CHAPTER 13

INCOME TAXES (IAS 12)

Objective

The objective of this Standard is to prescribe the accounting treatment for income taxes. The principal issue in accounting for income taxes is how to account for the current and future tax consequences of:

(a) The future recovery (settlement) of the carrying amount of assets (liabilities) that are recognized in an entity's balance sheet; and
(b) Transactions and other events of the current period that are recognized in an entity's financial statements

Basic Principle

It is inherent in the recognition of an asset or liability that the reporting entity expects to recover or settle the carrying amount of that asset or liability. If it is probable that recovery or settlement of that carrying amount will make future tax payments larger (smaller) than they would be if such recovery or settlement were to have no tax consequences, this Standard requires an entity to recognize a deferred tax liability (deferred tax asset), with certain limited exceptions.

Scope

This Standard shall be applied in accounting for income taxes.

1. Income taxes include all domestic and foreign taxes, which are based on taxable profits. Income taxes also include taxes, such as withholding taxes, which are payable by a subsidiary, associate or joint venture on distributions to the reporting entity.
2. This Standard does not deal with the methods of accounting for government grants (IAS 20) or investment tax credits. However, this Standard does deal with the accounting for temporary differences that may arise from such grants or investment tax credits.

Definitions

Taxable profit (tax loss) is the profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable).

Tax expense (tax income) is the aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax.

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

Deferred tax liabilities are the amounts of income taxes payable in future periods in respect of taxable temporary differences.

Deferred tax assets are the amounts of income taxes recoverable in future periods in respect of:

(a) Deductible temporary differences;
(b) The carry forward of unused tax losses; and
(c) The carry forward of unused tax credits.

Temporary differences are differences between the carrying amount of an asset or liability in the balance sheet and its tax base. Temporary differences may be either:

(a) ***taxable temporary differences***, which are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled; or
(b) ***deductible temporary differences***, which are temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

The tax base of an asset or liability is the amount attributed to that asset or liability for tax purposes.

Tax base

Tax base of an asset

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 an entity when it recovers the carrying amount of the asset. If those economic benefits will not be taxable, the tax base of the asset is equal to its carrying amount. [Tax base = (Carrying value – Future taxable benefits + Future deductible amounts)].

Examples

Determine the tax base of the following: -

- A machine cost Rs. 1,000. For tax purposes depreciation of Rs. 500 has already been deducted in the current and prior years and the remaining cost will be deductible in future periods, either as depreciation or through a deduction on disposal.
- A machine cost Rs. 1,000. The tax depreciation of Rs. 500 has already been used for determination of tax but accounting depreciation of Rs. 300 has been charged on the asset.
- Interest receivable has a carrying value of Rs. 100,000. The related interest revenue will be taxed on cash receipt basis.
- Trade receivables have a carrying value of Rs. 100,000. The related revenue has already been included in the taxable profit (loss) for the year.
- Dividend receivable from a subsidiary has a carrying value of Rs. 200,000. The dividends are not taxable.
- A loan receivable has a carrying value of Rs. 50,000. The repayment of loan will have no tax consequences.

The tax base of a liability

The tax base of a liability is ***its carrying amount, less any amount that will be deductible for tax purposes in respect of that liability in future periods***. [Tax base = Carrying amount – future deductible amount]

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 = Carrying amount – revenue not taxable in future]

Examples

- Current liabilities include expenses with a carrying value of Rs.100. The related expenses will be deducted for tax purposes on a cash basis.
- Current liabilities include interest revenue in advance, with a carrying amount of 100. The related interest revenue was taxed on a cash basis.
- Current liabilities include accrued expenses with a carrying amount of Rs. 500. The related expense has already been deducted for tax purposes.
- Current liabilities include accrued fines and penalties with a carrying amount of Rs.100. Fines and penalties are not deductible for tax purposes.
- A loan repayment has carrying amount of Rs. 100. The repayment of loan will have no tax consequences.

Tax base of assets/liabilities having carrying value NIL

Some items have a tax base but are not recognized as assets and liabilities in the balance sheet. For example, research costs are recognized as an expense in determining accounting profit in the period in which they are incurred but may not be permitted as a deduction in determining taxable profit (tax loss) until a later period. The difference between the tax base of the research costs, being the amount the taxation authorities will permit as a deduction in future periods, and the carrying. Where amount of nil is a deductible temporary difference that results in a deferred tax asset

Tax base in group financial statements

In consolidated financial statements, temporary differences are determined by comparing the carrying amounts of assets and liabilities in the consolidated financial statements with the appropriate tax base. The tax base is determined by reference to a consolidated tax return in those jurisdictions in which such a return is filed. In other jurisdictions, the tax base is determined by reference to the tax returns of each entity in the group.

Recognition of Current Tax Liabilities and Current Tax Assets

- Current tax for current and prior periods shall, to the extent unpaid, be recognized as a liability. If the amount already paid in respect of current and prior periods exceeds the amount due for those periods, the excess shall be recognized as an asset.
- The benefit relating to a tax loss that can be carried back to recover current tax of' a previous period shall be recognized as an asset

Recognition of Deferred Tax Liabilities and Deferred Tax Assets

Taxable Temporary Differences

A deferred tax liability shall be recognized 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).

However, for taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, a deferred tax liability shall be recognized in accordance with this IAS.

Example

An asset which cost 150 has a carrying amount of 100. Cumulative depreciation for tax purposes is 90 and the tax rate is 25%?

Some temporary differences arise when income or expense is included in accounting profit in one period but are included in taxable profit in a different period. Such temporary differences are often described as timing differences. The following are the examples:

(a) Interest revenue is included in accounting profit on a time proportion basis but may, in some jurisdictions, included in taxable profit when cash is collected;

(b) Depreciation used in determining taxable profit (tax loss) may differ from that used in determining accounting profit. A taxable temporary difference arises, and results in a deferred tax liability, when tax depreciation is accelerated; and

(c) Development costs may be capitalized and amortized over future periods in determining accounting profit but deducted in determining taxable profit in the period in which they are incurred. The temporary difference is the difference between the carrying amount of the development costs and their tax base of nil.

Temporary differences also arise when:

(a) The cost of a business combination is allocated by recognizing the identifiable assets acquired and liabilities assumed at their fair values, but no equivalent adjustment is made for tax purposes;

(b) Assets are revalued and no equivalent adjustment is made for tax purposes

(c) Goodwill arises in a business combination

(d) the tax base of an asset or liability on initial recognition differs from its initial carrying amount, for example when an entity benefits from non-taxable government grants related to assets; or

(e) the carrying amount of investments in subsidiaries, branches and associates or interests in joint ventures becomes different from the tax base of the investment or interest.

