Deferred income tax
IAS 12

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**Introduction**

- The financial statements for a period should recognise the tax effects of all transactions occurring in that period.
- But the current tax charge for that period will not be calculated in the same way.
- An entity should account for the tax consequences of transactions and other events in the same way it accounts for the transactions or other events themselves.
- Accounting for deferred tax is a matching exercise that aims to get the correct tax charge in the profit and loss account.
Introduction

Income tax income /expense

Current income tax (payable min zero) XXXX
Deferred income tax charge / credit XXXX
Tax over / under provision in previous year XXXX
Comprehensive balance sheet method' of accounting for income taxes
Recognizes both
- the current tax consequences of transactions and events, and
- the future tax consequences of the future recovery or settlement of the carrying amount of an entity's assets and liabilities.

Differences between the carrying amount and tax base of assets and liabilities, and carried forward tax losses and credits, are recognized, with limited exceptions, as deferred tax liabilities or deferred tax assets, with the latter also being subject to a 'probable profits' test.
Nil provision of deferred tax

- the flow-through, or "do nothing" arguments.

- Using the argument that the tax liability applies to taxable profits rather than accounting profits, it leaves the tax charge in the profit and loss account as that calculated.

- Imagine an entity with basic assets such as furniture, computers and motor vehicles and depreciation rate are harmonized with capital allowances as per the income tax act.
Current tax

- Current tax for the current and prior periods is recognised as a liability to the extent that it has not yet been settled, and as an asset to the extent that the amounts already paid exceed the amount due. [IAS 12.12]

- The benefit of a tax loss which can be carried back to recover current tax of a prior period is recognised as an asset. [IAS 12.13]
Current income taxes

- Current income tax is tax payable in respect of the taxable profit for the current period.
- Recognise current tax in accordance with provision of Income Tax Act.
- Current income tax paid as the year progress through installment tax systems
Current income tax

- Current income tax assets and liabilities for the current and prior periods are measured at the amount expected to be recovered from or paid to the taxation authorities.

- The tax rates and tax laws used to compute the amount are those that are enacted or substantively enacted, by the reporting date.
Current income tax relating to items recognised in OCI is recognised as offset to the respective item and not in the income statement.

Management should periodically evaluate positions taken in the tax returns with respect to situations in which applicable tax regulations are subject to interpretation and establishes provisions where appropriate.
Computing taxable business income for each source of income

MNP co Ltd, Tax computation for the year ended

Net profit per accounts/ ledger for a source xx

Add:

Non-allowable expenses for the source xx
Expenses relating to exempt income xx

Less:

Capital allowances (xx)
Other deductible expenses for the source (xx)
Exempt income (xx)

Adjusted profit/(loss) for tax xx
Key principle: Expenses incurred wholly and exclusively in earning income are allowable in computing the chargeable income for the company.

Specific allowable expenses include:

- Legal expenses and stamp duties in connection with the acquisition of a lease not exceeding 99 years
- Interest paid on borrowings made to generate investment income (but restricted to the amount of investment income earned).
- Legal and other costs incurred in issuing shares and debentures to the general public
Disallowable expenses

- Expenditure not wholly and exclusively incurred in the production of income;
- Capital costs and losses;
- Income tax, compensating tax and similar taxes;
- Personal expenses, other than those incurred specifically in the course of business – e.g. club subscriptions, entertainment expenses, travel
Disallowable expenses (cont’d)

- A loss incurred in a business which the Commissioner considers is not being carried on with a view to realisation of profits
- Pension contributions to unregistered pension schemes
Deferred income tax

- Deferred tax is provided using the liability method on temporary differences at the reporting date between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes.
Deferred income tax:

- Deferred income tax is tax payable or recoverable in future periods,
- Arise as a result of the entity recovering or settling its assets and liabilities for their current carrying amount, or
- The tax effect of the carry forward of currently unused tax losses.
- No deferred income tax if effects are permanent.
Deferred income tax

- Deferred tax created by temporary differences
- Income statement liability method focuses on differences between accounting profit and taxable profit which are also called timing differences
- Balance sheet liability method focuses on the differences between tax basis and carrying amount of assets and liabilities also called temporary differences.
- All timing differences are temporary differences but temporary also include revaluation, initial recognition business combination etc.
Deferred income tax

- Taxable temporary differences will increase future current tax liability thus the need to create deferred tax liability
  - Tax base of asset is lower than carrying amount
  - Tax base of liability is higher than carrying amount
- Deductible temporary differences will reduce the future current tax liability thus the need to create deferred tax asset.
  - Tax base of asset is higher than carrying amount
  - Tax base of liability is higher than carrying amount
Deferred tax liabilities are recognised for all taxable temporary differences, except:

- Where the deferred tax liability arises from the initial recognition of goodwill or of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss.
In respect of taxable temporary differences associated with investments in subsidiaries, associates and interests in joint ventures, where the timing of the reversal of the temporary differences can be controlled and it is probable that the temporary differences will not reverse in the foreseeable future.
Deferred tax assets

- Deferred tax assets are recognised for all deductible temporary differences, carry forward of unused tax credits and unused tax losses, to the extent that it is probable that taxable profit will be available against which the deductible temporary differences, and the carry forward of unused tax credits and unused tax losses can be utilised except:

- Where the deferred tax asset relating to the deductible temporary difference arises from the initial recognition of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss.
In respect of deductible temporary differences associated with investments in subsidiaries, associates and interests in joint ventures, deferred tax assets are recognised only to the extent that it is probable that the temporary differences will reverse in the foreseeable future and taxable profit will be available against which the temporary differences can be utilised.
The carrying amount of deferred tax assets is reviewed at each reporting date and reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow all or part of the deferred tax asset to be utilised.

Unrecognised deferred tax assets are reassessed at each reporting date and are recognised to the extent that it has become probable that future taxable profits will allow the deferred tax asset to be recovered. (allowance required under the exposure draft)

Deferred tax assets and liabilities are measured at the tax rates that are expected to apply in the year when the asset is realised or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted at the reporting date.
Deferred tax on OCI

- Deferred tax relating to revaluation reserves of property, plant and equipment is recognized in equity or OCI.

- Deferred tax assets and deferred tax liabilities are offset, if a legally enforceable right exists to set off current tax assets against current income tax liabilities and the deferred taxes relate to the same taxable entity and the same taxation authority.
# Deferred tax on OCI

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>PROFIT FOR THE YEAR</strong></td>
<td>551,383</td>
<td>139,801</td>
</tr>
<tr>
<td><strong>OTHER COMPREHENSIVE INCOME</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revaluation of property, plant and equipment</td>
<td>-</td>
<td>293,410</td>
</tr>
<tr>
<td>Deferred tax on revaluation</td>
<td>6,686</td>
<td>(40,023)</td>
</tr>
<tr>
<td><strong>OTHER COMPREHENSIVE INCOME AFTER TAX</strong></td>
<td>6,686</td>
<td>253,387</td>
</tr>
<tr>
<td><strong>TOTAL COMPREHENSIVE INCOME FOR THE YEAR</strong></td>
<td>558,069</td>
<td>393,188</td>
</tr>
</tbody>
</table>
Procedures of computing Deferred tax

- Identify the assets and liabilities that would affect taxable profit if they were recovered or settled for their present carrying amounts.
- Determine the **tax basis of** the assets and liabilities and other items that have a tax basis although they are not recognised.
- Compute any temporary differences, unused tax losses.
The tax bases determines the amounts that will be included in taxable profit on recovery or settlement of the carrying amount of an asset or liability;
the tax basis of an asset equals the amount that would have been deductible in arriving at taxable profit if the carrying amount of the asset had been recovered through sale at the end of the reporting period.

If the recovery of the asset through sale does not increase taxable profit, the tax basis shall be deemed to be equal to the carrying amount.
A machine cost Ksh 100,000. For tax purposes, depreciation of Ksh 30,000 has already been deducted in the current and prior periods and the remaining cost will be deductible in future periods. Revenue generated by using the machine is taxable. *The tax base of the machine is Ksh 70,000.*

Interest receivable has a carrying amount of 200,000. The related interest revenue will be taxed on a cash basis. *The tax base of the interest receivable is nil.*

Trade receivables have a carrying amount of 2500. The related revenue has already been included in taxable profit. *The tax base of the trade receivables is 2500.*
Dividends receivable from a subsidiary have a carrying amount of 100,000. The dividends are not taxable. *the tax base of the dividends receivable is 100.*

A loan receivable has a carrying amount of 100. The repayment of the loan will have no tax consequences. *The tax base of the loan is 100,000.*
the tax basis of a liability equals its carrying amount less any amounts deductible in determining taxable profit (or plus any amounts included in taxable profit) that would have arisen if the liability had been settled for its carrying amount at the end of the reporting period.

