it is necessary to grant the exemption in the public interest. Any such exemption may be granted either unconditionally or subject to such conditions as may be specified in the notification. (3A) Every profit and loss account and balance sheet of the company shall comply with the accounting standards.

(3B) Where the profit and loss account and the balance sheet of the company do not comply with the accounting standards, such companies shall disclose in its profit and loss account and balance sheet, the following, namely:-

- (a) the deviation from the accounting standards; (b) the reasons for such deviation; and
- (c) the financial effect, if any, arising due to such deviation.

(3C) For the purposes of this section, the expression "accounting standards" means the standards of accounting recommended by the Institute of Chartered Accountants of India constituted under the Chartered Accountants Act, 1949 as may be prescribed by the Central Government in consultation with the National Advisory Committee on Accounting Standards established under sub-section (1) of section 210A :

Provided that the standard of accounting specified by the Institute of Chartered Accountants of India shall be deemed to be the Accounting Standards until the accounting standards are prescribed by the Central Government under this sub-section. (4) The Central Government may, on the application, or with the consent of the Board of directors of the company, by order, modify in relation to that company any of the requirements of this Act as to the matters to be stated in the company's balance sheet or profit and loss account for the purpose of adapting them to the circumstances of the company.

(5) The balance sheet and the profit and loss account of a company shall not be treated as not disclosing a true and fair view of the state of affairs of the company, merely by reason of the fact that they do not disclose-

(i) in the case of an insurance company, any matters which are not required to be disclosed by the Insurance Act, 1938;

(ii) in the case of a banking company, any matters which are not required to be disclosed by the Banking Companies Act, 1949;

(iii) in the case of a company engaged in the generation or supply of electricity, any matters which are not required to be disclosed by both the Indian Electricity Act, 1910, and the Electricity (Supply) Act, 1948;

(iv) in the case of a company governed by any other special Act for the time being in force, any matters which are not required to be disclosed by that special Act; or

(v) in the case of any company, any matters which are not required to be disclosed by virtue of the provisions contained in Schedule VI or by virtue of a notification issued under sub-section (3) or an order issued under sub-section (4).

(6) For the purposes of this section, except where the context otherwise requires, any reference to a balance sheet or profit and loss account shall include any notes thereon or documents annexed thereto, giving information required by this Act, and allowed by this Act to be given in the form of such notes or documents.

(7) If any such person as is referred to in sub-section (6) of section 209 fails to take all reasonable steps to secure compliance by the company, as respects any accounts laid before the company in general meeting, with the provisions of this section and with the other requirements of this act as to the matters to be stated in the accounts, he shall, in respect of each offence, be punishable with imprisonment for a term which may extend to six months, or with fine which may extend to ten thousand rupees, or with both :

Provided that in any proceedings against a person in respect of an offence under this section, it shall be a defence to prove that a competent and reliable person was charged with the duty of seeing that the provisions of this section and the other requirements aforesaid were complied with and was in a position to discharge that duty :

Provided further that no person shall be sentenced to imprisonment for any such offence, unless it was committed wilfully. (8) If any person, not being a person referred to in sub-section (6) of section 209, having been charged by the managing director or manager, or Board of directors, as the case may be, with the duty of seeing that the provisions of this section and the other requirements aforesaid are complied with, makes default in doing so, he shall, in respect of each offence, be punishable with imprisonment for a term which may extend to six months or with fine which may extend to ten thousand rupees, or with both:

Provided that no person shall be sentenced to imprisonment for any such offence, unless it was committed wilfully.

SCHEDULE VI

(See section 211)

1[PART I

Form of Balance-sheet]

The balance sheet of a company shall be either in horizontal form or vertical form

A. HORIZONTAL FORM]

Balance sheet of .

[Here enter the name of the Company] As at

[Here enter the date as at which the balance-sheet is made out.] Instructions in accordance with which liabilities should be made out LIABILITIES ASSETS Instructions in accordance with which assets should be made out Figures for the previous year Rs. (b)

Figures for the current year Rs. (b) Figures for the previous year Rs. (b) Figures for the current year Rs. (b) *SHARE CAPITAL *FIXED ASSETS Terms of redemption or conversion (if any), or any redeemable preference capital to be stated, together with earliest date of redemption or conversion. Authorised shares of Rs. each. Distinguishing as far as possible between expenditure upon (a) goodwill, (b)

land, (c) buildings, (d) leaseholds, (e) railway sidings, (f) plant and machinery, (g) furniture and fittings, (h) development of property, (i) patents, trade marks and designs, (j) live-stock and (k) vehicles, etc. *Under each head the original cost, and the additions

thereto and deductions therefrom during the year, and total depreciation written off or provided up to the end of the year to be stated. Where the original cost aforesaid and additions and deductions thereto, relate to any fixed asset which has been acquired from a

country outside India, and in consequence of a change in the rate of exchange at any time after the acquisition of such asset, there has been an increase or reduction in the liability of the company, as expressed in Indian currency, for making payment towards the whole or a part of the cost of the asset or for repayment of the whole or a part of moneys borrowed by the company from any person, directly or indirectly in any foreign currency

specifically for the purpose of acquiring the asset (being in either case the liability existing immediately before the date on which the change in the rate of exchange takes effect), the amount by which the liability is so increased or reduced during the year, shall be added to, or, as the case may be deducted from the cost, and the amount arrived at after such addition or deduction shall be taken to be the cost of the fixed asset. Explanation 1: This paragraph shall apply in relation to all balance-sheets that may be made out as at the 6th day of June, 1966, or any day thereafter and

where, at the date of issue of the notification of the Government of India, in the Ministry of Industrial Development and Company Affairs (Department of Company Affairs), G.S.R. No. 129, dated the 3rd day of January, 1968, any balance sheet, in relation, to which this paragraph applies, has already been made out and laid before the company in Annual General Meeting, the adjustment referred to in this paragraph may be made in the first balance-sheet made out after the issue of the said notification. Explanation 2:-In this paragraph, unless the context otherwise requires, the expressions "rate of exchange", "foreign currency" and "Indian Currency" shall have the meanings respectively assigned to them under sub-section (1) of section 43A of the Income-tax Act, 1961 (43 of 1961), and Explanation 2 and Explanation 3 of the said sub-section shall, as far as may be, apply in relation to the said paragraph as they apply to the said sub-section (1). In every case where

the original cost cannot be ascertained, without unreasonable expense or delay, the valuation shown by the books shall be given. For the purposes of this paragraph, such valuation shall be the net amount at which an asset stood in the company's books at the commencement of this Act after deduction of the amounts previously provided or written off for depreciation or diminution in value, and where any such asset is sold, the amount of sale proceeds shall be shown as deduction. Particulars of any option on un-issued share capital to be specified. Issued (distinguishing between the various classes of capital and stating the particulars specified below, in respect of each class) shares of Rs. each. Where sums have been written off on a reduction of capital or a revaluation of assets, every balance sheet, (after the first balance sheet) subsequent to the reduction or revaluation shall show the reduced figures and with the date of the reduction in place of the original cost. Particulars of the different classes of preference shares to be given. Subscribed (distinguishing between the various classes of Capital and stating the particulars specified below in respect of each class.) Each balance sheet for the first five years subsequent to the date of the reduction, shall show also the amount of the reduction

made. (c) shares of Rs. each. Similarly, where sums have been added by writing up the assets, every balance-sheet subsequent to such writing up shall show the increased

figures with the date of the increase in place of the original cost. Each balance sheet for the first five years subsequent to the date of writing up shall also show the amount of increase made. Rs. called up. Explanation.- Nothing contained in the preceding two paragraphs shall apply to any adjustment made in accordance with the second paragraph.

Of the above shares shares are allotted as fully paid-up pursuant to a contract without payments being received in cash. Specify the source from which bonus shares are issued, .g., capitalisation of profits or Reserves or from Share Premium Account. Of the above shares ___ shares are allotted as fully paid-up by way of bonus shares+Any capital profit on reissue of forfeited shares should be transferred to Capital Reserve. Less: calls unpaid: 1[(i) By managing agent or secretaries and treasurers and where the managing agent or secretaries and treasurers are a firm, by the partners thereof, and where the managing agent or secretaries and treasurers are a private company by the directors or members of that company.](ii) By directors.(iii) By others. Add: Forfeited shares (amount originally paid up)]. Additions and deductions since last balance sheet to be shown under each of the specified heads. *RESERVES AND SURPLUS INVESTMENTS* Aggregate amount of company's quoted investment and also the market value thereof shall be shown.

The word "fund" in relation to any "Reserve" should be used only where such Reserve is specifically represented by earmarked investments.(1) Capital Reserves.Showing nature of investments and mode of valuation, for example, cost or market value and distinguishing between-Aggregate amount of companys unquoted investments shall also be shown.(2) Capital Redemption Reserve.*(1) Investments in Government or Trust

Securities.All unutilised monies out of the issue must be separately disclosed in the Balance Sheet of the company indicating the form in which such unutilised funds have been invested.(3) Share Premium Account (cc).*(2) Investments in shares, debentures or

bonds (showing separately shares fully paid-up and partly paid-up and also distinguishing the different classes of shares and showing also in similar details investments in shares, debentures or bonds of subsidiary companies.(4) Other Reserves specifying the nature of each Reserve and the amount in respect thereof.(3) Immovable properties.Less: Debit balance in profit and loss account (if any) (h).(4) Investments in the Capital of partnership firms. (5) Surplus i.e., balance in profit and loss account after providing for proposed allocations, namely:-(5) Balance of unutilised monies raised by issue.Dividend, Bonus or Reserves.(6) Proposed additions to Reserves.(7) Sinking Funds.] SECURED LOANS:CURRENT ASSETS, LOANS AND ADVANCES:Loans from Directors, Manager should be shown separately.(1) Debentures A. CURRENT ASSETS Mode of valuation of stock shall be stated and the amount in respect of raw material shall also be stated separately where practicable.Interest accrued and due on Secured Loans should be

included under the appropriate sub-heads under the head "SECURED LOANS".(2) Loans and Advances from Banks.(1) Interest accrued on InvestmentsMode of valuation of works-in-progress shall be stated.The nature of the security to be specified in each case. (3) Loans and Advances from subsidiaries.(2) Stores and spare parts.In regard to Sundry Debtors particulars to be given separately of- (a) debts considered good and in respect of hich the company is fully secured; and (b) debts considered good for which the company holds no security other than the debtors personal security; and (c) debts considered doubtful or bad.Where loans have been guaranteed by managers and/or directors, a mention thereof shall also be made and the aggregate amount of such loans under each head(4) Other Loans and Advances.(3) Loose Tools.Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or ebts due by firms or private companies respectively in which any director is a partner or a director or a members to be separately stated.Terms of redemption or conversion (if any) f debentures issued to be stated together with earliest date of redemption or conversion.(4) Stock-in-trade.Debts due from other companies under the same anagement within the meaning of sub-section (1B) of section 370, to be disclosed with the names of he Companies.(5) Works-in-Progress.The maximum amount due by directors or other fficers of the company at any time during the year to be shown by way of a note.

(6) Sundry debtors-The provisions to be shown under this head should not exceed the mounts of debts stated to be considered doubtful or bad and any surplus of such provision f already created, should be shown at every closing under "Reserves and Surplus" (in the liabilities side) under a separate sub-head "Reserve for Doubtful or Bad Debts".(a) Debts outstanding for a period exceeding six months.In regard to bank balances, particulars to e given separately of-(b) Other debts.(a) the balances lying with Scheduled Banks on urrent accounts, call accounts and deposit accounts; Less: Provision(b) the name of the bankers ther than Scheduled Banks and the balance lying with each such banker on current accounts, call accounts and deposit account the maximum amount

outstanding at any time during the year from each such banker; and (7A) Cash balance on hand. (c) the nature of the interest, if any, of any director or his relative or the interest in each of the bankers (other than Scheduled Banks) referred to in (b) above. (7B) Bank balances-All unutilised monies out of the issue must be separately disclosed in the Balance Sheet of the company indicating the form in which such unutilised funds have been invested. (a) with Scheduled Banks, and (b) with others. B. LOANS AND ADVANCES*The above instructions regarding "Sundry Debtors" apply to "Loans and Advances" also. (8) (a) Advances and loans to subsidiaries. (b) Advances and loans to partnership firms in which the company or any of its subsidiaries is a partner. (9) Bills of Exchange. (10) Advances recoverable in cash or in kind or for value to be received, e.g., Rates, Taxes, Insurance, etc. (11) ***] (12) Balances with Customs, Port Trust, etc. (where payable on demand). UNSECURED LOANS: MISCELLANEOUS EXPENDITURE (to the extent not written off or adjusted): Loans from directors, manager should be shown separately. Interest accrued and due on Unsecured Loans should be included under the appropriate sub-heads under the head "Unsecured Loans". (1) Fixed Deposits. (1) Preliminary expenses. Where loans have been guaranteed by managers and/ or directors, a mention thereof shall be made and also aggregate amount of such loans under each head. (2) Loans and Advances from subsidiaries. (2) Expenses including commission or brokerage on underwriting or subscription of shares or debentures. See note (d) at foot of Form (3) Short Term Loans and Advances: (3) Discount allowed on the issue of shares or debentures. (a) From Banks.

(4) Interest paid out of capital during construction (also stating the rate or interest.) (b) From others. (5) Development expenditure not adjusted. (4) Other Loans and Advances: (6) Other items (specifying nature). (a) From Banks. (b) From others. CURRENT LIABILITIES AND PROVISIONS: PROFIT AND LOSS ACCOUNT. Show here the debit balance of profit and loss account carried forward after deduction of the uncommitted reserves, if any. The name(s) of the small scale industrial undertaking(s) to whom the Company owe a sum exceeding Rs. 1 lakh which is outstanding for more than 30 days, are to be disclosed. A. CURRENT LIABILITIES (1) Acceptances (2) Sundry creditors. (i) Total outstanding dues of small scale industrial undertaking(s); and (ii) Total outstanding dues of creditors other than small scale industrial undertakings(s). (3) Subsidiary companies. (4) Advance payments and unexpired discounts for the portion for which value has still to be given e.g., in the case of the following classes of companies:- Newspaper, Fire Insurance, Theatres, Clubs, Banking, Steamship Companies, etc. (5) Unclaimed Dividends. (6) Other Liabilities (if any). (7) Interest accrued but not due on loans. B. PROVISIONS (8) Provisions for taxation. (9) Proposed dividends. (10) For contingencies. (11) For provident fund scheme. (12) For insurance, pension and similar staff benefit schemes.

(13) Other provisions. A foot-note to the balance-sheet may be added to show separately: (1) Claims against the company not acknowledged as debts. (2) Uncalled liability on shares partly paid. The period for which the dividends are in arrear of if there is more than one class of shares, the dividends on each such class are in arrear, shall be stated. (3) Arrears of fixed cumulative dividends. The amount shall be stated before deduction of income-tax, except that in the case of tax-free dividends the amount shall be shown free of income-tax and the fact that it is so shown shall be stated. (4) Estimated amount of contracts remaining to be executed on capital account and not provided for. The amount of any guarantees given by the company on behalf of Directors or other officers of the company shall be stated and where practicable, the general nature and amount of each such contingent liability, if material, shall also be specified. (5) Other money for which the company is contingently liable.

General instructions for preparation of balance sheet.- (a) The information required to be given under any of the items or sub-items in this Form, if it cannot be conveniently included in the balance sheet itself, shall be furnished in a separate Schedule or Schedules to be annexed to and to form part of the balance sheet. This is recommended when items are numerous.

(b) Naye Paise can also be given in addition to Rupees, if desired.

(c) In the case of subsidiary companies the number of shares held by the holding company as well as by the ultimate holding company and its subsidiaries must be separately stated.

The auditor is not required to certify the correctness of such shareholdings as certified by the management. (cc) The item "Share Premium Account" shall include details of its utilisation in the manner provided in section 78 in the year of utilisation. (d) Short Term Loans will include those which are due for not more than one year as at the date of the balance- sheet.

(e) Depreciation written off or provided shall be allocated under the different asset heads and deducted in arriving at the value of Fixed Assets. (f) Dividends declared by subsidiary companies after the date of the balance sheet should not be included] unless they are in respect of period which closed on or before the date of the balance sheet.

(g) Any reference to benefits expected from contracts to the extent not executed shall not be made in the balance sheet but shall be made in the Board's report. (g) Any reference to benefits expected from contracts to the extent not executed shall not be made in the balance sheet but shall be made in the Board's report. [(h) The debit balance in the Profit and Loss Account shall be shown as a deduction from the uncommitted reserves, if any.

(i) As regards Loans and Advances, amounts due by the Managing Agents or Secretaries and Treasurers, either severally or jointly with any other persons to be separately stated; the amounts due from other companies under the same management within the meaning of sub- section (1B) of section 370 should also be given with the names of the companies the maximum amount due from every one of these at any time during the year must be shown. (j) Particulars of any redeemed debentures which the company has power to issue should be given. (k) Where any of the company's debentures are held by a nominee or a trustee for the company, the nominal amount of the debentures and the amount at which they are stated in the books of the company shall be stated. (l) A statement of investments (whether shown under "Investment" or under "Current Assets" as stock-in-trade) separately classifying trade investments and other investments should be annexed to the

balance sheet, showing the names of the bodies corporate (indicating separately the names of the bodies corporate under the same management) in whose shares or debentures, investments have been made (including all investments whether existing or not, made subsequent to the date as at which the previous balance sheet was made out) and the nature and extent of the investment ; so made in each such body corporate; provided that in the case of an investment company that is to say, a company whose principal business is the acquisition of shares, stock, debentures or other securities, it shall be sufficient if the statement shows only the investments existing on the date as at which the balance sheet has been made out. In regard to the investments in the capital of partnership firms, the names of the firms (With the names of all their partners total capital and the shares of each partner) shall be given in the statement. (m) If, in the opinion of the Board, any of the current assets, loans and advances have not a value on realisation in the ordinary course of business at least equal to the amount at which they are stated, the fact that the Board is of that opinion shall be stated. (n) Except in the case of the first balance sheet laid before the company after the commencement of the Act, the corresponding amounts for the immediately preceding financial year for all items shown in the balance sheet shall be also given in the balance sheet The requirement in this behalf shall, in the case of companies preparing quarterly or half-yearly accounts, etc., relate to the balance sheet for the corresponding date in the previous year.

(o) The amounts to be shown under Sundry Debtors shall include the amounts due in respect of goods sold or services rendered or in respect of other contractual obligations but shall not include the amounts which are in the nature of loans or advances. (p) Current accounts with directors, and Manager, whether they are in credit or debit, shall be shown separately.

(q) A small scale industrial undertaking has the same meaning as assigned to it under clause (j) of section 3 of the Industries (Development and Regulation) Act, 1951.

B. VERTICAL FORM

Name of the Company

Balance Sheet as at

Schedule No. Figures as at the end of current financial year Figures as at the end of previous financial year
1 2345I. Sources of funds:

(1) Shareholder's funds

(a) Capital

(b) Reserves and Surplus

(2) Loan funds

(a) Secured loans

(b) Unsecured loans

TOTAL:

II. Applications of funds:

(1) Fixed assets

(a) Gross block

(b) Less depreciation

(c) Net block

(d) Capital work-in-progress

(2) Investments

(3) Current assets, loans, and advances: (a) Inventories

(b) Sundry debtors

(c) Cash and bank balances

(d) Other current assets

(e) Loans and advances

Less:

Current liabilities and provisions: (a) Liabilities

(b) Provisions

Net current assets

(4) (a) Miscellaneous expenditure to the extent not written off or adjusted

(b) Profit and Loss account

TOTAL:

Notes.-

1. Details under each of the above items shall be given in separate Schedules. The Schedules shall incorporate all the information required to be given under A-Horizontal Form read with notes containing general instructions for preparation of balance sheet.

2. The Schedules, referred to above, accounting policies and explanatory notes that may be attached shall form an integral part of the balance sheet.

3. The figures in the balance sheet may be rounded off to the nearest "000" or "00" as may be convenient or may be expressed in terms of decimals of thousands. (TO BE COMPARED)

4. A foot-note to the balance sheet may be added to show separately contingent liabilities.

PART II

Requirements as to Profit and Loss Account

1. The provisions of this Part shall apply to the income and expenditure account referred to in sub-section (2) of section 210 of the Act, in like manner as they apply to a profit and loss account, but subject to the modification of references as specified in that sub-section.

2. The profit and loss account-

(a) shall be so made out as clearly to disclose the result of the working of the company during the period covered by the account; and (b) shall disclose every material feature, including credits or receipts and deb its or expenses in respect of non-recurring transactions or transactions of an exceptional nature.

3. The profit and loss account shall set out the various items relating to the income and expenditure of the company arranged under the most convenient heads; and in particular, shall disclose the following information in respect of the period covered by the account:- (i) (a) The turnover, that is, the aggregate amount for which sales are effected by the company, giving the amount of sales in

respect of each class of goods dealt with by the company, and indicating the quantities of such sales for each class separately.

(b) Commission paid to sole selling agents within the meaning of section 294 of the Act. (c) Commission paid to other selling agents. (d) Brokerage and discount on sales, other than the usual trade discount.

(ii) (a) In the case of manufacturing companies,-

(1) The value of the raw materials consumed, giving item-wise break-up and indicating the quantities thereof. In this break-up, as far as possible, all important basic raw materials shall be shown as separate items. The intermediates or components procured from other manufacturers may, if their list is too large to be included in the break-up, be grouped under suitable headings without mentioning the quantities, provided all those items which in value individually account for 10 per cent or more of the total value of the raw material consumed shall be shown as separate and distinct items with quantities thereof in the break-up.

(2) The opening and closing stocks of goods produced, giving break-up in respect of each class of goods and indicating the quantities thereof.

(b) In the case of trading companies, the purchases made and the opening and closing stocks, giving break-up in respect of each class of goods trade in by the company and indicating the quantities thereof. (c) In the case of companies rendering or supplying services, the gross income derived from services rendered or supplied. (d) In the case of a company, which falls under more than one of the categories mentioned in (a), (b) and (c) above, it shall be sufficient compliance with the requirements herein if the total amounts are shown in respect of the opening and closing stocks, purchases, sales and consumption of raw material with value and quantitative break-up and the gross income from services rendered is shown.

(e) In the case of other companies, the gross income derived under different heads. Note 1.- The quantities of raw materials purchases, stocks, and the turnover shall be expressed in quantitative denominations in which these are normally purchased or sold in the market.

Note 2.- For the purpose of items (ii)(a), (ii)(b) and (ii)(d), the items for which the company is holding separate industrial licences, shall be treated as separate classes of goods, but where a company has more than one industrial licence for production of the same item at different places or

for expansion of the licensed capacity, the item covered by all such licences shall be treated as one class. In the case of trading companies, the imported items shall be classified in accordance with the classification adopted by the Chief Controller of Imports and Exports in granting the import licences.

Note 3.- In giving the break-up of purchases, stocks and turnover, items like spare parts and accessories, the list of which is too large to be included in the break-up, may be grouped under suitable headings without quantities, provided all those items, which in value individually account for 10 per-cent or more of the total value of the purchases, stocks, or turnover, as the case may be, are shown as separate and distinct items with quantities thereof in the break-up.

(iii) In the case of all concerns having works- in-progress, the amounts for which such works have been completed] at the commencement and at the end of the accounting period.

(iv) The amount provided for depreciation, renewals or diminution in value of fixed assets. If such provision is not made by means of a depreciation charge, the method adopted for making such provision.

If no provision is made for depreciation, the fact that no provision has been made shall be stated and the quantum of arrears of depreciation computed in accordance with section 205(2) of the Act shall be disclosed by way of a note.

(v) The amount of interest on the company's debentures and other fixed loans, that is to say, loans for fixed periods, stating separately the amount of interest, if any, paid or payable to the managing director and the manager, if any.

(vi) The amount of charge for Indian income-tax and other Indian taxation on profits, including, where practicable, with Indian income-tax any taxation imposed elsewhere to the extent of the relief, if any, from Indian income-tax and distinguishing, where practicable, between income-tax and other taxation.

(vii) The amounts reserved for-

(a) repayment of share capital; and (b) repayment of loans.

(viii) (a) The aggregate, if material, of any amounts set aside or proposed to be set aside, to reserves, but not including provisions made to meet any specific liability, contingency or commitment known to exist at the date as at which the balance-sheet is made up. (b) The aggregate, if material, of any amounts withdrawn from such reserves.

(ix)(a) The aggregate, if material, of the amounts to set aside to provisions made for meeting specific liabilities, contingencies or commitments.

(b) The aggregate, if material, of the amounts withdrawn from such provisions, as no longer required.

(x) Expenditure incurred on each of the following items, separately for each item:- (a) Consumption of stores and spare parts. (b) Power and fuel.

(c) Rent.

(d) Repairs to buildings.

(e) Repairs to machinery.