Business Combinations

The cost of a business combination is allocated by recognizing the identifiable assets acquired and liabilities assumed at their fair values at the acquisition date. Temporary differences arise when the tax bases of the identifiable assets acquired and liabilities assumed are not affected by the business combination or are affected differently. For example, when the carrying amount of an asset is increased to fair value but the tax base of the asset remains at cost to the previous owner, a taxable temporary difference arises which results in a deferred tax liability. The resulting deferred tax liability affects goodwill.

Assets Carried at Fair Value

IFRSs permit or require certain assets to be carried at fair value or to be revalued for example, IAS 16, IAS 38, IAS 39 and IAS 40. In those jurisdictions, where the revaluation or restatement of an asset does not affect taxable profit in the period of the revaluation or restatement and, consequently, the tax base of the asset is not adjusted. The difference between the carrying amount of a revalued asset and its tax base is a temporary difference and gives rise to a deferred tax liability or asset.

Goodwill

- Many taxation authorities do not allow reductions in the carrying amount of goodwill as a deductible expense in determining taxable profit. Moreover, in such jurisdictions, the cost of goodwill is often not deductible when a subsidiary disposes of its underlying business. In such jurisdictions, goodwill has a tax base of nil. Any difference between the carrying amount of goodwill and its tax base of nil is a taxable temporary difference. ***However, this Standard does not permit the recognition of the resulting deferred tax liability because goodwill is measured as a residual and the recognition of the deferred tax liability would increase the carrying amount of goodwill.***
- Subsequent reductions in a deferred tax liability that is un-recognized because it arises from the initial recognition of goodwill are also regarded as arising from the initial recognition of goodwill and are therefore not recognized under.
- Deferred tax liabilities for taxable temporary differences relating to goodwill are, however, recognized to the extent they do not arise from the initial recognition of goodwill. For example, if goodwill acquired in a business combination has a cost of 100 that is deductible for tax purposes at a rate of 20 per cent per year starting in the year of acquisition, the tax base of the goodwill is 100 on initial recognition and 80 at the end of the year of acquisition. If the carrying amount of goodwill at the end of the year of acquisition remains unchanged at 100, a taxable temporary difference of 20 arises at the end of that year. Because that taxable temporary difference does not relate to the initial recognition of the goodwill, the resulting deferred tax liability is recognized.

Initial Recognition of an Asset or Liability

A temporary difference may arise on initial recognition of an asset or liability, for example if part or all of the cost of an asset will not be deductible for tax purposes. The method of accounting for such a temporary difference depends on the nature of the transaction which led to the initial recognition of the asset:

(a) in a business combination, an entity recognizes any deferred tax liability or asset and this affects the amount of goodwill or the amount of any excess over the cost of the combination of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities;

(b) if the transaction affects either accounting profit or taxable profit, an entity recognizes any deferred tax liability or asset and recognizes the resulting deferred tax expense or income in the income statement;

(c) if the transaction is not a business combination, and affects neither accounting profit nor taxable profit, an entity would, in the absence of the exemption, recognize the resulting deferred tax liability or asset and adjust the carrying amount of the asset or liability by the same amount. Such adjustments would make the financial statements less transparent. Therefore, this Standard does not permit an entity to recognize the resulting deferred tax liability or asset, either on initial recognition or subsequently. Furthermore, an entity does not recognize subsequent changes in the un-recognized deferred tax liability or asset as the asset is depreciated.

(d) In accordance with IAS 32 Financial Instruments: the issuer of a compound financial instrument (for example, a convertible bond) classifies the instrument's liability component as a liability and the equity component as equity. In some jurisdictions, the tax base of the liability component on initial recognition is equal to the initial carrying amount of the sum of the liability and equity components. The resulting taxable temporary difference arises from the initial recognition of the equity component separately from the liability component. Therefore, the exception set out above does not apply. Consequently, an entity recognizes the resulting deferred tax liability. The deferred tax is charged directly to the carrying amount of the equity component. Subsequent changes in the deferred tax liability are recognized in the income statement as deferred tax expense (income).

Example

An entity intends to use an asset which cost 1,000 throughout its useful life of five years and then dispose of it for a residual value of nil. The tax rate is 40%. Depreciation of the asset is not deductible for tax purposes. On disposal, any capital gain would not be taxable and any capital loss would not be deductible.

Deductible Temporary Differences

A deferred tax asset shall be recognized 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 utilized, 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).

However, for deductible temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, a deferred tax asset shall be recognized in accordance with this IAS.

Example

An entity recognizes a liability of 100 for accrued product warranty costs. For tax purposes, the product warranty costs will not be deductible until the entity pays claims.

The following are examples of deductible temporary differences, which result in deferred tax assets:

(a) Retirement benefit costs may be deducted in determining accounting profit as service is provided by the employee, but deducted in determining taxable profit either when contributions are paid to a fund by the entity or when retirement benefits are paid by the entity;

(b) Research costs are recognized as an expense in determining accounting profit in the period in which they are incurred but may not be permitted as a deduction in determining taxable profit (tax loss) until a later period.;

(c) The cost of a business combination is allocated by recognizing the identifiable assets acquired and liabilities assumed at their fair values at the acquisition date. When a liability assumed is recognized at the acquisition date but the related costs are not deducted in determining taxable profits until a later period, a deductible temporary difference arises which results in a deferred tax asset. A deferred tax asset also arises when the fair value of an identifiable asset acquired is less than its tax base. In both cases, the resulting deferred tax asset affects goodwill; and certain assets may be carried at fair value, or may be revalued, without an equivalent adjustment being made for tax purposes.

Un-used Tax Losses and Unused Tax Credits

A deferred tax asset shall be recognized for the carry forward of 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.

An entity considers the following criteria in assessing the probability that taxable profit will be available against which the unused tax losses or unused tax credits can be utilized:

(a) whether the entity has sufficient taxable temporary differences relating to the same taxation authority and the same taxable entity, which will result in taxable amounts against which the unused tax losses or unused tax credits can be utilized before they expire;

(b) Whether it is probable that the entity will have taxable profits before the unused tax losses or unused tax credits expire;

(c) whether the unused tax losses result from identifiable causes which are unlikely to recur; and

(d) Whether tax planning opportunities (see paragraph 30) are available to the entity that will create taxable profit in the period in which the unused tax losses or unused tax credits can be utilized.

