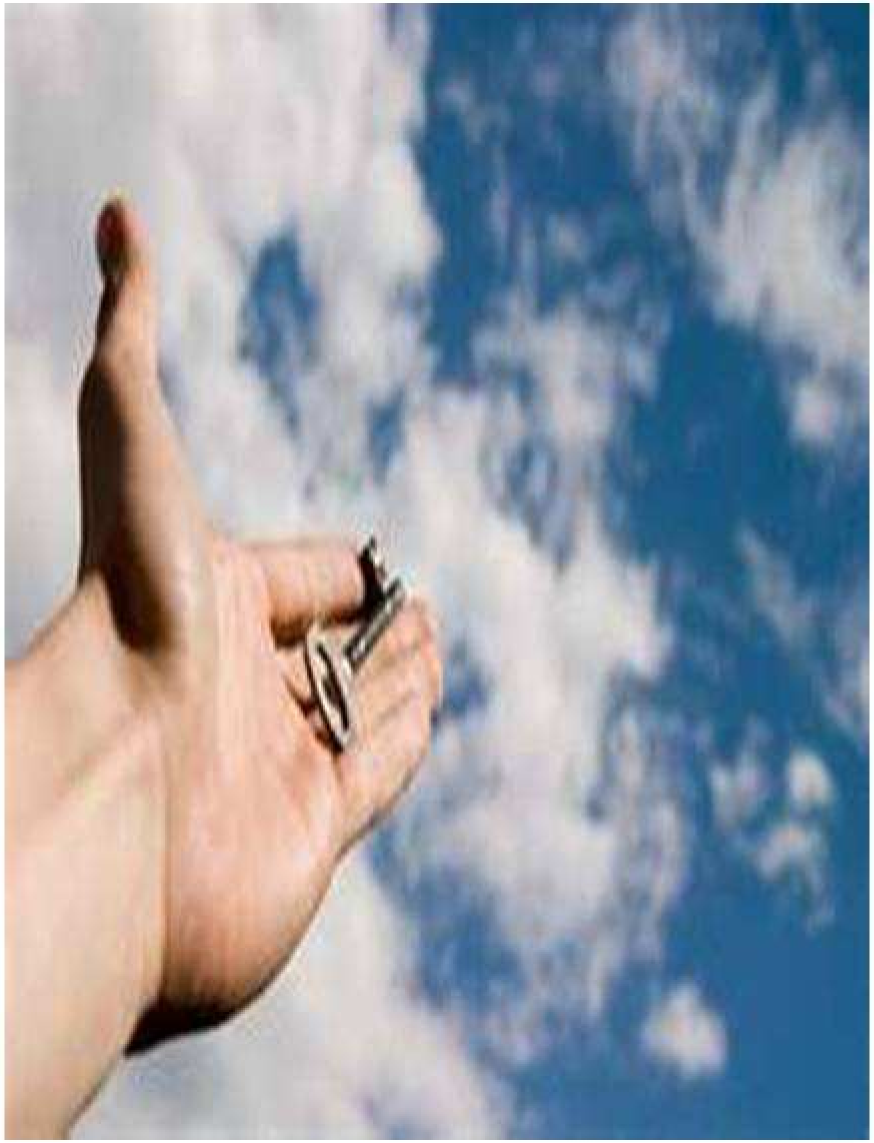
CAA

CHARTERED ACCOUNTANTS ACADEMY



IAS 12 INCOME TAXES

Agenda

- IAS 12: Income Taxes Common Errors – focusing on:
- Recognition of Deferred Tax
  - In the Profit and loss account
  - Through the Other Comprehensive
  - Directly to Equity in Statement of Changes in Equity
  - Business Combination
- Tax Expense and Tax Reconciliation
- Offsetting
- Deferred Tax on Investment in Subsidiary, Associate and Joint Ventures

Common Errors/Findings

- Failure to understand the components of tax expense
- Failure to understand the functions (movement) that affect the deferred tax balance
- Incorrect tax expense reconciliations
- Offsetting of Deferred Tax Assets and Deferred Tax liabilities in Consolidated Accounts
- No deferred tax recognised for investments in subsidiaries, associates, JVs and branches.