(f) (1) Salaries, wages and bonus. (2) Contribution to provident and other funds. (3) Workmen and staff welfare expenses to the extent not adjusted from any previous provision or reserve.

Note 1-Information in respect of this item should also be given in the balance sheet under the relevant provision or reserve account. Note 2. * * *

(g) Insurance.

(h) Rates and taxes, excluding taxes on income. (i) Miscellaneous expenses:

Provided that any item under which the expenses exceed one per cent of the total revenue of the company or Rs. 5,000 whichever is higher shall be shown as a separate and distinct item against an appropriate account head in the Profit and Loss Account and shall not be combined with any other item to be shown Under "Miscellaneous expenses". (xi) (a) The amount of income from investments, distinguishing between trade investments and other investments.

(b) Other income by way of interest, specifying the nature of the income.

(c) The amount of income-tax deducted if the gross income is stated under sub-paragraphs (a) and (b) above.

(xii) (a) Profits or losses on investments showing distinctly the extent of the profits and losses earned or incurred on account of membership of a partnership firm to the extent not adjusted from any previous provision or reserve.

Note.- Information in respect of this item should also be given in the balance sheet under the relevant provision or reserve account. (b) Profits or losses in respect of transactions of a kind, not usually undertaken by the company or undertaken in circumstances of an exceptional or non-recurring nature, if material in amount. (c) Miscellaneous income.

(xiii) (a) Dividends from subsidiary companies. (b) Provisions for losses of subsidiary companies.

(xiv) The aggregate amount of the dividends paid, and proposed, and stating whether such amounts are subject to deduction of income-tax or not.

(xv) Amount, if material, by which any items shown in the profit and loss account are affected by any change in the basis of accounting.

4. The profit and loss account shall also contain or give by way of a note detailed information, showing separately the following payments provided or made during the financial year to the directors (including managing directors), or manager, if any, by the company, the subsidiaries of the company and any other person:- (i) managerial remuneration under section 198 of the Act paid or payable during the financial year to the directors (including managing directors), manager, if any;

(ii) ***;

(iii) ***;

(iv) ***;

(vi) other allowances and commission including guarantee commission (details to be given); (vii) any other perquisites or benefits in cash or in kind (stating approximate money value where practicable);

(viii) pensions, etc.,-

(a) pensions,

(b) gratuities,

(c) payments from provident funds, in excess of own subscriptions and interest thereon,

(d) compensation for loss of office, (e) consideration in connection with retirement from office.

4A. The profit and loss account shall contain or give by way of a note a statement showing the computation of net profits in accordance with section 349 of the Act with relevant details of the calculation of the commissions payable by way of Percentage of such profits to the directors (including managing directors), or manager (if any).

4B. The profit and loss account shall further contain or give by way of a note detailed information in regard to amounts paid to the auditor, whether as fees, expenses or otherwise for services rendered- (a) as auditor;

(b) as adviser, or in any other capacity, in respect of-

(i) taxation matters;

(ii) company law matters;

(iii) management services; and

(c) in any other manner

4C. In the case of a manufacturing companies, the profit and loss account shall also contain, by way of a note in respect of each class of goods manufactured, detailed quantitative information in regard to the following, namely:-

(a) the licensed capacity (where licence is in force);

(b) the installed capacity; and

(c) the actual production.

Note 1.- The licensed capacity and installed capacity of the company as on the last date of the year to which the profit and loss account relates, shall be mentioned against items (a) and (b) above, respectively. Note 2.- Against item (c), the actual production in respect of the finished products meant for sale shall be mentioned. In cases where semi-processed products are also sold by the company, separate details thereof shall be given.

Note 3.- For the purpose of this paragraph, the items for which the company is holding separate industrial licences shall be treated as separate classes of goods but where a company has more than one industrial licence for production of the same item at different places or for expansion of the licensed capacity, the item covered by all such licences shall be treated as one class. 4D. The profit and loss account shall also contain by way of a note the following information, namely:- (a) value of

imports calculated on C.I.F. basis by the company during the financial year in respect of:-

(i) raw materials;

(ii) components and spare parts;

(iii) capital goods;

(b) expenditure in foreign currency during the financial year on account of royalty, know-how, professional, consultation fees, interest, and other matters;

(c) value of all imported raw materials, spare parts and components consumed during the financial year and the value of all indigenous raw materials, spare parts and components similarly consumed and the percentage of each to the total consumption; (d) the amount remitted during the year in foreign currencies on account of dividends, with a specific mention of the number of non-resident shareholders, the number of shares held by them on which the dividends related;

(e) earnings in foreign exchange classified under the following heads, namely:-

(i) export of goods calculated on F.O.B. basis; (ii) royalty, know-how, professional and consultation fees;

(iii) interest and dividend;

(iv) other income, indicating the nature thereof.

5. The Central Government may direct that a company shall not be obliged to show the amount set aside to provisions other than those relating to depreciation, renewal or diminution in value of assets, if the Central Government is satisfied that the information should not be disclosed in the

public interest and would prejudice the company, but subject to the condition that in any heading stating an amount arrived at after taking into account the amount set aside as such, the provision shall be so framed or marked as to indicate that fact.

6. (1) Except in the case of the first profit and loss account laid before the company after the commencement of the Act, the corresponding amounts for the immediately preceding financial year for all items shown in the profit and loss account shall also be given in the profit and loss account.

(2) The requirement in sub-clause (1) shall, in the case of companies preparing quarterly or half-yearly accounts, relate to the profit and loss account for the period which entered on the corresponding date of the previous year.

AUDIT

Section 227. Powers and duties of auditors (1) Every auditor of a company shall have a right of access at all times to the books and accounts and vouchers of the company, whether kept at the head office of the company or elsewhere, and shall be entitled to require from the officers of the company such information and explanations as the auditor may think necessary for the performance of his duties as auditor.

(1A) Without prejudice to the provisions of sub-section (1), the auditor shall inquire- (a) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interest of the company or its members; (b) whether transactions of the company which are represented merely by book entries are not prejudicial to the interests of the company; (c) where the company is not an investment company within the meaning of section 372 or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company; (d) whether loans and advances made by the company have been shown as deposits; (e) whether personal expenses have been charged to revenue account;

(f) where it is stated in the books and papers of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance-sheet is correct, regular and not misleading. (2) The auditor shall make a report to the members of the company on the accounts examined by him, and on every balance-sheet and profit and loss account and on every other document declared by this Act to be part of or annexed to the balance-sheet or profit and loss account which are laid before the company in general meeting during his tenure of

office, and the report shall state whether, in his opinion and to the best of his information and according to the explanations given to him, the said accounts give the information required by this Act in the manner so required and give a true and fair view-

(i) in the case of the balance-sheet, of the state of the company's affairs as at the end of its financial years; and

(ii) in the case of the profit and loss account, of the profit or loss for its financial year. (3) The auditor's report shall also state- (a) whether he has obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purposes of his audit; (b) whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books, and proper returns adequate for the purposes of his audit have been received from branches not visited by him;

(bb) whether the report on the accounts of any branch office audited under section 228 by a person other than the company's auditor has been awarded to him as enquired by clause (c) of sub-section (3) of that section and how he has dealt with the same in preparing the auditor's report;

(c) whether the company's balance-sheet and profit and loss account dealt with by the report are in agreement with the books of account and returns; (d) whether, in his opinion, the profit and loss account and balance-sheet comply with the accounting standards referred to in sub-section (3C) of section 211;

(e) in thick type or in italics the observations or comments of the auditors which have any adverse effect on the functioning of the company; (f) whether any director is disqualified from being appointed as director under clause (g) of sub-section (1) of section 274.

(g) whether the cess payable under section 441A has been paid and if not, the details of amount of cess not so paid.

(4) Where any of the matters referred to in clauses (i) and (ii) of sub-section (2) or in clauses (a), (b), (bb) (c) and (d)] of sub-section (3) is answered in the negative or with a qualification, the auditor's report shall state the reason for the answer. (4A) The Central Government may, by general or special order, direct that, in the case of such class or description of companies as may be specified in the order, the auditor's report shall also include a statement on such matters as may be specified therein:

Provided that before making any such order the Central Government may consult the Institute of Chartered Accountants of India constituted under the Chartered Accountants Act, 1949 (38 of 1949), in regard to the class or description of companies and other ancillary matters proposed to be specified therein unless the Government decides that such consultation is not necessary or expedient in the circumstances of the case.

(5) The accounts of a company shall not be deemed as not having been, and the auditors report shall- not state that those accounts have not been properly drawn up on the ground merely that the company had not disclosed certain matters if- (a) those matters are such as the company is not required to disclose by virtue of any provisions contained in this or any other Act, and (b) those provisions are specified in the balance- sheet and profit and loss account of the company. (emphasis supplied)

SCHEDULES, FORMS AND RULES

Section 641. Power to alter Schedules. (1) Subject to the provisions of this section, the Central Government may, by notification in the Official Gazette, alter any of the regulations, rules, tables, forms and other provisions contained in any of the Schedules to this Act, except Schedules XI and XII.

(2) Any alteration notified under sub-section (1) shall have effect as if enacted in this Act and shall come into force on the date of the notification, unless the notification otherwise directs : Provided that no such alteration in Table A of Schedule I shall apply to any company registered before the date of such alteration. (3) Every alteration made by the Central Government under sub-section (1) shall be laid as soon as may be after it is made before each House of Parliament while it is in session for a total period of thirty days which may be comprised in one session or in two or more successive sessions, and if, before the expiry of the session immediately following the session or the successive sessions aforesaid, both Houses agree in making any modification in the alteration, or both Houses agree that the alteration should not be made, the alteration shall thereafter have effect only in such modified form or be of no effect, as the case may be, so, however, that any such modification or annulment shall be without prejudice to the validity of anything previously done in pursuance of that alteration.

Section 642. Power of Central Government to make rules.

(1) In addition to the powers conferred by section 641, the Central Government may, by notification

in the Official Gazette, make rules-

(a) for all or any of the matters which by this Act are to be, or may be, prescribed by the Central Government; and

(b) generally to carry out the purposes of this Act.

(2) Any rule made under sub-section (1) may provide that a contravention thereof shall be punishable with fine which may extend to five thousand rupees and where the contravention is a continuing one, with a further fine which may extend to five hundred rupees for every day after the first during which such contravention continues. (3) Every rule made by the Central Government under sub-section (1) shall be laid as soon as may be after it is made before each House of Parliament while it is in session for a total period of thirty days which may be comprised in one session or in two or more successive sessions, and if, before the expiry of the session immediately following the session or the successive sessions aforesaid, both Houses agree in making any modification in the rule or both Houses agree that the rule should not be made, the rule shall thereafter have effect only in such modified form or be of no effect, as the case may be, so, however, that any such modification or annulment shall be without prejudice to the validity of anything previously done under that rule. (4) Every regulation made by the Securities and Exchange Board of India under this Act shall be laid, as soon as may be after it is made, before each House of Parliament, while it is in session, for a total period of thirty days which may be comprised in one session or in two or more successive sessions, and if, before the expiry of the session immediately following the session or the successive sessions aforesaid, both Houses agree in making any modification in the regulation or both Houses agree that the regulation should not be made, the regulation shall thereafter have effect only in such modified form or be of no effect, as the case may be; so however, that any such modification or annulment shall be without prejudice to the validity of anything previously done under that regulation.

12. Analysing the above provisions of the Companies Act the position is that at every AGM of a company the Board of Directors is required to place before it a balance-sheet and a P&L a/c for the financial year. Section 210 of the Companies Act requires a company to place before AGM, a balance-sheet and a P&L a/c for the relevant period. The function of a balance-sheet is to show the share capital, reserves and liabilities of the company at the date on which it is prepared and the manner in which the total moneys representing them are distributed over several types of assets. A balance-sheet is a historical document. As a general rule it does not show the net worth of an undertaking at any particular date. It does not show the present realizable value of goodwill, land, plant and machinery etc. It also does not show the realizable value of stock-in-trade, except in cases where the realizable value of stock-in-trade is less than cost. Therefore, it cannot be said that the balance-sheet shows the true financial position.

13. Section 210A was inserted by Companies (Amendment) Act, 1999 with effect from 31.10.98 to provide for constitution of National Advisory Committee (NAC) on Accounting Standards. The said NAC was constituted to advise the Central Government on the formation and laying down of accounting policies and Accounting Standards for adoption by companies or class of companies. The accounting policies and Accounting Standards were required to be prescribed by the Central Government as contemplated by Section 2(33). The object behind Section 210A was to make it obligatory on the part of the companies to comply with the Accounting Standards. NAC was constituted vide Notification dated 18.9.03. Under Section 211(3C) it is provided, that till such time the Accounting Standards are prescribed by the Central Government in consultation with NAC on Accounting Standards; the Accounting Standards prescribed by the Institute shall be deemed to be the Accounting Standards to be complied with by all the companies. In all, the Institute has so far framed 29 Accounting Standards.

14. Section 211(1) requires the balance-sheet to be in the form set out in Part I of Schedule VI or as near thereto as circumstances admit. The said phrase or as near thereto as circumstances admit allows adoption of improved techniques in the presentation of accounts to shareholders. It is important to note that the information which is required to be given to shareholders pursuant to Schedule VI should be given in a manner which they will understand and which must give a true and fair view of the company's affairs as also it must give a proper picture of the company's profits(losses) for the relevant year.

15. By Companies (Amendment) Act, 1999, sub-sections (3A), (3B) and (3C) as well as a proviso thereto stood inserted in Section 211 of the Companies Act w.e.f. 31.10.98 in order to provide for compliance of Accounting Standards by companies in the preparation of P&L a/c and balance-sheet. By virtue of the said amendment, Accounting Standards are required to be prescribed by the Central Government in consultation with the NAC established under Section 210A. Until the NAC is established and Accounting Standards are prescribed by the Central Government, the Accounting Standards specified by the Institute shall be followed by all the companies. In the present case, the NAC has been established. In the present case, by the impugned notification dated 7.12.06, the Accounting Standards have been prescribed by the Central Government. In the present case, by the impugned notification, AS 22 earlier specified by the Institute has been adopted by the Central Government in the form of a Rule. Therefore, vide the impugned notification, AS 22 stands prescribed by the Central Government in consultation with NAC which has been established under Section 210A of the Companies Act. It is made clear that the Accounting Standards prescribed by the Central Government in consultation with NAC need not be identical with the Accounting Standards specified by the Institute. In the present case, the impugned notification indicates that the Central Government has been given the authority to enact a Rule and accordingly the rule-making authority, namely, the Central Government has prescribed the Accounting Standard No.22 in consultation with NAC by adopting AS 22 originally specified by the Institute.

16. Under Section 211(1) every balance-sheet of a company has to comply with the following requirements: (i) It must give true and fair view of the affairs of the company at the end of the financial year; (ii) it must be in the form set out in Part I of Schedule VI or as near thereto as

circumstances admit; and (iii) it must give regard to the general instructions for preparation of balance-sheet under the heading Notes.

17. Similarly, Section 211(2) of the Companies Act requires that every P&L a/c of a company must give a true and fair view of the profit or loss of the company for the financial year and comply with the requirements of Part II of Schedule VI so far as they are applicable thereto. It may be noted that the balance-sheet prescribed by Part I of Schedule VI has to be in the form of a proforma. However, the Companies Act does not prescribe a proforma of P&L a/c. Part I of Schedule VI prescribes a proforma of balance-sheet. Part II of Schedule VI only prescribes the particulars which must be furnished in the P&L a/c. Therefore, as far as possible, the P&L a/c must be drawn up according to the requirements of Part II of Schedule VI. It is important to note that Section 211 read with Part I and Part II of Schedule VI prescribes the form and contents of balance-sheet and P&L a/c. However, Section 211(1), inter alia, states that every balance-sheet of a company shall subject to the provisions of that section, be in the form set out in Part I of Schedule VI. The words subject to the provisions of this section would mean that every sub-section following sub-section (1) including sub-sections (3A), (3B) and (3C) shall have an overriding effect and consequently every P&L a/c and balance-sheet shall comply with the Accounting Standards. Therefore, implementation of the Accounting Standards and their compliance are made compulsory and mandatory by the aforesaid sub-sections (3A), (3B) and (3C). The insertion of the concept of true and fair view in place of true and correct has been made to do away with the view that accounts should disclose arithmetically accuracy. Adherence to the disclosure requirements as per Schedule VI is subservient to the overriding requirement of true and fair view as regards the state of affairs. Therefore, the annual financial statements should convey an overall fair view and should not give any misleading information or impression. All the relevant information should be disclosed in the balance-sheet and the P&L a/c in such a manner that the financial position and the working results are shown as they are. There should be neither an overstatement nor an understatement. Further, the information to be disclosed should be in consonance with the fundamental accounting assumptions and commonly accepted accounting policies. Therefore, failure to make provision for taxation would not disclose true and fair view of the state of affairs. Non-compliance for taxation would, therefore, amount to contravention of Sections 209 and 211 of the Companies Act. Accordingly, it is necessary for the auditor to qualify in his report, and such qualification should bring out in what manner the accounts do not disclose a true and fair view of the state of affairs of the company as well as the profit/loss of the company. Several Accounting Standards prescribed by the Institute have been made mandatory. The Institute has, however, clarified that the expression mandatory in nature implies that while discharging their functions, it will be the duty of the Chartered Accountants who are members of the Institute to examine whether the said Accounting Standard has been complied with in the presentation of financial statements covered by their audit (See: Section 227(3)(d)). In this regard it may be noted that under Section 227(3)(d) it is the duty of the auditor, to state in his audit report whether the P&L a/c and the balance-sheet complies with the Accounting Standards referred to in Section 211(3C). Before introduction of sub-sections (3A), (3B) and (3C) in Section 211 (w.e.f. 31.10.98), these Standards were not mandatory. Therefore, the companies were then free to prepare their annual financial statements, as per the specific requirements of Section 211 read with Schedule VI. However, with the insertion of sub-sections (3A), (3B) and (3C) in Section 211 the P&L a/c and the balance-sheet have to comply with the Accounting Standards. For this purpose the expression Accounting Standards shall mean the standards of accounting recommended by the Institute as may be prescribed by the Central Government in consultation with NAC on Accounting Standards. Thus, the Accounting Standards are prescribed by the Central Government. Thus, the

Accounting Standards prescribed by the Central Government are now mandatory qua the companies and non-compliance with these Standards would lead to violation of Section 211 inasmuch as the annual accounts may then not be regarded as showing a true and fair view.

18. Section 641 empowers the Central Government to alter any of the regulations, rules, tables, forms and other provisions contained in Schedule VI to the Companies Act. However, this power can be used only for making simple alterations which will not affect the legislative policies enshrined in the Companies Act.

19. Section 642 refers to the powers of the Central Government to make rules. It states that in addition to the powers conferred by Section 641, the Central Government may, by notification in the official gazette, make rules for all or any of the matters which by the Companies Act are to be prescribed by the Central Government and to carry out the purposes of the Companies Act. Therefore, Section 641 and Section 642 form part of the same scheme. Under Section 642, the Central Government exercises power of delegated legislation by prescribing rules. Under various provisions of the Act, Rules are to be prescribed. Rules can also be prescribed vide clause (b) to Section 642(1) to carry out the purposes of the Act.

20. In exercise of the powers conferred by clause (a) to sub-section (1) of Section 642 of the Companies Act read with sub-section (3C) of Section 211 and Section 210A(1), the Central Government in consultation with NAC on Accounting Standards has made the following Rules vide the impugned notification dated 7.12.06. The said Rules are called as the Companies (Accounting Standards) Rules, 2006. We quote hereinbelow the said impugned notification in entirety together with annexures: Ministry of Company Affairs

NOTIFICATION

New Delhi, the 7th December, 2006

ACCOUNTING STANDARDS

G.S.R. 739 (E). In exercise of the powers conferred by clause (a) of sub-section (1) of section 642 of the Companies Act, 1956 (1 of 1956), read with sub-section (3C) of section 211 and sub-section (1) of section 210A of the said Act, the Central Government, in consultation with National Advisory Committee on Accounting Standards, hereby makes the following rules, namely:-

1. Short title and commencement. -

1. These rules may be called the Companies (Accounting Standards) Rules, 2006.

2. They shall come into force on the date of their publication in the Official Gazette.

2. Definitions. - In these rules, unless the context otherwise requires, -

a. Accounting Standards means the Accounting Standards as specified in rule 3 of these rules; b. Act means the Companies Act, 1956 (1 of 1956); c. Annexure means an Annexure to these rules; d. General Purpose Financial Statements include balance sheet, statement of profit and loss, cash flow statement (wherever applicable), and other statements and explanatory notes which form part thereof. e. Enterprise means a company as defined in section 3 of the Companies Act, 1956.

f. Small and Medium Sized Company (SMC) means, a company-

i. whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India; ii. which is not a bank, financial institution or an insurance company;

iii. whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year;

iv. which does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and

v. which is not a holding or subsidiary company of a company which is not a small and medium-sized company.

Explanation: For the purposes of clause (f), a company shall qualify as a Small and Medium Sized Company, if the conditions mentioned therein are satisfied as at the end of the relevant accounting period.

(2) Words and expressions used herein and not defined in these rules but defined in the Act shall have the same meaning respectively assigned to them in the Act.

3. Accounting Standards.-

(1) The Central Government hereby prescribes Accounting Standards 1 to 7 and 9 to 29 as recommended by the Institute of Chartered Accountants of India, which are specified in the Annexure to these rules. (2) The Accounting Standards shall come into effect in respect of accounting periods commencing on or after the publication of these Accounting Standards.

1. Obligation to comply with the Accounting Standards.- (1) Every company and its auditor(s) shall comply with the Accounting Standards in the manner specified in Annexure to these rules.

(2) The Accounting Standards shall be applied in the preparation of General Purpose Financial Statements.

2. An existing company, which was previously not a Small and Medium Sized Company (SMC) and subsequently becomes an SMC, shall not be qualified for exemption or relaxation in respect of Accounting Standards available to an SMC until the company remains an SMC for two consecutive accounting periods. [No. 1/3/2006/CL-V]

JITESH KHOSLA, Jt. Secy.

ANNEXURE

(See rule 3)

ACCOUNTING STANDARDS

General Instructions

1. SMCs shall follow the following instructions while complying with Accounting Standards under these rules:- 1.1 the SMC which does not disclose certain information pursuant to the exemptions or relaxations given to it shall disclose (by way of a note to its financial statements) the fact that it is an SMC and has complied with the Accounting Standards insofar as they are applicable to an SMC on the following lines: The Company is a Small and Medium Sized Company (SMC) as defined in the General Instructions in respect of Accounting Standards notified under the Companies Act, 1956. Accordingly, the Company has complied with the Accounting Standards as applicable to a Small and Medium Sized Company.

1.2 Where a company, being a SMC, has qualified for any exemption or relaxation previously but no longer qualifies for the relevant exemption or relaxation in the current accounting period, the relevant standards or requirements become applicable from the current period and the figures for the corresponding period of the previous accounting period need not be revised merely by reason of its having ceased to be an SMC. The fact that the company was an SMC in the previous period and it had availed of the exemptions or relaxations available to SMCs shall be disclosed in the notes to the financial statements.

1.3 If an SMC opts not to avail of the exemptions or relaxations available to an SMC in respect of any but not all of the Accounting Standards, it shall disclose the standard(s) in respect of which it has availed the exemption or relaxation.

1.4 If an SMC desires to disclose the information not required to be disclosed pursuant to the exemptions or relaxations available to the SMCs, it shall disclose that information in compliance with the relevant accounting standard.

1.5 The SMC may opt for availing certain exemptions or relaxations from compliance with the requirements prescribed in an Accounting Standard: Provided that such a partial exemption or relaxation and disclosure shall not be permitted to mislead any person or public.

2. Accounting Standards, which are prescribed, are intended to be in conformity with the provisions of applicable laws. However, if due to subsequent amendments in the law, a particular accounting standard is found to be not in conformity with such law, the provisions of the said law will prevail

and the financial statements shall be prepared in conformity with such law.

3. Accounting Standards are intended to apply only to items which are material.

4. The accounting standards include paragraphs set in bold italic type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. An individual accounting standard shall be read in the context of the objective, if stated, in that accounting standard and in accordance with these General Instructions.

Accounting Standard (AS) 22

Accounting for Taxes on Income

(This Accounting Standard includes paragraphs set in bold italic type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective and the General Instructions contained in part A of the Annexure to the Notification.)

Objective

The objective of this Standard is to prescribe accounting treatment for taxes on income. Taxes on income is one of the significant items in the statement of profit and loss of an enterprise. In accordance with the matching concept, taxes on income are accrued in the same period as the revenue and expenses to which they relate. Matching of such taxes against revenue for a period poses special problems arising from the fact that in a number of cases, taxable income may be significantly different from the accounting income. This divergence between taxable income and accounting income arises due to two main reasons. Firstly, there are differences between items of revenue and expenses as appearing in the statement of profit and loss and the items which are considered as revenue, expenses or deductions for tax purposes. Secondly, there are differences between the amount in respect of a particular item of revenue or expense as recognised in the statement of profit and loss and

Scope

1. This Standard should be applied in accounting for taxes on income. This includes the determination of the amount of the expense or saving related to taxes on income in respect of an

accounting period and the disclosure of such an amount in the financial statements.

