# MATCHING PRINCIPLE AND INCOME TAX LAW

I.This basic accounting principle has been a huge bone of contention in numerous matters and is an oft misunderstood concept leading to oversimplification and misinterpretation which in turn results in litigation.The article proposes to explain the concept in terms of settled law by numerous SC decisions and is expected to be useful to new entrants in field of litigation law ,esp the lawyers who may not have had a formal and detailed exposure to accountancy with reference to income tax law.This is a basic exposition and the author shall welcome advanced queries on the subject.I am deeply obliged to my exposure on the subject through my adjudicatory attempts as first appellate authority specially relating to coal fields and to my senior CA colleagues with whom my endless debates over endless cups of tea in my chambers, on accountancy principles and **accounting standards** vis-a –vis income tax law sharpened my understanding of tax accounting inspite of not being formally instructed on the issue save and except my training days in National Academy Of Direct Taxes.

II.. The principle is **at the core of the accrual basis of accounting** and adjusting entries. The cause and effect relationship is the basis for the matching principle.

The mercantile system of accounting is based on accrual. Basically, it is a double entry system of accounting. Under the mercantile system of accounting, profits arising or accruing at the date of the transaction are liable to be taxed notwithstanding the fact that they are not actually received or deemed to be received under the Act. Under the mercantile system of accounting, therefore, book profits are liable to be taxed. The profits earned and credited in the books of account constitute the basis of computation of income. The system postulates the existence of tax in so far as monies due and payable by the parties to whom they are debited (see Keshav Mills Ltd. v. CIT [1953] 23 ITR 230, 239 (SC)). **Therefore, under the mercantile system of accounting, in order to determine the net income of an accounting year, the revenue and other incomes are matched with the cost of resources consumed (expenses). Under the mercantile system of accounting, this matching is required to be done on accrual basis. Under this matching concept, revenue and income earned during an accounting period, irrespective of actual cash in-flow, is required to be compared with expenses incurred during the same period, irrespective of actual outflow of cash.**

Depreciation is an example of the matching principle in action. Depreciation is the "expensing" of a physical asset, such as a truck or a machine, **over its estimated useful life**.

Lets take a more concrete example:

Imagine that a company pays its employees an annual bonus for their work during the fiscal year 2020-21. The policy is to pay 5% of revenues generated over the year, which is paid out in April of the following year.

In 2020-21, the company generated revenues of 100 million rupees and thus will pay its employees a bonus of 5 million rupees in April 2021.

Even though the bonus is not paid until the following year, the matching principle stipulates that the expense should be recorded on the 2020-21 income statement as an expense of rupees 5 million.

On the balance sheet at the end of 2020-21, a bonuses payable balance of rupees 5 million will be credited, and retained earnings will be reduced by the same amount (lower net income), so the balance sheet will continue to balance.

In April 21, when the bonus is paid out there is no impact on the income statement. The cash balance on the balance sheet will be credited by Rs.5 million, and the bonuses payable balance will also be debited by Rs.5 million, so the balance sheet will continue to balance.

**III.In the case of J. K. Industries Ltd. v. Union of India reported in [2007] 13 Scale 204,** it has been held that-

*" 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 the provisions of the Companies Act."*

These two paras mistakenly are cited often as reason why revenue cannot upset profits and expenses even if they present a distorted picture.To offset such a interpretation,the following para of the same judgment should be read-

"**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 recognize 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.”***

## IV.The Exceptions debate:

1.This matching concept is very relevant to compute taxable income but in claims invoking **Deferred Revenue Expenses and in cases exceptioned by prior period expenses there arises a legal contest**.

DRE has been recognised by numerous judgments- the hon’ble Supreme Court in the case of **Madras Industrial Investment Corporation Ltd. [1997] 225 ITR 802** under the following observations (headnote) :

*' Ordinarily, revenue expenditure which is incurred wholly and exclusively for the purpose of business must be allowed in its entirety in the year in which it is incurred. It cannot be spread over a number of years even if the assessee has written it off in his books, over a period of years. However, the facts may justify an assessee who has incurred expenditure in a particular year to spread and claim it over a period of ensuing years. In fact, allowing the entire expenditure in one year might give a very distorted picture of the profits of a particular year. Issuing debentures is an instance where, although the assessee has incurred the liability to pay the discount in the year of issue of debentures, the payment is to secure a benefit over a number of years. There*

