Accounting for Income Taxes IAS 12 (Basics)

Lecture Video

IAS 12 INTRODUCTION & OVERVIEW
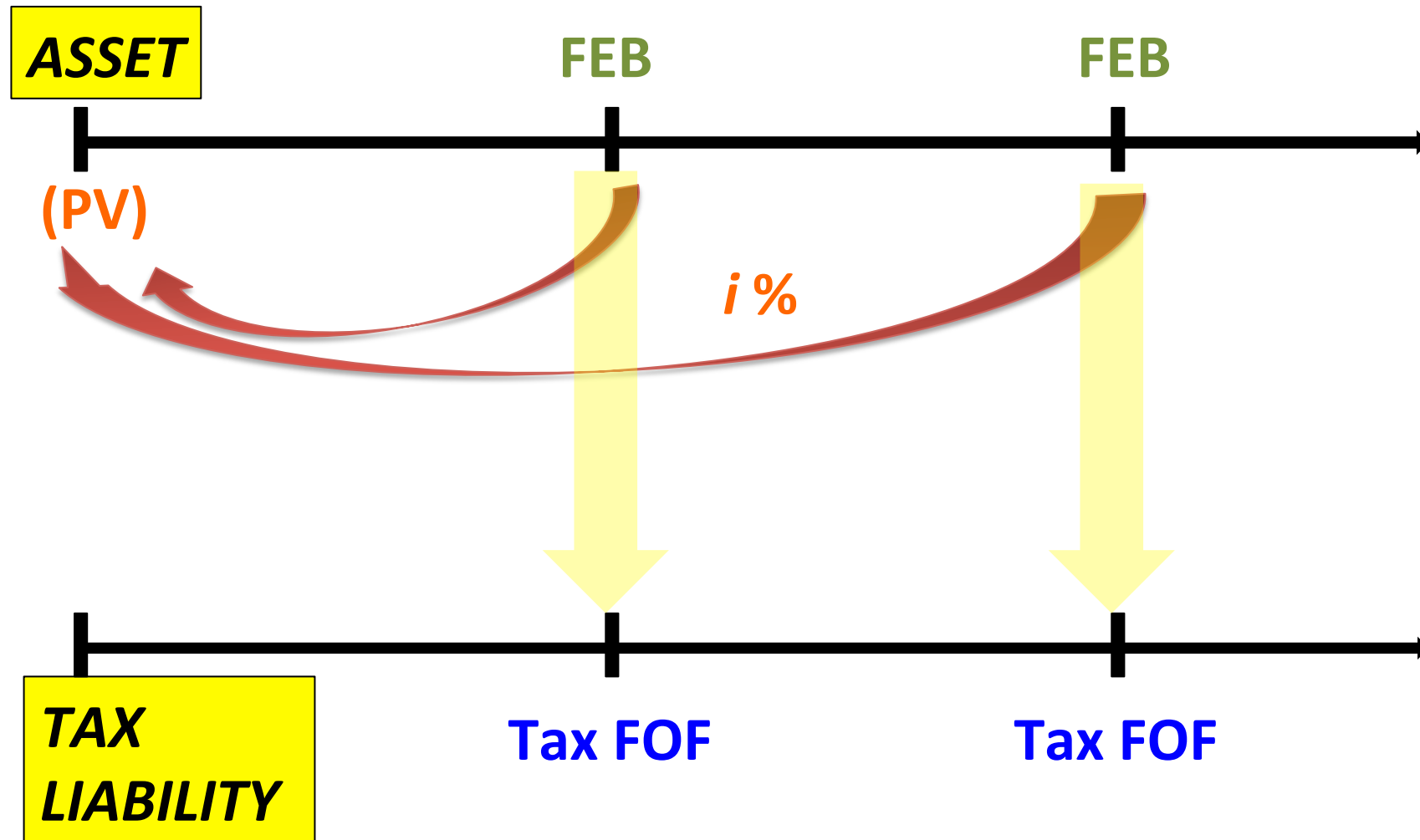
Profit: Accounting vs Tax