2. For the purposes of this Standard, taxes on income include all domestic and foreign taxes which are based on taxable income.

3. This Standard does not specify when, or how, an enterprise should account for taxes that are payable on distribution of dividends and other distributions made by the enterprise.

Definitions

4. For the purpose of this Standard, the following terms are used with the meanings specified:

4.1 Accounting income (loss) is the net profit or loss for a period, as reported in the statement of profit and loss, before deducting income tax expense or adding income tax saving.

4.2 Taxable income (tax loss) is the amount of the income (loss) for a period, determined in accordance with the tax laws, based upon which income tax payable (recoverable) is determined.

4.3 Tax expense (tax saving) is the aggregate of current tax and deferred tax charged or credited to the statement of profit and loss for the period.

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

4.5 Deferred tax is the tax effect of timing differences.

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

4.7 Permanent differences are the differences between taxable income and accounting income for a period that originate in one period and do not reverse subsequently.

5. Taxable income is calculated in accordance with tax laws. In some circumstances, the requirements of these laws to compute taxable income differ from the accounting policies applied to determine accounting income. The effect of this difference is that the taxable income and accounting income may not be the same.

6. The differences between taxable income and accounting income can be classified into permanent differences and timing differences. Permanent differences are those differences between taxable income and accounting income which originate in one period and do not reverse subsequently. For instance, if for the purpose of computing taxable income, the tax laws allow only a part of an item of expenditure, the disallowed amount would result in a permanent difference.

7. Timing differences are those differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods. Timing differences arise because the period in which some items of revenue and expenses are included in taxable income do not coincide with the period in which such items of revenue and expenses are included or considered in arriving at accounting income. For example, machinery purchased for scientific research related to business is fully allowed as deduction in the first year for tax purposes whereas the same would be charged to the statement of profit and loss as depreciation over its useful life. The total depreciation charged on the machinery for accounting purposes and the amount allowed as deduction for tax purposes will ultimately be the same, but periods over which the depreciation is charged and the deduction is allowed will differ. Another example of timing difference is a situation where, for the purpose of computing taxable income, tax laws allow depreciation on the basis of the written down value method, whereas for accounting purposes, straight line method is used. Some other examples of timing differences arising under the Indian tax laws are given in Illustration I.

8. Unabsorbed depreciation and carry forward of losses which can be setoff against future taxable income are also considered as timing differences and result in deferred tax assets, subject to consideration of prudence (see paragraphs 15-18).

Recognition

9. Tax expense for the period, comprising current tax and deferred tax, should be included in the determination of the net profit or loss for the period.

10. Taxes on income are considered to be an expense incurred by the enterprise in earning income and are accrued in the same period as the revenue and expenses to which they relate. Such matching may result into timing differences. The tax effects of timing differences are included in the tax expense in the statement of profit and loss and as deferred tax assets (subject to the consideration of prudence as set out in paragraphs 15-18) or as deferred tax liabilities, in the balance sheet.

11. An example of tax effect of a timing difference that results in a deferred tax asset is an expense provided in the statement of profit and loss but not allowed as a deduction under Section 43B of the Income-tax Act, 1961. This timing difference will reverse when the deduction of that expense is allowed under Section 43B in subsequent year(s). An example of tax effect of a timing difference resulting in a deferred tax liability is the higher charge of depreciation allowable under the Income-tax Act, 1961, compared to the depreciation provided in the statement of profit and loss. In subsequent years, the differential will reverse when comparatively lower depreciation will be allowed for tax purposes.

12. Permanent differences do not result in deferred tax assets or deferred tax liabilities.

13. Deferred tax should be recognised for all the timing differences, subject to the consideration of prudence in respect of deferred tax assets as set out in paragraphs 15-18.

Explanation:

(a) The deferred tax in respect of timing differences which reverse during the tax holiday period is not recognised to the extent the enterprises gross total income is subject to the deduction during the tax holiday period as per the requirements of sections 80-IA/80 IB of the Income-tax Act, 1961 (hereinafter referred to as the Act). In case of sections 10A/10B of the Act (covered under Chapter III of the Act dealing with incomes which do not form part of total income), the deferred tax in respect of timing differences which reverse during the tax holiday period is not recognised to the extent deduction from the total income of an enterprise is allowed during the tax holiday period as per the provisions of the said sections.

(b) Deferred tax in respect of timing differences which reverse after the tax holiday period is recognised in the year in which the timing differences originate. However, recognition of deferred tax assets is subject to the consideration of prudence as laid down in paragraphs 15 to 18.

(c) For the above purposes, the timing differences which originate first are considered to reverse

first.

The application of the above explanation is illustrated in the Illustration attached to the Standard.

14. This Standard requires recognition of deferred tax for all the timing differences. This is based on the principle that the financial statements for a period should recognise the tax effect, whether current or deferred, of all the transactions occurring in that period.

15. Except in the situations stated in paragraph 17, deferred tax assets should be recognised and carried forward only to the extent that there is a reasonable certainty that sufficient future taxable income will be available against which such deferred tax assets can be realised.

16. While recognising the tax effect of timing differences, consideration of prudence cannot be ignored. Therefore, deferred tax assets are recognised and carried forward only to the extent that there is a reasonable certainty of their realisation. This reasonable level of certainty would normally be achieved by examining the past record of the enterprise and by making realistic estimates of profits for the future.

17. Where an enterprise has unabsorbed depreciation or carry forward of losses under tax laws, deferred tax assets should be recognised only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such deferred tax assets can be realised.

Explanation:

1. Determination of virtual certainty that sufficient future taxable income will be available is a matter of judgement based on convincing evidence and will have to be evaluated on a case to case basis. Virtual certainty refers to the extent of certainty, which, for all practical purposes, can be considered certain. Virtual certainty cannot be based merely on forecasts of performance such as business plans. Virtual certainty is not a matter of perception and is to be supported by convincing evidence. Evidence is a matter of fact. To be convincing, the evidence should be available at the reporting date in a concrete form, for example, a profitable binding export order, cancellation of which will result in payment of heavy damages by the defaulting party. On the other hand, a projection of the future profits made by an enterprise based on the future capital expenditures or future restructuring etc., submitted even to an outside agency, e.g., to a credit agency for obtaining loans and accepted by that agency cannot, in isolation, be considered as convincing evidence.

2(a) As per the relevant provisions of the Income-tax Act, 1961 (hereinafter referred to as the Act), the loss arising under the head Capital gains can be carried forward and set-off in future years, only against the income arising under that head as per the requirements of the Act.

(b) Where an enterprise's statement of profit and loss includes an item of loss which can be set-off in future for taxation purposes, only against the income arising under the head Capital gains as per the requirements of the Act, that item is a timing difference to the extent it is not set-off in the current year and is allowed to be set-off against the income arising under the head Capital gains in subsequent years subject to the provisions of the Act. In respect of such loss, deferred tax asset is recognised and carried forward subject to the consideration of prudence. Accordingly, in respect of such loss, deferred tax asset is recognised and carried forward only to the extent that there is a virtual certainty, supported by convincing evidence, that sufficient future taxable income will be available under the head Capital gains against which the loss can be set-off as per the provisions of the Act. Whether the test of virtual certainty is fulfilled or not would depend on the facts and circumstances of each case. The examples of situations in which the test of virtual certainty, supported by convincing evidence, for the purposes of the recognition of deferred tax asset in respect of loss arising under the head Capital gains is normally fulfilled, are sale of an asset giving rise to capital gain (eligible to set-off the capital loss as per the provisions of the Act) after the balance sheet date but before the financial statements are approved, and binding sale agreement which will give rise to capital gain (eligible to set-off the capital loss as per the provisions of the Act).

(c) In cases where there is a difference between the amounts of loss recognised for accounting purposes and tax purposes because of cost indexation under the Act in respect of long-term capital assets, the deferred tax asset is recognised and carried forward (subject to the consideration of prudence) on the amount which can be carried forward and set-off in future years as per the provisions of the Act.

18. The existence of unabsorbed depreciation or carry forward of losses under tax laws is strong evidence that future taxable income may not be available. Therefore, when an enterprise has a history of recent losses, the enterprise recognises deferred tax assets only to the extent that it has timing differences the reversal of which will result in sufficient income or there is other convincing evidence that sufficient taxable income will be available against which such deferred tax assets can be realised. In such circumstances, the nature of the evidence supporting its recognition is disclosed.

Re-assessment of Unrecognised Deferred Tax Assets

19. At each balance sheet date, an enterprise re-assesses unrecognised deferred tax assets. The

enterprise recognises previously unrecognised deferred tax assets to the extent that it has become reasonably certain or virtually certain, as the case may be (see paragraphs 15 to 18), that sufficient future taxable income will be available against which such deferred tax assets can be realised. For example, an improvement in trading conditions may make it reasonably certain that the enterprise will be able to generate sufficient taxable income in the future.

Measurement

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.

Explanation:

(a) The payment of tax under section 115JB of the Income-tax Act, 1961 (hereinafter referred to as the Act) is a current tax for the period.

(b) In a period in which a company pays tax under section 115JB of the Act, the deferred tax assets and liabilities in respect of timing differences arising during the period, tax effect of which is required to be recognised under this Standard, is measured using the regular tax rates and not the tax rate under section 115JB of the Act.

(c) In case an enterprise expects that the timing differences arising in the current period would reverse in a period in which it may pay tax under section 115JB of the Act, the deferred tax assets and liabilities in respect of timing differences arising during the current period, tax effect of which is required to be recognised under AS 22, is measured using the regular tax rates and not the tax rate under section 115JB of the Act.

22. Deferred tax assets and liabilities are usually measured using the tax rates and tax laws that have been enacted. However, certain announcements of tax rates and tax laws by the government may have the substantive effect of actual enactment. In these circumstances, deferred tax assets and liabilities are measured using such announced tax rate and tax laws.

23. When different tax rates apply to different levels of taxable income, deferred tax assets and liabilities are measured using average rates.

24. Deferred tax assets and liabilities should not be discounted to their present value.

25. The reliable determination of deferred tax assets and liabilities on a discounted basis requires detailed scheduling of the timing of the reversal of each timing difference. In a number of cases such scheduling is impracticable or highly complex. Therefore, it is inappropriate to require discounting of deferred tax assets and liabilities. To permit, but not to require, discounting would result in deferred tax assets and liabilities which would not be comparable between enterprises. Therefore, this Standard does not require or permit the discounting of deferred tax assets and liabilities.

Review of Deferred Tax Assets

26. The carrying amount of deferred tax assets should be reviewed at each balance sheet date. An enterprise should write-down the carrying amount of a deferred tax asset to the extent that it is no longer reasonably certain or virtually certain, as the case may be (see paragraphs 15 to 18), that sufficient future taxable income will be available against which deferred tax asset can be realised. Any such write-down may be reversed to the extent that it becomes reasonably certain or virtually certain, as the case may be (see paragraphs 15 to 18), that sufficient future taxable income will be available.

Presentation and Disclosure

27. An enterprise should offset assets and liabilities representing current tax if the enterprise:

(a) has a legally enforceable right to set off the recognised amounts; and (b) intends to settle the asset and the liability on a net basis.

28. An enterprise will normally have a legally enforceable right to set off an asset and liability representing current tax when they relate to income taxes levied under the same governing taxation laws and the taxation laws permit the enterprise to make or receive a single net payment.

29. An enterprise should offset deferred tax assets and deferred tax liabilities if:

(a) the enterprise has a legally enforceable right to set off assets against liabilities representing current tax; and

(b) the deferred tax assets and the deferred tax liabilities relate to taxes on income levied by the same governing taxation laws.

30. Deferred tax assets and liabilities should be distinguished from assets and liabilities representing current tax for the period. Deferred tax assets and liabilities should be disclosed under a separate heading in the balance sheet of the enterprise, separately from current assets and current liabilities.

Explanation:

Deferred tax assets (net of the deferred tax liabilities, if any, in accordance with paragraph 29) is disclosed on the face of the balance sheet separately after the head Investments and deferred tax liabilities (net of the deferred tax assets, if any, in accordance with paragraph 29) is disclosed on the face of the balance sheet separately after the head Unsecured Loans.

31. The break-up of deferred tax assets and deferred tax liabilities into major components of the respective balances should be disclosed in the notes to accounts.

32. The nature of the evidence supporting the recognition of deferred tax assets should be disclosed, if an enterprise has unabsorbed depreciation or carry forward of losses under tax laws.

Transitional Provisions

33. On the first occasion that the taxes on income are accounted for in accordance with this Standard, the enterprise should recognise, in the financial statements, the deferred tax balance that has accumulated prior to the adoption of this Standard as deferred tax asset/liability with a corresponding credit/charge to the revenue reserves, subject to the consideration of prudence in case

of deferred tax assets (see paragraphs 15-18). The amount so credited/charged to the revenue reserves should be the same as that which would have resulted if this Standard had been in effect from the beginning.

34. For the purpose of determining accumulated deferred tax in the period in which this Standard is applied for the first time, the opening balances of assets and liabilities for accounting purposes and for tax purposes are compared and the differences, if any, are determined. The tax effects of these differences, if any, should be recognised as deferred tax assets or liabilities, if these differences are timing differences. For example, in the year in which an enterprise adopts this Standard, the opening balance of a fixed asset is Rs. 100 for accounting purposes and Rs. 60 for tax purposes. The difference is because the enterprise applies written down value method of depreciation for calculating taxable income whereas for accounting purposes straight line method is used. This difference will reverse in future when depreciation for tax purposes will be lower as compared to the depreciation for accounting purposes. In the above case, assuming that enacted tax rate for the year is 40% and that there are no other timing differences, deferred tax liability of Rs. 16 [(Rs. 100 - Rs. 60) x 40%] would be recognised. Another example is an expenditure that has already been written off for accounting purposes in the year of its incurrance but is allowable for tax purposes over a period of time. In this case, the asset representing that expenditure would have a balance only for tax purposes but not for accounting purposes. The difference between balance of the asset for tax purposes and the balance (which is nil) for accounting purposes would be a timing difference which will reverse in future when this expenditure would be allowed for tax purposes. Therefore, a deferred tax asset would be recognised in respect of this difference subject to the consideration of prudence (see paragraphs 15 - 18).

Submissions

21. Dr. D. Pal, learned senior counsel appearing on behalf of M/s. Simplex Infrastructures Ltd. and Anr., submitted that under para 9 of AS 22 tax expense for the period, comprising current tax and deferred tax, is now required to be included in the determination of net profit (loss) for that period. That, deferred tax is now defined under the said AS 22 to mean the tax effect of timing differences. Timing difference in turn is defined to mean the difference between the taxable income and the accounting income for a period that originates in one period and is capable of reversal in one or more subsequent periods. Therefore, DTL along with current tax liability (CTL) are now required to be included in the determination of the net profit (loss) for the period. This inclusion of DTL along with CTL in the determination of the net profit (loss), according to learned counsel, is repugnant to Part II of clause 3(vi) of Schedule VI to the Companies Act. In this connection, learned counsel urged that under the said Part II only the tax liability of the relevant accounting year can be charged to P&L a/c. Therefore, clause 9, insofar as it provides for the inclusion of DTL in the determination of the net profit (loss) is contrary to and inconsistent with Part II of clause 3(vi) of Schedule VI. According to the learned counsel, DTL as an element of P&L a/c is not mentioned in the form prescribed for the balance-sheet or the P&L a/c but it is made substantive provision by para 9 by making it a charge on the P&L a/c and thus resulting in enhancement of tax liability for the year.

22. Learned counsel further contended that Section 211(1) of the Companies Act lays down that every balance-sheet of a company shall give a true and fair view of the state of affairs of the company at the end of the financial year and shall subject to the provisions of the said section, be in the form set out in Part I of Schedule VI or as near thereto as circumstances admit or in such other form as may be approved by the Central Government. According to learned counsel, Section 211(1) of the Companies Act should be read with the proviso which inter alia provides that nothing contained in Section 211(1) shall apply to insurance company, banking company, electricity company etc. for which a separate balance-sheet has been specified in the Companies Act. Therefore, according to learned counsel, what is contemplated by the expression subject to the provisions of Section 211 is that where there is inconsistency or conflict between the other provisions of Section 211, the other provision will prevail as there are circumstances when insurance and banking company or any company for which a form or balance-sheet has been specified under the Act. Therefore, according to learned counsel, because Section 211 is subject to the said provision, the provision contained in the proviso shall apply whenever there is any inconsistency or conflict between Section 211(1) and the proviso.

23. Learned counsel next contended that the impugned rule has been framed in exercise of power under Section 642 of the Companies Act. Therefore, Accounting Standard has been prescribed by the rules framed under that Section. The rules so framed are placed before the Parliament. However, Section 642(1) has not the effect as if it is enacted in the Act. That, on the other hand, under Section 641(1) the Central Government has been given the power to alter any of the existing regulations, rules, tables or forms or any of the schedules to the Act including Schedule VI. Therefore, any alteration notified in Section 641(1) has the effect as if enacted in the Act and shall come into force on the date of the notification unless the notification otherwise directs. These rules are also required to be placed before the Parliament. Therefore, Schedule VI can be amended or altered by a notification issued under Section 641(1) of the Companies Act. If Schedule VI is not altered or amended in exercise of power under Section 641(1) of the said Act, then, Schedule VI being part of the Act, the rule adopting the AS under Section 642(1) of the Act cannot modify or amend the provisions of Schedule VI to the Companies Act. In this connection, learned counsel urged that AS 22 has now been prescribed by the rules framed under Section 641(1) of the Companies Act. That, it runs counter to or inconsistent with Schedule VI to the Companies Act and consequently it amounts to excessive exercise of the powers conferred under Section 211 read with Section 642(1) of the Companies Act as well as in excess of the provisions of Sections 209, 211 and Schedule VI to the Companies Act and is ultra vires the said Act. In other words, learned counsel submitted that Section 641 empowers the Central Government to amend Schedule VI but Section 642 does not confer any such power. According to the learned counsel, if Schedule VI is amended under Section 641 the amendment will have the effect as if enacted in the Act and the schedule so amended under Section 641 of the Act becomes part of the Act but that is not the case where AS is prescribed by the rules under Section 641(1) of the Act. Learned counsel, therefore, submitted that Accounting Standard, as prescribed by the rules under Section 642(1) of the Act run contrary to or being inconsistent with Schedule VI of the Companies Act without any amendment being made under Section 641(1) of the Act. According to the learned counsel, rules framed under Section 642(1) of the Act do not have any effect as if enacted in the Companies Act; that, the effect of amendment of schedule under Section 641 is as if enacted in the Act but rules framed under Section 642 do not have that effect. Therefore, the effect of the notifications under Section 641 on the one hand and the

notifications issued under Section 642 on the other hand is entirely different. According to learned counsel, so long as Schedule VI to the Companies Act is not altered or amended by exercising the power under Section 641(1) of the Act the AS prescribed by the rules notified under Section 642(1) cannot alter or amend Schedule VI and if the said rules are contrary to or inconsistent with Schedule VI then the same are liable to be struck down as inconsistent with the provisions of the Companies Act.

24. Learned counsel further submitted that in any case the requirement of maintaining accounts on accrual basis and on double entry system of accounting as required under Section 209 of the Companies Act is mandatory and it is not subject to any provisions of Section 211 of the Companies Act. Therefore, according to learned counsel, the rule prescribing AS 22 under Section 642(1) is not only contrary to and inconsistent with Section 209 but also with Schedule VI to the Companies Act insofar as it requires the DTL to be included in the determination of net profit (loss) for the current year. That, it is in excess of the provisions of Section 209 and Schedule VI to the Companies Act. According to the learned counsel, if the accounts are to be maintained on accrual basis, DTL cannot be considered as an accrued liability. That, the requirements of giving true and fair view can be made only on accrual basis and on double entry system of accounting. However, if DTL is a notional and contingent liability, it cannot be charged to the P&L a/c. It can only be disclosed by way of a Note in the balance-sheet and P&L a/c which will give a true and fair view of the state of affairs of the company.

25. Lastly, learned counsel submitted that clause 33 of AS 22 gives a retrospective effect to the transactions which have taken place much earlier and in respect of which the DTL is to be calculated as if the said AS 22 has been in effect from the beginning and the entire amount of such DTL is now required to be provided for in the opening balance of the year in which AS 22 has been given effect to i.e. in the year 2001.

26. Mr. Arvind P. Datar, learned senior counsel appearing on behalf of M/s. First Leasing Company of India Ltd., submitted that AS 22 is a subordinate legislation. It cannot be contrary to the provisions of the parent Act, namely, Companies Act, 1956 and, in particular, Sections 205, 209, Schedule VI and Schedule XIV thereof. According to the learned counsel, AS 22 is ultra vires the rule making power conferred by Section 642 to the extent it seeks to create a fictional tax liability. According to learned counsel, AS 22 is also ultra vires as no subordinate legislation can seek to reconcile divergent profits that are arrived at by two independent enactments, namely, accounting or book profits as per the Companies Act and taxable profits under the I.T. Act. In this connection, it was urged that all 29 Accounting Standards stood notified by Notification No.739(E) dated 7.12.2006. Accordingly, all 29 Accounting Standards are now contained in the Companies (Accounting Standards) Rules, 2006. They have, therefore, the status of subordinate legislation. That, para 2 of the Annexure to the Accounting Standards has expressly stated that the Standards are intended to be in conformity with the provisions of applicable laws and, therefore, according to learned counsel, the intention is not to treat the Accounting Standards as part of the Companies Act but as a subordinate legislation. Therefore, AS 22 cannot be treated as amending or altering Schedule VI which is part of the Companies Act and which can only be done under Section 641(2)

by way of appropriate notification. That, under Section 641(2), any amendment to the schedules by way of notification is treated as if it is enacted in the Act. Such a provision is absent in Section

642. That, as the Accounting Standards in the present case have not been notified under Section 641, they cannot alter or amend the Schedule VI to the Companies Act.

27. As regards matching principle, learned counsel submitted that the said principle has to be applied in two ways: (i) on revenue basis; and

(ii) on time basis

That, the said principle can be applied for both the profits, namely, accounting profits and taxable profits. That, broadly speaking, the matching principle can be applied by matching expenditure against specific revenues as having been used in generating those specific revenues or by matching expenses against the revenues of a given period in general on the basis that the expenditure pertains to that period. The former is termed as matching principle on revenue basis and the latter is termed as matching principle on time basis. According to learned counsel, the said principle applies only where the assessee has a choice of debiting or crediting expenditure or income in a particular financial year (time basis) or for correlating a particular expenditure against particular revenue (revenue basis). That, matching principle cannot be extrapolated to divergent results that arise under two statutes and, therefore, Accounting Profits and Taxable Profits computed under the Companies Act and the I.T. Act respectively cannot be reconciled by applying the matching principle or on the basis of effect of Time Differences. In this connection, learned counsel pointed out that in India the timing difference arises mainly because different rates of depreciation are statutorily prescribed by Schedule XIV to the Companies Act and by Rule 5, Appendix-I to the Income Tax Rules. It is submitted that 99% of DTL arises only on account of difference in depreciation rates. This position is not disputed by the Institute. Learned counsel, therefore, urged that if the rates of depreciation are statutorily different, then the Institute or the Central Government, as a rule making authority, has no power to apply the matching principle or timing difference and bring the accounting depreciation in line with tax depreciation. Therefore, according to learned counsel, the Institute as well as the Central Government has erred in prescribing AS 22 as a mandatory rule to bring about a reconciliation between tax depreciation and accounting depreciation for which it has no such jurisdiction or power. According to learned counsel, in India, unlike U.K., rates of depreciation are statutorily prescribed. They are separately prescribed under I.T. Act and Companies Act. Therefore, it is only for the court/tax department to apply the matching principle in a given case. It would depend on the facts of a given case. The matching principle cannot be prescribed by a rule or an Accounting Standard. Learned counsel, therefore, submitted that the Central Government as a rule making authority under Section 642 or the Institute has no power to apply the matching principle or timing difference across the board to bring the accounting depreciation in line with tax depreciation. The rates of depreciation are not prescribed statutorily in U.K. In U.K. the assessee is at liberty to adopt any rate of depreciation he chooses and, therefore, according to learned counsel, there could

be some justification for invoking the matching principle and applying an accounting standard for deferred taxation.