Recognition Of Deferred Tax

In the Profit and Loss Account

Recognition of current and deferred tax

57 Accounting for the current and deferred tax effects of a transaction or other event is consistent with the accounting for the transaction or event itself. Paragraphs 58 to 68C implement this principle.

Items recognised in profit or loss

58 Current and deferred tax shall be recognised as income or an expense and included in profit or loss for the period, except to the extent that the tax arises from:

(a) a transaction or event which is recognised, in the same or a different period, outside profit or loss, either in other comprehensive income or directly in equity (see paragraphs 61A-65); or

(b) a business combination (see paragraphs 66-68).

Illustration in P&L

Profit before tax	xxxxxx
<u>Less</u> INCOME TAX EXPENSE	(xxxx)
Profit for the Year	**xxxxxx**

Tax Expense

Tax expense is a composite of :

Current Tax (derived from taxable income)

\+ **Deferred tax** (mvt btwn closing and opening DT bals)

\- Deferred tax amounts recognised other comprehensive income statement (e.g. deferred tax revaluation surplus of PPE)

Components of Tax Expense

Income Tax expense may include the following components:

- Current tax
  - Current Year (Taxable income X Current tax rate)
  - Prior Year: Less Over/add under provision
- **Deferred Tax**:
  - Current deferred tax (mvt btwn current closing & op DT bals)
  - +/-Effect of tax rate change (%change/prior rate X opening bal)
  - -Recognised deferred tax asset on assessed & capital losses
  - -/+ unrecognised deferred tax asset on prior period assessed loss
- Dividend Withholding tax
- Capital gains tax (other jurisdictions)
- Foreign tax expense (foreign income X foreign tax rate)

Current tax defined

- **Current tax:** amount of income tax payable/refundable based on taxable profit/loss for the current period or past periods

Deferred tax defined

- **Deferred tax:** tax payable/recoverable in the future period as a result of past transactions
- **Carrying amount:** measurement under IFRSs
- **Tax base:** measurement under tax law
- **Temporary difference:** difference in carrying amount of an item in the statement of financial position and its tax base

Current Tax Calculation Formula

	$
Profit Before Tax	**240,000**
Add/Less Permanent Differences (non-taxable income & expenses)	xxxxx
Less: Mvt in temporary differences as per the SOFP	**(100,000)**
Taxable Profit	**140,000**
Current Tax @ 25% of 140,000	35,000
Deferred Tax@25% of 100,000	**25,000**
Tax expense (Profit before Tax x 25%) 240,000 x 25%	**60,000**

Example: current tax

- Tax rate 25%
- Profit (accounting) for 20X1 = $150,000
- $20,000 dividend income is tax exempt
- $5,000 meals expense is not deductible
- Tax Penalty $500 not deductible
- Current Year closing taxable temporary differences are $43,000 and prior year taxable temporary differences were $35,000. Assume that non of the temporary differences were recognised outside the profit and loss. No Provisional Tax Payments (QPDs) were made during the year.

Example: current tax continued

Taxable Income	
Profit Before Tax	**150,000**
+/- Permanent Differences:	
Less nontaxable dividend income	(20,000)
Plus nondeductible meals	5,000
Plus nondeductible bad debts	500
	135500
+/-Temporary Differences:	
Less mvt in temporary diffs (35k-43k)	**(8,000)**
Taxable profit	**127,500**
Current tax expense/liability (127500*25%)	31,875
Deferred Tax expense (8000*25%)	2,000
Tax Expense	**33,875**

Note: because no provisional tax has been paid the liability = current tax expense

	Dr	Cr
Dr Tax Expense (P/L)	33,875	
Cr Current Tax Liability (SOFP)		31,875
Cr Deferred Tax (SOFP)		2000

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	20X7	20X6
Revenue	390,000	355,000
Cost of sales	(245,000)	(230,000)
Gross profit	145,000	125,000
Other income	20,667	11,300
Distribution costs	(9,000)	(8,700)
Administrative expenses	(20,000)	(21,000)
Other expenses	(2,100)	(1,200)
Finance costs	(8,000)	(7,500)
Share of profit of associates[a]	35,100	30,100
Profit before tax	161,667	128,000
Income tax expense	(40,417)	(32,000)
Profit for the year from continuing operations	121,250	96,000
Loss for the year from discontinued operations	–	(30,500)
PROFIT FOR THE YEAR	121,250	65,500