- Accounting profit

  = accounting framework such as IFRS

- Tax profit *(taxable income)*

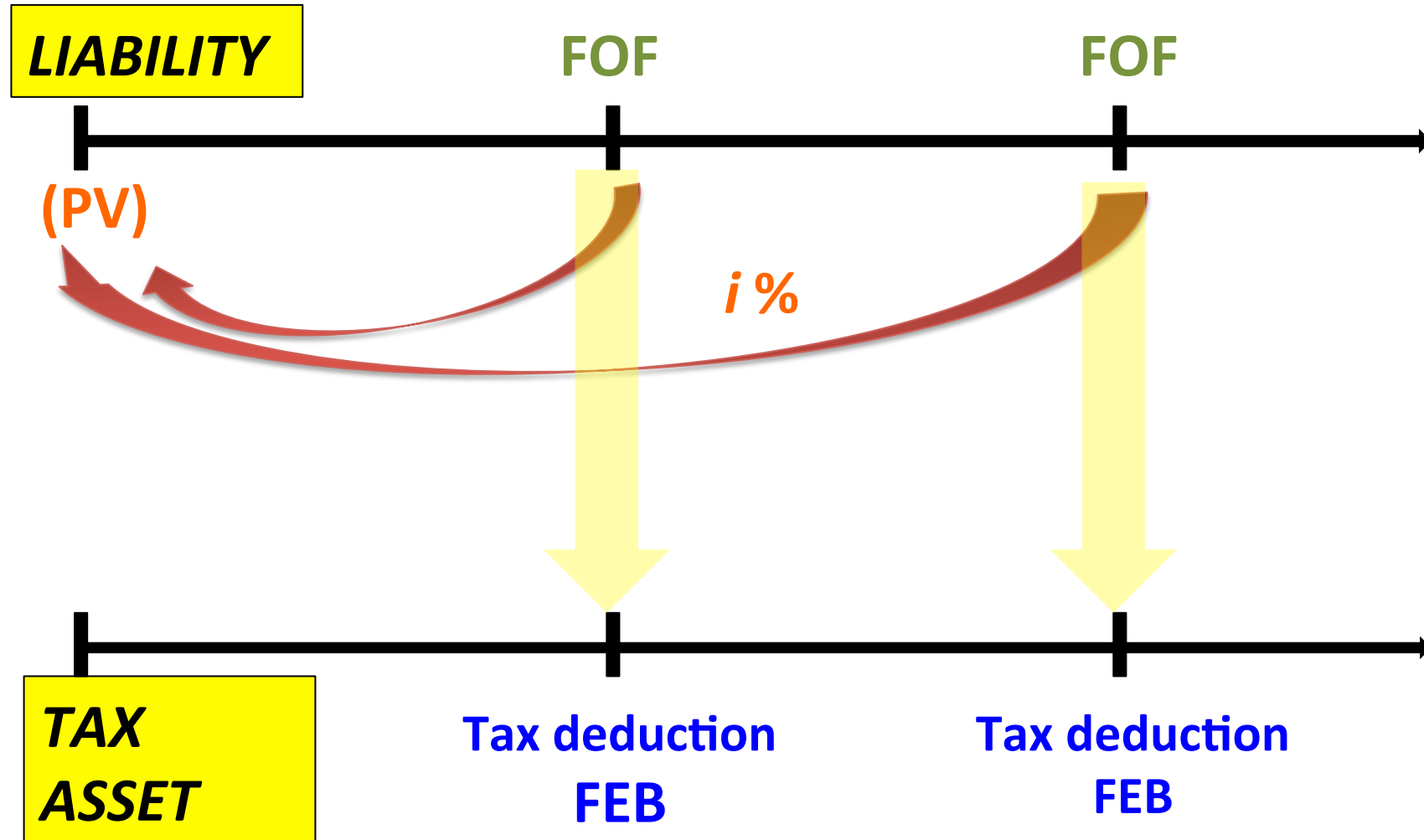 = tax legislation and rules

SoFP approach

- Assets = future benefits

- Liabilities = future outflows

- What about the tax effects of these future benefits and future outflows ?

Assets

ASSET

FEB

FEB

(PV)

i %

TAX LIABILITY

Tax FOF

Tax FOF

Liabilities

LIABILITY

FOF

FOF

(PV)

i **%**

TAX ASSET

Tax deduction FEB

Tax deduction FEB

<u>Underlying concepts</u>

- "Match" tax expense to accounting profit before tax

- 2 components

  – Current tax and

  – Deferred tax

- Two statements

  – Tax expense (both P/L and OCI)

  – Assets / Liabilities (current and deferred)

Deferred tax
Basic illustration of
financial position approach

Accounting for Income Taxes (Basics)

Illustration information

- Tabaldi Ltd has profit before tax of 100,000 (2011) and 100,000 (2010).

- Tabaldi Ltd purchased an asset (an item of Property, plant and equipment) for 5,000 on the first day of 2010. The useful life of the asset is 2 years with a zero residual value.

- The Tax Authority allows a 100% deduction for this type of asset in the first year.

- The current tax liability was paid in full 3 months after reporting date and assume that there was no interim or provisionl tax payments.

Current tax computation

	2010	2011
Profit before tax	100 000.00	100 000.00
Movements in temporary differences		
Depreciation		
Tax allowance		
Taxable Income		
Current tax expense	JNL1	
Total tax expense should be:		
Under/(over): deferred tax expense		

Deferred tax - SoFP approach

	Carrying Amount	Tax Base	Temp. Diff.	Deferred tax
PPE (on day 1)				
PPE (2010 RD)				
PPE (2011 RD)				

Journals 2010

JNL1 2010: Current tax expense

JNL2 2010: Deferred tax expense

Journals 2011

JNL1 2011: Current tax expense

JNL2 2011: Deferred tax expense

JNL3 2011: Payment of 2010 current tax liaility

Notes to the FS – Tax expense

1) Income tax expense	*Jnl ref*	**2010**	**2011**
1.1 Major components of tax expense			
Current tax expense			
SA Current tax expense	*Jnl 1*		
Deferred tax expense			
Movement in temporary differences	*Jnl 2*		
Total tax expense (SoCI)		28 000	28 000

Notes to the FS – Financial Position

	2010	2011
2) Deferred tax balance (Analysis of temporary differences)	**Dr / (Cr)**	**Dr / (Cr)**
Property, plant and equipment – accelerated tax depreciation		