*is a continuing benefit to the business of the company over the entire period. The liability should, therefore, be spread over the period of the debentures.'*

*1.1 DRE is recognized in US as ''****systematic allocation*** **of a cost to the accounting periods''.Illustration** is given that *if a company purchases an elaborate office system for $252,000 that will be useful for 84 months, the company will match $3,000 of expense each month to its monthly income statement.* **The Financial Accounting Standards Board (FASB)** issues a standardized set of accounting principles in the U.S. referred to as **generally accepted accounting principles** (**GAAP**).[For the uninitiated Accounting principles differ from country to country. The **International Accounting Standards Board** (**IASB**) issues **International Financial Reporting Standards (IFRS).** These standards are used in over 120 countries, including those in the European Union (EU). **IFRS is a standards-based approach that is used internationally, while GAAP is a rules-based system** used primarily in the U.S. The IFRS is seen as a more dynamic platform that is regularly being revised in response to an ever-changing financial environment, while GAAP is more static.]

**2.IND AS 18** in para 19 recoginizes the principle and the exception as follows:

''Revenue and expenses that relate to the same transaction or other event are recognised simultaneously; **this process is commonly referred to as the matching of revenues and expenses.** Expenses, including warranties and other costs to be incurred after the shipment of the goods can normally be measured reliably when the other conditions for the recognition of revenue have been satisfied. **However, revenue cannot be recognised when the**

**expenses cannot be measured reliably;** in such circumstances, any consideration already received for the sale of the goods is recognised as a liability"

[Base note:**An accounting standard is a common set of principles, standards, and procedures that define the basis of financial accounting policies and practices**]

**3.Prior period expenses**('INCURRED BUT NOT CRYSTALLIZED' is the understanding in Indian context) also seemingly upsets the apple cart as well as issues in revenue recognition timing.IND AS 8 and old AS 5 deal with these expenses. These expenses which are relating to the current year in the sense they are crystallised i.e. ascertainable and legally enforceable during the year, but pertain to activities of an earlier year.

These are parts of a more advanced debate.

4.Further, under certain circumstances, the costs of applying the principles of accounting exceed the benefits. In these situations, management departs from the principles. All rules have exceptions, even the measurement principles of financial accounting. Two important exceptions are **materiality and conservatism. Materiality** states that only those transactions dealing with money amounts large enough to make a difference to financial statement users need be accounted for in a manner consistent with the principles of financial accounting. For example, the matching principle indicates that the cost of a wastebasket should be included on the balance sheet and converted to expense over future periods because its usefulness is expected to extend beyond the current period.

However, the cost of an individual wastebasket is probably immaterial to the balance sheet worth.Hence the materiality principle is applied.

**4.1 The conservatism or prudence principle** in accounting is the general concept of recognizing expenses and liabilities as soon as possible when there is uncertainty. In practice however it states that you should always err on the most conservative side and **record uncertain losses and expenses, but not record uncertain gains.** It is almost impossible for anyone to predict the future successfully and so this principle advises you to lean towards the more conservative side of any transaction.Conservatism principle has some in built potential for misuse.Companies **may create misleading provisions(e.g.for doubtful debts) just to understate their net income**(e.g.using esoteric concepts like 'net realizable value'- recognized however now in s 145A(i) and (iv)of the IT Act 1961 )so that the benefits of lower taxation can be reaped. There is also a possibility of companies **overstating expenses and understating income** thus also presenting a bleak picture to the shareholders.The tax implications are easy to imagine. With inventories valued at lower of cost or NRV, provision of debts accounted for,& no future revenues recorded, the net income of the company might be understated which would allow them to pay much less in taxes.

**5.CFI, an online accounting course. states well some of the other Challenges with the Matching Principle**

**QUOTE**

‘’The principle works well when it’s easy to connect revenues and expenses via a direct cause and effect relationship. There are times, however, when that connection is much less clear, and estimates must be taken.

Imagine, for example, that a company decides to build a new office headquarters that it believes will improve worker productivity. Since there’s no way to directly measure the timing and impact of the new office on revenues, the company will take the useful life of the new office space (measured in years) and depreciate the total cost over that lifetime.

For example, if the office costs $10 million and is expected to last 10 years, the company would allocate $1 million of straight-line depreciation expense per year for 10 years.  The expense will continue regardless of whether revenues are generated or not.

