IAS 12

Income Taxes

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Learning objectives

Upon completion you will understand

- Provisions of current tax
- Provisions of deferred tax
- Accounting for current and deferred tax
- Disclosure requirements

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General rules

Current tax – Recognition and Measurement

Deferred tax

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Comparison of IFRS and Ind AS

Income Tax

Income tax

=

Current tax

+

Deferred tax

Current tax is the amount of income tax payable (recoverable) in respect of the taxable profit (tax loss) for a period

DT – simply recognises the difference between when an item is TAXABLE and when it is ACCOUNTED FOR…

Recognition of current tax

In the statement of financial position current tax for current and prior periods should be recognised as an asset or liability

Tax payable = liability

Tax paid but recoverable = asset

Tax assets may arise in some jurisdictions through the ability to redeem current period tax losses against tax paid in earlier periods

Recognition of current tax (continued)

Profit or Loss	→ Unless relates to item outside profit or loss (either in other comprehensive income or in equity)
OCI/Equity	→ If relates to item either in other comprehensive income or in equity

Measurement of current tax

Applicable tax rate
for that type of income

Enacted or substantively enacted by end of the reporting period

- General rate
- Specific rates (e.g. capital gains tax rate)
- Assume no distribution

Distribution of profit - Example

Taxable income as at 31 December 2014 is $**100,000.** Subsequently, on 15 March 2015 proposed dividends of $**10,000** are approved and recognised as a liability

Tax rate for undistributed earnings 50%

Tax rate for distributed earnings 35%

What tax rate ?

Measure tax on undistributed earnings at 50 % as at 31 December 2014

- Recognise current income tax liability and expense of $50,000
- Expectation of future distribution irrelevant

Remeasure when distribution recognised as at 15 March 2015

- Credit 1,500 (15%) as at 15 March 2015 to profit or loss

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Deferred tax: Overview

IFRS book value Vs Tax base

=

Temporary differences

Deductible

Taxable

Tax rate applicable

Profit or loss OR

-OCI / Equity

- Goodwill

Deferred tax recognition ?

Tax base

The tax base of an item is the amount attributed to that item for tax purposes

Tax base of an asset:

- Amount deductible for tax purposes when the asset is recovered
- Example:
  - Interest receivable of 100 (carrying amount)
  - Related interest revenue are taxed on a cash basis.
  - Tax base is nil

Tax base of a liability:

- Carrying amount less any amount that will be deductible for tax purposes in respect of that liability
- Example:
  - Warranty provision of 100 (carrying amount)
  - Amount deducted only on claim by tax authorities
  - Tax base is Nil

Class discussion:

Initial cost of a building: $120

Useful life: 3 years (tax) vs 6 years (accounting)

Tax rate: 40%

Annual profit before taxes and depreciation: $200

How is income tax calculated?

Contd..

Year	1	2	3	4	5	6
Profit before depreciation and tax	200	200	200	200	200	200
Depreciation expense	(20)	(20)	(20)	(20)	(20)	(20)
Profit before tax (PBT)	180	180	180	180	180	180
Current tax expense (CTE)	(64)	(64)	(64)	(80)	(80)	(80)
Effective tax rate (CTE/PBT)	36%	36%	36%	44%	44%	44%
Net profit	116	116	116	100	100	100

Why does effective tax rate not agree to the applicable tax rate of 40%?

Solution:

Year	1	2	3	4	5	6
Building, tax base	80	40	-	-	-	-
Building, carrying amount	100	80	60	40	20	-
Temporary difference	20	40	60	40	20	-
Deferred tax liability	8	16	24	16	8	-
Deferred tax expense	8	8	8			
Deferred tax income				(8)	(8)	(8)
Current tax expense	64	64	64	80	80	80
Income tax expense	72	72	72	72	72	72
Profit before tax	180	180	180	180	180	180
Effective tax rate	40%	40%	40%	40%	40%	40%

Examples: Tax base of assets

State the tax base of each of the following assets.