3) Current tax payable

Current normal income tax payable

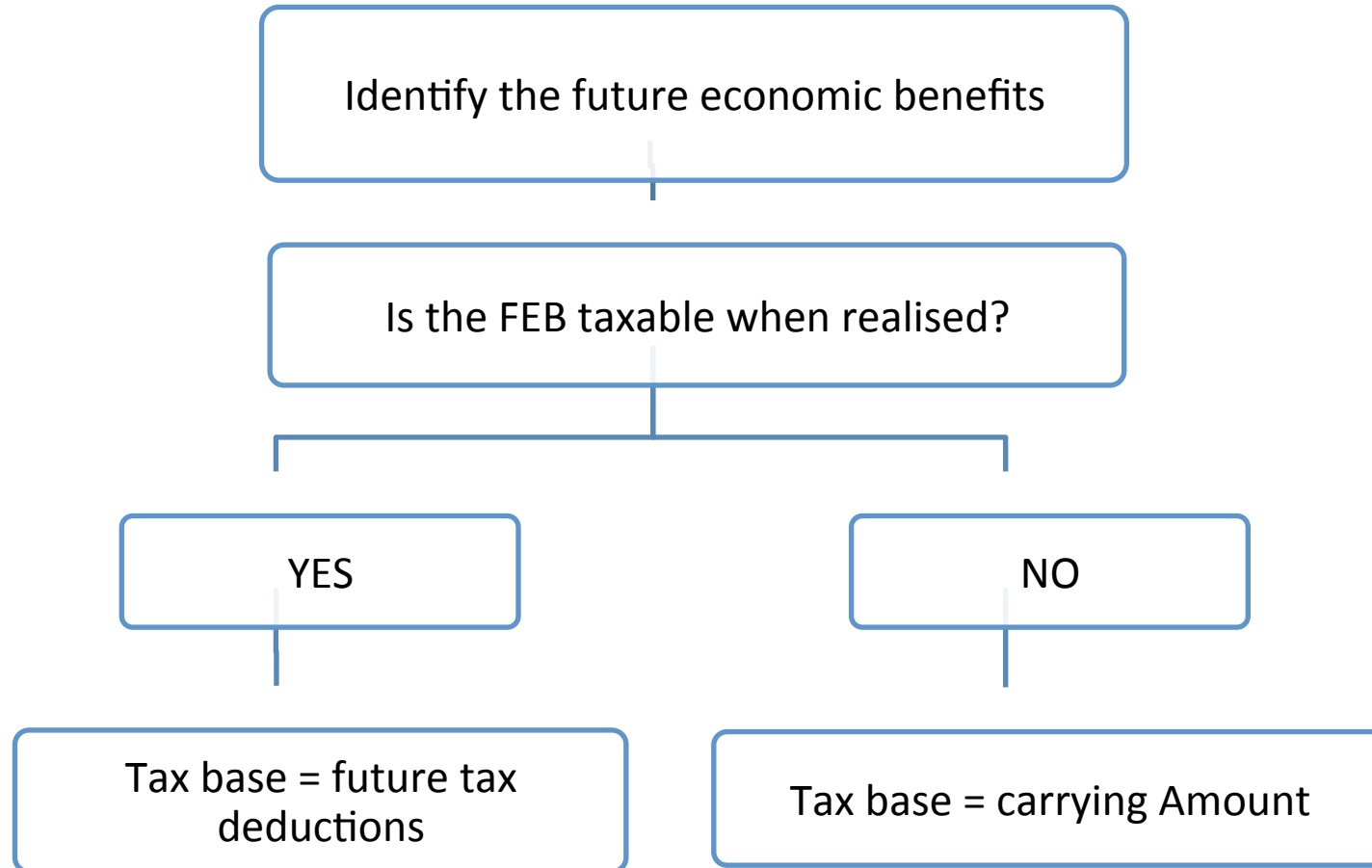# TAX BASE DEFINITION OF AN ASSET

Accounting for Income Taxes (Basics)

IAS 12 Basic Concepts

IAS12 par 7

- The tax base of an asset is the amount that will be *deductible for tax purposes*

- *against any taxable economic benefits* that will flow to the entity when it recovers the carrying amount of the asset