Tax planning opportunities are actions that the entity would take in order to create or increase taxable income in a particular period before the expiry of a tax loss or tax credit carry forward. For example, in some jurisdictions, taxable profit may be created or increased by:

(a) electing to have interest income taxed on either a received or receivable basis;
(b) deferring the claim for certain deductions from taxable profit;
(c) selling, and perhaps leasing back, assets that have appreciated but for which the tax base has not been adjusted to reflect such appreciation; and
(d) selling an asset that generates non-taxable income (such as, in some jurisdictions, a government bond) in order to purchase another investment that generates taxable income.

Where tax planning opportunities advance taxable profit from a later period to an earlier period, the utilization of a tax loss or tax credit carry forward still depends on the existence of future taxable profit from sources other than future originating temporary differences.

To the extent that it is not probable that taxable profit will be available against which the unused tax losses or unused tax credits can be utilized, the deferred tax asset is not recognized.

Goodwill

If the carrying amount of goodwill arising in a business combination is less than its tax base, the difference gives rise to a deferred tax asset. The deferred tax asset arising from the initial recognition of goodwill shall be recognized as part of the accounting for a business combination to the extent that it is probable that taxable profit will be available against which the deductible temporary difference could be utilized.

Re-assessment of Unrecognized Deferred Tax Assets

At each balance sheet date, an entity re-assesses un-recognized deferred tax assets. The entity recognizes a previously unrecognized deferred tax asset to the extent that it has become probable that future taxable profit will allow the deferred tax asset to be recovered.

Investments in Subsidiaries, Branches and Associates and Interests in Joint Ventures

Temporary differences arise when the carrying amount of investments in subsidiaries, branches and associates or interests in joint ventures (namely the parent or investor's share of the net assets of the subsidiary, branch, associate or investee, including the carrying amount of goodwill) becomes different from the tax base (which is often cost) of the investment or interest. Such differences may arise in a number of different circumstances, for example:

(a) the existence of undistributed profits of subsidiaries, branches, associates and joint ventures;

(b) changes in foreign exchange rates when a parent and its subsidiary are based in different countries; and

(c) a reduction in the carrying amount of an investment in an associate to its recoverable amount.

In consolidated financial statements, the temporary difference may be different from the temporary difference associated with that investment in the parent's separate financial statements if the parent carries the investment in its separate financial statements at cost or revalued amount.

An entity shall recognize a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, except to the extent that both of the following conditions are satisfied:

(a) the parent, investor or venturer 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.

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

- the temporary difference will reverse in the foreseeable future; and
- Taxable profit will be available against which the temporary difference can be utilized.

Measurement

- Current tax liabilities (assets) for the current and prior periods shall be measured at the amount expected to be paid to (recovered from) the taxation authorities, using the tax rates (and tax laws) that have been enacted or substantively enacted by the balance sheet date.
- Deferred tax assets and liabilities shall be measured at the tax rates that are expected to apply to the period when the asset is realized or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the balance sheet date.
- *The measurement of deferred tax liabilities and deferred tax assets shall reflect the tax consequences that would follow from the manner in which the entity expects, at the balance sheet date, to recover or settle the carrying amount of its assets and liabilities.*

Deferred tax assets and liabilities shall not be discounted.

- The Standard does not require or permit the discounting of deferred tax assets and liabilities.
- Temporary differences are determined by reference to the carrying amount of an asset or liability. This applies even where that carrying amount is itself determined on a discounted basis.

Recognition of Current and Deferred Tax

Income Statement

Current and deferred tax shall be recognized as income or 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 recognized, in the same or a different period, directly in equity; or

b) a business combination

The carrying amount of deferred tax assets and liabilities may change even though there is no change in the amount of the related temporary differences. This can result, for example, from:

(a) a change in tax rates or tax laws;

(b) a re-assessment of the recoverability of deferred tax assets; or

(c) a change in the expected manner of recovery of an asset.

The resulting deferred tax is recognized in the income statement, except to the extent that it relates to items previously charged or credited to equity.

Items recognized outside profit or loss

Current tax and deferred tax shall be charged or credited to outside profit and loss account if the tax relates to items that are credited or charged, in the same or a different period, outside profit and loss account.

Deferred Tax Arising from a Business Combination

- In accordance with IFRS 3 Business Combinations, an entity recognizes any resulting deferred tax assets (to the extent that they meet the recognition criteria) or deferred tax liabilities as identifiable assets and liabilities at the acquisition date. Consequently, those deferred tax assets and liabilities affect goodwill or the amount of any excess of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over the cost of the combination. However, an entity does not recognize deferred tax liabilities arising from the initial recognition of goodwill.
- As a result of a business combination, an acquirer may consider it probable that it will recover its own deferred tax asset that was not recognized before the business combination. For example, the acquirer may be able to utilize the benefit of its unused tax losses against the future taxable profit of the acquirer. In such cases, the acquirer recognizes a deferred tax asset, but does not include it as part of the accounting for the business combination, and therefore does not take it into account in determining the goodwill or the amount of any excess of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over the cost of the combination.
- If the potential benefit of the acquiree's income tax loss carry-forwards or other deferred tax assets did not satisfy the criteria in IFRS 3 for separate recognition when a business combination is initially accounted for but is subsequently realized, the acquirer shall recognize the resulting deferred tax as follows: -
  - (a) acquired deferred tax asset recognized within the measurement period and relates new information obtained for the conditions existing at the date of acquisition shall be applied to reduce the carrying amount of goodwill if goodwill is zero then charged to income statement.
  - (b) all other deferred tax assets realized shall be recognized in profit and loss account.

Presentation

Tax Assets and Tax Liabilities

An entity shall offset current tax assets and current tax liabilities if, and only if, the entity:

a) has a legally enforceable right to set off the recognized amounts; and

b) intends either to settle on a net basis, or to realize the asset and settle the liability simultaneously.

An entity shall offset deferred tax assets and deferred tax liabilities if, and only if:

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

b) the deferred tax assets and the deferred tax liabilities relate to income taxes levied by the same taxation authority on either:
   a. the same taxable entity; or
   b. different taxable entities which intend either to settle current tax liabilities and assets on a net basis, or to realize the assets and settle the liabilities simultaneously, in each future period in which significant amounts of deferred tax liabilities or assets are expected to be settled or recovered.

Tax Expense

Tax Expense (Income) Related to Profit or Loss from Ordinary Activities

The tax expense (income) related to profit or loss from ordinary activities shall be presented on the face of the income statement.