28. On the concept of true and fair view, learned counsel urged that under Section 211(1), a balance-sheet has to present a true and fair view. Similarly, under Section 211(2), P&L a/c must also be true and fair. However, according to learned counsel, the said concept does not mean that Accounting Standards can alter Schedule VI or enable alteration of accounting profits which have been computed as per Sections 205, 209 read with Schedule VI and Schedule XIV to the Companies Act. Learned counsel further pointed out that in fact under Section 211(5)(v) there is a stipulation that anything not disclosed as per Schedule VI will not render the balance-sheet/P&L a/c as not disclosing the true and fair view.

29. On the question of effect of AS 22, learned counsel urged that the effect of implementation of AS 22 would result in drastic reduction in profits of a company. In this connection, learned counsel urged that AS 22 provides for TOI. That, the difference between accounting profit (profit under the Companies Act after providing for depreciation and taxation) and the taxable profit (profit as per I.T. Act) are to be multiplied by the rate of income tax. This amount has to be reduced/deducted from the accounting profit. Therefore, the formula would be read as under:

$(AP-TP) \times \text{rate of income tax} = \text{DTL}$ In other words, if the accounting profit is Rs.50 crores and the taxable profit is Rs.30 crores and the rate of income tax is 30% then DTL will be Rs.6 crores $(50-30 \times 30/100)$.

30. Similarly, $(\text{loss/unabsorbed depreciation}) \times \text{rate of income tax} = \text{DTA}$. If a company has a loss and carry forward depreciation of Rs.40 crores and the rate of income tax is 30% then DTA will be:

$$40 \times 30/100 = \text{Rs.12 crores}$$

In such a case the loss of Rs.40 crores will be reduced to Rs.28 crores $(40-12)$.

Relying upon the above illustrations, learned counsel submitted that if a company is making accounting profits year after year the said profits will stand reduced year after year by DTL if AS 22 is implemented. Similarly, according to learned counsel, the DTL of each year will become accumulated and shown on the liability side of the balance-sheet, below Unsecured Loans. That, this accumulated liability on account of DTL will reduce the net-worth of a company. On the other hand, DTA has to be shown on the Asset side. But DTA can be claimed as an asset only on the basis of the

concept of virtual certainty (See: paras 17 and 18 of AS 22). Accordingly, it is urged that profits available for distribution as dividend shall also be reduced between 20% to 30% each year if DTL is shown as accumulated liability. According to learned counsel, the Institute has not produced any evidence of any company getting any benefit from implementation of AS 22. In this connection, learned counsel submitted that provision for DTL unfortunately has not been treated as a reserve which can be utilized in times of financial crisis. That the Institute has not given a single example of a situation where timing difference has been reversed. According to learned counsel, AS 22 does not in any way help collection of higher taxes. That, as long as a company continues to be profitable, it is impossible for any reversal by timing difference. In this connection, learned counsel urged that, in India, income tax depreciation is substantially higher than accounting depreciation as per Schedule XIV and, therefore, the accounting profits will always be more than the book profits. Therefore, every year, there would be DTL which will keep on accumulating. For example, according to learned counsel, accumulated DTL of Reliance Industries Ltd. was Rs.6982 crores as on 31.3.07 and this liability will keep on accumulating. According to learned counsel, except in the case of companies which are likely to make loss in the near future, reversal will never take place. Therefore, the basic stipulation of timing difference getting reversed will never happen. Learned counsel further submitted that DTL is made chargeable to the P&L a/c even when it is a non-existent or fictional liability; that the amount which is reduced from the profit is not even treated as a reserve and, therefore, DTL cannot be utilized if the company runs into financial difficulty.

31. According to learned counsel, under para 33 of AS 22 companies are required to rework the entire liability from the beginning of the existing assets. For example, in the case of Indian Railway Finance Corporation Ltd., provision is required to be made in respect DTL of Rs. 940.55 crores. The transitional provision took place for the year ended 2001-02. The said provision of Rs.940.55 crores has diminished Bond Redemption Reserve. Similarly, according to learned counsel, in the case of M/s. First Leasing Company of India Ltd., application of para 33, as transitional provision, has resulted in DTL of Rs.62 crores.

32. On the question of legal status of AS 22, learned counsel submitted that the said Standard is a subordinate legislation and, therefore, it cannot create a tax liability. DTL is neither a liability nor a tax. It is not a deferral. That, the levy of tax can either be by the Central Government or State Government under List I or List II of Schedule VII to the Constitution. That, under Article 366(28), taxation includes imposition of any tax or impost. Under Article 265, taxes can be levied only by authority of law. DTL, according to learned counsel, is not a tax by definition or by understanding. It cannot be treated as a tax by any process of interpretation. If it is a tax, it has to be credited to the Consolidated Fund of India/State. DTL is also not a fee or a cess or any surcharge. That, under para 3(vi) of Part II of Schedule VI deduction of taxes on income has to be shown. At present, the taxes that can be deducted are Income Tax, Fringe Benefit Tax (FBT), Minimum Alternate Tax (MAT). Similarly, any surcharge or cess levied by the Finance Act as a percentage of such taxes will also be deductible. According to learned counsel, gross receipts of any company can be reduced by following items to arrive at profits before taxation. These items are expenses such as salaries, raw materials and overheads; liability towards gratuity, PF, etc.. A tax liability can be created only under an Act of Parliament. DTL can only be a liability by way of tax. It is not a liability of any other nature since it is not required to be discharged in future. It is not enforceable against the company. Thus, DTL creates a legal fiction with respect to the concepts of taxation and liability which is

contrary to the legal meaning enunciated by several judgments of this Court (See: State of Kerala v Madras Rubber Factory Ltd. AIR 1998 SC 723 at 730 and Shree Digvijay Cement Co. Ltd. v. Union of India (2003) 2 SCC 614 at 627, para 26 and 27).

33. On the question of effect of Section 211(3A), (3B) and (3C), learned counsel submitted that Section 211(3A) cannot be read to imply that Accounting Standards have to be complied with even if they are inconsistent with the Act or that they alter/amend any provisions of the Companies Act. As regards Section 211(3B), learned counsel submitted that any deviation from the Accounting Standards has to be qualified by the auditors which may lead to adverse consequences for the company. According to learned counsel, unless the company is likely to make loss in near future, timing difference can never arise. According to learned counsel, tax depreciation, in India, is higher than book depreciation and, therefore, DTL will exist in the financial statements indefinitely. This is one more effect of AS 22 being implemented in India. On the other hand, according to learned counsel, the very purpose of AS 22 of presenting true and fair view can be easily achieved by making AS 22 a disclosure requirement as Notes to the Accounts, rather than inserting it in Schedule VI, Parts I and II to the Companies Act.

34. Mr. S.K. Bagaria, learned counsel appearing on behalf of J.K. Tyre & Industries Ltd. (formerly known as J.K. Industries Ltd.), submitted that AS 22 requires charging the P&L a/c for an assumed liability on account of deferred tax which is not payable according to the provisions of I.T. Act for the accounting period nor does it represent any tax which would become payable in future. That, AS 22 requires provision to be made for alleged tax liabilities and recognition of alleged tax assets which are not at all accrued liabilities or assets. According to learned counsel, AS 22 requires provision for assumed tax liabilities and recognition of assumed tax assets which are in reality non-existent, commercially or under the law. According to the learned counsel, notional and imaginary working is required to be made for AS 22; that, deferred tax is neither an asset nor a liability; that, the accrual basis of accounting requires a provision to be made for a known liability existing on the balance-sheet date and that any provision made on account of tax not payable under I.T. Act for the accounting period is not a provision for any known liability according to the accrual basis of accounting. According to the learned counsel, any amount set aside on account of tax for which there is no liability under the I.T. Act cannot be considered as a tax expense for the period of account; that, statutory levy of tax has to be measured and recognized as per the I.T. Act or the Companies Act or any other applicable enactment and that if the I.T. Act does not create DTL, such liability does not exist at all. According to the learned counsel, under the accrual basis of accounting, a company is required to make provision only for a liability which has accrued in the relevant accounting year; that, in respect of contingent liability, it is not required to make any provision but only a note is required to be given in the accounts known as Disclosure Note; that, DTL is not even a contingent liability; and that, on the balance-sheet date several events such as the working of the company in future years, whether the company will earned a taxable profit (loss) in future are events which are totally unknown at the end of the accounting period when the company is required to recognize, measure and account for DTL. According to the learned counsel, if there is no income in future, there would be no liability for tax in future and if there is income and additions to assets in future, the difference in depreciation under the Companies Act and under the I.T. Act for the accounting period will not result in any tax liability in future and there would be no reversal of the DTL created in the accounting period. According to learned counsel, AS 22 requires recognition

of the tax effect, whether current or deferred, in respect of individual transaction during the accounting period as if in future the company would have to make payment on account of deferred tax. According to learned counsel, the aforesaid concept is merely an assumption. Under the I.T. Act, tax is determined with reference to the total income and not with reference to any individual transaction. The total income in future is uncertain. The total statutory tax liability in future is also uncertain. The difference between the current accounting income and the current taxable income, for example, on account of depreciation, may or may not have any impact on the computation of the total income of a future year or it may or may not entail any tax liability. Therefore, it cannot be said with certainty that deferred tax in respect of an individual transaction of the accounting period would result in any cash outflow on account of tax in a future year. According to learned counsel, AS 22 has been framed on the fundamental accounting assumption of going concern. However, it is one thing to assume that business would go on and quite another to assume that it will produce profits. If there is no taxable income in future, the tax effect of the transactions of the accounting period will not translate into any actual liability or cash outflow. According to learned counsel, AS 22 assumes that there would be sufficient taxable income in future entailing tax liability in future and that the tax effect of the transactions in the accounting period would have a role to play in the determination of future taxable income and liability. According to learned counsel, the above is also an assumption. According to learned counsel, the accrued liability for tax is the liability in respect of the amount of tax statutorily payable on the taxable income computed from the accounting income in accordance with the I.T. Act after making appropriate deduction allowances and disallowances. Such liability for tax represents the provision for taxation. Any amount in excess of such liability would be a reserve. If the I.T. Act does not create any liability for tax, such liability does not exist in fact or in law and, therefore, it would be contrary to all norms of prudence to recognize or provide for a non-existent liability. According to learned counsel, liability for tax must exist under I.T. Act for it to be called an accrued liability; that the contention of the Institute that liability for tax should be considered in the accounting sense and not in the strict legal sense proceeds on the basis that deferred tax is not an accrued liability in the legal sense; that, the tax liability in the income is only to the extent the I.T. Act provides for such liability; that real liability for income tax is only as computed under the I.T. Act; that, merely because the difference between the accounting income and taxable income is ascertainable and merely because tax effect on account of such difference can be worked out on the basis of existing tax rates, it cannot be said that such tax effect represents a real liability payable today or tomorrow. According to learned counsel, the difference between accounting and taxable income in a given year may or may not give rise to a liability or outflow of money in future. According to learned counsel, this is an assumption. This is totally uncertain. Therefore, according to learned counsel, to give tax effect on such difference cannot be treated as an accrued liability and in respect of such difference, no income tax is payable under the I.T. Act for the accounting period.

35. Mr. Bagaria, learned counsel, further submitted that accrual is a legal concept. It has not been defined under I.T. Act. It has not defined under the Companies Act. An accrued liability arises only if that liability has arisen in the accounting year concerned. This position has been settled by various decisions of this Court. It has been further held in numerous decisions by this Court that provision for taxation is the provision for tax liability under the I.T. Act as on the last date of the accounting year and that if anything is provided in excess of such tax liability, it will not be a provision but it will be a reserve (See: the judgment of this Court in *Metal Box Company of India Ltd. v. Their Workmen* AIR 1969 SC 612). Therefore, according to learned counsel, if the I.T. Act does not create any liability for tax, there is no liability for tax either in fact or in law. Learned counsel,

however, invited our attention to the difference between contractual liability in case of cars sold with warranties and tax liabilities which, according to learned counsel, stand on a totally different footing as it is to be determined in accordance with the principles laid down in various judgments of this Court under the I.T. Act.

36. Learned counsel next contended that under Section 209(3)(b) of the Companies Act read with Section 209(1), income and expenditure and assets and liabilities should be accounted for in the books of account on accrual basis and according to the double entry system of accounting; that, the concept of accrual in Section 209(3)(b) is required to be understood in the same manner as it is required to be understood judicially. According to the learned counsel, accrual has been defined in AS 1, which has also been prescribed by the impugned Notification dated 7.12.06, as revenues and costs recognized as they are earned or incurred and recorded in the financial statements of the periods to which they relate. According to learned counsel, the definition of the word accrual in Notification dated 25.1.96 issued by the Central Government under Section 145(2) of the I.T. Act also referred to the word accrual as an assumption, namely, that revenues and costs are recognized as they are earned or incurred and so recorded in the financial statements for the period(s) to which they relate. According to learned counsel, the Accounting Standard notified under I.T. Act also requires the accounts to give a true and fair view. Therefore, according to learned counsel, the definition of the word accrual is the same both in the Accounting Standard prescribed under Section 211(3C) and that which is notified under Section 145(2) of the I.T. Act. Therefore, according to learned counsel, the word accrual for the purposes of the Companies Act does not carry any meaning different from that mentioned for the purposes of the I.T. Act. That, only the amount of income tax actually payable under the I.T. Act with reference to the taxable income for the period covered by the account computed in accordance with the provisions of that Act can constitute a charge for income tax and is, therefore, an accrued liability. Any amount in excess of such tax is a reserve and not a provision for taxation. According to learned counsel, therefore, for the above reasons AS 22 insofar as it relates to deferred tax is contrary to the concept of accrual which concept is recognized under Section 209(3)(b) read with Section 209(1) of the Companies Act.

37. On the question of matching principle, learned counsel urged that the matching concept is fully complied with when a provision is made for tax computed in accordance with the provisions of the I.T. Act with reference to the taxable income derived from the accounting income after making appropriate deductions, allowances and disallowances in accordance with the statutory provisions. According to learned counsel, matching tax in respect of accounting income is only the tax computed for the accounting period, according to the provisions of the I.T. Act. It is not any assumed future taxation dependent upon any assumed future working of the company. The object of incurring expenses is to produce revenue. In measuring the income for a period, revenue is to be adjusted against expenses incurred for producing that revenue. This concept of adjusting/offsetting the expenses against revenue is the matching principle. This concept is fully satisfied when provision for taxation is made for tax liability in accordance with the provisions of the I.T. Act and it is such tax alone which is the tax liability incurred on the income earned during the period concerned.

38. As regards the question of the functional utility of Accounting Standards under Section 211(3A), (3B) and (3C) is concerned, learned counsel submitted that Section 209 provides that every company keeping proper books of account with respect to moneys received and expended and the matters in respect of which the receipt and expenditure takes place as well as the assets and liabilities of the company. According to learned counsel, therefore, Section 209(1) recognizes the receipt and expenditure as well as assets and liabilities; that, prior to substitution of Section 209(3) by the Companies Act (Amendment) Act, 1988 w.e.f. 15.6.88, did not provide for keeping the books of account on accrual basis. However, based on the report of Sachar Committee to the effect that true and fair view should be projected, Section 209 was suitably amended to make it obligatory on all companies to maintain accounts on mercantile system of accounting. Based on the recommendation of the Sachar Committee sub-section (3) was substituted. Thus, from Section 209, according to learned counsel, the following position becomes clear, namely, that Section 209 recognises receipt and expenditure as well as assets and liabilities on accrual basis and on double entry system for accounting. After the said amendment, books of account are required to be kept on accrual basis. Therefore, according to learned counsel, the requirement of true and fair view stands incorporated in Section 209(3)(a), Section 211(1), (2) and (5); Section 217(2AA)(ii); and Section 227(2). According to learned counsel, on bare reading of Section 227 read with Section 209 it is clear that the auditor of the company has to report that proper books of account as required by law has been kept by the company; that, proper books of account shall not be deemed to be kept unless they are kept on accrual basis and double entry system of accounting; that, the auditor has to report that the balance-sheet and the P&L a/c are in agreement with the books of account and that the auditor has also to report whether profit and loss account as well as balance-sheet complies with the Accounting Standards referred to in Section 211(3C). According to learned counsel, sub-section (3A) of Section 211 requires every P&L a/c and balance-sheet of the company to comply with the Accounting Standards; that, sub-sections (3A), (3B) and (3C) do not refer to keeping of proper books of account; that this subject is covered by Section 209 only which mandates that proper books of account shall not be deemed to be kept unless the same are kept on accrual basis and double entry system of accounting; that, the said mandate of Section 209 cannot be altered by the Accounting Standards and since the Accounting Standards as per sub-section (3A) can only relate to the P&L a/c and balance-sheet and not to keeping proper books of account which are basic primary records from which the P&L a/c and balance sheet are prepared and since P&L a/c and balance-sheet are not books of account but only abstracts.

39. AS 22 relating to deferred tax is directly in conflict with Section 209 of the Companies Act and in excess of the powers vested under sub-section (3A), (3B) and (3C) of Section 211. In this connection, learned counsel submitted that the power conferred upon the Central Government under sub-section (3C) of Section 211 for prescribing Accounting Standards by framing of rules is in the nature of delegated legislation; that under the scheme of sub-section (3A), (3B) and (3C) of Section 211, Accounting Standards can be prescribed only in relation to P&L a/c and balance-sheet; that a delegatee of power cannot assumed jurisdiction in areas or over subjects which are not delegated; that the power being limited to prescribing Accounting Standards for P&L a/c and balance-sheet, cannot be exercised in relation to maintenance of books of account and that too on a basis different from accrual basis mandated in Section 209 and any such exercise of power by prescribing any Accounting Standard affecting the maintenance of proper books of account and that too on a basis different from accrual basis will be in excess of the powers vested in the Central Government under sub-section (3A), (3B) and (3C) of Section 211 and will be directly in conflict with Section 209 of the Companies Act. In this connection, learned counsel submitted that AS 22 requires a company to

reduce or increase its net profit by passing journal entries in its books of account in respect of DTL or DTA; that it is only after these entries are made in the books of account in respect of DTA or DTL that the net profit in the P&L a/c can be increased or reduced and DTA or DTL can be reflected in the balance-sheet after the head Investments in case of DTA and after the head Unsecured Loans in case of DTL and, therefore, according to learned counsel, AS 22 exceeds the power conferred by sub-sections (3A), (3B) and (3C). According to learned counsel, the power under sub-sections (3A), (3B) and (3C) only relates to prescribing Accounting Standards for presentation of P&L a/c and balance-sheet whereas AS 22 directly and immediately encroaches upon preparation of books of account and maintenance and proper books of account on accrual basis and in the process violates the mandate statutorily imposed by Section 209(3). That, there is no power conferred by sub-sections (3A), (3B) and (3C) nor by any other sub-sections of 211 to prescribe Accounting Standards relating to maintenance of proper books of account. In this connection, learned counsel pointed out that the duty of the auditor is to report in terms of Section 227(3)(d) about compliance with the Accounting Standards referred to in sub-section (3C) of Section 211 which applies only in respect of P&L a/c and balance-sheet; that, the said provision makes it clear that compliance with the Accounting Standards is to be made only in respect of the P&L a/c and balance-sheet whereas keeping of books of account in terms of Section 209 is required to be reported upon by the auditor only in terms of Section 227(3)(d) and, therefore, AS 22 exceeds the power conferred by sub-sections (3A), (3B) and (3C) of Section 211. Learned counsel submitted that AS 22 is confined to prescribing Accounting Standards for presentation of P&L a/c and balance-sheet. It does not deal with preparation of books of account. That subject falls under Section 209(3). Therefore, AS 22 prescribes Accounting Standards only for P&L a/c and balance-sheet without directing that exercise to be made in respect of preparation and maintenance and proper books of account on accrual basis and, therefore, AS 22 brings about inconsistency between the provisions of Section 209(3) on one hand and sub-sections (3A), (3B) and (3C) of Section 211. According to learned counsel, Section 217(2AA)(i) merely relates to preparation of annual accounts; it does not deal at all with preparation and maintenance of books of account; that annual accounts are not books of account (See: Section 210) and, therefore, the said Section 217(2AA)(i) has nothing to do with preparation and maintenance of proper books of account which subject is independently dealt with in Section 209. According to learned counsel, the provisions of AS 22 insofar as it requires making of entries in the books of account reducing the profit by accounting for DTL or increasing the profit by accounting for DTA and to reflect such entries in the P&L a/c and balance-sheet, are ultra vires sub-sections (3A), (3B) and (3C) of Section 211 and Section 209 of the Companies Act. That, by AS 22, insofar as the same relates to deferred tax, the delegatee of power (Central Government) has attempted to encroach upon the areas far beyond those covered by the delegation.

40. According to the learned counsel, Section 211(1) starts with the mandate that every balance-sheet of a company shall give a true and fair view at the end of the financial year. This mandate is, according to learned counsel, not subject to anything. It is not qualified by the expression subject to the provisions of this section. Similar is the position in sub-section (2) of Section 211 with regard to the P&L a/c. Therefore, according to learned counsel, true and fair view requirement is the primary requirement of Section 211(1) and Section 211(2) which requirement stands satisfied only if the accrual basis is followed as mandated in Section 209(3). According to learned counsel, the expression subject to the provisions of this section in Section 211(1) obviously includes the provision of sub-section (1). Therefore, according to learned counsel, even in terms of the specific language of Section 211(1) the requirement of true and fair view in that sub-section is a stand-alone

concept and it is not subject to anything. According to learned counsel, accrual basis in Section 209(3) is a necessary component of true and fair view as a requirement and, therefore, the said requirement in Section 211 and in Section 209 would have the same meaning. However, according to learned counsel, the expression subject to the provisions of this section in Section 211(1) only qualifies the requirement of balance-sheet being in the form set out in Part I of Schedule VI; that, similarly the expression subject as aforesaid in sub-section (2) of Section 211 only qualifies the requirement of Part II of Schedule VI in respect of P&L a/c; that, sub-section (3A) of Section 211 inter alia provides that every P&L a/c and balance-sheet of the company shall comply with the Accounting Standards and, therefore, according to learned counsel in the entire scheme relating to accounts and audit in Part VI, Chapter I, Section 209 to Section 233B of the Companies Act, the statutory mandate of keeping proper books of account on accrual basis is not allowed to be altered or encroached upon by any Accounting Standards. According to learned counsel, it is the statutory mandate that P&L a/c and balance-sheet shall be in consonance with the books of account. Therefore, sub-sections (3A), (3B) and (3C) can only relate to presentation of and disclosures in P&L a/c and balance-sheet, keeping intact the statutory mandate of maintaining proper books of account on accrual basis. Therefore, if the format of a balance-sheet or the requirements of P&L a/c is allowed to be altered by any Accounting Standards it would amount to encroachment upon the statutory mandate of keeping proper books of account on accrual basis. Therefore, according to learned counsel, Accounting Standards can provide in relation to presentation of and disclosures in P&L a/c and balance-sheet without touching upon the basic requirement of maintaining proper books of account on accrual basis and only thereby one can comply with the concept of true and fair view. Any other interpretation would mean that AS 22 far exceeds the power conferred by sub-sections (3A), (3B) and (3C) of Section 211 and it would amount to creating inconsistencies between various sections of the Companies Act.

41. Learned counsel next contended that accrual basis of accounting does not recognize DTA or DTL; that, accounting for any DTA or DTL would be contrary to the accrual basis of accounting and would not result in keeping of proper books of account in terms of Section 209. Neither the books of account nor the P&L a/c or balance-sheet which are required to be in agreement with the books of account will give a true and fair view if accounting has to be made in respect of DTA or DTL; that, AS 22 does not result in a true and fair measurement of the P&L a/c or the state of affairs of a company and if any provision is made on account of deferred tax with reference to the difference between accounting and taxable incomes for which no liability exists under the I.T. Act, such provision would distort the books of account and financial statements and would not give a true and fair view. That, similarly creation of a deferred tax asset because of current losses would distort the books of account and financial statements and would not give a true and fair view. According to learned counsel, accrual basis is a necessary component of true and fair view requirement. The provision contrary to the accrual basis cannot satisfy the said requirement. Lastly, according to learned counsel, the only way out of the above inconsistencies is to harmoniously construe Sections 209, 211 and AS 22 by reading down the said Standard so that the company is only required to make a disclosure in the P&L a/c and balance-sheet as regards DTA or DTL without requiring the company to make any entry in the books of account or without making any company to reduce or increase its net profit.