- If those economic benefits will *not be tax deductible, the TB = CA*

Tax base: asset

```
┌─────────────────────────────────────┐
│  Identify the future economic benefits │
└─────────────────────────────────────┘
                    │
┌─────────────────────────────────────┐
│    Is the FEB taxable when realised?   │
└─────────────────────────────────────┘
          │                     │
    ┌──────────┐          ┌──────────┐
    │   YES    │          │    NO    │
    └──────────┘          └──────────┘
          │                     │
┌──────────────────┐   ┌──────────────────┐
│ Tax base = future tax │ │ Tax base = carrying Amount │
│    deductions     │   │                  │
└──────────────────┘   └──────────────────┘
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Rules if you must

CA		TB	Temporary difference	Deferred tax (SFP)

CA_A > TB_A = Taxable TD = DT Liability

CA_A < TB_A = Deductible TD = DT Asset

Asset Example – Property, plant & equipment

Asset Example - Debtors

TAX BASE DEFINITION OF A LIABILITY

Accounting for income taxes (Basics)

IAS 12 Basic Concepts

IAS12 par 8

- The Tax base of a liability is

- its **Carrying amount – any amount that will be deductible**

- for tax purposes in respect of that liability in future periods

Tax base: liability

Identify the future outflow of resources

Is the FOF tax deductible in the future?

YES

Tax base = Carrying amount - future tax deductions

Rules if you must

CA		TB	Temporary difference	Deferred tax (SFP)

CA_L > TB_L = Deductible TD = DT Asset

CA_L < TB_L = Taxable TD = DT Liability

Liability Example - provision
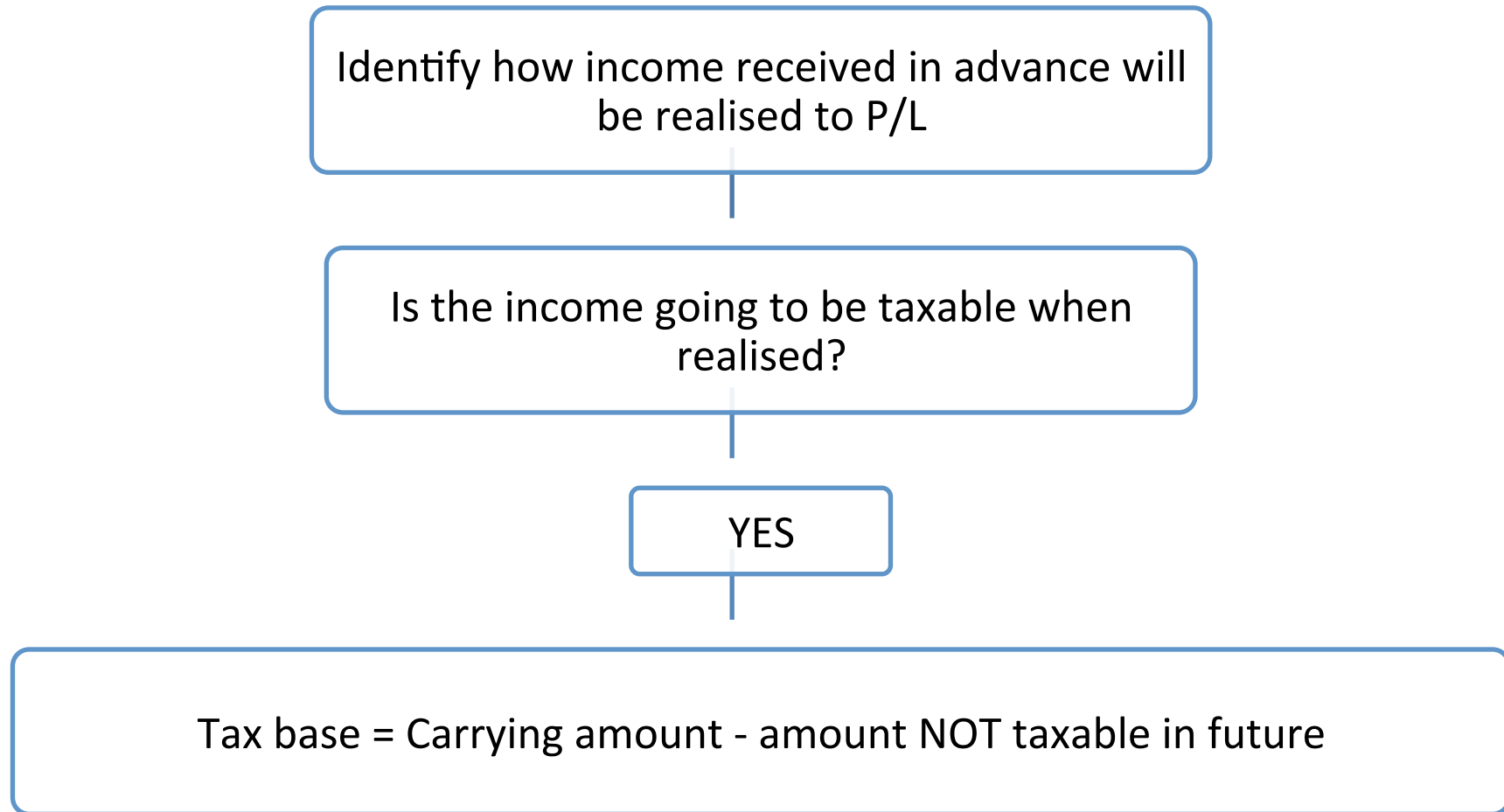
Liability Example - Creditors

TAX BASE DEFINITION OF INCOME

RECEIVED IN ADVANCE

Accounting for Income Taxes (Basics)

IAS12 par 8 cont.

- In the case of revenue which is received in advance,

- the tax base of the resulting liability is its

- carrying amount, less any amount of the revenue that will not be taxable in future periods.

Tax base: income received in advance

Identify how income received in advance will be realised to P/L

Is the income going to be taxable when realised?

YES

Tax base = Carrying amount - amount NOT taxable in future

<u>Rules if you must</u>

CA		TB	Temporary difference	Deferred tax (SFP)

$$CA_{IRA} \quad > \quad TB_{IRA} = \quad \text{Deductible TD} = \quad \text{DT Asset}$$

$$CA_{IRA} \quad < \quad TB_{IRA} = \quad \text{Taxable TD} = \quad \text{DT Liability}$$

Income in advance Example

Accounting for income taxes (Basics)

DISCLOSURE: INCOME TAXES (IAS12)

Start with the end in sight….

- Why?

- Result = disclosure in AFS

- Suggested format gets consistent results

- Not the only format, plenty of variations

- NB have a consistent approach

Overview of notes to AFS

1. Income tax expense (profit or loss)

   1.1 Major components of tax expense

   1.2 Tax rate reconciliation

2. OCI Component

3. Financial position (balances)

   2.1 Deferred tax asset / liability

   2.2 Current tax payable / receivable

DISCLOSURE: Income tax expense
Note 1.1: Major components of income tax

	X / (X)
Current tax expense	
Normal local current income tax expense	X
Under provision of prior year income tax	X
Over provision of prior year income tax	(X)
Current foreign income tax expense	X
Deferred tax expense	**X / (X)**
Movement in temporary differences	X / (X)
• *Normal rates*	X / (X)
• *CGT rates*	X / (X)
Change in tax rate	X / (X)
Tax losses carried forward / utilized	
• *Assessed losses for normal income tax*	X / (X)
○ *Assessed loss prior year – brought forward*	X
○ *Assessed loss prior year – not recognised*	(X)
○ *Assessed loss current year – carried forward*	(X)
○ *Assessed loss current year – not recognised*	X
• *Capital losses*	X / (X)
○ *Capital loss prior year – brought forward*	X
○ *Capital loss prior year – not recognised*	(X)
○ *Capital loss current year – carried forward*	(X)