(a) A machine cost $10,000. For tax purposes, depreciation of $3,000 has already been deducted in the current and prior periods and the remaining cost will be deductible in future periods, either as depreciation or through a deduction on disposal. Revenue generated by using the machine is taxable, any gain on disposal of the machine will be taxable and any loss on disposal will be deductible for tax purposes.

(b) Interest receivable has a carrying amount of $1,000. The related interest revenue will be taxed on a cash basis.

(c) Trade receivables have a carrying amount of $10,000. The related revenue has already been included in taxable profit (tax loss).

(d) A loan receivable has a carrying amount of $1m. The repayment of the loan will have no tax consequences.

Examples: Tax base of liabities

State the tax base of each of the following liabilities

(a) Current liabilities include accrued expenses with a carrying amount of $1,000. The related expense will be deducted for tax purposes on a cash basis.

(b) Current liabilities include interest revenue received in advance, with a carrying amount of $10,000. The related interest revenue was taxed on a cash basis.

(c) Current liabilities include accrued expenses with a carrying amount of $2,000. The related expense has already been deducted for tax purposes.

(d) Current liabilities include accrued fines and penalties with a carrying amount of $100. Fines and penalties are not deductible for tax purposes.

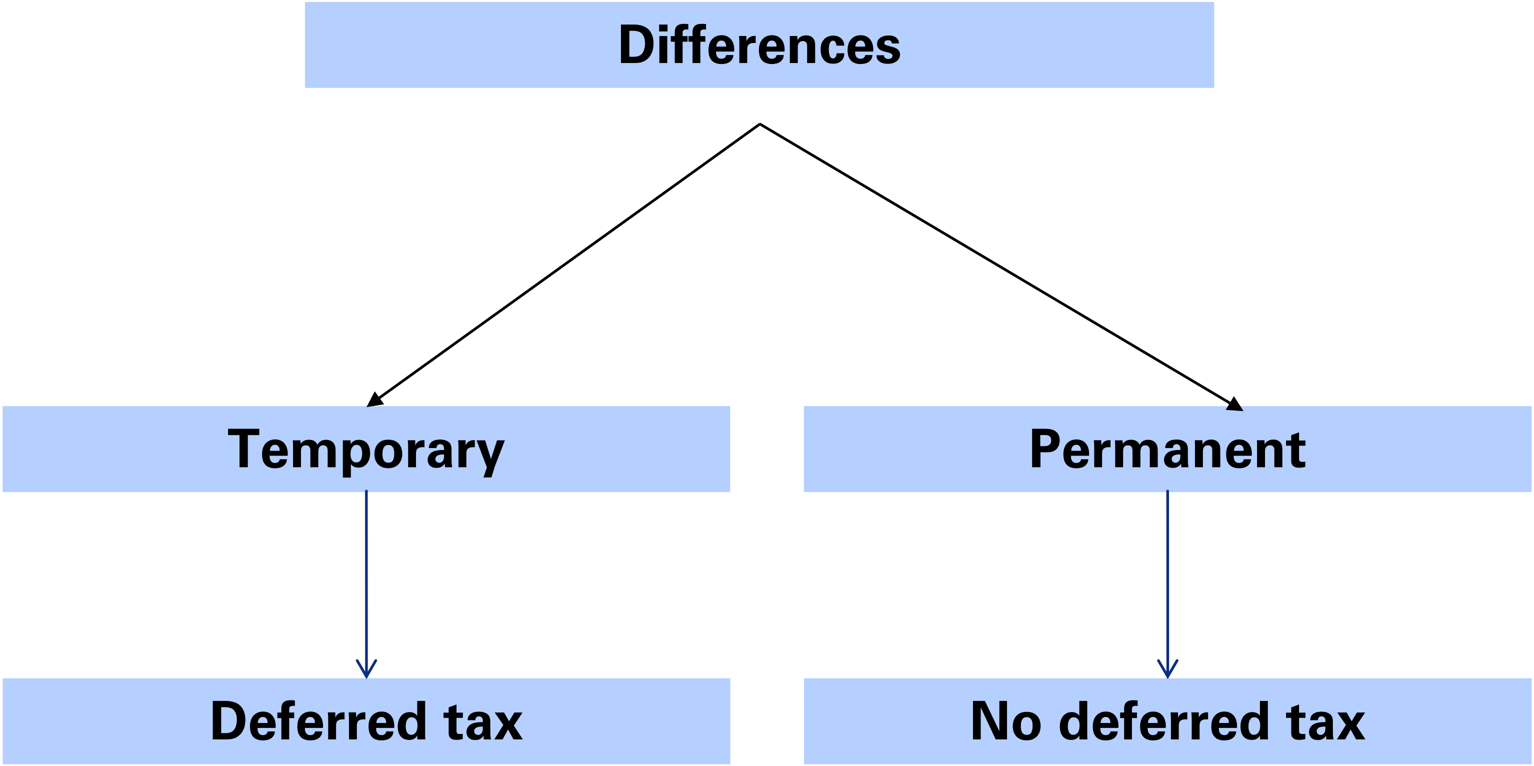
(e) A loan payable has a carrying amount of $1m. The repayment of the loan will have no tax consequences..