42. Lastly, learned counsel submitted that vide para 33 of AS 22 DTL is sought to be created in

respect of individual transactions since the inception of the company which may be long before the AS 22 came into effect resulting in reduction of the revenue reserve by the amount of such DTL. That, the working required to be made in terms of para 33 of AS 22 is complicated. In this connection, learned counsel pointed out that under para 34 of AS 22, not only opening balances of assets but also opening balances of liabilities for accounting purposes and for tax purposes have got to be compared; that, para 33 requires a working to be made in respect of individual transactions since the inception of the company in order to ascertain DTAs or DTLs. That, in case of DTL, the revenue reserve has to be reduced and conversely in case of a DTA, the revenue reserve has to be increased. This is, according to learned counsel, indicates that para 33 which is termed as transitional provision is clearly retrospective in its operation. Therefore, according to learned counsel, para 33 of AS 22 would result in reduction of the companys revenue reserves. It will erode the companys net worth. It will alter the companys debt- equity ratio. It will adversely effect the companys borrowing capacity. Therefore, according to learned counsel, the High Court had erred in dismissing the writ petitions filed by the appellants. According to learned counsel, Section 211(3C) does not enable the Central Government to give any retrospective operation to the Accounting Standards. The rule-making power under Section 642 of the Companies Act also does not permit the making of any rules with retrospective effect and, therefore, according to learned counsel, para 33 deserves to be set aside. For the above reasons, learned counsel submitted that AS 22 far exceeds the power and jurisdiction conferred by sub-sections (3A), (3B) and (3C) of Section 211 and that it brings about inconsistencies between various sections of the Companies Act and, therefore, the said AS 22 deserves to be struck down or in the alternative AS 22 deserves to be read down so that at best the company is required to make a disclosure in the P&L a/c and balance-sheet as regards any DTA or DTL without requiring it to make any entry in the books of account and without requiring any company to increase or reduce its net profit (loss).

43. Mr. A Sharan, learned Additional Solicitor General appearing for Union of India, submitted that validity of a legislation could be challenged on grounds of incompetence of the legislation or same being violative of Part III of the Constitution. That, a subordinate legislation can be challenged additionally on the grounds that the same is beyond the authority of delegate or that it is violative of provisions of the enactment. According to learned counsel, in the present case, appellants have not challenged the competence of the Central Government to notify or provide for Accounting Standards, they have restricted their challenge only on the ground that AS 22 contravenes the provisions of Companies Act by stating that the same violates Sections 205, 209, 211 and Schedule VI of the Companies Act. According to learned counsel, even in that regard no details have been given by the appellants in their original writ petition as to how the impugned Accounting Standard contravenes the provisions of the Companies Act. Therefore, according to learned counsel, the entire original writ petition filed by the appellant is misplaced, misconceived and not maintainable for want of details. Learned counsel urged that AS-22 provides for a different manner than Schedule VI in which account of a company required to be prepared. It is submitted that Schedule VI is the form set out under the Companies Act in which a company is required to submit its balance-sheet and profit and loss account. Section 211(1) requires the companies to prepare their balance-sheet in the form set out in Part-I of Schedule VI. A plain reading of Section 211 reveals that the requirement of submission of balance-sheet in the said form is subject to the other sub-sections of Section 211 and hence the format of the said balance shall necessarily be guided by the Accounting Standards provided under sub-section (3A) as same is having overriding effect on Part I of Schedule VI. According to learned counsel, when any provision made is subject to other provisions of that section, then the said provision (Part I of Schedule VI) has to give way the other provisions (AS-22

as provided by Section 221(3A)). In this connection, reliance is placed on the judgment of this Court in the case of *South India Corporation (P) Ltd. v. Board of Revenue, Trivandrum and Anr.* AIR 1964 SC 207 at p.215, in which this Court has held that the expression subject to conveys the idea of a provision yielding place to another provision or other provision(s) to which it is subject to. Reliance was also placed by the learned counsel on the judgment of this Court in the cases:

The State of Bihar and Anr. v. Sir Kameshwan Singh and Anr. AIR 1952 SC 252;

K.R.C.S. Balakrishna Chetty and Sons & Co. v. The State of Madras AIR 1961 SC 1152; and
Heggade Janardhan Subbaraya v. The State of Mysore and Ors. AIR 1963 SC 702.

In the alternative, learned counsel submitted that in any event Section 641 empowers the Central Government to amend Schedule VI whereas Section 642 confers powers on the Central Government to formulate rules. That, Part I of Schedule VI prescribes the form in which the balance-sheet and P&L a/c is required to be prepared. According to learned counsel, AS 22 is prescribed by the Central Government with respect to computation of tax liability; that, AS 22 lays down the manner in which the said computation of tax liability in the balance-sheet is required to be prepared and, therefore, in pith and substance AS 22, according to learned counsel, prescribes additional mode in which tax liability of a company is required to be calculated. Thus, according to learned counsel, exercise of power by the Central Government under Section 642 providing for AS 22 is exercise of power for same purpose which is required to be exercised under Section 641 to amend Schedule VI and, therefore, in pith and substance, according to learned counsel, exercise of power by the Central Government under Section 642 will be deemed to be exercise of power by the Central Government under Section 641 and accordingly Part I of Schedule VI will stand modified/amended to the extent it contravenes AS 22. This is particularly because Part I of Schedule VI is subject to Section 211(3A) of the Companies Act. According to learned counsel, under Section 211 every company is required to prepare its balance-sheet and P&L a/c in the manner provided therein. Sub-section (3A) of that Section makes it mandatory to comply with Accounting Standards. While preparing P&L a/c and balance-sheet (See: Section 211(3C)). According to learned counsel, since AS 22 is an Accounting Standard prescribed under sub-section (3C) it has a statutory status, required to be followed while preparing the books of account in terms of Section 211 of the Companies Act. Lastly, learned counsel urged that the Companies Act is a special statute; that, Section 211 is a special provision aimed at providing the form and content of P&L a/c and balance-sheet required to be prepared by the company; that, a special provision like Section 211 ordinarily overrides the general provision; that, if a special provision is made on a particular subject then that subject is excluded from the general provision and since AS 22 is a special provision notified under Section 211(3C) with respect to form and content of accounts of the company, the same will override other provisions of the Companies Act as well as any other statute to the extent provided therein. In this connection, learned counsel placed reliance on the judgment of this Court in the cases: *Gadde Venkateswara Rao v. Government of Andhra Pradesh and Ors.* AIR 1966 SC 828;

State of Bihar v. Dr. Yogendra Singh GOL (Retired) and Ors. (1982) 1 SCC 664 Maharashtra State Board of Sec. and High. Sec. Education and Anr. etc. v. Paritosh Bhupeshkumar Sheth and Ors. etc.

State of Gujarat and Anr. etc. v. Patel Ramjibhai Danabhai and Ors. etc. (1979) 3 SCC 347

44. In view of the aforesaid submissions learned counsel submitted that AS 22 is intra vires the Companies Act and, therefore, the appeals deserve to be dismissed with costs.

45. Mr. N.K. Poddar, learned senior counsel appearing for the Institute, submitted that corporate accounts are required to disclose a true and fair view. It is a requirement. That requirement has to be ensured by the auditors who have to certify that the accounts are prepared so as to provide true and fair view of the state of affairs of the company. This responsibility is undertaken by accountants and auditors who are members of the Institute. If Accounting Standards are not followed, financial accounts would not be true and fair and in that case, the statutory requirement in Section 211 for preparing true and fair accounts would not be satisfied. According to learned counsel, prior to 1988 the requirement contemplated by the Companies Act was disclosure of true and correct view. This requirement was deliberately changed by the Legislature to true and fair view. When it was a question of disclosing a true and correct view, it was permissible to look into the legal liability for tax, and make a provision accordingly; but when the requirement in law is to disclose true and fair accounts, a wider perspective is warranted. That is why, the Institute states that the I.T. provision should be based not only on the strict legal liability to be discharged immediately, but also on the legal liability based on book profits (real profits) which are earned and reflected in the corporate accounts of the company. Therefore, the Institute insists that there should be a reasonable matching of cost and benefit, if the accounts are to disclose a true and fair view. The Institute has legal obligation of ensuring disclosure of true and fair view in the corporate accounts. However, in the absence of a statutory definition of true and fair, it is the Institutes function to determine the basic rules for ensuring disclosure of a true and fair view. According to learned counsel, true and fair view is a concept which requires the Auditor to look at the substance rather than pure legal form and that is why all its Accounting Standards emphasize the importance of Substance over Form. The said view of the Institute is duly affirmed by Parliament when Parliament decreed that corporate accounts shall comply with the proper Accounting Standards (See: sub-sections (3A) and (3B) of Section 211 of the Companies Act). The basic reason for issuing AS 1 through Notification dated 25.1.96 of Government of India, to be followed by all assessees following mercantile system of accounting, was to lay down that accounting policies adopted by an assessee should represent a true and fair view of the state of affairs of the business in the financial statements prepared and presented based on such accounting policies. Therefore, the requirement true and fair view overrides all other statutory requirements as to the matters to be included in the corporate accounts. In order to give a true and fair view it is not necessary to provide information, additional to the one needed to comply with all other statutory requirements or even to depart from compliance with one or the other requirements. Any departure has to be disclosed in a Note to the Financial Statements giving reasons for such departure and its effects. Moreover, the concept of true and fair is not static. It is dynamic in nature. It continues to evolve in accordance with the changes in the requirements of economy.

46. It is the function of the Institute to regulate the profession of Chartered Accountants. By formulating Accounting Standards, Institute is fulfilling its statutory function. It is furthering Legislative intent of Parliament, which requires that accounts should be true and fair. Therefore, by laying down Accounting Standards, which explains what is true and fair, the Institute is merely fulfilling its statutory duty and function.

47. Learned counsel submitted that conceptually, the justification for Accounting Standards lies in the compelling logic and conceptual validity of each Standard. Those who prepare Accounting Standards are not framing the Standards without any basis. The framers review accounting policies already adopted and select those policies which are most appropriate in the presentation of accounts based on the requirement of true and fair view. The Standard represents the most appropriate accounting policies out of various accounting policies adopted by different companies over last several years. This is what is called as conceptual validity. The acceptance in such cases is not only recognized by statutory provisions but it is recognized by a wider degree of acceptance in the corporate world. That is why, almost all the major public companies, in India, have recognized and accepted the validity of the Standards. Even, this Court has expressed confirmation of commercial accounting Principles, Practices & Standards recommended by the Institute (See: *Challapalli Sugars Ltd. v. Commissioner of Income Tax* (1975) 98 ITR 167 at 172; *Commissioner of Central Excise v. Dai Ichi Karkaria Ltd. & Ors.* (1999) 7 SCC 448 at 461.

48. On the topic of accrual learned counsel submitted that under Section 209(3)(b) all books of account are required to be kept on accrual basis and according to the double entry system of accounting. According to learned counsel, the expressions accrual, accrual basis of accounting, accrued asset, accrued expense, accrued liability, accrued revenue, current assets, current liabilities, deferred expenditure, depreciation, provision, prudence etc. are explained and defined in the Guidance Note on Terms Used in Financial Statements issued by the Institute. Learned counsel submitted that the matching principle is the most important concept in accrual accounting. The matching principle indicates as to when expenses should be recorded against the revenue. The Institute had issued Guidance Note on Accrual Basis of Accounting in 1988, since after the amendment of Section 209, requiring all companies to maintain their accounts on accrual basis of accounting. All relevant above mentioned expressions relating to accrual basis of accounting including recognition of revenue and expenses, assets and liabilities have been explained in the said Guidance Note on Accrual Basis of Accounting which inter alia lays down the matching principle of recognizing costs against revenue or against the relevant time period to determine the periodic income. According to learned counsel, in order to understand the relevance of Accounting Standards issued by the Institute for preparation and presentation of financial statements vis-à-vis the accrual system of accounting and vis-à-vis the matching principle it is necessary to refer to the concepts that underline the preparation and presentation of such statements. The main purpose of Accounting Standards is, therefore, to assist the Accountants to prepare financial statements and to deal with topics that have yet to form the subject of an Accounting Standard. The entire object is to promote harmonization of Regulations, Accounting Standards and Procedures relating to the preparation of financial statements by providing a basis for reducing a number of alternative accounting treatments permitted by Accounting Standards. According to learned counsel, accrual basis, going concern and

consistency are underlying assumptions in preparation of financial statements. Prudence is important in the preparation of financial statements. It is a degree of caution in the exercise of judgments needed in making the estimates required under conditions of uncertainty so that assets or income are not overstated and liabilities or expenses are not understated. That, the principles to be followed in the recognition of assets, liabilities, income and expenses require application of the matching concept i.e. matching of costs with revenue, which principle involves combined recognition simultaneous recognition of revenues and expenses that result directly from the same transactions or other events. According to learned counsel, this Court has always recognized the need for estimation in accrual system of accounting. This Court, according to learned counsel, has recognized the accounting concept of matching costs with revenue in preparation of financial statements. In this connection, learned counsel placed reliance on the judgment of this Court in Calcutta Company Ltd. v. Commissioner of Income Tax (1959) 37 ITR 1; Madras Industrial Investment Corporation Ltd. v. Commissioner of Income Tax - (1997) 225 ITR 802. According to learned counsel, at one point of time in the past strict legal concept of accrual was laid down in the case of Commissioner of Income Tax v. Tungabhadra Industries Ltd. (1994) 207 ITR 553 (Cal.). However, according to learned counsel, that strict legal concept is no longer accepted by the Courts and for that purpose learned counsel places reliance on the judgment of this Court on the same issue in the case of Madras Industrial Investment Corporation Ltd. (supra). In short, learned counsel submitted that with globalization and with new concepts coming in, the law is no more confined to the strict legal concept of accrual which does not recognize the matching principle.

49. Learned counsel urged that the requirement for accrual basis of accounting was introduced in the Companies Act in 1988 through Section 209. Under Section 209(1) every company is required to maintain proper books of account with respect to receipts and expenses, sales and purchases of goods, assets and liabilities of the company, utilization of material or labour and such other items of costs incurred in production, process, manufacturing etc. Under Section 209(3) proper books of account shall not be deemed to be kept if such books of account do not give true and fair accounts and if such books fail to explain its transactions further if such books are not kept on accrual basis they have to be rejected for not giving a true and fair view of the state of affairs of the company. This position is also reflected in Section 211. Therefore, according to learned counsel, under the scheme of Companies Act, two requirements have to be satisfied, namely, accrual system of accounting and true and fair view. Both must read together with each other. According to learned counsel, the accrual basis of accounting must be applied so that true and fair accounts are presented. Indeed, the requirement to present a true and fair view precedes the requirement for accrual accounting. The requirement to present true and fair accounts is wider than the requirement of accrual accounting. Therefore, in a given case it is possible that accounts prepared on accrual basis may not present true and fair view because of certain deficiencies, however, it is not possible for accounts to be true and fair unless they are prepared on accrual basis. According to learned counsel, while Section 209(3)(b) mandates the accrual basis of accounting, it does not indicate the amount which should be recognized (accrued) in respect of specific matters. This is left to the judgment of the Accountant. According to learned counsel, accrual basis is a fundamental accounting assumption which means that all Accounting Standards including AS 22 are framed on the basis of accrual system of accounting and, therefore, the question of conflict of an Accounting Standard with the accrual basis of accounting does not arise. That, all Accounting Standards are framed in order to present a true and fair view; that, the primary consideration in the selection of accounting policies is to disclose a true and fair view and, therefore, the purpose of all Accounting Standards including AS 22 is to adopt the accrual basis of accounting in the context of disclosing a true and fair view and if

this principle is kept in mind then there would be no conflict between AS 22 with accrual basis of accounting. In fact, according to learned counsel, it is significant to note that while auditors are required to certify that accounts are true and fair, they are not required to certify that they are prepared on the accrual basis for the simple reason that accounts cannot be true and fair unless the accrual basis is adopted. For example, a particular liability is not provided for, because it is not legally imminent, it could still be argued that accrual basis has been adopted in a legalistic sense, but the accounts would nevertheless not represent true and fair view. According to learned counsel, for the aforesaid reasons Accounting Standards require that the accrual basis should be adopted in the context of presenting/disclosing a true and fair view. Therefore, the need to disclose a true and fair view is wider than the need for accrual accounts since it automatically includes accrual method of accounting. Learned counsel urged that there is overriding importance for the disclosure of a true and fair view, since the entire structure of corporate credibility is built on this foundation. Therefore, if any rules for technical disclosure are not consistent with the true and fair view requirement, then the company has to depart from the technical provisions, to the extent necessary, to give a true and fair view. That, the disclosure requirements are subservient to the overriding requirement of presenting a true and fair view. Therefore, in other words, the need to present a true and fair view should override technical compliance of the law on the basis of true and correct accrual. Therefore, according to the learned counsel, AS 22 goes far beyond technical compliance in order to ensure a true and fair presentation. Therefore, according to learned counsel, since Section 211(1) requires true and fair presentation, AS 22, is not beyond the mandate of the Companies Act.

50. Coming to the concept of prudence, learned counsel submitted that when financial statements are prepared, sometimes, the accountant comes across uncertainties that surround many events and in such case caution in exercise of the judgments is required while making estimates, so that assets or income are not overstated and liabilities or expenses are not understated. This is the principle of prudence. The said principle applies in view of uncertainties attached to future events. Profits are not anticipated, but they are recognized only when they are realized. Similarly, Provision is made for all known liabilities and losses, even though the amount cannot be determined with certainty and, therefore, Provision represents only an estimate in the light of available information. The principle of prudence has also been recognized in the Accounting Standard issued by the Central Government under Section 145(2) of the I.T. Act through its notification dated 25.2.96 which is required to be followed by all assesseees following mercantile system of accounting. In this connection, reliance was placed by learned counsel on the judgment of this Court in the case of *Chainrup Sampatram v. Commissioner of Income Tax* (1953) 24 ITR 481 at 485 in which this Court has also underlined the effect that even for income tax purposes profits are to be computed in conformity with ordinary principles of commercial accounting unless such principles stand modified by specific legislative enactments/provisions contained in the Income Tax Law. Similarly, in the case of *Commissioner of Income Tax v. Duncan Brothers & Co. Ltd.* (1996) 8 SCC 31 at 35, this Court has observed that the terms used in the Companies Act should be read in the manner as understood in accounting parlance.

51. On the question of alleged conflict between AS 22 and Schedule VI of Companies Act, learned counsel submitted that Accounting Standards, issued by the Institute, deal with recognition, measurement and disclosure and certain elements in financial accounts of every enterprise. That, Schedule VI deals with manner of presentation of financial data in the annual financial statements,

namely, the balance-sheet and P&L a/c to be drawn by a corporate enterprise at the end of each financial year. That, Part I of Schedule VI lays down the form of balance-sheet whereas Part II lays down the requirements as to the presentation of various financial data in the P&L a/c. Part II deals with interpretation of some of the expressions, namely, provisions, reserve, capital reserve, liability, investment etc. According to learned counsel, except in the case of Depreciation which is provided by every corporate enterprise in accordance with the rates laid down in Schedule XIV of the Companies Act, having regard to the provisions contained in Sections 205, 350 of the said Act, the said Act does not lay down the procedure for recognition and measurement of either the income or expenses and or the assets and liabilities. For example, Schedule VI nowhere lays down as to which assets should be recognized as Investments and also the method of valuing Investments. Similarly, AS 6 deals with Depreciation Accounting, however, except the statutorily fixed rate of depreciation as laid down in Schedule XIV of the Companies Act, all other aspects relating to recognition and measurement of depreciation are dealt with only in AS 6. They are not dealt with in the Companies Act. Similarly, under Part II of Schedule VI to the Companies Act the manner of presentation of various items of income and expenses in the P&L a/c has been laid down. However, the said Act nowhere lays down as to how and when income or expenditure should be measured and/or recognized. This aspect is dealt with by AS 9 alone and not by the provisions of the Companies Act. According to learned counsel, events and contingencies occurring after the balance-sheet date mentioned in AS 4, net profit or loss for a given period, prior period items and changes in accounting policies mentioned in AS 5, Accounting for Construction Contracts in AS 7, Accounting for Fixed Assets in AS 10, the Effect of changes in Foreign Exchange Rates as mentioned in AS 11, Accounting for Intangible Assets contained in AS 26, Accounting for Impairment of Assets in AS 28 are various aspects dealt with only under Accounting Standards and not under the Companies Act. According to learned counsel, since the Companies Act nowhere deals with recognition and measurement of various items of income and expenses, assets and liabilities, and since it deals with only presentation, there can never be any conflict between the provisions of the said Act and the Accounting Standards issued by the Institute in discharge of its statutory obligations under the Chartered Accountants Act, 1949 read with the Companies Act, 1956 which requires that every corporate enterprise must maintain such books as are necessary to give a true and fair view of its state of affairs and to explain its transactions (See: Section 209(3)), and that every balance-sheet of a company shall give a true and fair view of the State of affairs of the company at the end of the financial year, and that every P&L a/c of a company shall also give true and fair view of the P&L a/c of a company for the financial year (See: Section 211(1)(ii)). It is in this context of true and fair view requirement that the Institute has framed Accounting Standards so as to enable proper recognition and measurement of all income and expenses, assets and liabilities etc. as laid down in Section 209(1) read with Section 211(3A), (3B) and (3C).

52. Coming to the question of true scope and AS 22, learned counsel submitted that AS 22 deals with accounting for taxes on income. According to learned counsel, as far back as in 1991, the Institute had issued the Guidance Note on Accounting for Taxes on Income. This Note recommended deferred tax adjustments. It also explained the taxes payable method. It also explained the tax effect accounting method. It also explained the method for calculating deferred tax adjustments under deferred method and under liability method. It recommended that till the tax effect accounting method stood developed, it would be permissible for an enterprise to follow the taxes payable method as an alternative. After 10 years, AS 22 was finally issued by the Institute in 2001 in order to ensure a true and fair view of the profits earned during a financial year, and the taxes payable with reference thereto, to be presented in the corporate accounts. That is the reason

why, AS 22 leaves out of account differences between book profits and taxable profits which are of permanent nature. But AS 22 requires that DTL/DTA arising on account of timing differences should be reflected in the corporate accounts through what is called as deferred tax account. According to learned counsel, deferred tax accounting ensures that profits are measured in a real and factual manner. It also ensures that the benefit obtained in one year, which could be reversed in a subsequent year, is duly recognized as a liability. Therefore, according to learned counsel, AS 22 not only complies with the requirement for accrual accounting, but it applies the need for accrual accounting, in the context of presenting a true and fair view, rather than purely on the basis of a true and correct view. Accounting treatments contained in various Accounting Standards issued by the Institute are based on accrual accounting and, therefore, these Standards adopt the accounting treatments mentioned therein to ensure that a company has followed the accrual basis of accounting. According to learned counsel, AS 22, therefore, fulfills, the need for accrual accounting in the context of the true and fair view requirement. According to learned counsel, there is a difference between accrual accounting on the basis of true and correct view vis-à-vis accrual accounting on the basis of true and fair view. In the case of former, the profits are likely to be overstated and in which event the investors would be misled. That, the purpose of true and fair accounts is to protect investors and, therefore, the purpose of AS 22 is to ensure that accrual is made on a true and fair basis, by reference to the Substance rather than the Form. Learned counsel urged that the very object behind issuance of AS 22 is that in accordance with the matching concept, taxes on income are recognized (accrued) in the same period as the revenue and expenses to which they relate. Matching of such taxes against income/revenue for a period raises problems as taxable income may be different from accounting income significantly. According to learned counsel, para 4 of AS 22 lays down the definitions of various terms used in AS 22. One such term is current tax which has been defined to mean the amount of income tax determined as payable in respect of taxable income (loss) for a particular period. Similarly, in para 4 the expression deferred tax has been defined to mean what is called as timing differences which in turn has been defined to mean the differences between taxable income and accounting income for a period. Such timing differences originates in one period and are capable of reversal in one or more subsequent periods. Timing differences arises because the period in which some items of revenue and expenses are included in taxable income which items do not coincide with the period in which such items are included or considered in arriving at accounting income. This difference between taxable income and accounting income arises for two reasons. Firstly, there are differences between items of revenue and expenses, as appearing in the P&L a/c, and the items which are considered as revenue, expenses or deductions for tax purposes. Secondly, there are differences between the amount in respect of a particular item of revenue or expense, as recognized in the P&L a/c, and the corresponding amount, which is recognized for the computation of taxable income. This happens in the case of depreciation. The tax laws allow incentive depreciation on increased rate, as prescribed in Rule 5 read with the percentages mentioned in second column of the table in appendix I to the I.T. Rules, 1962 on the written down value of the block of assets, as are used by the assessee for the purpose of the business at any time during the relevant previous year. Depreciation includes amortization of assets whose useful life is predetermined. The commercial accounting principle requires that the original cost of an asset should be written off in the accounts by way of charge against income of each year in such a manner that its entire cost is debited against the income arising therefrom during life time of such asset. However, the I.T. Act lays down incentive rates of depreciation. While for accounting purposes, depreciation is provided for on straight line method, the Income Tax Act allows depreciation by way of incentive at much higher rate with reference to its written down value. The total depreciation charged on the plant and machinery for accounting purposes and the amount allowed as deduction for tax purposes ultimately remains constant, but period over which

depreciation is charged in the accounts as compared to the period during which the deduction is allowed under I.T. Act, will differ. This is a case of timing difference. For example, machinery purchased for scientific research is fully allowed as deduction in the very first year for tax purposes, whereas the same would be charged in the P&L a/c, as depreciation, over its useful life of, let us say, 15 years. Unabsorbed depreciation and carry forward of losses, which can be set off against future taxable income, are also examples of timing differences. Such timing differences result in DTAs. According to learned counsel, for the above reasons para 9 of AS 22 lays down that tax expense for a given period, shall, therefore, consist of current taxation and deferred tax which is included in the determination of the net profit or loss for the period. Similarly, para 10 of AS 22 further provides that tax effects of timing differences should be included in the tax expense in the P&L a/c and as deferred tax assets or as deferred tax liabilities in the balance-sheet.