○ *Capital loss current year – not recognised*	X
Foreign tax (Deferred)	X / (X)
Total tax charge / credit in profit and loss	**X / (X)**

Note 1.2: Tax rate reconciliation

Profit before tax (Accounting)	**X**
Tax thereon at normal tax rate	**X**
Permanent differences	X / (X)
• Exempt / non taxable income	
o Dividend income	(X)
• Non deductible expenses	
o Donations	X
o Fines	X
Capital gains tax	(X)
• Capital gains at normal rate	(X)
• Tax provided on capital gains	X
Change in tax rate	X / (X)
Under / (over) provision	X / (X)
Foreign income	X
• At SA rate	(X)
• At foreign rate	X
Deferred tax assets not recognised	X / (X)
Total tax charge / (credit) in profit and loss	**X**
Effective tax rate	**X%**

DISCLOSURE: Deferred Tax Balance

Note 2: Analysis of deferred tax balance

	Normal rates	CGT rates	Total Dr / (Cr)	
Taxable temporary differences				
• Property plant equipment	X	X	X	L
• Prepaid expenses	X	-	X	L
• Financial instruments	X	X	X	L
Deductible temporary differences				
• Provisions	(X)	-	(X)	A
• Deferred income	(X)	(X)	(X)	A
Deferred tax on temporary differences			X / (X)	A/L
Deductible temporary differences not recognised			X	L
Unused assessed loss – asset recognised			X / 0	A
• Total tax loss carry-forward			X	A
• Unrecognised			(X)	L
Unused capital loss – asset recognised			X / 0	A
• Total capital loss carry-forward			X	A
• Unrecognised			(X)	L
Total deferred tax asset / liability			X / (X)	A/L

THE CURRENT TAX COMPUTATION

Accounting for Income Taxes (Basics)

What's the point?

Profit before tax (Accounting)   XXX

.

.

.

Taxable income (Tax)   XXX

Current tax expense (taxable income X tax rate)   XXX

Current tax journal:

Debit Current tax expense (P/L)

    Credit Current tax payable (SFP)

Simplified
(*Ignoring capital gains*)

Profit before tax (Accounting)	**XXX**
Permanent differences	X / (X)
Foreign income	(XX)
	XXX
Movements in temporary differences	X / (X)
Reverse accounting treatment (eg depreciation)	X
Replace with tax treatment (eg wear & tear / capital allowance)	(X)
	X / (X)
Assessed tax loss brought forward from prior year	(X) / 0
	X / (X)
Assessed tax loss carried forward in current year	0 / X
Taxable income	X / 0

PROPERTY, PLANT AND EQUIPMENT:

DEFERRED TAX ILLUSTRATION

Accounting for Income Taxes (Basics)

The logic

- Accounting depreciation is based on the economic life of the asset.

- Tax depreciation (wear & tear or capital allowance) is based on legislative rules.

- Therefore, accounting expense and tax deduction can be in different periods.

- = temporary difference = deferred tax

Illustration - information

- Tabaldi Ltd purchases equipment on 1 January 2012 for CU 60,000.

- Useful life of equipment estimated = 5 years

- Residual value estimated = CU 10,000.

- Accounting depreciation straight line basis.

- Tax wear and tear is 25% per annum.

- Equipment sold on 31 December 2013.

- Proceeds on sale = CU 58,000

- Reporting date 31 December 2013 with profit before tax **before** accounting for the sale of equipment = CU 100 000.

- Tax rate = 28%

W1) Equipment balances

	RUL (Years)	CA (IFRS)	TB (Tax)
Cost (1/1/2012)	5	60 000	60 000
Depreciation 2012 *(60 000 – 10 000) x 1/5*	(1)		
Wear & tear *(60 000 x 25%)*			
Balance 31/12/2012	4		
Depreciation 2013	(1)		
Wear & tear			
Balance before sale 31/12/2013	3		
Sale 31/12/2013	(3)		
Proceeds (selling price)		(58 000)	(58 000)
Profit (accounting) *(58 000 – 40 000)*			
Recoupment (tax) *(58 000 – 30 000)*			

W2) Current tax computation

	CU
Profit before tax (incomplete)	*100 000*
Accounting profit on sale of equipment	_____
Profit before tax (accounting correct)	
Movement in temporary differences	
Depreciation (accounting) – reverse out	
Profit on sale (accounting) – reverse out	
Wear & tear (tax) - deduction	
Recoupment on sale (tax) – taxable income	
	_____
Taxable income	
Current tax expense @ 28%	

