

HKAS 12 *Income Taxes* deals with both current taxes and deferred taxes but the most complex issue in HKAS 12 is no doubt rested on deferred taxes. HKAS 12 adopts a balance sheet liability method in accounting for deferred tax and requires full provision for deferred tax with only certain exceptions.

This note covers the following areas of HKAS 12:<sup>2</sup>

1. Objective and scope of HKAS 12
2. The recognition of current tax liabilities and current tax assets
3. The recognition of deferred tax liabilities and deferred tax assets
4. Measurement of current tax liabilities (assets) and deferred tax liabilities (assets)
5. Recognition of current tax and deferred tax
6. Presentation, and
7. Disclosures.

## 1. Objective and Scope of HKAS 12

The objective of HKAS 12 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 recognised in an entity's balance sheet; and
- (b) transactions and other events of the current period that are recognised in an entity's financial statements.

HKAS 12 ***shall be applied in accounting for income taxes.***<sup>3</sup> (HKAS 12 para. 1) For the purposes of HKAS 12, income taxes include all domestic and foreign taxes which are based on taxable profits, and also include taxes, such as withholding taxes, which are payable by a subsidiary, associate or joint venture on distributions to the reporting entity.

HKAS 12 does not deal with the methods of accounting for government grants that are covered by HKAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*, or investment tax credits. However, HKAS 12 does deal with the accounting for temporary differences that may arise from such grants or investment tax credits.

## 2. Recognition of Current Tax Liabilities and Current Tax Assets

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

***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)***

***Accounting profit is profit or loss for a period before deducting tax expense.*** (HKAS 12 para. 5)

<sup>1</sup> This note is sourced from HKAS 12 *Income Taxes*. While the note is aimed at covering all critical points of HKAS 12, a complete and comprehensive coverage of it should still be the original standard, HKAS 12.

<sup>2</sup> Definitions used in HKAS 12 are specifically incorporated in the above sections and have not grouped into a single section.

<sup>3</sup> All the paragraphs in HKAS have equal authority while main principles are highlighted in bold.

*Current tax for current and prior periods shall, to the extent unpaid, be recognised 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 recognised as an asset. (HKAS 12 para. 12)*

*The benefit relating to a tax loss that can be carried back to recover current tax of a previous period shall be recognised as an asset. (HKAS 12 para. 13)*

When a tax loss is used to recover current tax of a previous period, an entity recognises the benefit as an asset in the period in which the tax loss occurs because it is probable that the benefit will flow to the entity and the benefit can be reliably measured.

### 3. Recognition of Deferred Tax Liabilities and Deferred Tax Assets

HKAS 12 adopts a balance sheet liability method in accounting for deferred tax and the calculation of the deferred tax is largely referenced to the differences (i.e. temporary differences) between the carrying amount of an asset or liability in the balance sheet and its tax base.

In consequence, the understanding of tax base and temporary difference is critical in understanding the accounting for deferred tax under HKAS 12. Both of them are discussed below.

#### Examination question

##### Question

*Modified from ACCA 3.6H 2002 Dec. Q2(d)*

Write a report to Autol for the following information:

The potential impact on the reported profit of Autol if it prepared its consolidated financial statements in accordance with HKASs in relation to its current accounting practices for deferred tax.

##### Answers

The revised HKAS 12 uses the full provision method to determine the liability and the revised HKAS 12 is based upon temporary differences. The potential impact on profitability could be quite significant as the HKAS requires a provision for deferred tax based on a “balance sheet” approach whereby most temporary differences are accounted for

## 3.1 Tax Base

*The tax base of an asset or liability is the amount attributed to that asset or liability for tax purposes. (HKAS 12 para. 5)*

To understand the concept of tax base is of key importance in implementing the principles in HKAS 12. Thus, HKAS 12 provides guidance on calculating the tax base of different assets and liabilities.

### 3.1.1 Tax base of assets

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.

The tax base of an asset may be calculated as asset’s carrying amount, less any future taxable amounts plus any future deductible amounts that are expected to arise from recovering the asset’s carrying amount as at the balance sheet date. For example, in the case of plant and equipment, the tax base is the tax written down value.

$$\boxed{\text{Tax base}} = \boxed{\text{Carrying amounts of assets}} - \boxed{\text{Future taxable amounts}} + \boxed{\text{Future deductible amounts}}$$

If those economic benefits will not be taxable, the tax base of the asset is equal to its carrying amount.