Another example would be if a company were to spend $1 million on online marketing (Google AdWords). It may not be able to track the timing of the revenue that comes in, as customers may take months or years to make a purchase.  In such a case, the marketing expense would appear on the income statement during the time period the ads are shown, instead of when revenues are received .

**UNQUOTE**

**[ACK:CFI]**

6.To me deferred revenue recognition and deferred revenue expenses principles are strong tools of harmonization and settlement of issues in such matters.

7.The key justification of matching principle is that claiming the entire expenditure distorts the profits of a particular year and violates s 4 of the Income Tax Act..To some however this can't be a universal principle and is a matter of debate in specific cases and can be easily seen in issues like OVER BURDEN REMOVAL EXPENSES in case of a coal company.

**VI. ANOTHER COUNTERPOINT:**

**1.IN BILAHARI INVESTMENTS[299 ITR 1] THE HON'BLE SC has held that**

*''20. As stated above, we are concerned with the assessment years 1991-92 to 1997-98. In the past, the Department had accepted the completed contract method and because of such acceptance, the assessees, in these cases, have followed the same method of accounting, particularly in the context of chit discount.* ***Every assessee is entitled to arrange its affairs and follow the method of accounting, which the Department has earlier accepted. It is only in those cases where the Department records a finding that the method adopted by the assessee results in distortion of profits, the Department can insist on substitution of the existing method."***

1.1 The HON'BLE Supreme Court did not consider the question on the basis whether, since section 211(2) of the Companies Act, 1956, required the Accounting Standards enacted by the Institute of Chartered Accountants of India to be adopted, the position would be the same as the developments were of recent origin and they were not invoked by the Department in this case.But it was observed that-

*"21. **Before concluding, we may point out that <u>under section 211(2) of the Companies Act, Accounting Standards (" AS" ) enacted by the Institute of Chartered Accountants of India have now been adopted</u> (see : judgment of this court in J. K. Industries case).** Shri Tripathi, learned counsel for the Department, has placed reliance on AS 22 as the basis of his argument that the completed contract method should be substituted by deferred revenue expenditure (spreading the said expenditure on proportionate basis over a period of time). He also relied upon the concept of timing difference introduced by AS 22. **It may be stated that all these developments are of recent origin. It is open to the Department to consider these new accounting standards and concepts ................................We express no opinion in that regard. Suffice it to state that, these new concepts and accounting standards have not been invoked by the Department in the present batch of civil appeals.**"*

**2.Thus the reverse case could be that** in every case of substitution of one method by another method, the burden is on the Department to prove that the method in vogue is not correct and it distorts the profits of a particular year. Under the mercantile system of accounting based on the concept of accrual, the method of accounting followed by the assessees is relevant and determinative.

3.In the case of **Calcutta Co. Ltd. v. CIT [1959] 37 ITR 1 (SC)** the facts were as follows: The assessee bought lands and sold them in plots. When the plots were sold the purchasers paid only a portion of the purchase price and undertook to pay the balance in instalments. The assessee, in turn, agreed to develop the plots within six months. In the relevant accounting year, the assessee actually received only Rs. 29,392 towards sale price of the lands, but, in accordance with the mercantile system of accounting followed by the assessee, it credited in its accounts Rs. 43,692 representing the full sale price of the lands. At the same time, it also debited Rs. 24,809 as expenditure for the development it had undertaken even though, no part of that amount was actually spent. The Department, therefore, disallowed the expenditure of Rs. 24,809 on the ground that the amount was not actually spent. The assessee ultimately succeeded in the Supreme Court. It was held by the Supreme Court that the expression ' Profits or gains' in section 10(1) of the Indian Income-tax Act, 1922, should be understood in its commercial sense and there can be no computation of such profits and gains until the expenditure, which is necessary for the purposes of earning the receipts is deducted therefrom. Accordingly, the Supreme Court took the view, that since the assessee was following mercantile system of accounting and since the assessee had credited the full sale price of lands in its accounts amounting to Rs. 43,692, **the assessee was entitled to estimate the expenditure because, without such estimation of expenditure, it was not possible to compute profits and gains.**

**VIII.The takeaways :**

**1.As matter of general or thumb rule I would say that** expenditure which is relevant to the earning of income only should be deducted from such income so that a correct picture of the real income chargeable to tax can emerge. For this proposition, observations of the Hon'ble Bombay High Court decision in the case of ***Taparia Tools Ltd.* v. *Jt. CIT*** [**2003**] **260 ITR 102**. The following observations which are extracted below from para 22 of the order are relevant :