W3) Deferred tax balance calc

	Carrying amount	**Tax base**	**Temporary difference balance**	**Deferred tax balance @ 28%**
2012 - Equipment				
2013 - Equipment				

W4) Deferred tax movement

2013 Movement	Temporary difference	Deferred tax @ 28%
2012 Balance	5 000 Taxable TD balance	1 400 L balance
2013 Balance	0	0
2013 Movement	5 000 Deductible TD movement	1 400 A mvt (Debit FP=decrease L)

Deferred tax movement journal

PROVISIONS & LIABILITIES:

DEFERRED TAX ILLUSTRATION

Accounting for Income Taxes (Basics)

The logic

Accounting (ACCRUAL BASIS):

Dr Expense (P/L)	XXXX	
Cr Provision (SFP)		XXXX

Dr Provision (SFP)	XXXX	
Cr Bank (SFP)		XXXX

Tax:

Earlier of cash payment or accrual (LEGAL)

Generally tax authority allows deduction in period of payment.

Illustration - information

- Tabaldi Ltd recognises the following items ate reporting date 31 December 2013:

  – Provision for leave pay 2013 = CU120 000

    (2012 = CU 90 000)

  – Rental expense accrual (invoice for December unpaid) 2013 = CU 80 000 (2012 = CU 75 000)

- Profit before tax = CU 100 000.

- Tax rate = 28%

W2) Current tax computation

	CU 2013
Profit before tax	*100 000*
Movement in temporary differences	
Provision for leave pay	
Opening balance	
Closing balance	
Rental expense accrual (No temporary difference)	
Taxable income	
Current tax expense @ 28%	

W3) Deferred tax balance calc

2013 calc	**Carrying amount**	**Tax base**	**Temporary difference balance**	**Deferred tax balance @ 28%**
Rental accrual				
Provision				
2013 – DT Balance				

W3) Deferred tax balance calc

2012 calc	**Carrying amount**	**Tax base**	**Temporary difference balance**	**Deferred tax balance @ 28%**
Rental accrual				
Provision				
			_____	
2013 – DT Balance				
			_____	

W4) Deferred tax movement

2013 Movement	Temporary difference	Deferred tax @ 28%
2012 Balance	90 000 Deductible TD Bal	25 200 A
2013 Balance	120 000 Deductible TD Bal	33 600 A
2013 Movement	30 000 TD mvt	8 400 A mvt (Debit FP=decrease L)

Deferred tax movement journal

PREPAID EXPENSES:

DEFERRED TAX ILLUSTRATION

Accounting for Income Taxes (Basics)

The logic

Accounting :

Dr Prepaid expense (SFP)	XXXX
Cr Bank (SFP)	XXXX

Dr Expense (P/L)	XXXX
Cr Prepaid expense (SFP)	XXXX

Tax:

Earlier of cash payment or accrual (LEGAL)

Illustration - information

- Tabaldi Ltd prepaid the January 2013 rental expense during December 2013.

- The prepaid rental expense balance at the

    31 December 2013 reporting date:

        CU 200 000 (2012 = CU 180 000)

- Profit before tax = CU 100 000.

- Tax rate = 28%

W1) Current tax computation

<u>CU</u>
<u>2013</u>

Profit before tax   *100 000*

Movement in temporary differences

  Prepaid rental expense
    Opening balance

    Closing balance

Taxable income

Current tax expense @ 28%

W2) Deferred tax balance calc

2013 calc	**Carrying amount**	**Tax base**	**Temporary difference balance**	**Deferred tax balance @ 28%**
Prepaid expense				
				_____

W3) Deferred tax balance calc

2012 calc	Carrying amount	Tax base	Temporary difference balance	Deferred tax balance @ 28%
Prepaid expense				
				_____

W4) Deferred tax movement

2013 Movement	Temporary difference	Deferred tax @ 28%
2012 Balance	180 000 Taxable TD Bal	50 400 L
2013 Balance	200 000 Taxable TD Bal	56 000 L
2013 Movement	20 000 TD mvt	5 600 DT Mvt

Deferred tax movement journal

INCOME RECEIVED IN ADVANCE:

DEFERRED TAX ILLUSTRATION

Accounting for Income Taxes (Basics)

The logic

Accounting :

Dr Bank (SFP)	XXXX
Cr Income received in advance (SFP)	XXXX

Dr Income received in advance (SFP)	XXXX
Cr Income (P/L)	XXXX

Tax:

Earlier of cash receipt or accrual (LEGAL)

Illustration - information

- Tabaldi Ltd received tuition fees income in December 2013 for classes to be provided in January 2013.

- The income received in advance balance at the 31 December 2013 reporting date:

    CU 200 000 (2012 = CU 180 000)