Recognition Of Deferred Tax

Through Other Comprehensive Income

Items recognised outside profit or loss- IAS 12.61A

Current tax and deferred tax shall be recognised outside profit or loss if the tax relates to items that are recognised, in the same or a different period, outside profit or loss. Therefore, current tax and deferred tax that relates to items that are recognised, in the same or a different period:

(a) in other comprehensive income, shall be recognised in other comprehensive income (see paragraph 62).

(b) directly in equity, shall be recognised directly in equity (see paragraph 62A).

Recognised through other comprehensive income

62 International Financial Reporting Standards require or permit particular items to be recognised in other comprehensive income. Examples of such items are:

(a) a change in carrying amount arising from the revaluation of property, plant and equipment (see IAS 16); and

(c) exchange differences arising on the translation of the financial statements of a foreign operation (see IAS 21)

PROFIT FOR THE YEAR	121,250	65,500
Other comprehensive income:		
Items that will not be reclassified to profit or loss:		
Gains on property revaluation	933	3,367
Remeasurements of defined benefit pension plans	(667)	1,333
Share of gain (loss) on property revaluation of associates[(b)]	400	(700)
Income tax relating to items that will not be reclassified[(c)]	(166)	(1,000)
	500	3,000
Items that may be reclassified subsequently to profit or loss:		
Exchange differences on translating foreign operations[(d)]	5,334	10,667
Available-for-sale financial assets[(d)]	(24,000)	26,667
Cash flow hedges[(d)]	(667)	(4,000)
Income tax relating to items that may be reclassified[(c)]	4,833	(8,334)
	(14,500)	25,000
Other comprehensive income for the year, net of tax	(14,000)	28,000
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	107,250	93,500
Profit attributable to:		
Owners of the parent	97,000	52,400

Recognition Of Deferred Tax

Directly through Equity in Statement Changes in Equity

Directly through Equity in Statement Changes in Equity

62A International Financial Reporting Standards require or permit particular items to be credited or charged directly to equity. Examples of such items are:

(a) an adjustment to the opening balance of retained earnings resulting from either a change in accounting policy that is applied retrospectively or the correction of an error (see IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors); and*

(b) amounts arising on initial recognition of the equity component of a compound financial instrument (see paragraph 23).

Recognition Of Deferred Tax

Deferred tax arising from a business combination

Deferred tax arising from a business combination

66 As explained in paragraphs 19 and 26(c), temporary differences may arise in a business combination. In accordance with IFRS 3, an **entity recognises any resulting deferred tax assets (to the extent that they meet the recognition criteria in paragraph 24) or deferred tax liabilities as identifiable assets and liabilities at the acquisition date.** Consequently, those deferred tax assets and deferred tax liabilities affect the amount of goodwill or the bargain purchase gain the entity recognises. However, in accordance with paragraph 15(a), an entity does not recognise deferred tax liabilities arising from the initial recognition of goodwill.

Deferred Tax Reconcilliation

Opening Balance………………………….	**XXXX**
Mvt in deferred Tax analyzed as follows:	
Recognised through the P/L………………	XXX
Recognised through OCI…………………..	XXX
Recognised directly in equity…………	XXX
Recognised in goodwill……………………	XXX
Closing Balance………………………….	**XXXXX**

Questions ?

Tax Expense Reconciliation

Disclosure

Example: current tax continued

Taxable Income	
Profit Before Tax	**150,000**
+/- Permanent Differences:	
Less nontaxable dividend income	(20,000)
Plus nondeductible meals	5,000
Plus nondeductible bad debts	500
	135500
+/-Temporary Differences:	
Less mvt in temporary diffs (35k-43k)	**(8,000)**
Taxable profit	**127,500**
Current tax expense/liability (127500*25%)	31,875
Deferred Tax expense (8000*25%)	2,000
Tax Expense	**33,875**

Note: because no provisional tax has been paid the liability = current tax expense

Dr Tax Expense (P/L)	33,875	
Cr Current Tax Liability (SOFP)		31,875
Cr Deferred Tax (SOFP)		2000