*"Therefore, under the mercantile system of accounting, in order to determine the net income of an accounting year, the revenue and other incomes are matched with the cost of resources consumed (expenses). Under the mercantile system of accounting, this matching is required to be done on accrual basis. Under this matching concept, revenue and income earned during an accounting period, irrespective of actual cash-in-flow, is required to be compared with expenses incurred during the same period, irrespective of actual outflow of cash.*

*2.*This concept is also applied by the Supreme Court in the case of MIIC Ltd.[ **Madras Industrial Investment Corpn. (MIIC) Ltd. v. CIT [1997] 225 ITR 802** referred(supra)-

*''Therefore, the matching concept, which we have referred to is well recognized by various judgments of the Supreme Court. In this case, the issue is whether the entire expenditure distorts the profits of a particular year. In this case, we are concerned with computation of income and, therefore, method of accounting followed by the assessee is relevant because accrual of income is to be seen in the light of method of accounting."*

3. The issue is also covered by decision of Hon'ble Supreme Court in the case of ***CIT* v. *Woodward Governor India (P.) Ltd.* [2009] 312 ITR 254**/ 179 Taxman 326. Para 16 of this judgment may be noted:

*''Profits and gains of the previous year are required to be computed in accordance with the relevant accounting standard. On general principles of commercial accounting, the value of the stock-in-trade at the beginning and at the end of the accounting year should be entered in the*

*profit and loss account at cost or market price, whichever is lower-the market value being ascertained on the last date of the accounting year, not at any intermediate date. No gain or profit can arise until a balance is struck between the cost of acquisition and the proceeds of sale. The word "profits" implies a comparison between the state of business at two specific dates, usually separated by an interval of twelve months. Stock-in-trade is an asset: it is a trading asset. Therefore, the concept of profits and gains made by a business during the year can only materialize where a comparison of the assets of the business at two different dates are taken into account.*

***Under the mercantile system of accounting, what is due is brought into credit before it is actually received : it brings into debit an expenditure for which a legal liability has been incurred before it is actually disbursed."*** [emphasis:supplied]

4.Accounting Principles and taxation provisions have a chequered history of conflict and the law definitely prevails in so far as accountancy principles go**. NARMADA CHEMATUR PETROCHEMICALS LTD. (2010) 327 ITR 0369(GUJ.)**held in para 29 that"**………** *The position in law is well-settled that making of an entry or absence of an entry cannot determine rights and liabilities of parties. In other words, if the law does not lead to incurring of a liability, or does not lead to a corresponding right to insist for discharging such a liability* ***any accounting practice (even if suggested by the ICAI) cannot lay down anything to the contrary….."*** In **Tuticorin Alkali Chemicals & Fertilizers Ltd. vs. CIT (1997) 227 ITR 172 (SC) it was held as follows:** ''*As was pointed out by Lord Russell in the case of B.S.C. Footwear Ltd. vs. Ridgway (Inspector of*

*Taxes) (1970) 77 ITR 857 (CA), 860, **the IT law does not march step by step in the footprints of the accountancy profession."***

***5.ICDS notified unders 145(2)are income computation standards and not book keeping principles as given under AS or IND AS.*** The ICDS have been derived from the existing AS with specific deviations. However, there are no explanations and examples given in the ICDS, as given in AS.

***6.It would interest readers to know that for*** **''Events occurring after the end of Previous Year''** **& ''Prior Period Expenses''** were two of the items for which drafts were circulated but were not notified.Presumption is that these continue to be determined under ICAI Guidelines.But the area of debate has been left unattended .AOs take free calls on these items as per their station of understanding,since debate vistas have been left open.

In any case **Chamber of Tax Consultants *v.*Union of India***[2018] 400 **ITR 178 (Delhi) has already desanctified the ICDS BY HOLDING THAT** 'Income computation and Disclosure Standards' (ICDS) notified by Central Government in exercise of power under section 145(2) can not override binding judicial precedents or provisions of Act or Rules framed thereunder.5 of the 10 standards stand diluted or held ultra vires.Yet again,the IT Deptt's technical competence and legal understanding stands judicially deprecated.

7.In this scenario it's a virtual free for all as final accounts management and structuring tax audit report is in a discretion and interpretation filled playing field.The best tax advice I always give is that ''discretion is the better part of valour" and conservative presentation of accounts is preferable to an adventurous one.