Carrying value equal to tax base

IAS 12 gives the following examples of circumstances in which the carrying amount of an asset or liability will be **equal to its tax base**.

- **Accrued expenses** which have already been deducted in determining an enterprise's current tax liability for the current or earlier periods.
- A **loan payable** is measured at the amount originally received and this amount is the same as the amount repayable on final maturity of the loan.
- **Accrued expenses** which will never be deductible for tax purposes.
- **Accrued income** will never be taxable.

Differences



Temporary Differences

Taxable temporary differences (DTD) → TTDs are subject to tax in future and therefore a deferred tax liability has to be recognised (as you have some amount of tax payable in future)

Deductible temporary differences (DTD) → DTDs are subject to deduction from taxable profit in future and therefore a deferred tax asset has to be recognised

Temporary differences

Temporary differences	=	**Accounting** IFRS Book value	-	**Tax** Base
Taxable amount on recovery/settlement	→	**Taxable** temporary difference	→	**Deferred tax LIABILITY**
Deductible amount on recovery/settlement	→	**Deductible** temporary difference	→	**Deferred tax ASSET**

Typical Temporary Differences

Account	Potential temporary differences
Marketable securities	Recorded at fair value for financial statement purposes, generally recorded at historical cost for tax purposes.
Allowance for doubtful accounts	Allowance for tax purposes, if permitted, generally different from the financial statement allowance.
Inventory	Valuation reserves for financial statement purposes not recorded for tax purposes.
Property, plant and equipment	Costs capitalized for financial statement purposes but not for tax purposes.
	Different depreciation lives or methods for financial statement and tax purposes.
Pension liability (or asset)	Generally not deductible for tax purposes until paid.

Taxable temporary difference - Example 1

PPE with original cost of $150

- Accounting treatment: depreciate straight line to zero residual value over 5 years
- Tax treatment: original cost tax deductible straight line over three years

At end of year 1

- Accounting: carrying amount = $120
- Tax: tax base = $100

Taxable temporary difference: 120 – 100 = 20

Deferred tax liability

Deductible temporary difference - Example 2

Restructuring provision of $100

- Accounting treatment: expense as per IAS 37
- Tax treatment: tax deductible upon reversal (when actual expenses incurred