**Exhibit 1: Examples of the calculation of tax base of assets**

**1. Asset carried at cost with different depreciation for accounting and tax purposes**

A machine cost \$100 and is expected to be ultimately disposed of at an amount being equal or less than cost. For accounting purpose, depreciation of \$20 has been made.

For tax purpose, depreciation of \$30 has been deducted in the current and prior periods. The remaining cost of \$70 will be deductible in future periods, either as depreciation or through a deduction on disposal. Revenue generated by using the machine (i.e. revenue generated from recovering the carrying amount of the machine) is taxable and any gain or loss on disposal will be subject to a balancing adjustment for tax purposes.

The tax base of the machine is:

Carrying Amount	Taxable amounts	Deductible amounts	Tax base
\$80	- \$80	+ \$70	= \$70

**2. Freehold land carried at revalued amount**

Freehold land with a cost of \$100 is revalued to \$150. For tax purposes, there is no depreciation. Revenue generated from the use of the freehold land is taxable. However, any gain on disposal of the land at the revalued amount will not be taxable.

The tax base of the freehold land is:

Carrying amount	Taxable amounts	Deductible amounts	Tax base
\$150	- \$150	+ \$100	= \$100

**3. Receivable with general provision for bad debt**

Trade receivable has a carrying amount of \$100, for which general bad debt provisions amounting to \$20 have been made. These provisions have not yet been deducted for tax purposes but are expected to give rise to future deductible amounts.

The tax base of the trade receivables is:

Carrying amount	Taxable amounts	Deductible amounts	Tax base
\$100	- Nil	+ \$20	= \$120

**4. Interest income taxed upon receipt**

An interest receivable has a carrying amount of \$100. The related interest revenue will be taxed only when received.

The tax base of the interest receivable is:

Carrying amount	Taxable amounts	Deductible amounts	Tax base
\$100	- \$100	+ Nil	= Nil

**3.1.2 Tax base of liabilities**

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. It may be calculated as the liability's carrying amount as at the balance sheet date less any future deductible amounts, plus any future taxable amounts, that are expected to arise from settling the liability's carrying amount as at the balance sheet date.

Tax base	=	Carrying amounts of assets	-	Future deductible amounts	+	Future taxable amounts
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**Exhibit 2: Examples of the calculation of tax base of liabilities**

**1. Accrued expenses with related expenses deducted for tax purpose on an accrued basis**

Current liabilities include accrued wages with a carrying amount of \$100. The related expense has already been deducted for tax purposes on an accrued basis.

The tax base of the accrued expenses is:

Carrying Amount	Deductible amount	Taxable amounts	Tax base
\$100	- Nil	+ Nil	= \$100

**2. Accrued expenses with related expenses deductible for tax purpose on a cash basis**  
 An interest payable has a carrying amount of \$100. The related interest will be deductible for tax purposes only when it is paid.

The tax base of the accrued expenses is:

Carrying Amount	Deductible amounts	Taxable amounts	Tax base
\$100	- \$100	+ Nil	= Nil

**3. Loan payable adjusted for exchange rate change**  
 A foreign currency loan payable has a carrying amount on initial recognition of \$100. Subsequently, the carrying amount is reduced to \$90 to reflect the change in exchange rates (an unrealised foreign exchange gain). Exchange gains are only taxable when they are realised. The repayment of the \$90 carrying amount of the loan will give rise to taxable amounts of \$10.

The tax base of the loan is:

Carrying amount	Deductible amounts	Taxable amounts	Tax Base
\$90	- Nil	+ \$10	= \$100

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. The tax base of such liability is calculated as the liability's carrying amount less any amount of the "revenue received in advance" that has been included in taxable amounts in the current or a previous reporting period.

Tax base	=	Carrying amounts of assets	-	Revenue that will not be taxable in future periods
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**Exhibit 3: Example of calculation of tax base of "revenue received in advance"**

Current liabilities include interest revenue received in advance, with a carrying amount of \$100. The related interest revenue was taxed on a cash basis. The tax base of the interest received in advance is:

Carrying Amount	Amount of revenue received in advance that has increased taxable amount (or decreased tax loss)	Tax base
\$100	- \$100	= Nil

### 3.2 Temporary Differences

*Temporary differences are differences between the carrying amount of an asset or liability in the balance sheet and its tax base. Temporary difference 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. (HKAS 12 para. 5)*

Generally, if the carrying amount of an asset is higher (or lower) than the tax base, the temporary difference is a taxable temporary difference (or a deductible temporary difference). While the carrying amount of a liability is higher (or lower) than its tax base, the temporary difference is a deductible temporary difference (or a taxable temporary difference).