Disclosure

The major components of tax expense (income) shall be disclosed separately:

Components of tax expense (income) may include:

(a) current tax expense (income);
(b) any adjustments recognized in the period for current tax of prior periods;
(c) the amount of deferred tax expense (income) relating to the origination and reversal of temporary differences;
(d) the amount of deferred tax expense (income) relating to changes in tax rates or the imposition of new taxes;
(e) the amount of the benefit arising from a previously unrecognized tax loss, tax credit or temporary difference of a prior period that is used to reduce current tax expense;
(f) the amount of the benefit from a previously unrecognized tax loss, tax credit or temporary difference of a prior period that is used to reduce deferred tax expense;
(g) deferred tax expense arising from the write-down, or reversal of a previous write-down, of a deferred tax asset; and
(h) the amount of tax expense (income) relating to those changes in accounting policies and errors that are included in profit or loss in accordance with IAS 8, because they cannot be accounted for retrospectively.

SIC Interpretation 25

Income Taxes—Changes in the Tax Status of an Entity or its Shareholders

Issue

1 A change in the tax status of an entity or of its shareholders may have consequences for an entity by increasing or decreasing its tax liabilities or assets. This may, for example, occur upon the public listing of an entity's equity instruments or upon the restructuring of an entity's equity. It may also occur upon a controlling shareholder's move to a foreign country. As a result of such an event, an entity may be taxed differently; it may for example gain or lose tax incentives or become subject to a different rate of tax in the future.

2 A change in the tax status of an entity or its shareholders may have an immediate effect on the entity's current tax liabilities or assets. The change may also increase or decrease the deferred tax liabilities and assets recognized by the entity, depending on the effect the change in tax status has on the tax consequences that will arise from recovering or settling the carrying amount of the entity's assets and liabilities.

3 The issue is how an entity should account for the tax consequences of a change in its tax status or that of its shareholders.

Consensus

4 A change in the tax status of an entity or its shareholders does not give rise to increases or decreases in amounts recognized outside profit or loss. The current and deferred tax

consequences of a change in tax status shall be included in profit or loss for the period, unless those consequences relate to transactions and events that result, in the same or a different period, in a direct credit or charge to the recognized amount of equity or in amounts recognized in other comprehensive income. Those tax consequences that relate to changes in the recognized amount of equity, in the same or a different period (not included in profit or loss), shall be charged or credited directly to equity. Those tax consequences that relate to amounts recognized in other comprehensive income shall be recognized in other comprehensive income.

Q-1

XYZ is a listed company engaged in the business of manufacturing of leather goods. The applicable rate for the Co. is 40% in year 19X5 and 35% in 19X6.
The relevant information for calculation of deferred tax is as under: -

1. Charitable donations are recognized as expenses when they incurred and are not deductible for tax purposes. (19X5 500, 19X6 350)
2. In 19X5 the entity was notified by the relevant tax authorities that they intend to pursue action against the entity with respect to sulphur emissions. Although as at December 19X6 the action had not yet come to court the entity recognized a liability of 700 in 19X5 being its best estimate of the fine arising from the action. Fines and penalties are not deductible for tax purposes. (19X5 700)
3. In 19X2 the entity incurred 1,250 of costs in relation to the development of new product. These costs were deducted for tax purposes in 19X2. For accounting purposes, the entity capitalized this expenditure and amortized it on the straight-line basis over five years. At 31st December 19X4, the un-amortized balance of these product development costs was 500.
4. In 19X5 the entity entered into an agreement with its existing employees to provide health care benefits to retirees. The entity recognizes as an expense the cost of this plan as employees provide service. No payments to retirees were made for such benefits in 19X5 and X6. Healthcare costs are deductible for tax purposes when payments are made to retirees. The entity estimated that it is probable that taxable profit will be available against which any resulting deferred tax asset can be utilized. (19X5 2,000 19X6 1,000)
5. Buildings are depreciated for accounting purposes at 5% a year on a straight-line basis and at 10% a year on a straight-line basis for tax purposes. Motor vehicles are depreciated for accounting purposes at 20% a year on straight-line basis and a 25% a year on a straight-line basis for tax purposes. A full year's depreciation is charged for accounting purposes in the year that an asset is acquired.
6. There was an addition to Buildings of 6,000 during the year 19X5 and in vehicles of 15,000 during the year 19X6.
7. The cost of buildings is 50,000 and vehicles 10,000 at the end of 19X4 and accumulated depreciation balance on Buildings at the end of 19X4 is 20,000 and on vehicles is 4,000. The tax allowance on the assets already taken is Building 40,000 and vehicles 5,000.
8. At 1st January 19X6, the building was revalued to 65,000 and the entity estimated that the remaining useful life of the building was 20 years from the date of the revaluation. The revaluation did not affect taxable profit in 19X6 and the taxation authorities did not adjust the tax base of the building to reflect the revaluation. In 19X6 the entity transferred 1,033 from the revaluation reserve to retained earnings. This represents the difference of 1,590 between the actual depreciation on building (3,250) and equivalent depreciation based on the cost of the building (1,660 which is the book value at 1st

January 19X6 of 33,200 divided by the remaining useful life of 20 years) less the related deferred tax of 557.

9. The accounting profit for 19X5 is 8,775 and for 19X6 is 8,740.

The summarized balance sheets for 19X4, 19X5 and 19X6 are as under: -

	19X4 Carrying amount	**19X5 Carrying amount**	**19X6 Carrying amount**
Accounts receivable	500	500	500
Inventory	2,000	2,000	2,000
Product development costs	500	250	-
Investments	33,000	33,000	33,000
Property, plant & equipment	36,000	37,200	75,750
TOTAL ASSETS	72,000	72,950	111,250
Current income taxes payable	3,000	3,570	2,359
Accounts payable	500	500	500
Fines payable	-	700	700
Liability for healthcare benefits	-	2,000	3,000
Long-term debt	2,000	12,475	12,805
Deferred income taxes	8,600	9,020	19,845
TOTAL LIABILITIES	32,100	28,265	39,209
Share capital	5,000	5,000	5,000
Revaluation surplus	-	-	19,637
Retained earnings	34,900	39,685	47,404
TOTAL LIABILITIES / EQUITY	72,000	72,950	111,250

Required:

i) Provide the working for Deferred Tax for all the three years

ii) Provide current tax appearing in the balance sheets for 19X5 and 19X6.

iii) Major components of tax expense for 19X5 and 19X6.

iv) The disclosure of calculation of deferred tax liability/asset in the notes to the accounts.

v) Reconciliation of application of tax rate on Accounting profit and tax expense for the year for 19X5 and 19X6 and;

vi) Effective tax rate for the years 19X5 and 19X6

Q-2

On 1 January 20X5 entity A acquired 100 per cent of the shares of entity B at a cost of 600. At the acquisition date, the tax base in A's tax jurisdiction of A's investment in B is 600. Reductions in the carrying amount of goodwill are not deductible for tax purposes, and the cost of the goodwill would also not be deductible if B were to dispose of its underlying business. The tax rate in A's tax jurisdiction is 30 per cent and the tax rate in B's tax jurisdiction is 40 per cent.