53. Learned counsel for the Institute next submitted that para 33 of AS 22 is Transitional Provisions. According to the learned counsel, it is not retrospective as alleged by the appellants. According to learned counsel, under Section 209(3)(b) of the Companies Act, books of account must be kept on accrual basis and according to the double entry system of accounting. In other words, if a company was maintaining its accounts on cash basis prior to 1988 when the present section came into existence, the said company is required to change the system of accounting from cash to mercantile w.e.f. 15.6.88. However, this would not mean that without maintaining accounts on mercantile basis, the company would not record the opening balances of its assets and liabilities merely because Section 209(3)(b) does not refer to retrospective application. Learned counsel submitted that, therefore, there is no merit in the submissions made on behalf of the appellants that para 33 of AS 22 is ultra vires the provisions of the Companies Act. For the above reasons, learned counsel submitted that AS 22 is in no way contradictory to and/or in conflict of Schedule VI to the Companies Act having regard to the statutory requirement/consideration of presenting the financial statements in true and fair manner as laid down in Section 211(1)(ii) of the Companies Act. That, clause (vi) under para 3 of Part II of Schedule VI to the Companies Act reference is made only to presentation of income liability in the P&L a/c. It does not refer to the method of its recognition and/or measurement which aspects are considered and dealt with only by AS 22. Therefore, the portion of income tax expenses deferred to future tax returns is required to be credited to a Liability Account called as Deferred Income Tax Account.

54. On behalf of the appellants it was vehemently submitted that the DTL is a notional and contingent liability and, therefore, it is not required to be charged to the P&L a/c as per the requirements of the Companies Act. According to the appellants DTL is a future liability and, therefore, it does not exist on the balance-sheet. Appellants have also argued that DTL is a contingent liability because it may or may not arise in future. They have argued that DTL is not in accordance with the requirement of Section 209(3)(b) of the Companies Act as it does not amount to keeping books of account on accrual basis. In reply, Mr. Poddar, submitted that DTL is not a notional tax liability, but a real liability as it results in future cash outflow in the form of tax payment to the Income Tax Department. According to learned counsel, DTL arises in the current year in which the timing difference originates i.e. during the year the difference in the tax depreciation and accounting depreciation arises. Therefore, according to learned counsel, DTL exists on the balance-sheet date for the financial year in which it originates and, therefore, it is a real liability. According to learned counsel, the liability which arises in the current year (i.e. the year in

which timing difference arises) and is payable in a future year is not a future liability. According to learned counsel, DTL arises, therefore, in the current financial year in which timing difference arises but is payable in a future financial year. According to learned counsel, the aforesaid concept is the essence of the accrual basis of accounting which has been defined in AS 1. Learned counsel further submitted that for the above reasons DTL is not a contingent liability as it actually arises in the financial year in which the timing difference originates. According to learned counsel, a contingent liability becomes a liability on happening or not happening of an uncertain event in future. That DTL is not contingent. It does not arise in future on happening or not happening of future event. That, there is a difference in the liability arising in future or contingent on a future event taking place and a liability, which exists today, but payment in respect of which is to be made in future. That, any existing liability payable in future is not a future or contingent liability. According to learned counsel, DTL is an existing liability on the balance-sheet date. According to learned counsel, reversal of timing difference in respect of an asset is definite during the life of an asset. Therefore, there is no uncertainty with regard to the reversal of timing difference in future over the life of the asset. The accounts of a company are prepared under the fundamental accounting assumption of going concern which is defined in AS 1 under which the enterprise is normally looked upon as a going concern, i.e., continuing in operation for the foreseeable future. Under that assumption it is assumed that the enterprise has neither the intention nor the necessity of liquidation or to reduce the scale of its operations. Therefore, according to learned counsel, the examples, given on behalf of the appellants, of liquidation or fall in the scale of operations are not apposite illustrations for treating DTL as a notional liability. According to learned counsel, DTL is a liability for the current period i.e. for the period in which the timing difference originates, on the basis of matching principle also, which is a part of accrual basis of accounting. In the light of the said submissions, learned counsel contended that the charge in the P&L a/c for deferred tax expense is in respect of a known liability payable in future; and, therefore, it is covered by the definition of the word Provision as contained in Part II of Schedule VI to the Companies Act.

55. On the question of ultra vires learned counsel for the Institute had adopted the contentions advanced by learned Additional Solicitor General on behalf of Union of India. Finding:

56. For the following reasons we hold that the impugned Rule which adopts AS 22 neither suffers from the vice of excessive delegation nor is the said Rule incongruous/inconsistent with the provisions of the Companies Act, 1956.

Reasons:

(i) Preface:

57. India is an emerging economy. Globalization has helped India to achieve the GDP rate of around 8 to 9 per cent. However, with globalization, India is required to face challenges in various forms.

Corporate India has been acquiring companies in India and abroad. Indian companies are partners in joint ventures. They are part of international consortium. Therefore, Indian Accounting Standards (IAS) have to harmonize and integrate with International Accounting Standards by which harmonization of various accounting policies, practices and principles could take place.

58. In its origin, an accounting standard is the policy document. In matters of recognition of various items of income, expenditure, assets and liabilities, the aim is to achieve standards/norms which would help to reflect true and fair view of the accounts of a company. Every Indian and foreign investor/partner before entering into joint venture agreement(s) with its counterpart examines the financial statements and tries to ascertain the real income of the Indian company.

59. With globalization, we have conventional/orthodox system of accounting (recognition, measurement and disclosure) vis-a-vis modern system of advanced accountancy. Therefore, the role of accounting has undergone a revolutionary change with the passage of time. Traditionally, accounting was considered solely a historical description of financial activities. That view is no longer acceptable. Accounting is now considered as a service activity. Its function is to provide quantitative information, primarily of financial nature about the economic entities. Accounting today includes several branches, e.g., Financial Accounting, Management Accounting and Government Accounting. The primary role of accounting is to provide an effective measurement and reporting system. This is possible only when accounting is based on certain coherent set of logical principles that constitute the general frame of reference for evaluation and development of sound accounting practices. That is why, we have different accounting concepts and fundamental accounting assumptions, such as, separate entity concept, going concern concept, accrual concept, matching concept etc.. Therefore, Accounting Standards are based on a number of accounting principles. For example, the Matching Principle and Fair Valuation principle. Historically, matching principles ensured that costs incurred matched with revenues they generated, though they resulted in assets and liabilities in the balance-sheet at other than fair values. Similarly, they resulted in assets, which were not assets in the real sense, e.g., deferred revenue expenditure. However, the matching principles ensured purity of the profit and loss statement. Therefore, matching principles ensure ascertainment of true income. Today under Advanced Accountancy, matching principles recognizes not only costs against revenue but also against the relevant time period to determine the Periodic Income. Therefore, matching principle today forms an important component of Accrual Basis of Accounting.

60. On the other hand, Fair Valuation principles are important in the context of valuing derivatives and other investments. If one were to describe one single change in accounting practice over the last few years, it would be the use of Fair Valuation principles. Today, the object behind enactment of A.S., which are now made mandatory under section 211(3A) of the Companies Act, is to shift from historical method of accounting to fair valuation. In the case of mergers and acquisitions, which is common today in the world of globalization, fair valuation principles have important role to play. Mergers and acquisitions are sometimes undertaken to defer revenue expenditure over future years by invoking the matching concept, which results in putting fictitious assets on the balance-sheet. This is one reason why fair valuation principles are accepted.

61. A.S. are established rules relating to recognition, measurement and disclosures thereby ensuring that all enterprises that follow them are comparable and that their financial statements are true and fair. Measurements and disclosures based on fair value are becoming increasingly important. Fair valuation is generally used in valuation and disclosure of financial instruments, derivatives, conversions, auctions in a bond, business combinations, impairment of assets, retirement obligations, transactions involving exchange of assets without monetary consideration, transfer pricing, etc..

62. In conclusion, the importance of the Preface is to show a paradigm shift in the thinking of Accountants all over the world, particularly with the coming-in of the abovementioned new concepts.

(ii) Doctrine of Ultra Vires

63. At the outset, we may state that on account of globalization and socio-economic problems (including income disparities in our economy) the power of Delegation has become a constituent element of legislative power as a whole. However, as held in the case of *Indian Express Newspaper v. Union of India* reported in (1985) 1 SCC 641 at page 689, subordinate legislation does not carry the same degree of immunity which is enjoyed by a statute passed by a competent Legislature. Subordinate legislation may be questioned on any of the grounds on which plenary legislation is questioned. In addition, it may also be questioned on the ground that it does not conform to the statute under which it is made. It may further be questioned on the ground that it is inconsistent with the provisions of the Act or that it is contrary to some other statute applicable on the same subject matter. Therefore, it has to yield to plenary legislation. It can also be questioned on the ground that it is manifestly arbitrary and unjust. That, any inquiry into its vires must be confined to the grounds on which plenary legislation may be questioned, to the grounds that it is contrary to the statute under which it is made, to the grounds that it is contrary to other statutory provisions or on the ground that it is so patently arbitrary that it cannot be said to be in conformity with the statute. It can also be challenged on the ground that it violates Article 14 of the Constitution. Subordinate legislation cannot be questioned on the ground of violation of principles of natural justice on which administrative action may be questioned. A distinction must, however, be made between delegation of a legislative function in which case the question of reasonableness cannot be gone into and the investment by the statute to exercise a particular discretionary power. In the latter case, the question may be considered on all grounds on which administrative action may be questioned, such as, non-application of mind, taking irrelevant matters into consideration, failure to take relevant matters into consideration etc.. A subordinate legislation may be struck down as arbitrary or contrary to statute if it fails to take into account vital facts which expressly or by necessary implication are required to be taken into account by the statute or the Constitution. This can be done on the ground that the subordinate legislation does not conform to the statutory or constitutional requirements or that it offends Article 14 or Article 19 of the Constitution. However, it may be noted that, a notification issued under a section of the statute which requires it to be laid before Parliament does not make

any substantial difference as regards the jurisdiction of the Court to pronounce on its validity.

64. Apart from the grounds referred to by this Court in the above judgment in the case of Indian Express Newspaper, it is important to bear in mind that where the validity of subordinate legislation is challenged, the question to be asked is whether the power given to the rule making authority (in the present case the Central Government under section 642(1) of the Companies Act) is exercised for the purpose for which it is given. Before reaching the conclusion that the Rule is *intra vires* (we have to begin with the presumption that the Rule is *intra vires*), the court has to examine the nature, object and the scheme of the legislation as a whole and in that context, the court has to consider what is the Area over which powers are given by the section under which the Rule Making Authority is to act. However, the court has to start with the presumption that the impugned Rule is *intra vires*. This approach means that, the Rule has to be read down only to save it from being declared *ultra vires* if the court finds in a given case that the above presumption stands rebutted.

65. If the impugned rule is a delegated legislation it would follow that the said rule is made in exercise of the power conferred by the statute. Legislature has wide powers of delegation. This, however, is subject to one limitation, namely, it cannot delegate uncontrolled power. Delegation is valid only when it is confined to legislative policy and guidelines.

66. In the present case, abovementioned guideline is provided by section 211(1), which has brought in a stand- alone concept of true and fair accounting. The said concept is the controlling consideration. As stated above, delegation is valid when it is confined to Legislative Policy and Guidelines which are adequately laid down and the delegate is only empowered to implement such Policy within the Guidelines laid down by the Legislature (see *TISCO v. The Workmen & ors.* reported in AIR 1972 SC 1917)

67. In the present case, we are required to consider the scope of section 642(1), which refers to the power of Central Government (rule making authority) to make rules vis a vis section 641, which states that subject to the provision of the section, the Central Government may, by Notification in the Official Gazette, alter any of the regulations, rules, forms, tables and other provisions contained in any of the Schedules to the Companies Act (including Schedule VI). This aspect is of some importance. Section 642 is in addition to the powers conferred by section 641, therefore, the two sections form part of the same scheme. However, the scope of section 641 is different from the scope of section 642. Power to alter any provision of the Schedules and the power to carry out gap-filling exercise are both entrusted to the Central Government. The expression in addition to in section 642 indicates that both the above sections constitute one scheme. However, section 642 enables Central Government to provide details and, therefore, under section 642 the rules contemplated refers to gap-filling exercise.

68. It is well settled that, what is permitted by the concept of delegation is delegation of ancillary or

subordinate legislative functions or what is fictionally called as power to fill up the details. The judgments of this Court have laid down that the Legislature may, after laying down the legislative policy, confer discretion on administrative or executive agency like Central Government to work out details within the framework of the legislative policy laid down in the plenary enactment. Therefore, power to supplement the existing law is not abdication of essential legislative function. Therefore, power to make subordinate legislation is derived from the enabling Act and it is fundamental principle of law which is self-evident that the delegate on whom such power is conferred has to act within the limitations of the authority conferred by the Act. It is equally well settled that, Rules made on matters permitted by the Act in order to supplement the Act and not to supplant the Act, cannot be held to be in violation of the Act. A delegate cannot override the Act either by exceeding the authority or by making provisions inconsistent with the Act. (See *Britnell v. Secretary of State* 1991 (2) ALLER 726 at 730)

69. The issue before us in the present batch of civil appeals is whether the Central Government, which is the rule making authority, has overridden the Companies Act, 1956 either by exceeding its authority in adopting AS 22 or by making provisions inconsistent with sections 209 and 211 read with Part I and Part II of Schedule VI to the Companies Act as alleged by the appellants.

70. Since the said issue has two parts, for the sake of convenience, the first point which needs to be decided is as follows:

(a) Whether the impugned Rule adopting AS 22 is in excess of the powers conferred upon Central Government under section 642(1) of the Companies Act, 1956 ?

71. In the case of *Banarsi Das v. State of M.P.* reported in AIR 1958 SC 909 the State had issued a Notification under section 6(2) of the Central Provinces and Berar Sales Act, 1947 amending Item 33 in Schedule II by substituting for the words goods sold to or by the State Government by the words goods sold by the State Government. As a result of the said Notification, amending the schedule, the assessee who was entitled for exemption from payment of sales tax in respect of goods sold to the State Government could no longer claim such exemption by reason of the said Notification. That Notification was challenged on the ground that it was not open to the Government in exercise of the authority delegated to it under section 6(2) to modify or alter what the Legislature had enacted and, therefore, the said Notification was bad as being unconstitutional delegation of legislative authority. It was argued on behalf of the assessee that earlier they had been granted exemption under section 6(1) of the Act which subsisted when the impugned Notification came to be issued and that in consequences, while an exemption under section 6(1) existed any amendment to the Schedule under section 6(2) was bad as it had the effect of deletion of the exemption which had been granted. Section 6(1) of the Act contemplated exemption to be given by the State Government on certain types of transactions whereas section 6(2) empowered the State Government to amend the schedule. It is in this context that the question arose as to whether the impugned Notification was bad as being an unconstitutional delegation of legislative authority. The

said contention was rejected by this Court stating that the two sub-sections together constituted integral part of a single enactment. We quote hereinbelow para 11 of the said judgment, which reads as follows: 11. The contention of the appellant that the notification in question is ultra vires must, in our opinion, fail on another ground. The basic assumption on which the argument of the appellant proceeds is that the power to amend the schedule conferred on the Government under section 6(2) is wholly independent of the grant of exemption under section 6(1) of the Act, and that, in consequence, while an exemption under section 6(1) would stand, an amendment thereof by a notification under section 6(2) might be bad. But that, in our opinion, is not the correct interpretation of the section. The two sub-sections together form integral parts of a single enactment, the object of which is to grant exemption from taxation in respect of such goods and to such extent as may from time to time be determined by the State Government. Section 6(1), therefore, cannot have an operation independent of section 6(2), and an exemption granted thereunder is conditional and subject to any modification that might be issued under section 6(2). In this view, the impugned notification is intra vires and not open to challenge. (emphasis supplied)

Applying the tests laid down in the aforesaid judgment to the present case, it may be noted that, in this case, we are concerned only with the existence and the extent of the powers given to the Central Government to make rules, both for altering the Schedules to the Companies Act as well as to fill in details. Power to alter the Schedule as well as power to fill in details are two distinct powers. However, both the powers are entrusted to the same delegate, namely, the Central Government. Further, as stated above, sections 641 and 642 form part of the same scheme, hence, it cannot be said that merely because the impugned Notification has been issued under section 642 and not under section 641 the said Notification is exhaustive of the powers given to the Central Government to frame rules under the aforesaid two sections. Moreover, in the present case, section 642(1) begins with the expression in addition to the powers conferred by section 641, therefore, one has to read section 641 as an additional power given to the Central Government to make Rules, in addition to its power to alter the schedule by making appropriate Rules under section 641. There is one more way of looking at the arguments. The Companies Act has been enacted to consolidate and amend the law relating to companies and certain other associations. Under section 211(3A) Accounting Standards framed by National Advisory Committee on Accounting Standards constituted under section 210A are now made mandatory. Every company has to comply with the said standards. Similarly, under section 227(3)(d), every auditor has to certify whether the P&L a/c and balance-sheet comply with the accounting standards referred to in section 211(3)(c). Similarly, under section 211(1) the company accounts have to reflect true and fair view of the state of affairs. Therefore, the object behind insistence on compliance with the A.S. and true and fair accrual is the presentation of accounts in a manner which would reflect the true income/profit. One has, therefore, to look at the entire scheme of the Companies Act. In our view, the provisions of the Companies Act together with the Rules framed by the Central Government constitute a complete scheme. Without the Rules, the Companies Act cannot be implemented. The impugned Rules framed under section 642 are a legitimate aid to construction of the Companies Act as contemporanea expositio. Many of the provisions of the Companies Act, like computation of book profit, net profit etc. cannot be put into operation without the rules.

72. In the case of *P. Kasilingam and ors. v. P.S.G. College of Technology and ors.* 1995 Suppl(2) SCC 348 vide para 20 this Court ruled as follows:

20. The Rules have been made in exercise of the power conferred by Section 53 of the Act. Under Section 54(2) of the Act every rule made under the Act is required to be placed on the table of both Houses of the Legislature as soon as possible after it is made. It is accepted principle of statutory construction that rules made under a statute are a legitimate aid to construction of the statute as *contemporanea expositio* (See : Craies on Statute Law , 7th Edn., pp. 157-158; *Tata Engineering and Locomotive Co. Ltd. v. Gram Panchayat, Pimpri Waghere* (1976) 4 SCC 177.) Rule 2(b) and Rule 2(d) defining the expression College and Director can, therefore, be taken into consideration as *contemporanea expositio* for construing the expression private college in Section 2(8) of the Act. Moreover, the Act and the Rules form part of a composite scheme. Many of the provisions of the Act can be put into operation only after the relevant provision or form is prescribed in the Rules. In the absence of the Rules the Act cannot be enforced. If it is held that Rules do not apply to technical educational institutions the provisions of the Act cannot be enforced in respect of such institutions. There is, therefore, no escape from the conclusion that professional and technical educational institutions are excluded from the ambit of the Act and the High Court has rightly taken the said view. Since we agree with the view of the High Court that professional and technical educational institutions are not covered by the Act and the Rules, we do not consider it necessary to go into the question whether the provisions of the Act fall within the ambit of Entry 25 of List III and do not relate to Entry 66 of List I. (emphasis supplied)

73. To the same effect is the judgment of this Court in the case of *TELCO v. Gram Panchayat, Pimpri Waghere* reported in (1976) 4 SCC 177 in which the Court was required to consider the definition of the word house under the Rules framed in 1934. It was held that the rules provided internal legitimate aid for the interpretation of the words and phrases used in the main enactment.

74. In the present case also even under the Rules impugned herein AS 22, which is made mandatory, provides an internal legitimate aid to the meaning of the words in the Companies Act, including Schedule VI, namely, liability, provision for taxes on income, book profit, net profit, depreciation, amortization etc.. Therefore, it cannot be said that the impugned Rules framed under section 642(1) constitute an act on the part of the rule making authority, namely, the Central Government, in excess of its powers under section 642(1) of the Companies Act. In our view, the impugned Rule/Notification is valid. It has nexus with the matters entrusted to the Central Government to be covered by appropriate rules. Therefore, in our view, the impugned Rule is valid as it has nexus with statutory functions entrusted to Central Government which is the rule making authority under the Act. It is important to bear in mind that the power to regulate a business or profession implies the power to prescribe and enforce all such proper reasonable rules as may be deemed necessary to conduct business/profession in a proper and orderly manner and the power includes the power to prescribe conditions under which business/profession can be carried on. (See *Deepak Theatre, Dhuri v. State of Punjab and ors.* AIR 1992 SC 1519 at page 1521). The Scheme of the Companies Act indicates that Accounting Standards are made mandatory. They have to be followed by the auditors. They have to be followed by the companies. The Accounting Standards provide discipline. They provide harmonization of concepts. They provide harmonization of accounting principles. In the past, when Accounting Standards were not mandatory, various companies used to follow alternate system of accounting. This led to overstatement of profits. Therefore, the said Standards have now been made mandatory. In our view, it is the statutory function given to the Central Government to frame Accounting Standards in consultation with the National Advisory Committee on Accounting

Standards (NAC) under section 211(3C). It is not necessary for the Central Government to adopt in every case the Accounting Standards issued by the Institute. Nothing prevents the Central Government from enacting its own Accounting Standards which may not be in consonance with the Standards prescribed by the Institute. Similarly, nothing prevents the Central Government from adopting the Standards issued by that Institute as is the case in the present matter. Therefore, in our view, the impugned Rule is valid as it has nexus with the statutory functions entrusted to the Rule making authority, namely, the Central Government.

(b) Whether the impugned Rule is incongruous/contrary to sections 209 and 211 read with the provisions of Part I and Part II of Schedule VI to the Companies Act, 1956 and whether the said Rule seeks to modify the essential features of the Companies Act ?

(A) Concepts

75. To answer the above question, we need to examine the following concepts prevalent in Accounting.

Accrual System of Accounting

76. In the conventional sense, amounts which become receivables/recoverable are shown as income actually received and the liabilities incurred are shown as amounts actually disbursed in a given year. Therefore, under the aforesaid system of accounting, entries are posted in the books of accounts on the date of the transaction, i.e., on the date on which rights accrue or liabilities are incurred, irrespective of the date of payment. In such cases, a company has to account for its income or loss as per the above system and not otherwise, if that company has adopted mercantile system of accounting which is also known as accrual system of accounting. However, accrual does not mean confinement of items of revenue/expenditure to a given year. As stated above, mergers and acquisitions are undertaken to defer revenue expenditure over future years by invoking matching principles. Therefore, the said principle forms an important part of accrual accounting.

Taxes on Income (TOI)

77. It is an important item of P&L a/c. Taxes on income are considered as expenses incurred by a company in earning revenues. It is an expense which is recognized in the same period as revenue and expense to which they relate. This is called as matching principle. Such matching, results in what is called as Timing Differences. Tax effects of Timing Differences are included as tax expense in the statement of profit and loss and as deferred tax asset (DTA) or as deferred tax liability (DTL) in the balance-sheet. In short, deferred tax should be recognized for timing differences. This is the

basic mandate of AS 22. This mandate is based on an important principle of accounting, namely, that every transaction has a tax effect. However, DTA is subject to the principle of prudence and certainty that in future the company will have adequate income. This principle of prudence states that DTAs are recognized and carried forward only to the extent of their being a reasonable certainty of their realization, i.e., in future there would be taxable income. Therefore, under the rule of prudence, DTAs are to be recognized only to the extent of their being timing differences, the reversal whereof will result in sufficient taxable income in future against which they can be realized. On the other hand, DTL is to be recognized as liability under the said standard as it results in future cash outflow in the form of payments to the Income tax Department in the case of TOIs.

Current Tax

78. Current tax has to be measured by using the applicable tax rates. This is because current tax has to be measured at the amount expected to be paid to the Income tax Department by way of tax. Not only the tax rates, but also tax laws constitute the basis for measuring the amount of tax expected to be paid to the Income tax Department. It is important to note that while measuring current tax, companies have to go by the balance-sheet date. The company has to examine the tax rates and the tax laws on that date.