Tax Expense Reconciliation- IAS12.81(c)

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an explanation of the relationship between tax expense (income) and accounting profit in either or both of the following forms:

(i) a numerical reconciliation between tax expense (income) and the product of accounting profit multiplied by the applicable tax rate(s), disclosing also the basis on which the applicable tax rate(s) is (are) computed; or

(ii) a numerical reconciliation between the average effective tax rate and the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed;

Explanation of the relationship between tax expense and accounting profit (paragraph 81(c))

The Standard permits two alternative methods of explaining the relationship between tax expense (income) and accounting profit. Both of these formats are illustrated below.

(a) a numerical reconciliation between tax expense (income) and the product of accounting profit multiplied by the applicable tax rate(s), disclosing also the basis on which the applicable tax rate(s) is (are) computed

	X5	**X6**
Accounting profit	8,775	8,740
Tax at the applicable tax rate of 35% (X5: 40%)	3,510	3,059
Tax effect of expenses that are not deductible in determining taxable profit:		
Charitable donations	200	122
Fines for environmental pollution	280	–
Reduction in opening deferred taxes resulting from reduction in tax rate	–	(1,127)
Tax expense	3,990	2,054

The applicable tax rate is the aggregate of the national income tax rate of 30% (X5: 35%) and the local income tax rate of 5%.

(ii) a numerical reconciliation between the average effective tax rate and the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed

	X5	X6
	%	%
Applicable tax rate	40.0	35.0
Tax effect of expenses that are not deductible for tax purposes:		
Charitable donations	2.3	1.4
Fines for environmental pollution	3.2	–
Effect on opening deferred taxes of reduction in tax rate	–	(12.9)
Average effective tax rate (tax expense divided by profit before tax)	45.5	23.5

The applicable tax rate is the aggregate of the national income tax rate of 30% (X5: 35%) and the local income tax rate of 5%.

Tax Expense Reconciliation

		Amt		Rate
Profit Before Tax		**150,000**		**25%**
Tax @ std rate (150000*25%)		37,500	(37.5k/150k)	25%
+/- Reconciling items:				
Less nontaxable dividend income (20,000*25%)		(5000)	(5k/150k)	(3.33%)
Plus nondeductible meals	5,000*25%	1250	(1.25k/150k)	0.83%
Plus nondeductible bad debts	500*25%	125	(0.14k/150k)	0.08%
		33,875		22.58%

Reasonability Check: Effective Tax rate X PBT = Tax Expense

22.58%*150000 = 33870

Tax Expense = 33875

diff 5 rounding-off difference

Questions ?

Offsetting

- Do not offset current tax assets and liabilities or deferred tax assets and liabilities unless entity has legal right to offset and it intends either to settle net or simultaneously

Offset of Tax Assets and Liabilities

- According to IAS 12.74 deferred tax assets and liabilities may only be off-set, if:
  - Entity has legally enforceable right to off-set current tax assets against current tax liabilities and the deferred tax assets and deferred tax liabilities relate to the same taxable entity on a net basis to the same tax authority.
- Separate legal persons (individual entities) are liable for income taxes to ZIMRA and not Group of companies.
- Deferred tax assets and deferred tax liabilities in group of companies may not be off-set (shown on a net basis) in the consolidated accounts.
- These should be shown separately if not relating to the same entity.

Questions ?

Investments in associates, subsidiaries, divisions & JVs – IAS 12. 39-44

39 An entity shall recognise a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, EXCEPT TO THE EXTENT that both of the following conditions are satisfied:

(a) the parent, investor, joint venturer or joint operator is able to control the timing of the reversal of the temporary difference; and

(b) it is probable that the temporary difference will not reverse in the foreseeable future.

Investments in associates, subsidiaries, divisions & JVs – IAS 12. 39-44

44 An entity shall recognise a deferred tax asset for all deductible temporary differences arising from investments in subsidiaries, branches and associates, and interests in joint arrangements, to the extent that, and only to the extent that, it is probable that:

(a) the temporary difference will reverse in the foreseeable future; and

(b) taxable profit will be available against which the temporary difference can be utilised.

Questions ?