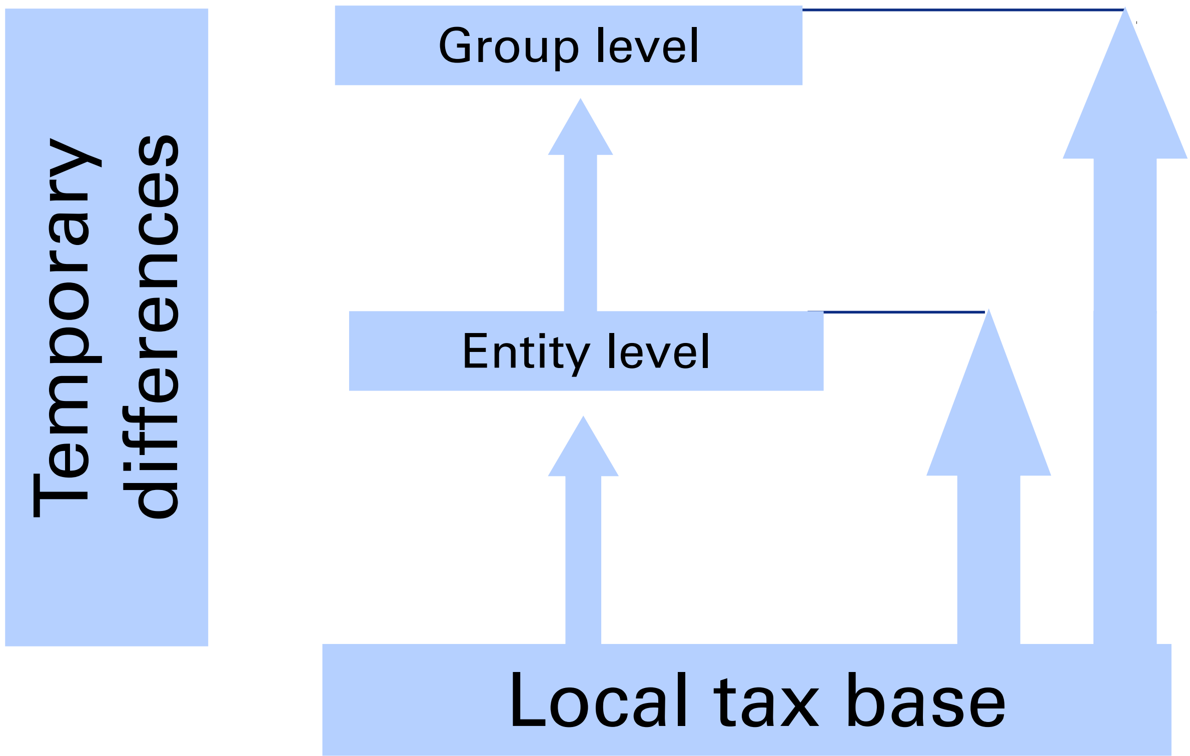
Immediately after making the provision

- Accounting: carrying amount = $100
- Tax: tax base = 0

Deductible temporary difference: -(100 – 0) = 100

Deferred tax asset

Temporary differences and consolidation



Measurement of deferred tax

Applicable tax rate

Enacted or substantively enacted by end of the reporting period

Expected manner of recovery or settlement:
- usage rate
- disposal rate

Assume no distribution

Measurement - No discounting

~~Discounting~~

Recognition of deferred tax

Profit or Loss	**All cases, unless:**
OCI / Equity	If relates to item either in other comprehensive income or in equity
Goodwill	If arises on a business combination

Recognition of deferred tax outside profit or loss - Examples

OCI

- Revaluation gain/loss
- Fair value through OCI (IFRS 9)
- Foreign exchange differences on the translation of a foreign entity (IAS 21)
- Cash flow hedge (IAS 39)

Equity

- Compound financial instruments (IAS 39)
- Adjustment to the opening balance of retained earnings (IAS 8/IFRS 1)
- Share based payments (IFRS 2)