- Profit before tax = CU 100 000.

- Tax rate = 28%

W1) Current tax computation

	CU 2013
Profit before tax	*100 000*
Movement in temporary differences	
Income received in advance	
Opening balance	
Closing balance	
Taxable income	
Current tax expense @ 28%	

W2) Deferred tax balance calc

2013 calc	**Carrying amount**	**Tax base**	**Temporary difference balance**	**Deferred tax balance @ 28%**
Income received in advance				
				_____

W3) Deferred tax balance calc

2012 calc	**Carrying amount**	**Tax base**	**Temporary difference balance**	**Deferred tax balance @ 28%**
Income received in advance				
				_____

W4) Deferred tax movement

2013 Movement	Temporary difference	Deferred tax @ 28%
2012 Balance	180 000 Deductible TD Bal	50 400 A
2013 Balance	200 000 Deductible TD Bal	56 000 A
2013 Movement	20 000 TD mvt	5 600 DT Mvt

Deferred tax movement journal

ALLOWANCE FOR CREDIT LOSSES ON TRADE RECEIVABLES: DEFERRED TAX ILLUSTRATION

Accounting for Income Taxes (Basics)

The logic

Accounting :

No more provision for bad debts.

Make an IAS 39 impairment estimate (allowance for credit losses)

Dr Expense (P/L)	XXXX	
Cr Allowance for credit loss (TR) (SFP)		XXXX

Tax:

Provision for doubtful debts – 25% allowed as deduction

The remaining 75% deductible when actually written off

Illustration - information

- Tabaldi Ltd had a trade receivables gross balance of CU150 000 on 31 December 2013 (2012 =CU125 000 trade receivables).

- Management performed a detailed analysis of individual credit customers with balances owing and estimated an allowance for credit losses (impairment allowance) of CU20 000 (2012 = CU16 000 allowance for credit loss)

- Profit before tax = CU 100 000.

- Tax rate = 28%

W1) Current tax computation

	<u>CU</u> <u>2013</u>
Profit before tax	*100 000*
Movement in temporary differences	
Accounting allowance for credit losses	
Closing balance	
Opening balance	
Tax provision for doubtful debts	
   Closing balance (25% x	
   Opening balance (25% x	
Taxable income	
Current tax expense @ 28%	

W2) Deferred tax balance calc

2013 calc	**Carrying amount**	**Tax base**	**Temporary difference balance**	**Deferred tax balance @ 28%**
Trade receivables				
Gross				
Allowance for CL				

W3) Deferred tax balance calc

2012 calc	Carrying amount	Tax base	Temporary difference balance	Deferred tax balance @ 28%
Trade receivables				
Gross				
Allowance for CL				

W4) Deferred tax movement

2013 Movement	Temporary difference	Deferred tax @ 28%
2012 Balance	12 000 Deductible TD Bal	3 360 A
2013 Balance	15 000 Deductible TD Bal	4 200 A
2013 Movement	3 000 TD mvt	840 DT Mvt

Deferred tax movement journal

PERMANENT DIFFERENCES IN THE CURRENT TAX COMPUTATION

Accounting for Income Taxes (Basics)

What are PD's?

- Non taxable income

  – Income that is never going to be taxable income

    - Dividend received

    - Some government grants

- Non deductible expenditure

  – Expenditure that will never be tax deductible

    - Fines and interest (eg. from late tax payments)

    - Donations (if not deductible)

    - Some accounting depreciation – if no tax depreciation (wear & tear / capital allowance)

So what?

- Income that is never taxable or deductions that are never deductible **distorts the tax rate**.

- Utilise permanent differences when doing tax rate reconciliation.

<u>Illustration</u>

- Tabaldi Ltd has a profit before tax for 2013 of CU100 000. Assume no temporary differences.

- <u>The PBT includes the following:</u>

	2013 <u>**Dr / (Cr)**</u>
Dividend received	(20 000)
Fines for late payment of VAT	8 000
Interest on late payment of VAT	2 000
Depreciation on admin building (no capital allowance for tax purposes)	15 000

W1) Current tax computation

	CU
Profit before tax	*100 000*
Permanent differences:	
Dividend received	
Fines for late payment of VAT	
Interest on late payment of VAT	