The fair value of the identifiable assets acquired and liabilities assumed (excluding deferred tax assets and liabilities) by A is set out in the following table, together with their tax bases in B's tax jurisdiction.

	Cost of acquisition	Tax base
Property, plant and	270	155

equipment		
Accounts receivable	210	210
Inventory	174	124
Accounts payable	(120)	(120)
Retirement benefit obligations	(30)	
	504	369

The profit for the year ended 20X5 is 150 out of which there is a dividend payable of 80.
Required: -
Calculate the deferred tax liability/asset at the acquisition date and any movement thereafter.

Q-3

An entity receives a non-interest-bearing convertible loan of 1,000 on 31 December X4 repayable at par on 1 January X8. In accordance with IAS 32 Financial Instruments: Disclosure and Presentation the entity classifies the instrument's liability component as a liability and the equity component as equity. The entity assigns an initial carrying amount of 751 to the liability component of the convertible loan and 249 to the equity component. Subsequently, the entity recognizes imputed discount as interest expense at an annual rate of 10% on the carrying amount of the liability component at the beginning of the year. The tax authorities do not allow the entity to claim any deduction for the imputed discount on the liability component of the convertible loan. The tax rate is 40%.

Required: -

Prepare the working for temporary differences associated with the liability component and the resulting deferred tax liability and deferred tax expense and income?

Q -4

Following is Balance Sheet of XYZ Company as at December 31, 2001 before incorporation of any taxation.

	Rs. in (000)			**Rs. in (000)**
Share capital	200,000	Fixed Assets – Net		225,000
Accumulated profit				
Retained earnings	70,000	Current Assets		
		Trade receivable	35,500	
Loan payable	15,000	Less: provision of doubtful debts	1,500	34,000
Income in advance	2,000			
Creditors and accrued Liabilities	15,500	Deferred cost		20,000
Deferred tax	2,500			
		Sundry Receivable		15,000
		Cash & bank balance		11,000
	305,000			305,000

Other information is as follows (All figures are in thousands)

a) The current year accounting profit is Rs.50,000 before tax.
b) Tax WDV is Rs.200,000.
c) The accounting depreciation is Rs.15,000 while tax allowance is Rs.20,000.
d) Accrued liabilities include Fine & Penalty Rs.2,000 of which provision for the year is Rs.1,500. The fine and penalties are not allowable expenses under tax laws.

e) Sundry Receivable include interest receivable Rs.2,000. The related interest revenue will be taxed on cash basis.
f) The provision for doubtful debts is not allowable expense, only the bad debts written off can be claimed as expense from taxable profits.
g) Current liabilities include accrued expenses Rs.3,000. The related expense will be deducted for tax purpose on a cash basis.
h) The income in advance is taxed on receipt basis.
i) The decrease in provision for doubtful debts during the year is Rs.500.
j) The deferred cost represents the development expense. The original expense was Rs.35,000 to be amortized over seven years. The whole amount as an expense under tax laws in the year of incurrence.
k) Tax rate of the Company is assumed at 30%.

Required:

a) Calculate the current tax and deferred tax expense/income and related asset/liability.

b) Redraft the balance sheet after incorporating current and deferred tax

Q-5

Identify the tax base of the following: -

- A machine cost Rs. 5,000. For tax purposes depreciation of Rs. 5000 has already been deducted in the current and prior years.
- A machine cost Rs. 1,000. The tax depreciation of Rs. 700 has already been used for determination of tax but accounting depreciation of Rs. 600 has been charged on the asset.
- Interest receivable has a carrying value of Rs. 100,000. The related interest revenue has been taxed on accrual basis.
- Trade receivables have a carrying value of Rs. 100,000. This amount is arrived at after deducting provision for doubtful debts of Rs. 5,000.The related revenue has already been included in the taxable profit (loss) for the year.
- The research expense having carrying value of nil already charged in the profit and loss account can be deducted from taxable profit up to Rs. 5,000.
- Current liabilities include expenses with a carrying value of Rs.100. The related expenses have been deducted for tax purposes on accrual basis.
- Current liabilities include interest revenue in advance, with a carrying amount of 100. The related interest revenue was taxed on cash basis.
- Warranties with a carrying amount of Rs.100 are not allowable unless paid.

Q-6

The taxable differences at the end of the year 2006 amounting to Rs. 5,000,000 which will reverse in the following years as under: -

	Rs.	Tax rate
2007	2,500,000	35%
2008	1,500,000	38%
2009	1,000,000	40%

Required: -Determine deferred tax liability at the end of year 2006?

Q-7

A company purchased an asset costing Rs.300,000 on June 30, 2005. The residual value of the asset is Rs.20,000 and useful life is 10 years. The company follows the straight line depreciation method for charging depreciation from the date of purchase (proportionate depreciation policy). While under tax laws a 50% tax allowance is available in the year of purchase and 25% on reducing balance basis thereafter. The tax rate is 30%.

Required: -

a) Calculate the deferred tax (asset/liability) at December 31, 2007.

b) Prepare ledger account of deferred tax for all the relevant years.

Q-8

An asset has a carrying amount of 100 and a tax base of 60. A tax rate of 20% would apply if the assets were sold and a tax rate of 30% would apply to other income.

What will be deferred tax implications in both circumstances?

Q-9

(i) Panel is leasing plant under a finance lease over a five year period. The asset was recorded at the present value of the minimum lease payments of Rs.12 million at the inception of the lease which was 1 November 2004. The asset is depreciated on a straight line basis over the five years and has no residual value. The annual lease payments are Rs.3 million payable in arrears on 31 October and the effective interest rate is 8% per annum. The directors have not leased an asset under a finance lease before and are unsure as to its treatment for deferred taxation. The company can claim a tax deduction for the annual rental payment as the finance lease does not qualify for tax relief.

(ii) A wholly owned overseas subsidiary, Pins, a limited liability company, sold goods costing Rs.7 million to Panel on 1 September 2005, and these goods had not been sold by Panel before the year end. Panel had paid Rs.9 million for these goods. The directors do not understand how this transaction should be dealt with in the financial statements of the subsidiary and the group for taxation purposes. Pins pays tax locally at 30%.