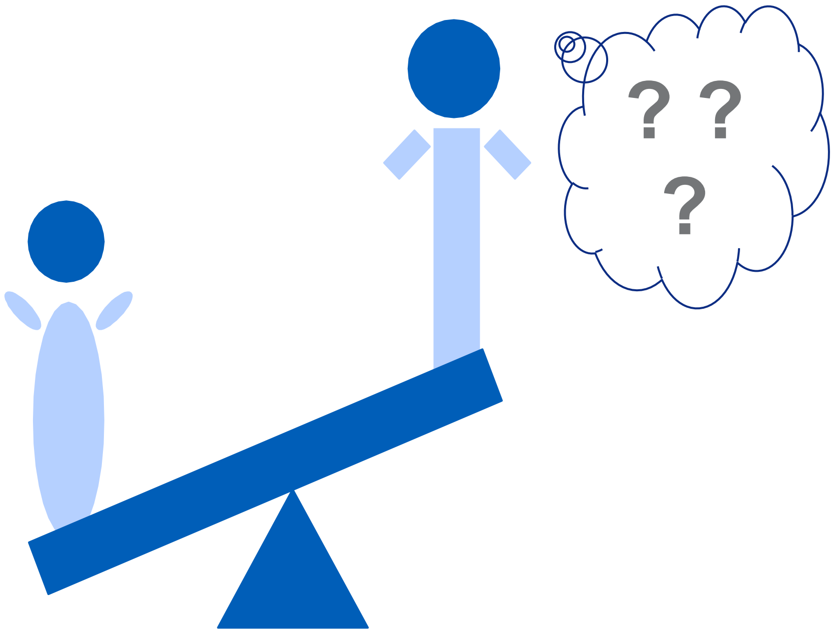
Recognition of deferred tax asset / liability

Liability

Recognise in full

Asset

Recognise if recoverable



Deferred tax asset - Examples

- **Deductible temporary differences**
- **Unused tax losses**
- **Unused tax credits**

Asset recognition: When?

Sufficient taxable profit:

- Taxable temporary differences
- Taxable profits
- Tax planning opportunities
- Carry back income

Deferred tax asset recognition - To what extent?

Company	DTA	Forecast taxable profit for 3 years	Recognised DTA
A	**100**	**500**	**100**
B	**100**	**(200)**	**0**
C	**100**	**80**	**?**

Evaluation of 'Probable/convincing evidence Criterion: Assessing the Evidence

Positive evidence	Negative evidence
- Existing contracts or firm sales backlog	- Losses expected in the early future years
- Cumulative earnings in recent years	- Cumulative losses in recent years
- Long carry forward/ carry back periods	- Brief carry forward/ carryback periods
- History of utilization of carry forwards before they expire	- History of carry forwards expiring unutilized
- Availability of feasible and prudent tax planning strategies	- Existence of loss contingencies

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Key differences of IGAAP & IFRS

Comparison of IFRS and Ind AS

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Presentation

- Deferred tax assets/liabilities to be classified as non current items in a classified statement of financial position
- Tax expense to be presented separately in the statement of comprehensive income
- Income tax recognised outside profit or loss-Equity/OCI
- Disclosure in case of offset of current/deferred tax
- Explanation of changes in tax rates compared to previous year
- Reconciliation of effective rate to statutory tax rate
- Unrecognized deferred tax assets and deferred tax liabilities

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Key Learning Points

- Analyse carefully whether there are any temporary differences arising in the assets and liabilities
- Understand the provisions of taxable and deductible temporary differences
- Provide for deferred tax liability or asset accordingly.
- Understand the specific presentation and disclosure requirements

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Key differences of IGAAP & IFRS (1/2)

Particulars	Indian GAAP	IFRS
Concept	Deferred tax assets and liabilities are based on the tax effect in future periods in respect of "timing differences" Timing differences is a term narrower than temporary differences.	Deferred tax assets and liabilities are based on the tax effect in future periods in respect of "Temporary differences"
Tax expense for consolidated financial statements	Tax expense as appearing in the separate financial statements of parent and subsidiaries are just added together.	In determining tax expense, temporary differences arising from elimination of unrealised profits and losses resulting from intra-group transactions should be considered.

Key differences of IGAAP & IFRS (1/2)

Particulars	Indian GAAP	IFRS
Recognition of Deferred Tax asset (DTA)	• **Unabsorbed depreciation and carry forward of losses:** DTA 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. • **Other 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.	• **Unabsorbed depreciation and carry forward of losses:** DTA shall be recognised 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 utilised and *convincing evidence* is available. • • **Other deferred tax assets** are recognised to the extent it is probable that taxable profits would be available.