The future tax consequences of transactions and other events recognised in an entity's balance sheet give rise to deferred tax liabilities and assets, and are calculated, based the above temporary differences, in accordance with the following formula:

Carrying amounts of assets (or liabilities)	-	Tax bases of assets (or liabilities)	=	Taxable (or deductible) temporary differences
Taxable (or deductible) temporary differences	×	Tax rates	=	Deferred tax liabilities (or assets)

Deferred tax assets also arise from unused tax losses (and unused tax credits) that tax law allows to be carried forward, and are calculated in accordance with the following formula:

$$\boxed{\begin{array}{c} \text{Unused tax} \\ \text{losses or credits} \end{array}} \times \boxed{\begin{array}{c} \text{Tax rates} \end{array}} = \boxed{\begin{array}{c} \text{Deferred tax assets} \end{array}}$$

#### Examination question

##### Question

*Modified from ACCA 2.5H 2003 Jun. Q2(v)*

Allgones' deferred tax (in credit) at 31 Mar. 2003 is \$3 million. Its directors have estimated the deferred tax provision at 31 Mar. 2003 is to be adjusted to reflect the tax base of the company's net assets being \$16 million less than their carrying values. The rate of income tax is 30% and deferred tax shall be charged to the income statement. Please advise.

##### Answers

The carrying values of net assets are higher than their tax base by \$16 million and it implies a taxable temporary difference, which gives rise to a deferred tax liability. It would require a balance sheet provision for deferred tax of \$4.8 million (at 30%). As the opening provision is \$3 million, an additional deferred tax charge of \$1.8 million is required.

### 3.2.1 Taxable temporary differences

HKAS 12 requires recognition of deferred tax liabilities and deferred tax assets for all taxable temporary differences and deductible temporary differences respectively, with only limited exceptions. In other words, HKAS 12 adopts a full provision approach on recognition of deferred tax liabilities and assets.

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

- (a) *the initial recognition of goodwill;*
- (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). (Point b here can be termed as "initial recognition exemption")*

***However, for taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, a deferred tax liability shall be recognised in accordance with paragraph 39 (of HKAS 12, i.e. section 3.4 below). (HKAS 12 para. 15)***

***Deferred tax liabilities are the amounts of income taxes payable in future periods in respect of taxable temporary differences. (HKAS 12 para. 5)***

#### **Exhibit 4: Examples of circumstances resulting in taxable temporary differences**

All taxable temporary differences give rise to a deferred tax liability.

##### *Transactions that affect the income statement*

1. Depreciation of an asset is accelerated for tax purposes.  
Example 1 of Exhibit 1 in section 3.1 sets out that the carrying amount of the machine is higher than its tax base and it gives rise a taxable temporary difference of \$10.
2. Interest revenue is received in arrears and is included in accounting profit on a time apportionment basis but is included in taxable profit on a cash basis.  
Example 5 of Exhibit 1 in section 3.1 sets out that the carrying amount of the interest receivable is higher than its tax base and it gives rise a taxable temporary difference of \$100.
3. Development costs have been capitalised and will be amortised to the income statement but were deducted in determining taxable profit in the period in which they were incurred.
4. Prepaid expenses have already been deducted on a cash basis in determining the taxable profit of the current or previous periods.

##### *Transactions that affect the balance sheet*

5. A borrower records a loan at the proceeds received (which equal the amount due at maturity), less transaction costs. Subsequently, the carrying amount of the loan is increased by amortisation of the transaction costs to accounting profit. The transaction costs were deducted for tax purposes in the period when the loan was first recognised. Since (1) the taxable temporary difference is the amount of transaction costs already deducted in determining the taxable profit of current or prior periods, less the cumulative amount amortised to accounting profit, and (2) the initial recognition of the loan also affects taxable profit, the borrower recognises the deferred tax liability.

*Fair value adjustments and revaluations*

6. Financial assets or investment property are carried at fair value which exceeds cost but no equivalent adjustment is made for tax purposes.
7. An entity revalues property, plant and equipment (under HKAS 16) but no equivalent adjustment is made for tax purposes.

Example 2 Exhibit 1 in section 3.1 sets out that the carrying amount of the freehold land is higher than its tax base and it gives rise a taxable temporary difference of \$50. HKAS 12 requires the related deferred tax to be charged directly to equity, not to income statement, as detailed in section 6.2 below.