In the case of deferred revenue, the tax base of the resulting liability is its carrying amount, less any amount of revenue that will not be taxable in future periods.
Current liabilities include accrued expenses with a carrying amount of 200,000. The related expense will be deducted for tax purposes on a cash basis. *The tax base of the accrued expenses is nil.*

Current liabilities include interest revenue received in advance, with a carrying amount of 300,000. The related interest revenue was taxed on a cash basis. *The tax base of the interest received in advance is nil.*

Current liabilities include accrued expenses with a carrying amount of 100,000. The related expense has already been deducted for tax purposes. *The tax base of the accrued expenses is 100,000.*
Current liabilities include accrued fines and penalties with a carrying amount of 20,000. Fines and penalties are not deductible for tax purposes. The tax base of the accrued fines and penalties is 20,000.

A loan payable has a carrying amount of 100,000. The repayment of the loan will have no tax consequences. The tax base of the loan is 100,000.
Temporary differences

- Temporary differences is the difference between the carrying amounts and tax bases of an asset or liabilities.
Temporary difference may arise on;

- on the initial recognition of assets and liabilities e.g. part of the cost of an asset will not be deductible for tax purposes
- at the time a tax basis is created for those items that have a tax basis but are not recognised as assets and liabilities.
- After initial recognition because income or expense is recognised in comprehensive income or equity in one reporting period but is recognised in taxable profit in a different period.
- when the tax basis of an asset or liability changes and the change will not be recognised in the asset or liability’s carrying amount in any period.
Deferred tax liability

Recognise

- a deferred tax liability for all temporary differences that are expected to increase taxable profit in the future.
Deferred tax asset

- A deferred tax asset for all temporary differences that are expected to reduce taxable profit in the future.
- A deferred tax asset for the carry forward of unused tax losses and unused tax credits.
The major provision outstanding as at the reporting date is the leave pay provision.

Provisions are recognised when the entity has a present legal or constructive obligation as a result of past events, for which it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and a reliable estimate of the amount of the obligation can be made.
Inventories are stated at the lower of cost and net realisable value.
Cost is determined on the weighted average cost. Cost comprises expenditure incurred in the normal course of business, including direct material costs, labour and production overheads, where appropriate, that have been incurred in bringing the stocks to their present location and condition.
Net realisable value is the price at which the inventory can be realised in the normal course of business after allowing for costs of realisation.
Consumable stores are stated at the weighted average cost less provisions for obsolescence, slow moving and defective stores.
Agricultural produce is measured at fair value less estimated point of sale costs at the point of harvest.

Any changes arising on initial recognition of agricultural produce at fair value less estimated point of sale costs are recognised in the Statement of comprehensive income. The cost of finished goods and work in progress comprise the fair value less estimated point-of-sale costs of agricultural produce at the point of harvest, raw materials, direct costs and related production overheads (based on normal operating capacity) but excludes borrowing costs.
Effect of deferred tax

- Changes in a deferred tax liability or deferred tax asset is recognised as increase/decrease of tax expense, except
- if attributable to an item of other comprehensive income.
Effect of deferred tax

- Recognise deferred tax assets and deferred tax liabilities at an amount that includes the effect of the possible outcomes of a review by the tax authorities.

- At the end of each reporting period, reassesses un-recognised deferred tax assets. The entity recognises a previously un-recognised deferred tax asset to the extent that it has become probable that future taxable profit will allow the deferred tax asset to be recovered.
Measurement

- not discount current or deferred tax assets and liabilities.
- In there is uncertainty measure current and deferred tax assets and liabilities using the probability-weighted average amount of all the possible outcomes.
Should not classify any deferred tax assets (liabilities) as current assets (liabilities).

- Offset current tax assets and current tax liabilities, only if there is a legally enforceable right to set off the amounts and it intends either to settle on a net basis.
- Deferred tax assets and deferred tax liabilities, only if there is a legally enforceable right to set off the amounts or to realise the asset and settle the liability simultaneously.
Disclosure

- Current income tax obligation and any adjustment due to prior period
- Deferred income tax arising in current period, and any effect of changes in tax rate, or adjustment due to possible review by tax authorities, or change in tax status.
- Tax expense due to change in accounting policies.
Disclosure

- a numerical reconciliation between tax expense (income) and the product of accounting profit multiplied by the applicable tax rate(s); or
- a numerical reconciliation between the average effective tax rate and the applicable tax rate.
Disclosure

- Explanation of difference between current income tax and tax expense.
- Tax relating to items of other comprehensive income
- Explanation of temporary differences comprising the deferred tax.
- Example: accelerated capital allowance, accelerated depreciation etc.
Cement Ltd reported loss before taxation of sh.118.4 million for the year ended 31 March 2017.