Comparison of IFRS and Ind AS

Particulars	IFRS	Ind AS
Deferred Tax assets in respect of business combinations	• Any deferred tax asset recognised subsequently but within 12 months of acquisition as a result of new information on facts and circumstances becoming available, and if there is no goodwill then deferred tax asset is recognised in profit and loss account	• If goodwill is zero then such deferred tax asset is recognised in other comprehensive income (OCI) and accumulated in the equity under capital reserve or directly recognised in capital reserve if already there is a capital reserve due to gain on bargain purchase.

IAS 37

Provisions, Contingent Liabilities and Contingent Assets

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Learning objectives

Upon completion you will understand

- Outline the definition of a provision, contingent liability and contingent asset
- Explain the recognition and measurement criteria for provisions, contingent liabilities and contingent assets
- Apply IAS 37 to specific circumstances
- Disclosure requirements

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Scope and definition

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IAS 37 to specific circumstances

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Scope of IAS 37

Applies to all entities in accounting for provisions, contingent liabilities and contingent assets except those:

- Resulting from **executory contracts,** unless they are onerous; or
- Covered by another standard, e.g.:
  - Insurance contracts (IFRS 4)
  - Financial instruments (IFRS 9)
  - Employee benefits (IAS 19)
  - Construction contracts (IAS 11)
  - Income taxes (IAS 12)
  - Leases (IAS 17)
  - Business combinations (IFRS 3)

Executory contracts are contracts under which neither party has performed any of its obligations or
both parties have partially performed their obligations to an equal extent.

Liabilities, accruals and provisions

Liabilities - present obligations from a past event expected to result in an outflow of resources

Accruals - liabilities to pay for goods or services received or supplied but not yet paid or invoiced

Provisions - liabilities of uncertain timing or amount

Legal and constructive obligations

Obligations

Legal

- Contract
- Law / legislation

Constructive

- Established pattern of past practice
- Published policies
- Sufficiently specific current statement
- Indication to other parties that certain responsibilities are accepted and creation of a valid expectation that they will be discharged

Identifying provisions: generally required categories

- Provisions for litigation
- Provisions for warranties
- Provisions for environmental obligations
- Provisions for loss orders / onerous contracts
- Provisions for restructuring costs

Contingent liabilities and contingent assets

Contingent liabilities:

Possible obligations arising from a past event to be confirmed by future events not wholly within the control of the entity, or

Present obligations arising from a past event

- Of which the outflow of economic benefits is not probable, or
- That cannot be measured reliably

Contingent assets: possible assets arising from a past event to be confirmed by future events not wholly within control of entity

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Recognition criteria - Provisions

Present legal or constructive obligation
as a result of a past event; AND

Probable outflow of economic benefits
to settle the obligation; AND

Obligation can be estimated reliably.

Recognition criteria - Provisions

Past event gives rise to an obligation	Yes
Outflow of resources	Probable
Reliable estimate of the obligation	Yes

All three criteria should get satisfied only then provision will be recognised and disclosed

Criteria - Contingent liabilities

Present obligation resulted from past event

However

Outflow of resources is not probable

Or

Reliable estimate cant be made

or

Possible obligation Depends on future event

Outflow of resources is probable

Reliable estimate cant be made

Contingent liability: Disclose only*

*Exceptions: If outflow remote – do nothing;

Criteria - Contingent assets

- Contingent assets: possible assets arising from a past event to be confirmed by future events not wholly within control of entity

Inflow of benefits

Virtually certain	ASSET: Recognise
Probable	Contingent asset: DISCLOSE ONLY
Not probable	Contingent asset: DO NOTHING

Recognition criteria - Judgement

Possible guidelines:

Virtually certain:	≥	90%
Probable (more likely than not):	>	50%*
Possible:	≤	50%
Remote:	≤	10%