(iii) Nails, a limited liability company, is a wholly owned subsidiary of Panel, and is a cash generating unit in its own right. The value of the property, plant and equipment of Nails at 31 October 2005 was Rs.6 million and purchased goodwill was Rs.1 million before any impairment loss. The company had no other assets or liabilities. An impairment loss of Rs.1·8 million had occurred at 31 October 2005. The tax base of the property, plant and equipment of Nails was Rs.4 million as at 31 October 2005. The directors wish to know how the impairment loss will affect the deferred tax provision for the year. Impairment losses are not an allowable expense for taxation purposes.

Assume a tax rate of 30%.

Required:

(b) Discuss, with suitable computations, how the situations (i) to (iii) above will impact on the accounting for deferred tax under IAS12 'Income Taxes' in the group financial statements of Panel.

Q-10

Cohort is a private limited company and has two 100% owned subsidiaries, Legion and Air, both themselves private limited companies. Cohort acquired Air on January 01, 20x2 for Rs.5 million when the fair value of the net assets was Rs.4 million, and the tax base of the net assets was Rs.3.5 million. The acquisition of Air and Legion was part of business combination strategy whereby Cohort would build up the value of the group over a three year period and then list its existing share capital on the stock exchange.

a) The following details relate to the acquisition of Air, which manufactures electronic goods.

   i) Part of the purchase price has been allocated to intangible assets because it relates to the acquisition of a database of key customers from Air. The recognition and measurement criteria for an intangible asset under IFRS 3 do not appear to have been met but the directors feel that the intangible asset of Rs.0.5 million will be allowed for tax purposes and have computed the tax provision accordingly. However, the tax authorities could possibly challenge this opinion.

ii) Air has sold goods worth Rs.3 million to Cohort since acquisition and made a profit of Rs.1 million on the transaction. The inventory of these goods recorded in Cohort's balance sheet at the year end of May 31, 20X 2 was Rs.1.8 million,

iii) The balance on the retained earnings of Air at acquisition was Rs.2 million. The directors are of Cohort have decided that, during the three years to the date that they intend to list the shares of the company, the will realize earning through future dividend payments from the subsidiary amounting to Rs.500,000 per year. Tax is payable on any remittance or dividends and no dividends have been declared for the current year.

b) Legion was acquired on June 01, 20X1 and is a company which undertakes various projects ranging from debt factoring to investing in property and commodities. The following details relate to Legion for the year ending May 31, 20X2.

i) Legion has a portfolio of readily marketable government securities which are held as current assets. These investments are stated at market value in the balance sheet and any gain or loss is taken to the income statement. These gains and losses are taxed when the investments are sold. Currently accumulated unrealized gains are Rs.4 million.

ii) Legion has calculated that it requires a specific allowance of Rs.2 million against loans in its portfolio. Tax relief is available when specific loan is written off.

iii) When Cohort acquired Legion it had unused tax losses brought forward. At June 01, 20x1, it appeared that Legion would have sufficient to realize all the unused tax loss.

The current tax rate for Cohort is 30% and for public companies is 35%.

Required: -

Write a note suitable for presentation to the partner of an accounting firm setting the deferred tax implications of the above information for Cohort Group of companies.

Q.1

Swat Limited is in the business of manufacturing and selling of biscuits. It sells biscuits through its authorized partners appointed in all major cities of Pakistan.

The company accounts for taxation and deferred taxation in accordance with the provisions of IAS 12. The relevant information relating to accounting year ended December 31, 2006 is summarized hereunder:

	Rupees in "000"
Accounting income before tax	797,000
Accounting WDV of fixed assets as at December 31, 2006	565,500
Tax WDV of fixed assets as at December 31, 2006	243,000
Dividend income (subject to final tax at 5%)	35,000
Capital gain (exempt from tax)	135,000
Turnover for the year	3,165,500
Total turnover tax paid during the last three years	65,000
Liabilities older than 3 years, disallowed in previous years.	65,000
Provision for gratuity as at December 31, 2006	138,500
Provision for Gratuity for the year (net of payments)	33,000
Donations to unapproved institutions	5,000

Effect of prior year's assessments finalized during the current year	6,400
Accounting depreciation for the year	103,000
Tax depreciation for the year	85,000
Fixed assets additions during the year	123,000

All the liabilities are less than three years old except for those disclosed in the above table. No payment was made in respect of liabilities disallowed earlier.

Only one fixed asset (a vehicle) was disposed off during the year 2006 against Rs 1,000,000. Its accounting WDV was Rs 700,000 while tax WDV was Rs 465,000. No disposal of fixed assets took place in the year 2005.

All expenses (except donations and timing differences) are considered to be allowable for tax purpose. Applicable tax rate is 35%.

During last three years, the company was in a loss and was paying turnover tax which is adjustable in future under the provisions of the Income Tax Ordinance, 2001, within a period of five years. The company had always believed that such tax credit will be utilized in the near future.

Required:

(a) Compute the amount of deferred tax required to be reported in the balance sheets for the years 2006 and 2005.

(b) Prepare a note to the Profit and Loss Account for the year 2006, giving appropriate disclosures related to tax expenses.

Q.2

XYZ is a listed company involved in providing data outsourcing facilities to various companies. Following is the list of balances before any current and deferred tax adjustments for the year ended December 31, 2007.

	Dr. Rs. (Million)	Cr. Rs. (Million)
Share capital		100
Retained earnings 1-1-2007		50
Property, plant and equipment	70	
Accumulated depreciation		25
Development cost	25	
Accumulated amortization		10
Profit before tax		20
Accrued expenses		10
Prepaid expenses	5	
Debtors	25	
Provision for doubtful debts		5
Closing stocks	40	
Deferred tax	10	
Cash	20	
Bank	20	
Vehicles	5	
	220	220

Notes:

i) The development cost was allowed as an expense in the year of incurrence of whole amount but being amortized over five years under IFRS.

ii) Property, plant and equipment is being depreciated at 10% per year and 15% allowance is available under the tax laws on WDV basis. The depreciation claimed under tax laws before current year is Rs. 30 million.
iii) Accrued expenses are allowable only when paid.
iv) Prepaid expenses are allowed in the year of payment.
v) Vehicles were purchased during the year and the management has not charged any depreciation on vehicles for the year. The tax consultant of the company informed that no allowance is available under the tax law.
vi) Provision for doubtful debts is not an allowable expense only bad debts written off can be claimed as an expense. The opening balance for provision was Rs. 2 million.
vii) The tax rate is 35% for current year and future years

Required:

a) Compute taxable profit and current tax?

b) Compute deferred tax?