Depreciation on admin building *(no capital allowance for tax purposes)*	
Movement in temporary differences	
Taxable income	
Current tax expense @ 28%	

Tax rate recon effect

	CU _OR_	%
Profit before tax	100 000	
Tax at 28 % (standard rate)	28 000	
Dividend received (20 000 x 28%)		
Fines for late payment of VAT (8 000 x 28%)		
Interest on late payment of VAT (2 000 x 28%)		
Depreciation on admin building (15 000 x 28%) _(no capital allowance for tax purposes)_		
Total tax expense		
Effective tax rate		

IAS 12 DEFERRED TAX EXEMPTION

Accounting for Income Taxes (Basics)

IAS 12 par 15 says…..

- A **deferred tax liability** shall be recognised for all taxable temporary differences, except to the extent that the deferred tax liability arises from:

    a) the initial recognition of goodwill; or

    b) the initial recognition of an asset or liability in a transaction which:

    i. is not a business combination; and

    ii. at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

IAS 12 par 24 says…..

- A **deferred tax asset** shall be recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised, unless the deferred tax asset arises from the initial recognition of an asset or liability in a transaction that:

  a) is not a business combination; and

  b) **at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).**

Example - Land

- Tabaldi Ltd purchased an empty piece of land

  to develop in the future.

- The land cost CU100 000 on 1 January 2012.

- Reporting date 31 December.

W1) Deferred tax balance calc
If no IAS 12 exemption

	Carrying amount	Tax base	Temporary difference balance	Deferred tax balance @ 28%
Land – 2012				_____
Land – 2011				_____
Movement 2012 ????				_____

<u>W2) Current tax computation ?</u>

<u>CU</u>
<u>2013</u>

Profit before tax   *XXXXX*

Movement in temporary differences

  Depreciation (Accounting) ?

  Wear & tear (tax) ?

Taxable income   *XXXXX*

Deferred tax proof?

- ## Deferred tax balance movement

Dr Deferred tax expense (P/L) 28 000	
Cr Deferred tax (SFP)	28 000

NOT EQUAL TO

- ## Current tax calculation – Mvt in TD

Movement in temporary differences   Nil   X 28% = Nil

    Depreciation (Accounting) ?   Nil

    Wear & tear (tax) ?   Nil

Deferred tax balance calc
WITH IAS 12 EXEMPTION

	Carrying amount	Tax base	Temporary difference balance	Deferred tax balance @ 28%
Land – 2012	100 000			NIL
				_____

OVER / UNDER PROVISION OF TAX

Accounting for Income Taxes (Basics)

The issue

- Tax authority does not always agree with your current tax computation.

- If tax assessment does not equal your current tax computation

  – CHANGE IN ESTIMATE (IAS 8)

  – OVER OR UNDER PROVISION of tax expense

Illustration – under provision

- Tabaldi Ltd calculated taxable income for the 2012 year (prior year) as CU90 000, with a current tax payable of CU25 200

- Reporting date is 31 December 2012.

- During June 2013, Tabaldi received a tax assessment indicating a current tax liability of CU30 000.

Journal

- Do **not** adjust in prior period 2012.

- This is a change in estimate – IAS 8

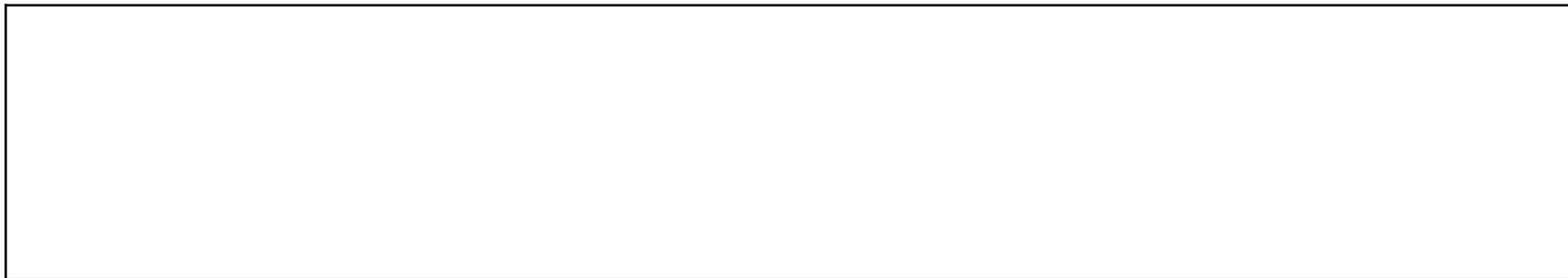- Change in estimate = prospective (current year)

Illustration – over provision

- Tabaldi Ltd calculated taxable income for the 2012 year (prior year) as CU90 000, with a current tax payable of CU30 000

- Reporting date is 31 December 2012.

- During June 2013, Tabaldi received a tax assessment indicating a current tax liability of CU25 200.

Journal

- Do **not** adjust in prior period 2012.

- This is a change in estimate – IAS 8

- Change in estimate = prospective (current year)
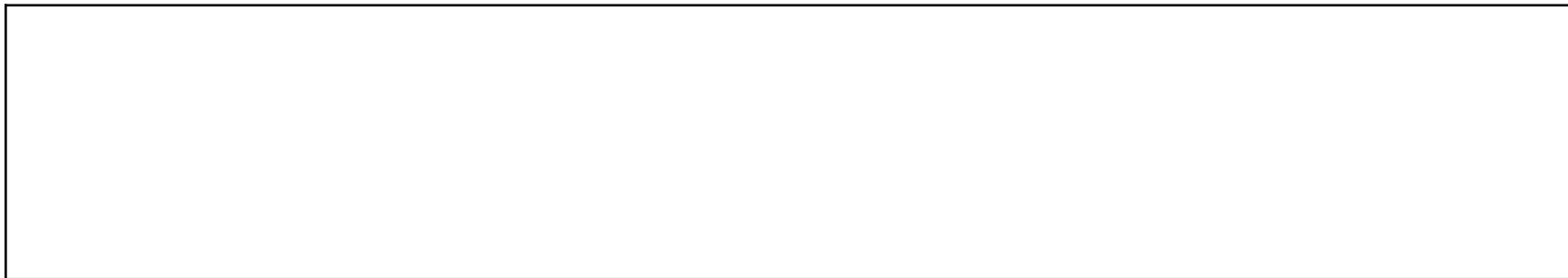
Disclosure ….

- Major components:
  - Current tax expense
    - Over / under provision   (XX) / XX

_____

- Tax rate reconciliation:
  - Profit before tax   _XX_
  - Tax @ 28%   xx
  - Over provision   (x)
  - Under provision   x
  - Total tax expense   xx