* In the standard

Derecognition of a provision

Through use

- Only for expenditures for which provision was recognised originally
- As a result, expenditures do not affect profit or loss

Through revision of estimate

- If an outflow of economic benefits is no longer probable
- Reversal affects profit or loss

Measurement

Best estimate

- Single item – most likely outcome
- Large population of similar items – expected value

Inherent risks and uncertainties to be considered

Discounting required, when effect material

Expected reimbursements (< / = provision) to be recognised as separate receivable, if virtually certain

Expected gains from disposal of assets should not be recognised as reduction of provision

Class discussion 1

Company A sells a product with one year warranty

- 20x9: number of items sold – 100,000
- Costs to repair one item:
  - minor defects – 10 $
  - major defects – 40 $
- Past statistics:
  - No defects for 75% goods
  - Minor defects for 20% goods
  - Major defects for 5% goods

What provision should be made for warranty costs?

Solution:

Expected value of the liability in respect of items sold in 20x9

	Calculation	Result, $
No defects	100,000 x 75% x 0	0
Minor defects	100,000 x 20% x 10	200,000
Major defects	100,000 x 5% x 40	200,000
Total		**400,000**

Class discussion 2

Measurement of a provision for a lawsuit

- Information provided by the legal advisors

	Estimated cost	Probability
Case is won	-	30%
Prior settlement	8	40%
Case is lost	12	30%

What provision should be made?

Answer: Provision will be created with estimated cost of $8

Class discussion 3

An entity has an obligation to resolve the seabed for the damage it has caused in the past. It has $2 million cash to pay on 31 December 2014 relating to this liability. The entity considered that 15% was an appropriate discount rate. The time value of money is considered to be material for the entity.

Calculate the amount to be provided at 31 December 2012 in respect of the costs of restoring the seabed.

Solution:

The entity should make the following provision after taking into the discount factor.

The present value of the provision is $\frac{\text{2 million}}{1.15 \times 1.15} = \$1,512,287$

Example

An entity has an obligation to restore environmental damage in the area surrounding its factory. The expert advice indicates that the restoration will be carried out in two distinct phases, the first phase requiring expenditure of \$2 million to remove the contaminated soil from the area, and the second phase commencing 3 years later to replant the area with suitable trees and vegetation. The estimated cost of replanting is \$3.5 million. The company uses a cost of capital (before taxation) of 10%, and the expenditure, when incurred, will attract tax relief at the company's marginal tax rate of 30%. The company has not recognised any provision for such costs in the past, and today's date is 31 December 2011. The first phase of the clean up will commence in a few months time, and will be completed on 31 December 2012 when the first payment of \$2 million will be made. Phase 2 costs will be paid 3 years later.

Required:

Calculate the amount to be provided at 31 December 2011 in respect of restoration costs.

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Application: Prudence is not the ultimate virtue!

Do not provide for...

- Future operating losses (rainy days)
- Currency risks
- Political risks
- Maintenance / refurbishment of own assets
- General restructuring projects
- General business risks

Application: Onerous contracts

Unavoidable costs **>** **Economic benefit**

Onerous contract

NB! If a contract can be terminated without paying penalty, then it is NOT onerous

Application: Onerous contracts (continued)

- **Present obligation under the onerous contract should be recognised as a provision**
- **Measurement at the lower of (regardless of management’s intention):**
  - Cost of terminating the contract; or
  - Net cost of continuing with the contract
- **First review the assets dedicated to the onerous contract for impairment**

Class discussion 4

The division of an entity operates out of leasehold premises. The lease is a non-cancellable operating lease with an unexpired term of five years from 30 September 2013. The annual lease rentals (payable on 30 September in arrears) are $1.5 million. The landlord is not prepared to discuss an early termination payment. Following the closure of the division it is estimated that the entity would be able to sub-let the property from 1 April 2014. The entity could expect to receive a rental of $300,000 for the six-month period from 1 April 2014 to 30 September 2014 and then annual rentals of $500,000 for each period ending 30 September 2015 to 30 September 2018 inclusive. All rentals will be received in arrears. Any discounting calculations should be performed using a discount rate of 5% per annum. You are given the following data for discounting at 5 % per annum:

Present value of $1 received at the end of year 1 = $0.95

Present value of $1 received at the end of years 1-2 inclusive = $1.86

Present value of $1 received at the end of years 1-3 inclusive = $2.72

Present value of $1 received at the end of years 1-4 inclusive = $3.54

Present value of $1 received at the end of years 1-5 inclusive = $4.32

Compute the amounts to be included in income statement for the y/e 30 Sep 2013 in respect of the decision to close the division.

Solution:

IAS 37 states that an onerous contract is one for which the expected cost of fulfilling the contract exceeds the benefits expected from the contract. Provision must be made for the lower of:

- The expected net cost of fulfilling the contract
- The cost of early termination (not available in this case)

The net cost of fulfilling the contract is

(1,500,000 x 4.32) – ($300,000 x 0.95) – ($500,000 x {4.32 – 0.95})

= $4,510,000

Application: Restructuring costs

- **Restructuring provisions require detailed formal plan or binding sale agreement**
- **Entity must illustrate a demonstrable commitment by either:**
  - Starting to implement that plan; or
  - Announcing its main features to those affected
- **Timing: begin/end in a timeframe that makes significant changes unlikely**
- **A board decision alone is not sufficient!**

Application: Details of a restructuring plan

- Business or part of the business concerned
- Principal locations
- Location, function and approximate number of employees who will be compensated for termination
- Cost entailed by the restructuring and not associated with ongoing activities
- Timing of implementation

Application: Restructuring costs-what to provide for?

Include if:

- Unavoidable, and
- Not associated with ongoing activities

Exclude if:

- Retaining or relocating continuing staff,
- Marketing, or
- Investment in new systems and distribution network

Example:

In which of the following circumstances might a provision be recognised?

(a) On 13 December 20X9 the board of an entity decided to close down a division. The accounting date of the company is 31 December. Before 31 December 20X9 the decision was not communicated to any of those affected and no other steps were taken to implement the decision.

(b) The board agreed a detailed closure plan on 20 December 20X9 and details were given to customers and employees.

(c) A company is obliged to incur clean up costs for environmental damage (that has already been caused).

(d) A company intends to carry out future expenditure to operate in a particular way in the future.

Application: Repairs and maintenance

General principle

- Repairs and maintenance of own assets cannot be provided for

Example

- An airline is required by law to overhaul its aircraft once every three years
- No present obligation that is independent of the entity's future actions
- No provision is recognised
- Depreciation takes account of the previously capitalised overhaul costs (IAS 16)

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Disclosures

Disclosures pursuant to IAS 37

❑By category
▪Brief description, timing, uncertainties of provisions
▪Detailed roll-forward of provisions
▪Expected and recognised reimbursements relating to provisions
▪Brief description and financial effect of any contingent assets and liabilities

Opening balances
+ additional provisions recognised
- amounts used
- unused amounts reversed
+ increase in the discounted amount due to the passage of time and / or changes in the discount rate
= ending balances

▪"Repurposing" of provisions prohibited!
▪No comparative information required

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Key Learning Points

- Outline the definition of a provision, contingent liability and contingent asset
- Identify the recognition criteria for provision. Contingent liability and contingent asset
- Apply the provisions of IAS 37 to specific circumstances
- Understand the disclosure requirements of IAS 37

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Key differences of IGAAP & IFRS

Particulars	Indian GAAP	IFRS
Onerous Contract	Required for accounting periods commencing 1 April, 2006	Provision required
Discounting	Prohibited	Required
Restructuring provision	Provision based on legal obligation	Provision based on constructive obligation
Contingent asset	Disclosure not permitted	Disclosure required

Comparison of IFRS and Ind AS

There are no differences between Ind AS and IFRS