Q.3

The summarized trial balance of Murphy Limited as at June 30, 2009 is as under: -

	Debit Rs. (000)	Credit Rs. (000)
Ordinary share capital		50,000
Retained earnings brought forward		15,000
Revenue		150,500
Cost of sales	75,500	
Closing stock	15,600	
Operating expenses	12,050	
Current tax paid in advance	5,000	
Property, plant and equipment (opening)	136,225	
Employee benefits payable		4,500
Loan from parent company		15,000
Trade debtors (Net)	15,500	
Cash and bank balances	15,125	
Trade creditors		40,000
	275,000	275,000

The following further information is relevant.

a) The opening tax base of property, plant and equipment was Rs. 100.250 million. The tax rate applicable in the previous year was 30%.

b) The accounting rate of depreciation is 15% p.a. on reducing balance basis but tax rate of depreciation is 25% p.a. on reducing balance basis.

c) The company has introduced post employment benefit plan during the current year, the expense is allowable under tax when paid, and no benefit has been paid during the year.

d) The brought forward tax loss is Rs. 35.5 million.

e) The entity was granted interest- free five year loan from its parent company at the start of the year. If the entity has applied for loan from the local bank then loan would have been available at 15%. The entity has recorded the loan at the amount received. The interest is allowed as an expense only when paid.

f) The debtor figure in the trial balance is net of provision for doubtful debts for the year of Rs. 2 million. The bad debt expense is only allowable when debtors are written off from the books. The closing stock includes Rs. 3.5 million some slow moving inventory, the NRV of which is only Rs. 1.5 million. The loss on inventory is allowable only when goods are sold.

g) By mistake the company has not incorporated deferred tax in the prior years.

h) The applicable tax rate for the current year is 35%.

Required: -

Prepare statement of comprehensive income, statement of changes in equity for the year then ended and statement of financial position as at June 30, 2004 after incorporating current tax and deferred tax?

Q.4

Jubilee Limited is a non-listed public company primarily engaged in construction of bridges and roads and is required to prepare financial statements under IFRS. The detail of temporary differences at July 01, 2009 is as under: -

	Carrying Value Rs. (000)	**Tax Base Rs. (000)**
Furniture	150	100
Motor Vehicles	270	150
Plant and machinery	250	100
Debtors	120	140
Provision for warranty	300	--
Accrued expenses	50	--
Un-used tax losses carried forward	--	150

The year 2010 has not been a very successful year and the accountant has prepared the following summarized trial balance for the year ended June 30, 2010.

	Debit Rs. (000)	**Credit Rs. (000)**
Furniture	150	
Motor Vehicles	270	
Plant and machinery	400	
Debtors	250	
Provision for warranty		350
Accrued expenses		40
Ordinary share capital		300
Retained earnings		120
Revaluation surplus		150
Bank loan @ 15%		100
Sales		1,000
Cost of sales	780	
Operating expenses	230	
Interest income		35
Finance cost	15	
	2,095	2,095

The following notes are also relevant for the computation of tax for the year ended June 30, 2010.

a) There has been no addition to any of the fixed assets; however, the plant and machinery were revalued at the start of the year, the revaluation surplus is not taxable until the assets are sold. The depreciation expense for the year is not recognized in above trial balance. The depreciation method under IAS-16 and tax laws is reducing balance method, however, the rates of depreciation are different which are as follows: -

	IAS-16	Tax law
	%	%
Furniture	10	15
Motor Vehicles	10	15
Plant and machinery	15	20

b) The expenses are allowable under tax laws when paid and interest income is chargeable to tax when received, the interest income recognized above is not received yet by the company.

c) The tax rate has been 35% in the previous year as well as in the current year.

d) The opening provision for doubtful debts was Rs. 20,000 and closing provision for doubtful debts is Rs. 30,000. The debtors are reported net of provision and bad debt expense for the year is included in operating expenses.

e) The management is of the opinion that these taxable losses will be recovered before their expiry and the economic situation will improve in the next year, the loss was due to high production cost which is coming down to normal in two year's time.

f) Ignore minimum tax under Income Tax Ordinance 2001

Required: -

Calculate the amount of provision to be recognized in the current year for current as well as deferred tax?

Q.5

An entity has the following balances at the start and end of an accounting period.

	2011		2010	
	Carrying value Rs. (000)	**Tax base Rs. (000)**	**Carrying value Rs. (000)**	**Tax base Rs. (000)**
Property, plant and equipment (NBV)	74,250	?	80,000	40,000
Development cost	20,000	--	25,000	--
Accrued expenses	5,000	?	--	--
Advance income	10,000	?	--	--
Provision for penalty	5,000	?	--	--

Additional information

a) The property, plant and equipment are being depreciated under IAS 16 using straight line depreciation method. The useful life of the asset was 5 years at the time of acquisition. However, the tax rate of depreciation is 20% p.a. on reducing balance basis after taking 50% first year allowance.

b) The property, plant and equipment were revalued at the start of year 2011 and revaluation surplus was Rs. 19 million.

c) The profit before tax for the year but after charging accounting depreciation was Rs. 250.5 million.

d) The development cost was claimed as an expense in full in 2010, however, is being amortized under IAS 38 over five years using straight line amortization method.

e) Advance income is chargeable to tax in the year of receipt, however, expenses are allowed in the year of payment.

f) The penalty is not allowable expense under the tax laws.

g) The applicable tax rate for both the tax years is 35%.

Required: -

a) Calculate current and deferred tax for the year 2011?

b) Provide reconciliation of tax on accounting profit and tax expense for the year 2011?

Q.6

Jamshed Limited has recently hired your services for the position of Accountant. The following summarized trial balance for the year ended December 31, 2008 along with the CFO's comments, has been provided to you.

	Debit Rs.	Credit Rs.	CFO's Comments
Share capital		75,000,000	
Retained earnings (1/1/2008)		54,134,997	
Obligation under finance leases		15,436,900	
Accounts payable		4,100,000	
Owned fixed assets – net	110,187,500		
Leased fixed assets – net	17,152,115		
Deferred tax asset (1/1/ 2008)	750,000		
Stock in trade	31,400,250		
Accounts receivable	13,075,000		
Provision for bad debts		653,750	
Advance tax paid	11,999,247		Including tax of Rs. 51,250 deducted on dividend received.
Cash and bank	1,025,000		
Sales		177,633,594	
Cost of sales excluding depreciation	122,106,875		
Depreciation expense – owned assets	9,385,542		Tax depreciation for the year is Rs. 8,501,758.
Depreciation expense – leased assets	1,815,212		
Donations	562,500		Not allowable for tax purposes.
Financial charges	2,237,500		Includes Rs. 1,750,222 relating to obligations under finance lease.
Other expenses	6,150,000		Includes bad debt expenses of Rs. 853,750.
Dividend income		512,500	Taxable under Final Tax Regime.
Gain on sale of machines		375,000	Carrying amount at disposal was Rs. 650,000.