Timing Differences

79. They are differences which arises because the period in which some items of revenue and expenses are included in the taxable income do not tally with the period in which items are considered to compute the Accounting Income. In other words, it recognizes expenses against the relevant time period to determine the periodic income. This concept has been brought in after the amendment to section 211(1) of the Companies Act which emphasizes that after 2001 the companies shall prepare their accounts so as to reflect true and fair view of the State of Affairs and to obliterate the difference between Accounting and Taxable Income. This concept bridges the gap between accounting income and taxable income. Deferred tax is the tax effect of such differences which are now required to be accounted for. As stated above, Accounting Standards today constitute a paradigm shift from the conventional system of accounting based on Historical Costs Method towards Fair Valuation Principles. Similarly, in the past, companies used to follow alternate system of accounting. The Accounting Standards today are trying to harmonize different accounting concepts and principles and, therefore, timing differences play an important role in harmonizing the matching principle under accrual system of accounting with the Fair Valuation Principles. The object is to achieve proper presentation of balance-sheet and P&L a/c. The object is to present before the investors, shareholders and other stake-holders the book profits (real income) of the company. The tax effect of timing difference under AS 22 has to be included in the tax expenses in the P&L a/c as DTA or DTL in the balance- sheet. Therefore, timing difference is the tax effect which forms part of tax expense in the P&L a/c. The primary object of AS 22 adopted by the impugned Rule is to prescribe an accounting treatment for TOI. In accordance with the matching

concept, TOIs are recognized in the same period as revenue and expenses to which they relate. Matching of TOI against revenue for a period poses problems due to the effect that in a number of cases, taxable income is different from accounting income. This difference arises for two reasons. Firstly, there are differences between items of revenue and expenses in the P&L a/c and items considered as revenue expenses or taken for tax purposes. Secondly, there are differences between the amount in respect of a particular item of revenue or expenses as recognized in the P&L a/c and the corresponding amount which is recognized for computing taxable income.

Tax Expense

80. As stated above, current tax is the amount of income tax determined to be payable in respect of taxable income for a period. On the other hand, deferred tax is the tax effect of Timing Differences. As stated above, Timing Differences are differences between taxable income and accounting income for a given period. Timing Difference originates in one period, but it is capable of reversal in one or more subsequent period(s). As stated above, every transaction has a tax effect, therefore, tax expense is the sum total of current tax + deferred tax charged or credited to the statement of profit and loss for the given period. Therefore, tax expense for that period has to be included in the Net Profit. Therefore, we see no inconsistency between liability as understood in the conventional sense and DTL as submitted on behalf of the appellants.

Assets

81. Assets represent expenditure. When an expenditure is written off for accounting purposes in the year in which it is incurred but is admissible as deduction for tax purposes over a period of time then in such cases, the asset representing expenditure would have a balance only for tax purposes but not for accounting purposes. The difference between the balance of the assets for tax purposes and the balance for accounting purposes would be a timing difference which will reverse in future when the expenditure would be allowed for tax purposes. In such a case, DTA would be recognized in respect of the timing difference, subject to the principle of prudence. This concept is important while deciding the question as to whether para 33 of AS 22 (transitional provision) is or is not inconsistent with the provisions of Schedule VI to the Companies Act.

Matching Principle

82. Matching Concept is based on the accounting period concept. The paramount object of running a business is to earn profit. In order to ascertain the profit made by the business during a period, it is necessary that revenues of the period should be matched with the costs (expenses) of that period. In other words, income made by the business during a period can be measured only with the revenue

earned during a period is compared with the expenditure incurred for earning that revenue. However, in cases of mergers and acquisitions, companies sometimes undertake to defer revenue expenditure over future years which brings in the concept of Deferred Tax Accounting. Therefore, today it cannot be said that the concept of accrual is limited to one year.

83. It is a principle of recognizing costs (expenses) against revenues or against the relevant time period in order to determine the periodic income. This principle is an important component of accrual basis of accounting. As stated above, the object of AS 22 is to reconcile the matching principle with the Fair Valuation Principles. It may be noted that recognition, measurement and disclosure of various items of income, expenses, assets and liabilities is done only by Accounting Standards and not by provisions of the Companies Act.

Depreciation

84. As stated above, timing difference is the difference between taxable income and accounting income for a period. Depreciation is one of the important items in computation of income, be it taxable income or accounting income. According to Pickles Accountancy, fourth edn., at page 0518, depreciation is the inherent decline in the value of an asset from any cause whatsoever. The wearing out of a machine is a simple example of depreciation. In double-entry system of accounting, there has to be complete double-entry for depreciation adjustment. The required entry under that system of Depreciation Adjustment is debit Trading and Profit & Loss account and credit the asset in respect of which depreciation is being recorded. Such an entry conforms with the principles enunciated, namely, that, the debit to Trading and Profit & Loss account is necessary because the amount written-off represents an expense and the credit to the asset is required, as the asset has, pro tanto, reduced in value. Therefore, from the above point of view in the principles of accountancy, even distribution in certain cases is treated as expenditure paid out over the years. The object of providing for such distribution is to spread the expenditure incurred in acquiring the assets over its effective lifetime. The amount of provision to be made in respect of the accounting period is intended to represent the portion of such expenditure which has expired during the period. Therefore, in that sense, it is money expended which is spread out over the effective life of an asset. Even under the Income tax Act, Parliament has used the expression allowances and depreciation in several sections in Chapter IV within which section 44A appears. In this connection, reference may be made to section 37 which enjoins that, any expenditure not falling in sections 30 to 36 expended wholly and exclusively or laid out for business purposes should be allowed in computing the business income. Therefore, depreciation and allowances have been dealt with in section 32 and the expression any expenditure in section 37 covers both, allowances and depreciation. [See Commissioner of Income-tax v. Indian Jute Mills Association (1982) 134 ITR 68 (Cal)]. Depreciation under Income tax Act is an incentive/allowance. However, in commercial accountancy, it is reduction/deduction from the value of an asset on the balance-sheet.

Reserves & Provisions

85. In *State Bank of Patiala v. CIT* reported in (1996) 219 ITR 706 substantial amounts were set apart by the assessee- bank as reserves. No amount of bad debt was actually written off or adjusted against the amounts claimed as reserves. No claim for any deduction by way of bad debts was made during the relevant assessment years. The assessee never appropriated any amount against any bad and doubtful debts. The amount remained in the account of the assessee by way of capital and the assessee treated the said amount as reserves and not as provisions designed to meet any liability, contingency, commitment or diminution in the value of assets known to exist on the date of the balance-sheet.

86. The question which arose for consideration by this Court was whether amounts set apart in the balance-sheet are provisions or reserves. The matter arose under the provisions of Companies (Profits) Surtax Act, 1964 which levied a charge on every company for every assessment year called as surtax, insofar as the chargeable profits of the previous year exceeded the statutory deduction at the rates mentioned in the Third Schedule. Rule (1) of Schedule II stipulated mandatory that the capital of the company shall be the total of the amounts including reserves. The assessee contended that the amounts set apart in the balance-sheet are reserves. The Department contended that the said amounts were provisions. The assessee succeeded. However, the reasoning given in the judgment is important. It was held by this Court, after referring to the relevant provisions of the Companies Act regarding the form of balance-sheet wherein the words reserves and surplus and current liabilities and provisions are dealt with, that if any retention or appropriation falls within the definition of provision it can never be a reserve but it does not follow that if the retention or appropriation is not a provision it is automatically a reserve. That question has to be decided having regard to the true nature and character of the sum so retained depending on several factors including the intention with which and the purpose for which such retention has been made because the substance of the matter is to be recorded. In the said judgment, it has been further held that if any retention is made to meet depreciation, renewal or diminution in value of asset, the same is not a reserve.

87. In that case, one of the other questions which arose for determination was whether a fund created or a sum of money set apart by assessee-bank to meet any liability which the assessee-bank can reasonably anticipate on the balance-sheet date is equivalent to the case where the liability has actually arisen. The High Court took the view that since the assessee is the banking company, it would be reasonable and legitimate to assume that the bank was in a position to anticipate any liability by way of bad debt on the balance-sheet date. This Court held that the aforesaid assumption made by the High Court was unjustified. According to this Court, the question to be asked in such cases is whether the liability was known or anticipated on the date when the balance-sheet was prepared and not whether the assessee can anticipate on the balance-sheet date the debt and doubtful debts.

88. Applying this test to the facts of the present case, the tax effect of the timing difference was known on the date when the balance-sheet was prepared and, therefore, AS 22 is right in stipulating that the tax effect of such timing differences should be included in the tax expense in the statement

of profit and loss as DTA/DTL in the balance-sheet.

89. Depreciation in accounting sense is similar to bad and doubtful debts. Provision for bad and doubtful debt like depreciation is not a provision for liability but it is a provision for diminution in value of assets. Where such provision is made and if that provision is not excessive or unreasonable, it is not a reserve, however, any amount in excess of the requirement can be considered to be a reserve. Thus, provision can be made for depreciation, renewal, diminution in the value of an asset or for any known liability. In this case, we are concerned with depreciation mainly because in 99 per cent of the cases the difference between tax depreciation and accounting depreciation results in timing differences.

90. The provision for bad and doubtful debt is always made with reference to debt receivable where there is doubt about full realization of debt. The provision is made in order to cover up the probable diminution in the value of an asset, i.e., debt which is amount receivable. For example, if the receivable is Rs. 1 crore and the assessee is of the opinion that Rs. One crore might not be realized and that only 90 per cent of the debt would be realized and, therefore, he makes a provision for Rs. 10 lacs for bad debts. By making the provision, the assessee is valuing his asset, namely, debt, which is the amount receivable, at Rs. 90 lacs as against the book figure of Rs. 1 crore. Thus, the provision for bad and doubtful debt is the provision for diminution in the value of asset, i.e., debt. Such provision is not a provision for liability, because even if a debt is not recovered, no liability would be fastened upon the assessee. The debt is the amount receivable by the assessee. It is not any liability payable by the assessee. Therefore, any provision towards irrecoverability of debt cannot be said to be provision for liability. It is the provision for diminution in the value of assets. The expression reserve has been defined in a negative manner by clause 7(1)(b) of Part III of Schedule VI to the Companies Act and it only says that the reserve shall not include any amount written off or retained by way of provision for depreciation, renewal, diminution in value of asset or by way of provision for any known liability. Thus, if the provision made by the assessee for depreciation, (diminution in value of the asset) is in excess of the amount which is reasonably necessary for the purpose for which the provision is made, the excess shall be treated as a reserve and not a provision. This aspect is important because the question as to whether the provision made is in excess of the requirement would depend on the facts of each case. This aspect is important also because it has been vehemently argued on behalf of the assessee that AS 22 requires the assessee to make provision for DTL which, in fact, should have been treated as a reserve and not as a provision. Reserve is not a charge to be deducted before arriving at the profit for the period under review. It is appropriation of profit. The reserve account is credited as a result of a debit to the appropriation account and not to the P&L a/c or revenue account. In a broad sense, all allocations to reserve represent additions to capital. In the case of a provision, unlike reserves, the charge is created as a result of debit to the P&L a/c and not a debit to the appropriation account.

Tax Base

91. The tax base of an asset or liability is the amount attributed to that asset or liability for tax purpose. As stated above, deferred tax has to be recognized for all timing differences. This is based on the principle that financial statements for a given period should recognize the tax effect, whether current or deferred, of all transactions occurring in a given period. One more principle needs to be noted that assets represent expenditure. Concept of DTL/DTA

92. DTL/DTA is recognized for all timing differences. AS 22 requires the companies to make a provision for Deferred Tax Accounting with reference to the difference between accounting income and taxable income. In our view, matching principle is an important component of Accrual Accounting. The said principle is not in conflict with accrual accounting as vehemently submitted on behalf of the appellants. Accrual Accounting is the concept recognized by sections 205, 209, 211 and Schedule VI to the Companies Act. However, the said provisions of the Companies Act nowhere lays down as to which asset should be recognized as an investment and the method of valuing investments. That exercise is left to the accounting standards. Similarly, the Companies Act nowhere lays down as to how and when income or expenditure should be measured/recognized. That exercise is left to the accounting standards. AS 22 proceeds on the basis that a benefit obtained in one year could be reversed in the subsequent year and, therefore, it has to be recognized as a liability. One more concept needs to be mentioned. Deferred tax is the same as timing difference. It arises on account of the difference between taxable and accounting incomes. This difference arises between items of revenue and expenses as comparing in P & L a/c vis-à-vis items considered as revenue, expenses or deduction for tax purposes. Secondly, difference also arises between the amount in respect of an item of revenue or expenses as recognized in the P & L a/c and the corresponding amount required in the computation of taxable income. It is the tax effect of time difference which is required to be included in Tax Expense in the P & L a/c and as DTA/DTL in the balance-sheet. Timing difference originates in the year in which difference arises between the tax depreciation and accounting depreciation. Therefore, it is a known liability for the current year, though payable in future period(s). Therefore, tax effect of timing difference is a real liability for which a provision is required to be made in the P & L a/c as well as DTL in the balance-sheet. As stated above, deferred tax is the tax effect of timing difference. It has been vehemently submitted that a provision for Matching Tax is required to be made in respect of accounting income only for accounting period. The emphasis is on the words only for accounting period. In our view, even under accrual system of accounting, the accounting period need not be confined to one year alone. As stated hereinabove, mergers and acquisitions today are sometimes undertaken by companies to defer revenue expenditure over future period(s) by invoking the matching concept. Historically, it may also be stated that prior to the introduction of AS 22, the companies used to follow what is called as Tax Payable Method. They were put to notice by the Institute that in future the companies shall have to follow what is called as Tax Effect Accounting method. AS 22 introduces tax effect accounting method.

93. Before us, it has been vehemently urged on behalf of the appellants that, unlike U.K., in India, rates of depreciation are statutorily prescribed under the Companies Act and under the Income-tax Act, 1961. According to the appellants, rates of depreciation are not prescribed statutorily in U.K.. Therefore, in U.K. the tax payer is at liberty to adopt any rate of depreciation and, therefore, there could be justification for invoking the matching principle and for applying AS 22 for deferred taxation. We find no merit in this argument. In our view, on the contrary, since in India we have two

separate rates of depreciation statutorily prescribed under two different Acts, introduction of matching principle becomes relevant. Ultimately, AS 22 is for deferred taxation. It brings out for the information of shareholders, investors and stake-holders the hidden liability which earlier could not be brought out. Today, we are living in the world of globalization in which, apart from merger, acquisitions play an important role. The buyer wants to know the income and liabilities of a company. He wants to know the real income of the company, which he proposes to buy. Because of the difference in the rates of depreciation statutorily prescribed under the Income-tax Act and the Companies Act, the concept of deferred taxation has been introduced in order to obliterate the difference between accounting depreciation and tax depreciation.

(B) Application of above Concepts:

94. As stated above, the power to alter the Schedule is distinct and separate from the power to fill in the details, though both together form part of the same scheme. In the present case, under section 641, the Central Government is empowered vide the Notification to alter any of the Regulations, Rules, Forms and other provisions contained in any of the Schedules except Schedules XI and XII. Under section 641(2), any alteration notified under sub-section (1) has the effect as if the notified alteration stood enacted in the parent Act and shall come into force on the date of the Notification, unless the Notification directs otherwise. In the present case, we are concerned with the provision of section 641(2) which is not there in section 642. However, as stated above, section 642 begins with the expression in addition to the powers conferred by section 641. The point which we would like to stress is that though the Central Government is vested with both the powers, namely, to amend the Schedule and to fill in details, the nature of the rules framed under section 641(2) continues to have the status of the rules despite the phraseology used in section 641(2) which, as stated above, says that any alteration notified under sub-section (1) of section 641 shall have effect as if enacted in the Companies Act. To this extent, we are in agreement with the submission made on behalf of the appellants. Our view is supported by the judgment of this Court in the case of Chief Inspector of Mines v. Karam Chand Thapar AIR 1961 SC 838. We quote hereinbelow para 20 of the said judgment, which reads as follows:

20. The true position appears to be that the Rules and Regulations do not lose their character as rules and regulations, even though they are to be of the same effect as if contained in the Act. They continue to be rules subordinate to the Act, and though for certain purposes, including the purpose of construction, they are to be treated as if contained in the Act, their true nature as subordinate rule is not lost. Therefore, with regard to the effect of a repeal of the Act, they continue to be subject to the operation of Section 24 of the General Clauses Act.

Therefore, in our view, Rules framed under section 641 followed by Rules framed under section 642(1) shall continue to be Rules subordinate to the Companies Act though for the purposes of construction, they are to be treated as forming part of the same scheme.

95. In the present case, the most important question, which we have to decide is whether the

impugned Rule adopted AS 22 is contrary to or inconsistent with the provisions of the Companies Act and in that connection our judgment proceeds on the basis that the impugned Rule is an example of subordinate legislation.

96. As stated above, tax expense or tax income represents total amount included in the determination of net profit or loss for the period in respect of current tax and deferred tax.

97. DTL is a tax payable in future period(s) which arises out of taxable temporary differences.

98. DTA is the tax recoverable in future period(s) which arises out of deductible temporary difference, carry forward of unused tax losses and carry forward of unused tax credits.

99. Temporary difference is the difference between the carrying amount of an asset or liability in the balance-sheet and its tax base, which is an amount attributable for tax purpose.

100. Taxable temporary difference will result in future period(s) when carrying amount of the asset or liability is recovered. It will arise when the tax base of an asset/liability is lower than the balance-sheet amount. Tax base of an asset gets reduced by over-charge of depreciation as per the tax law. The tax base of a liability gets reduced by over-charge of a liability which is to be written back as income in the future period(s). This analyses can be explained by the following examples:

Example-1

101. A Plant costs Rs. 100 lacs. Accelerated depreciation is charged on the Plant to the extent of Rs. 70 lacs as per the Income tax Rules. Therefore, the tax base of the Plant is (100 - 70) Rs. 30 lacs. On the other hand, Accounting Depreciation charged as per the Accounting Standard is Rs. 25 lacs. In such a case, the balance-sheet value or what is called as depreciated book value of the Plant would be (100 - 25) Rs. 75 lacs.

102. Therefore, a timing difference has arisen, in the above example, between the depreciated book value (balance-sheet value of the Plant) and its tax base.

103. The principle which emerges from the above example is that when tax base is lower than the

balance-sheet value of the asset (depreciated book value of the Plant) a deferred tax liability emerges.

104. Similarly, the following example will show as to when DTA emerges.

Example-2

105. Preliminary expenses of Rs. 10 lacs are allowed to be written off over a period of 10 years on a straight-line basis, which are charged to the income statement over a period of 5 years. Therefore, after 3 years from the date the expenses are incurred, book value (the balance-sheet value) of such preliminary expenses would be Rs. 4 lacs (106) and the tax base will be Rs. 7 lacs (10-3).

106. In the above example, the tax base of the Plant (asset) at Rs. 7 lacs is higher than the balance-sheet value of preliminary expenses at Rs. 4 lacs. There will, therefore, arise deductible timing difference which gives rise to deferred tax asset (DTA). However, a DTA, as stated above, should be recognized for all deductible temporary difference to the extent it is probable that taxable profit will be available against which the deductible timing difference can be utilized. A DTA should also be recognized for carrying forward the unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilized. It is, therefore, necessary to review DTA at each balance-sheet date.

107. We would also like to give few more examples of DTA and DTL as follows:

Example-3

108. Cost of a Plant is Rs. 100 lacs, its carrying amount is Rs. 80 lacs whereas its tax base is Rs. 20 lacs. Therefore, the Taxable Timing Difference is (Rs. 80 - 20) Rs. 60 lacs. In case the tax rate is 25 per cent then the DTL shall be computed as follows:

$$\text{DTL} = (\text{Taxable Timing Difference}) \text{ Rs. } 60 \text{ lacs} \times (\text{Tax Rate}) 25\% \text{ DTL} = 60 \times 25/100 = \text{Rs. } 15 \text{ lacs}$$

109. Similarly, if a company recognizes its liability for Provident Fund in its accounts at Rs. 30 lacs which is not allowed by the Income tax Department unless actually paid and if the tax rate is 30 per cent then the DTA will be Rs. 30 lacs \times 30/100 = Rs. 9 lacs as in such a case the tax base is Nil whereas the carrying amount is Rs. 30 lacs.

Example-4 (Matching Concept)

110. A leasing company deducts an amount of lease equalization charges from lease rental income. For that purpose, the company makes a provision for the said charges in accordance with the guidelines issued by the Institute on Accounting of income, depreciation and other aspects for leasing company. This charge is created to equalize the imbalance between lease rentals and depreciation charges over the period of lease. It is based on the rationale of matching costs with revenues so that the periodic net income from a finance lease is true and fair. Such matching is achieved by showing the lease rentals received under finance lease separately under Gross Income in the P&L a/c of the relevant period and against such lease rental income, a matching lease annual charge is made to the P&L a/c. This annual lease charge represents recovery of the net investment/fair value of the leased asset over the lease period and is calculated by deducting the finance income for the period from the lease rent for that period. Accordingly, where the annual lease charge is more than the statutory depreciation under the Income tax Act, lease equalization charge account would be debited to that extent; whereas when annual lease charge is less than statutory depreciation under the Income tax Act, a lease equalization would emerge. Therefore, lease equalization charge is created as a result of debit to the P&L a/c. It is a charge which has to be deducted to arrive at the true and correct profit of the leasing business and is neither an appropriation of profit nor a reserve. This example indicates applicability of matching concept.

(C) Whether AS 22 is contrary to or inconsistent with the provisions of the Companies Act.

111. In the case of C.I.T. v. Duncan Brothers & Co. Ltd. reported in (1996) 8 SCC 31 the assessee company submitted that provision for taxation made by it for assessment years 1963-64 and 1964-65 should be treated as a fund and, therefore, it should be deducted from the cost of asset required to be excluded under Rule 1(ii) of Schedule II to the Super Tax Act, 1963 and Rule 2(ii) of Schedule II to the Companies (Profits) Super Tax Act, 1964 respectively. This contention was rejected. This Court held that since Schedule II to both the Acts pertained to computation of capital, the terms used in Schedule II should be interpreted in the context of the balance-sheet of a company and its P&L a/c which will have to be looked at to ascertain the company's capital and its profits. It was held that a provision for taxation of the kind in question was not a fund etymologically in accounting parlance. It was observed that words of accounting language should be interpreted as understood in accounting practice.

112. Applying the above test to the present case, we are now required to interpret the words the amount of charge for Indian Income tax on profits in clause 3(vi) in Part II of Schedule VI to the Companies Act. Similarly, we are required to interpret the words current liabilities and provisions in the form of balance-sheet in Part I of Schedule VI to the Companies Act. Part III of the said Schedule defines the words provision as well as reserve.

113. As stated above, the form of balance-sheet is prescribed by Part I of Schedule VI. The Act does not prescribe a proforma of P&L a/c. However, Part II of Schedule VI prescribes the particulars

which must be furnished in a P&L a/c. As far as possible, the P&L a/c must be drawn up according to the requirements of Part II of Schedule VI. As stated above, section 211(1) emphasizes true and fair view in place of true and correct view of accounting. As stated above, the legislative policy is to obliterate the difference between the accounting income and the taxable income. As stated above, the accounting income/book profit is the real income. Therefore, section 211(1) emphasizes the concept of true and fair view. As stated above, it is a stand-alone consideration. It is the controlling element underlying the scheme of sections 209, 211 and 227. However, as stated above, the Companies Act does not deal with Recognition, Measurement and Disclosure. As stated above, how much amount should be recognized in respect of a specific matter is not covered by section 209(3)(b). Recognition, measurement and disclosure are the three items which can only be done by way of Accounting Standards and not by the provisions of the Companies Act. This aspect is important because under section 642(1) the Central Government is empowered to carry out ancillary/subordinate legislative functions which is also fictionally called as power to fill-up the details. Under section 211(1) Parliament has laid down the controlling consideration in presentation of balance-sheet and P&L a/c by companies and it has thereafter conferred discretion on Central Government to work out details within the framework of that Policy. Presentation of balance-sheet and P&L a/c is different from recognition, measurement and disclosure of various items of revenue, expenses, assets, liabilities etc.. That part has been left to the Central Government which is empowered to enact Accounting Standards in consultation with National Advisory Committee on Accounting Standards (NAC), which committee is to be established and which has been established under section 210A(1). As stated above, the Central Government is the rule making authority. As stated above, it is not bound to go by the recommendations of the Institute in the matter of framing of accounting standards. Generally, it follows such recommendations. However, in law nothing prevents the Central Government from enacting accounting standards in consultation with NAC which are in variance from the Standards prescribed by the Institute. In the present case, we are concerned with the accounting standards prescribed by Central Government in consultation with NAC under section 642(1) of the Companies Act.

114. In the present case, the main objection of the appellants is against paragraphs 9 and 33 of AS 22. Para 9 reads as under:

Tax expense for the period, comprising current tax and deferred tax, should be included in the determination of the net profit or loss for the period.