- This loss includes;
  - capital gain on the sale of some land sh.28 million.
  - non-allowable expenses sh.11.2 million
  - non-allowable depreciation charge of sh.124 million

- The equivalent tax-Allowable capital allowances was sh.58.6 million.
- During the year the company paid installment taxes amounting to sh 12.5 million.
- Compute the tax income or expense
- Prepare the necessary adjusting entries
The company is projecting that profit in the year to 31 March 2018 will be sh.168 million;

- Included in this figures are;
  - non-allowable expenses of sh.32 million
  - non-taxable capital gain will be made of sh.8 million
  - the depreciation charge will be sh.136.8 million.

- The capital allowances figure will be sh.88.9 million
- Tax losses cannot be carried backwards, but can be carried forward.
<table>
<thead>
<tr>
<th>Description</th>
<th>2017</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>current income tax</td>
<td></td>
<td></td>
</tr>
<tr>
<td>accounting profit / (loss)</td>
<td>(118.4)</td>
<td>168</td>
</tr>
<tr>
<td>add dis-allowable expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>non-allowable expense</td>
<td>11.2</td>
<td>32</td>
</tr>
<tr>
<td>depreciation</td>
<td>124</td>
<td>136.8</td>
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<tr>
<td>less non-taxable income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>capital gain</td>
<td>(28)</td>
<td>(8)</td>
</tr>
<tr>
<td>less allowable deduction</td>
<td></td>
<td></td>
</tr>
<tr>
<td>capital allowances</td>
<td>(58.6)</td>
<td>(88.9)</td>
</tr>
<tr>
<td>less tax losses brought forward (max 4 years)</td>
<td></td>
<td>(69.8)</td>
</tr>
<tr>
<td>Taxable profit / (loss)</td>
<td>(69.8)</td>
<td>170.1</td>
</tr>
<tr>
<td>Current income tax</td>
<td>Nil</td>
<td>51.03</td>
</tr>
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## Tax payable / recoverable

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
<th>Calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td>current income tax</td>
<td>nil</td>
<td>51.03</td>
</tr>
<tr>
<td>less instalment tax paid</td>
<td>(12.5)</td>
<td>-</td>
</tr>
<tr>
<td>less tax recoverable</td>
<td>(12.5)</td>
<td>(12.5)</td>
</tr>
<tr>
<td><strong>tax payable /(recoverable)</strong></td>
<td>(12.5)</td>
<td>38.53</td>
</tr>
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## Deferred income tax credit

<table>
<thead>
<tr>
<th>Description</th>
<th>2023</th>
<th>2022</th>
</tr>
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<tbody>
<tr>
<td>deferred tax computation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>depreciation for accounting purpose</td>
<td>124</td>
<td>136.8</td>
</tr>
<tr>
<td>capital allowances</td>
<td>58.6</td>
<td>88.9</td>
</tr>
<tr>
<td></td>
<td>65.4</td>
<td>47.9</td>
</tr>
<tr>
<td>tax losses originating</td>
<td>69.8</td>
<td>(69.8)</td>
</tr>
<tr>
<td>temporary differences (deductible) taxable</td>
<td>(135.2)</td>
<td>21.9</td>
</tr>
<tr>
<td>deferred tax credit /charge</td>
<td>(40.56)</td>
<td>6.57</td>
</tr>
</tbody>
</table>
## Disclosures

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
<th>Tax Expense / Income</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Income Tax Expense / Income</strong></td>
<td>0</td>
<td>51.03</td>
</tr>
<tr>
<td><strong>Current Income Tax</strong></td>
<td>40.56</td>
<td>6.57</td>
</tr>
<tr>
<td><strong>Deferred Income Tax</strong></td>
<td>40.56</td>
<td>57.6</td>
</tr>
<tr>
<td><strong>Reconciliation of Tax Expense</strong></td>
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<td></td>
</tr>
<tr>
<td><strong>Tax on Accounting Profit / (Loss)</strong></td>
<td>(118.4)</td>
<td>168</td>
</tr>
<tr>
<td>Adjusted for Exempt Items</td>
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<td></td>
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<tr>
<td><strong>Non Allowable Expenses</strong></td>
<td>11.2</td>
<td>32</td>
</tr>
<tr>
<td><strong>Capital Gain</strong></td>
<td>(28)</td>
<td>(8)</td>
</tr>
<tr>
<td><strong>Income Tax Expense / Income</strong></td>
<td>(135.2)</td>
<td>192</td>
</tr>
</tbody>
</table>

Income tax expense / income: (40.56) 57.6
Thank you

- Interactive session