	327,846,741	**327,846,741**

Following relevant information is also available:

(i) Bad debts written off during the year amounted to Rs. 200,000.

(ii) There was no addition or deletion in the leased assets. The principal repayment towards obligation under finance lease was Rs. 2,061,359.

(iii) The tax written down value of owned fixed assets as of December 31, 2007 was Rs. 96,550,000.

(iv) During the year, the company purchased fixed assets amounting to Rs. 7,500,000.

(v) The tax written down value of machines sold was Rs. 450,000. There was no other disposal of property, plant and equipment in the year 2008.

(vi) On account of an apparent mistake in the return relating to year ended December 31, 2007, a revised return was filed and the taxable income was reduced by Rs. 1,800,000.

(vii) Up to the year ended December 31, 2007, the company's assessed brought forward losses amounted to Rs. 14,251,700.

(viii) Applicable tax rate is 35%.

Required

Prepare a note to the statement of comprehensive income for the year ended December 31, 2008, giving appropriate disclosure related to current and deferred tax expenses?

Q.7

You are the Chief Accountant of Rubab Enterprises Limited which is engaged in manufacturing iron and steel products. The company was set up in August 1998 and started commercial production in November 1998. The accounting year-end of the company is June 30.

While analyzing the company's books of accounts for the year ended June 30, 2005, you came across the following balances:

	Rs.
Provision for taxation-current	2,410,000
Deferred tax liability	4,700,000

The assessments of the past four years although completed by the taxation officer but are still open due to appeals. The provision for taxation consists of the following:

Accounting year	**Accounting income**	**Assessed income**	**Tax rate %**	**Provision for taxation**
2002	1,000,000	1,800,000	45	810,000
2003	1,400,000	1,900,000	40	760,000
2004	1,700,000	2,100,000	40	840,000
2005	2,200,000		35	-
				2,410,000

The deferred taxation in on account of the following: -

	Rs.
Depreciation	(4,000,000)
Leasing	(2,000,000)
Penalties and fines paid by the company	100,000
Provision for gratuity	1,000,000
Provision for bad debts	200,000
	(4,700,000)

The following information is also available:

(a) The accounting depreciation for the year ended June 30, 2005 amounted to Rs.20.50 million whereas tax depreciation as calculated by one of your subordinates amounted to Rs. 15.50 million.
(b) The company operates an unfunded gratuity scheme. Gratuity of Rs.100,000 each was paid to two of the employees who had resigned during the year. The total provision required at year-end amounted to Rs. 3.5 million.
(c) Leased assets consisted of two machines only. In the accounting records of the company; one of the leases has been treated as operating lease. The machine under financial lease arrangement was sold during the year at a profit of Rs.400,000. The lease was cancelled with the consent of the leasing company.
(d) The company paid Rs. 1,000,000 on account of certain expenses. Your tax advisor has informed you that only 60% of this will be allowed for tax purposes and that too, over a period of five years (including the current year).
(e) Receivables of Rs.40,000 which were written off in the year 2002 were recovered during the year. The same had not been allowed by the tax authorities in the year in which they were written off.

During the year, the following decisions were made by various tax appellate authorities:
(a) While assessing the income for the year ended June 30, 2002 the value of closing stock had been increased by the taxation authorities by Rs. 4.0 million. Consequential effect on opening stock of next year had however been allowed. During the current year, add-back was declared invalid by the appellate authority.
(b) An expense incurred in the year 2003, amounting to Rs.0.5 million, which was disallowed then, was declared as allowable over a period of four years. Although the company had filed an appeal, it was of the view that the same would not be allowed; hence it has ignored it for the purpose of calculating deferred tax till last year.

Required:
(a) Among the transactions discussed above, identify those which give rise to permanent timing differences?
(b) Calculate the following:
 i) Provision for taxation – current
 ii) Provision for taxation – prior years
 iii) Deferred tax – current
 iv) Deferred tax – prior years
 iv) Deferred tax liability

Q.8

You are the auditor on the December 31, 20X8 audit of MNC Limited. 20X8 was the first year of operations for the Company. The audit is virtually complete and the only area that needs attention is the calculation of the tax provision. The audit has been very "clean", and as yet no adjusting entries have been proposed; however, since no taxes have as yet been provided for, adjusting entries will have to be suggested to the client.

Based upon the results of your audit, discussions with the company's chief accountant and your tax manager, you have identified the following transactions, which must be considered in the tax calculation:

	Rs.
Accounting income before tax	1,000,000
Accounting accumulated depreciation	200,000
Tax accumulated depreciation	400,000
Allowance for doubtful accounts at December 31, 20X8	150,000
Long-term debt financing expenditures	300,000
Book amortization of long-term debt financing costs	60,000

Corporate dividends received	50,000
Accrued management bonus, payable in 20X9	100,000

The tax regulations in the country of MNC Ltd. provide for the following:

- Depreciation of fixed assets using "accelerated" methods. The company uses the straight-line method of depreciation for accounting purposes. The estimated useful lives of the fixed assets are 10 years.
- Bad debts are deductible for tax purposes only when the account has actually been directly written off (no amounts were written off during 20X8).
- Expenses incurred to acquire debt are deductible for tax purposes in the year in which they are paid. For accounting purposes MNC Ltd. has written off Rs. 300,000 in fees directly against the related finance, and they are being amortized over the finance period using the effective interest rate method.
- 80% of corporate dividends received are not taxable.
- Based upon the results of the first year of operations, the Company has given bonuses to its top managers; however they will not be paid until 20X9. Such amounts are not deductible for tax purposes until they have been paid.
- The statutory tax rate is 50%. Tax losses can be carried forward to 15 years.

Required

a) Identify the temporary differences. Determine the amount of gross temporary differences at December 31, 20X8.

b) Calculate the net deferred tax liability or asset at December 31, 20X8 and pass journal entry.

c) Compute the amount of taxes payable that would be reported on the Company's 20X8 tax return. That is, what is the "current" tax expense?

d) Prepare the recommended journal entry to record the current tax liability (MNC Ltd. had not made any tax payments on its estimated tax liability for 20X8).

e) Prepare a reconciliation of expected to actual tax expense (IAS 12.81c).