115. Para 33 of AS 22 reads as under: On the first occasion that the taxes on income are accounted for in accordance with this Statement, the enterprise should recognise, in the financial statements, the deferred tax balance that has accumulated prior to the adoption of this Statement as deferred tax asset/liability with a corresponding credit/charge to the revenue reserves, subject to the consideration of prudence in case of deferred tax assets (see paragraphs 15-18). The amount so credited/charged to the revenue reserves should be the same as that which would have resulted if this Statement had been in effect from the beginning.

116. As regards para 9, the appellants had no objection to the disclosure of DTL/DTA in their financial statements. They object to a charge being created qua P&L a/c for DTL mainly because it results in reduction of reserves and net profits. Therefore, the main contention is that the DTL is a notional concept. According to the appellants, DTL is not a liability. Therefore, according to the appellants, there cannot be a charge for DTL to the P&L a/c of the company. According to the appellants, DTL distorts their financial statements. According to the appellants, Schedule VI forms part of the Companies Act. According to the appellants Part II of Schedule VI contains clause 3(vi). According to the appellants, the said clause 3(vi) refers to the amount of charge for income tax on the profits. According to the appellants when AS 22 states that tax expense for the period shall consist of current tax and deferred tax and that such tax expense should be included in the determination of net profit or loss, it amounts to alteration of clause 3(vi) of Schedule VI to the Companies Act which is the part thereof. According to the appellants, Rules framed by the Central Government as a delegate under section 642 cannot alter the provisions of the Companies Act including Schedule VI. We have dealt with this aspect in the earlier paragraphs. However, the appellants have further contended that para 9 of AS 22 is inconsistent with the provisions of the Companies Act including Schedule VI and, therefore, void. It is also contended on behalf of the appellants that section 211 deals with P&L a/c and balance-sheet. That, para 9 only refers to filling in the details qua items in P&L a/c and balance-sheet. According to the appellants, P&L a/c and balance-sheet do not constitute primary books of accounts. According to the appellants, deferred taxation do not form part of accrual system of accounting. According to the appellants para 9 of AS 22 requires the company to make provision for liability for taxation in the balance-sheet and P&L a/c, further, according to the appellants P&L a/c and balance-sheet do not constitute books of accounts and, therefore, according to the appellants, such a standard brings about inconsistency between maintenance of books of accounts which are primary documents on one hand and balance-sheet an P&L a/c on the other hand. According to the appellants, para 9 of AS 22 does not touch the subject maintenance of books of accounts. That, it only touches the presentation of balance-sheet and P&L a/c. According to the appellants, books of accounts constitute primary documents and if para 9 does not apply to the maintenance of books of accounts, para 9 cannot be made applicable only to balance-sheet and P&L a/c because if it is so permitted it would bring about inconsistency between maintenance of books of accounts under section 209 vis-à-vis presentation of financial statements under section 211. In short, according to the appellants para 9 and para 33 of AS 22 are inconsistent with the provisions of the Companies Act including Schedule VI.

117. We do not find any merit in the arguments of the appellants on the point of inconsistency.

118. As stated above, recognition and measurements bring in the concept of fair value. When a financial instrument is measured at fair value it brings transparency in financial reporting. Today, companies undertake multifarious activities which warrants segment reporting. For example in RIL we have three segments, namely, refining, industry and infrastructure. Similarly, in the case of Sterlite Industries (India) Ltd., it has different segments. Each segment earns its own revenue. For example, revenue from copper, revenue from aluminium and revenue from others. Under clause 3(vi) of Part II non-provision for taxation would amount to contravention of the provisions of sections 209 and 211 of the Companies Act. Accordingly, it is necessary for the auditor to say in what manner the accounts do not disclose a true and fair view of the state of affairs of the company and the P&L a/c of the company. AS 22 is mandatory. Therefore, it is the duty of the members of

the Institute to examine whether the accounting standard is complied with the said standard in the presentation of financial statement. [see also section 227(3)(d)]

119. In our view, para 9 only provides for details which are necessary for giving effect to the concept of true and fair accrual of accounts contemplated by section 211(1). As stated above, the concept of true and correct accrual is different from the concept of true and fair accrual. Both the concepts fall under accrual system of accounting. However, there is a difference. Under true and correct accrual, the matching principle was always recognized. However, fair valuation principle is the concept which brings out the real income of the company. Para 9 has been enacted, as stated above, to obliterate the difference between the accounting income and taxable income. Para 9 aims to present the real income to the investors, shareholders and stake-holders in the company. As stated above, there is also a difference between accounting depreciation and tax depreciation. In order to harmonize these differences, para 9 has been enacted. As stated above, true and fair view is the basic requirement in the matter of presentation of balance-sheet and P&L a/c. Therefore, in order to bring out the true income of a company, one has to read the provisions of the Companies Act with the accounting standards adopted by the impugned Notification. As held in the judgment of P. Kasilingam (supra) there are statute under which the rules provide an internal aid to the construction of the words used in the parent Act. The Companies Act uses the words like, provision, reserve, liability etc. in the accounting sense and as held in the case of Duncan Brothers (supra) the words of accounting language should be interpreted as understood in accounting practice. Therefore, in our view, para 9 of AS 22 merely provides for details in the matter of provision for liability for taxation.

120. The word tax expense in para 9 under conservative system of accounting was confined to current tax. However, with para 9 of AS 22 coming into force, the word tax expense now includes both, current tax and deferred tax. This inclusion became necessary because of developments not only in concepts but also in accounting practices. This inclusion becomes necessary if one has to go by paradigm shift from historical costs accounting to fair value principles. In our view, with the insertion of the words true and fair view in section 211, which is the requirement in the matter of presentation of balance-sheet and P&L a/c the rule making authority was entitled to include the concept of deferred tax in tax expense. It may be stated that under clause 3(vi) of Part II, Schedule VI the charge for tax on profit is contemplated. Provision for liability for taxation is contemplated by the said clause. Para 9 of AS 22 merely provides for a liability which arises on account of timing difference as explained hereinabove. As stated above, it is known on the balance-sheet date. One has to therefore consider matching principle and fair valuation principles as important concepts in Accrual Accounting. Further, as stated above, recognition and measurement is not covered by the provisions of the Companies Act, therefore, one has to read the presentation of balance-sheet and P&L a/c together with recognition and measurements. Therefore, one has to read the provisions of the Companies Act along with the impugned Rule which adopts AS 22 as recommended by the Institute. The matching principle recognizes cost against revenue or against the relevant time period to determine the periodic income. Therefore, the said principle constitutes an important component of the accrual basis of accounting. The concept of accrual, in case of mergers and acquisition, is not limited to one year. DTL/DTA arises out of timing differences. Therefore, such differences have got to be reflected in Deferred Tax Accounting. DTL in most cases arises on account of the difference between tax depreciation and accounting depreciation. When on account of over-charging of depreciation under the Income-tax Rules, the taxable income falls below the accounting income,

DTL emerges. This is because the rates of tax depreciation are incentive rates whereas accounting depreciation is based on the useful life of the asset. Thus, an asset under Income tax Act would be charged over a much shorter period as compared to the useful life of the asset. If the useful life of the asset is 10 years, for tax purposes it should be written off fully in 4 years. Thus, in the first year in which tax depreciation is higher than the accounting depreciation, the taxable income would be less than the accounting income, which would give rise to DTL on account of the difference between the amount of depreciation, i.e., the timing difference, which arises as it relates to the depreciation amounts for that particular year. It would become payable in future years when the timing difference reverses, i.e., when the taxable income becomes higher than the accounting income. Therefore, it is called as DTL. It is so called because it results in future cash outflow on account of the timing difference.

121. Hereinbelow, we are required to give two illustrations to indicate as to how the DTL emerges out of timing differences and, secondly, the application of Fair Valuation principles in advanced accounting.

Illustration 1

122. A company, ABC Ltd., prepares its accounts annually on 31st March. On 1st April, 20x1, it purchases a machine at a cost of Rs.1,50,000. The machine has a useful life of three years and an expected scrap value of zero.

Although it is eligible for a 100% first year depreciation allowance for tax purposes, the straight-line method is considered appropriate for accounting purposes. ABC Ltd. has profits before depreciation and taxes of Rs.2,00,000 each year and the corporate tax rate is 40 per cent each year.

The purchase of machine at a cost of Rs.1,50,000 in 20x1 gives rise to a tax saving of Rs.60,000. If the cost of the machine is spread over three years of its life for accounting

purposes, the amount of the tax saving should also be spread over the same period as shown below:

Statement of Profit and Loss

(for the three years ending 31st March, 20x1, 20x2, 20x3)

(Rupees in thousands)

20x1 20x2 20x3

Profit before depreciation

and taxes 200 200 200

Less: Depreciation for accounting

Purposes 50 50 50

Profit before taxes 150 150 150

Less: Tax expense

Current tax

0.40 (200-150) 20

0.40(200) 80 80

Deferred tax

Tax effect of timing differences originating during the year

0.40(150-50) 40

Tax effect of timing differences reversing during the year

0.40 (0-50) ___ (20) (20)

Tax expense 60 60 60

Profit after tax 90 90 90

Net timing differences 100 50 0

Deferred tax liability 40 20 0

In 20x1, the amount of depreciation allowed for tax purposes exceeds the amount of depreciation charged for accounting purposes by Rs.1,00,000 and, therefore, taxable income is lower than the accounting income. This gives rise to a deferred tax liability of Rs.40,000. In 20x2 and 20x3, accounting income is lower than taxable income because the amount of depreciation charged for accounting purposes exceeds the amount of depreciation allowed for tax purposes by Rs.50,000 each year. Accordingly, deferred tax liability is reduced by Rs.20,000 each in both the years. As may be seen, tax expense is based on the accounting income of each period.

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

Illustration-2 (Application of Fair Value Principles)

123. A convertible debenture is normally presented in the financial statements as a liability, while it has two components; a liability and an option to convert loan into equity. Appropriate accounting principle requires separate accounting for rights and obligations. Each component has to be separately accounted for. In the past, many of those rights and obligations were shown as off-

balance-sheet items. Only recently, on account of accounting standards, the number of such items stand reduced. The issuer of a financial instrument is required to classify convertible debentures (financial instrument) as liability or as equity depending on the terms of the contract. A convertible debenture is a compound instrument. In case of such instrument, having different components, one has to present such components in financial statements either as equity or as liability based on the terms of the contract. As a general principle, a contract that will be settled by an entity receiving a fixed number of its own shares is an equity instrument. For example, when an enterprise issues shares in consideration of cash or some other asset/service, the transaction does not result in any cash outflow. For example, a redeemable preference share should be classified as liability and not as equity because it gives rise to an obligation to deliver cash. This example is given to show that DTL is a liability because it results in cash outflow in future on account of timing differences.

124. A company has an option to designate a financial asset at fair value through profit or loss. A financial asset held for trading should be classified as an asset at fair value through profit or loss. The difference in the fair value of financial asset at the beginning of the period and at the end of the period is generally recognized as profit or loss in the P&L a/c. Similarly, loans and receivables are carried at amortized cost unless the company intends to sell the same immediately. Similarly, there are certain assets like Held-to-maturity-investments which are required to be carried in the balance-sheet at the amortized cost. In all such cases, the company will now have to classify such assets or liabilities at fair value through profit or loss. Therefore, fair value under the new A.S. has become the basis for measurement of financial assets. Application of new standards will require a change in the mind-set. At present, non-financial companies carry current investments at cost or market value, whichever is lower. However, they carry long term investments at cost. They provide for permanent diminution in value of long term investment.

125. Similarly, in case the company pays customs duty under section 43B of Rs. 100. For tax purpose, that company is entitled to deduction of Rs. 100/- in the year it makes payment. But for accounting purpose, it can divide Rs. 100/- into Rs. 80/- + Rs. 20/- (embedded in the closing stock). The company can show Rs. 20/- as pre-paid expense, in the balance-sheet.

126. The above examples indicate that measurement and recognition of timing differences and financial instruments at fair value brings transparency in presentation of financial statements. Lastly, valuation is an important element of the Method of Accounting.

127. In our view, para 9 of AS 22 merely represents gap-filling exercise, therefore, there is no merit in the contention advanced on behalf of the appellants that AS 22 is inconsistent with the provisions of the Companies Act including Schedule VI. It proceeds on the principle that every transaction has a tax effect. The words true and fair view in section 211(1) connotes the widest law making powers and, in that context, we hold that that impugned Rule adopting AS 22 is intra vires as the said Rule is incidental and/or supplementary to the specific powers given to the Central Government to make Rules, particularly when such power is given to fill-in details. The word supplementary means

something added to what is there in the Act, to fill-in details for which the Act itself does not provide. It is something in the sense that is required to implement what is there in the Act. [See *Daymond v. South West Water Authority* (1976) 1 All ER 39]. There is no merit in the contention advanced on behalf of the appellants that the impugned Rule seeks to modify the essential features of the Companies Act. Rules made on matters permitted by the Act to supplement the Act cannot be held to be in violation of the Act. [See *Britnell v. Secretary of State* (supra)]. When the power to make rules is limited to particular topics and if that rule falls within the ambit of that topic, namely, taxes on income in the present case, it cannot be said that the rule is inconsistent with the provisions of the Act. As stated above, the Act and the Rules form part of the composite scheme. The provisions of sections 205, 209 and 211 can be put into operation only if the Act and the Rules are read together. In the present case, in our view, the impugned Rule constitutes a legitimate aid to construction of the provisions of the Companies Act. Further, as stated above, the Central Government is the rule making authority under section 211(3C). As rule making authority, the Central Government is empowered to enact accounting standards in consultation with NAC which may be at variance with the Standards issued by the Institute.

128. In the case of *Union of India and anr. v. Cynamide India Ltd. and anr.* reported in (1987) 2 SCC 720 one of the arguments advanced on behalf of the company was that, in calculating the net worth the cost of works-in-progress and the amount invested outside business were excluded from free reserves and that such exclusion could not be justified on any known principle of commercial accountancy (See para 33). The matter related to price fixation. In the Control Order vide para 2(g) the word free reserve was defined. Similarly, in the Form prescribed in the Fourth Schedule, several items like bonus, bad debts and provisions, loss/gain on sale of assets etc. were required to be excluded from the cost of production. Therefore, it was argued that such exclusion was not warranted by principles of commercial accountancy. This argument was rejected by this Court on the ground that it was open to the subordinate body to prescribe and adopt its own mode of ascertaining the cost of production. That the said body was under no obligation to adopt the method indicated under the Income tax Act in allowing expenses for the purposes of ascertaining income. It was further held that so long as the method prescribed and adopted by the subordinate legislating body is not opposite to the principle statutory provisions and so long as the method prescribed is ancillary to the provisions of the parent Act, it cannot be legitimately questioned. In the present case, as stated above, measurement and recognition methods are not the items under the Companies Act. Methods of recognition and measurements are talked about by the provisions of the Companies Act. Recognition and measurement of various items of revenue expenses etc. stand covered only by the accounting standards. Therefore, it cannot be said that the said standards are contrary to the provisions of the Companies Act. We also do not find any merit in the argument advanced on behalf of the appellants that the impugned Rule does not touch upon maintenance of books of accounts to be kept by the company. Under section 209(3)(b) every company is required to keep its books of accounts on accrual basis and according to double- entry system of accounting. Under section 209(3)(a) every company is required to maintain books of accounts necessary to provide a true and fair view of the state of affairs of the company and its accounts. In our view, books of accounts do not include balance-sheet and P&L a/c. However, as stated above, there is a difference between true and correct accrual and true and fair accrual. In the past, what prevailed was true and correct accrual. At that time, it was noticed in several cases that profits were overstated and, therefore, the Legislature inserted what is called as true and fair accrual concept. The said concept is wider than the concept of true and correct accrual. When section 209(3) refers to maintenance of books of accounts on accrual basis it means true and fair accrual, which would include not only matching

principles but also fair valuation principles. These principles do not contravene accrual system of accounting. Moreover, we are concerned with presentation of balance-sheet and P&L a/c. These are financial statements. An investor, shareholder or stake-holder is entitled to know the real income which the company has earned during the year. Provision for diminution in value of an asset results in emergence of liability. In the past, when timing difference concept was not there, in many cases, profits were overstated, particularly because provision for DTL (deferred taxation) was not recognized. With the introduction of the timing difference concept, it cannot be said that the accrual system of accounting is violated. As stated above, it is the concept of timing difference which obliterates the difference between accounting and tax incomes. Ultimately, the object is to obliterate the difference between accounting income and taxable income. Accounting income is the real income, therefore, in our view, para 9 of AS 22 is not inconsistent with the provisions of the Companies Act, including Schedule VI.

129. In the case of *Bharat Hari Singhania and ors. V. Commissioner of Wealth-tax (Central) and ors.* reported in AIR 1994 SC 1355 valuation of unquoted equity shares based on the break-up method was challenged. That challenge was rejected on the ground that the break-up method leads to appropriate market value and, therefore, the said method adopted by Rule 1-D of Wealth-tax Rules was neither ultra vires nor inconsistent with section 7 of the Wealth tax Act. We quote hereinbelow paras 13, 14 and 21 of the said judgment which held that it is always open to the rule-making authority to prescribe an appropriate method of valuation out of several methods of valuing an asset. And since the break-up method adopted by the rule-making authority was a known method in the relevant circles, it cannot be said that the method adopted was an impermissible method. Paras 13, 14 and 21 read as under:

13. We may first take up the question whether Rule 1-D is void for being inconsistent with the Act or for the reason that it is beyond the rule-making authority conferred by the Act. Section 7(1) indeed defines the expression "value of an asset." It is "the price which in the opinion of the Wealth Tax Officer it would fetch if sold in the open market on the valuation date", but this is made expressly subject to the Rule made in that behalf. No. guidance is furnished by the Act to the rule-making authority except to say that the Rule made must lead to ascertainment of the value of the asset (unquoted equity share) as defined in Section 7. It is thus left to the rule-making authority to prescribe an appropriate method for the purpose. Now, there may be several method of valuing an asset or for that method an unquoted equity share. The rule-making authority cannot obviously prescribe all of them together. It has to choose one of them which according to it is more appropriate. The rule-making authority has in this case chosen the break-up method, which is undoubtedly one of the recognised methods of valuing unquoted equity shares. Even if it is assumed that there was another method available which was more appropriate, still the method chosen cannot be faulted so long as the method chosen is one of the recognised methods, though less popular. One probable reason why yield method or dividend method was not adopted in the case of unquoted equity shares was that bulk of these companies are private limited companies where the divided declared does not represent the correct state of affairs and to estimate the probable yield is no simple exercise. The dividends in these companies is declared to suit the purposes of the persons controlling the companies. Maintainable profits rather than the dividends declared represent the correct index of the value of their shares. The break-up method based upon the balance- sheet of the company, incorporated in Rule 1- D, is a fairly simple one. Indeed, no serious objection can also be

taken to this course since the basis of the Rule is the balance-sheet of the company prepared by the company itself - subject, of course, to certain modifications provided in Explanation-II.

14. We are not satisfied that the break-up method adopted by Rule 1-D does not lead to proper determination of the market value of the unquoted shares. The argument to this effect, advanced by the learned Counsel for the assesseees, is based upon the assumption/premise that the value determined by applying the yield method is the correct market value. We do not see any basis for this assumption. No empirical data is placed before us in support of this submission or assumption. It may be more advantageous to the assesseees but that is not saying the same thing that it alone represents the true market value. It cannot be stated as a principle that only the method that leads to lesser value is the correct method. The idea is to find out the true market value and not the value more favourable to the assessee. Accordingly, the contention that rule 1-D is inconsistent with Section 7(1) or that it travels beyond that purview of Section 7 is rejected.

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21. The statement of law in the decision would thus establish that it does not purport to "lay down any hard and fast rule." It recognises that various factors in each case will have to be taken into account to determine the method of valuation to be applied in that case. The dividend yield method is not the only method indicated in the case of a going concern; there is the 'earning method' and then a combination of both methods. The several qualifications added to the above rules, as already stated, make them highly cumbersome and time-consuming. The Wealth Tax Officer has to examine the facts and circumstances of each case including the nature of the business, prospects of profitability and similar other considerations before finally determining whether to apply the dividend method, yield method or whether the break-up method should be followed. There may be cases where an assessee may be holding shares of a large number of private companies or other public limited companies whose shares are not quoted. Compared to them, the break-up method incorporated in Rule 1-D is far simpler and far less time-consuming. It prescribes a simple uniform method to be followed in all cases. All that the Wealth Tax Officer has to do is to take the balance-sheet, delete some items from the columns relating to assets and liabilities as directed by Explanation-II, and then apply the formula contained in the Rule. He need not have to look into the profitability, the earning capacity and the various other factors mentioned in propositions (2), (3) and (4) of the decision. The decision, it bears repetition, recognises that break-up method "nonetheless is one of the methods." In the circumstances, it is difficult to agree with the learned Counsel for the assesseees either that break-up method is not a recognised method or that yield method is the only permissible method for valuing the unquoted equity shares. It is not as if the rule-making authority has adopted a method unknown in the relevant circles or has devised an impermissible method. There is no empirical data produced before us to show that break-up method does not lead to the determination of market value of the shares. Merely because yield method may be more advantageous from the assessee's point of view, it does not follow that it alone leads to the ascertainment of true market value and that all other methods are erroneous or misleading. This aspect we have emphasised hereinbefore too.

Validity of Para 33 of AS 22

130. We have already quoted hereinabove para 33. The said para is challenged on the ground that a subordinate legislation cannot be retrospective unless there is provision to that effect in the parent Act. Therefore, the short question which we have to decide is whether the said para is retrospective.

131. To decide the said question, we have to analyse the scope of para 33. For the purpose of determining accumulated deferred tax in the period in which the Standard is applied for the first time, the opening balances of assets and liabilities for accounting purposes and for tax purposes are to be compared and the differences, if any, are to be determined. The tax effect of these differences have got to be recognized as DTA or DTL, if such differences are timing differences. For example, in the year in which a company adopts AS 22, the opening balance of a fixed asset is, lets say, Rs. 100 for accounting purposes and Rs. 60 for tax purposes. This difference is because the company applied written down value method of depreciation for calculating taxable income, whereas for calculating accounting income it adopts straight-line method. This difference will reverse in future when depreciation for tax purposes will be allowed as compared to depreciation for accounting purposes. In this example, lets assume that the tax rate is 40 per cent and that there are no other timing differences then, DTL would be $[\text{Rs. } 100 - \text{Rs. } 60] \times 40/100 = \text{Rs. } 16$

132. Once we are required to take into account the concept of opening balance of a fixed asset in para 33, it cannot be said that the said para is retrospective. In fact, it is a transitional provision. Lets say that there is an expenditure which is written off for accounting purposes in the year in which it is incurred but is admissible for deduction under Income-tax Act over a period of time. In such a case, the asset representing expenditure would have a Balance only for tax purposes and not for accounting purposes. Therefore, the difference between the Balance of the asset for tax purposes and balance for accounting purposes, which is nil, would give rise to a timing difference which will reverse in future when expenditure would be allowed for tax purposes. In such a case, DTA would be recognized in respect of difference, subject to the principle of prudence. In the circumstances, it cannot be said that para 33 is retrospective.

Conclusion:

133. For the aforesaid reasons, we are of the view that the impugned Notification/Rule is neither ultra vires nor inconsistent with the provisions of the Companies Act, including Schedule VI.

134. To sum up, deferred tax is nothing but accrual of tax due to divergence between accounting

profit and tax profit. This difference arises on two counts, namely, different treatment of items of revenue/expense as per profit and loss account and as per the tax law. It also arises on account of the difference between the amount of revenue/expense as per profit and loss account and the corresponding amount considered for tax purposes, e.g., depreciation.

135. However, we need to comment on one aspect. Before the Calcutta High Court, the impugned Notification adopting AS 22 was also challenged on the ground that the provisions of AS 22 insofar as it relate to deferred taxation is violative of Articles 14 and 19(1)(g) of the Constitution of India. In this connection, it was pleaded that by making AS 22 mandatory, the appellants companies will suffer erosion of its net worth. That, as a result, the debt equity ratio will also increase and that the lenders may recall the loans and thereby the appellants rights to carry on business in future would be violated. Although, the aforestated challenge was pleaded in the writ petition, when the matter came for hearing before the High Court, it appears that the said grounds were not argued. According to the appellants, implementation of AS 22 would result in reduction of profits and reserves. In the circumstances, we do not wish to express any opinion on the constitutional validity of the said AS 22. Whether the said Standard constitutes a restriction on the rights of the appellants to carry on business under Article 19(1)(g) or whether the said Standard is violative of Article 14 are questions on which we express no opinion. We keep those questions open. Suffice it to state that, in the present case, we are of the view that the said AS 22 is neither ultra vires nor inconsistent with the provisions of the Companies Act, including Schedule VI.

136. For the aforestated reasons, we find no infirmity in the impugned judgment of the High Court and, accordingly, the civil appeals filed by the various companies stand dismissed with no order as to costs.