Temporary differences also arise when:

- (a) the cost of a business combination that is an acquisition is allocated to the identifiable assets and liabilities acquired by reference to 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 consolidation;
- (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.

## **1. Business combinations**

The cost of a business combination is allocated by recognising 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 (see Section 5.3 below).

## **2. Assets carried at fair value**

HKASs permit or require certain assets to be carried at fair value or to be revalued (see, for example, HKAS 16, HKAS 38 and HKAS 39).

In some jurisdictions, the revaluation or other restatement of an asset to fair value affects taxable profit (tax loss) for the current period. As a result, the tax base of the asset is adjusted and no temporary difference arises.

In other jurisdictions, 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.

Nevertheless, the future recovery of the carrying amount will result in a taxable flow of economic benefits to the entity and the amount that will be deductible for tax purposes will differ from the amount of those economic benefits. 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. This is true even if:

- (a) the entity does not intend to dispose of the asset. In such cases, the revalued carrying amount of the asset will be recovered through use and this will generate taxable income which exceeds the depreciation that will be allowable for tax purposes in future periods; or
- (b) tax on capital gains is deferred if the proceeds of the disposal of the asset are invested in similar assets. In such cases, the tax will ultimately become payable on sale or use of the similar assets.

### 3) Goodwill

Goodwill arising in a business combination is measured as the excess of the cost of the combination over the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities.

#### *i) Deferred tax relating to goodwill arising from initial recognition of 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, HKAS 12 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 unrecognised because it arises from the initial recognition of goodwill are also regarded as arising from the initial recognition of goodwill and are therefore not recognised under paragraph 15(a).

For example, if goodwill acquired in a business combination has a cost of 100 but a tax base of nil, point (a) in section 3.2.1 prohibits the entity from recognising the resulting deferred tax liability. If the entity subsequently recognises an impairment loss of 20 for that goodwill, the amount of the taxable temporary difference relating to the goodwill is reduced from 100 to 80, with a resulting decrease in the value of the unrecognised deferred tax liability. That decrease in the value of the unrecognised deferred tax liability is also regarded as relating to the initial recognition of the goodwill and is therefore prohibited from being recognised under point (a) in section 3.2.1.

#### *ii) Deferred tax relating to goodwill not arising from initial recognition of goodwill*

Deferred tax liabilities for taxable temporary differences relating to goodwill are, however, recognised 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 recognised.

### 4) 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 recognises 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 (see point 1 above);
- (b) if the transaction affects either accounting profit or taxable profit, an entity recognises any deferred tax liability or asset and recognises 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 initial recognition exemption as discussed above, recognise the resulting deferred tax liability or asset and adjust the carrying amount of the asset or liability by the same amount.

However, such adjustments would make the financial statements less transparent. Therefore, HKAS 12 does not permit an entity to recognise the resulting deferred tax liability or asset, either on initial recognition or subsequently. Furthermore, an entity does not recognise subsequent changes in the unrecognised deferred tax liability or asset as the asset is depreciated.

In accordance with HKAS 32 *Financial Instruments: Disclosure and Presentation* 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, initial recognition exemption in this section does not apply. Consequently, an entity recognises the resulting deferred tax liability. In accordance with section 5.2 below, the deferred tax is charged directly to the carrying amount of the equity component. In accordance with paragraph 5.1 below, subsequent changes in the deferred tax liability are recognised in the income statement as deferred tax expense (income).

### 3.2.2 Deductible temporary differences

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

- (a) *is not a business combination; and*
- (b) *at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).* (Point b here again can be termed as "initial recognition exemption")

*However, for deductible temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, a deferred tax asset shall be recognised in accordance with paragraph 44 (of HKAS 12, i.e. section 3.4 below). (HKAS 12 para. 24)*

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

- (a) *deductible temporary differences;*
- (b) *the carryforward of unused tax losses; and*
- (c) *the carryforward of unused tax credits.* (HKAS 12 para. 5)

#### **Exhibit 5: Examples of circumstances resulting in deductible temporary differences**

All deductible temporary differences give rise to a deferred tax asset. However, some deferred tax assets may not satisfy the recognition criteria under HKAS 12 as set out above.

*Transactions that affect the Income Statement*

1. Retirement benefit costs are deducted in determining accounting profit as service is provided by the employee, but are not deducted in determining taxable profit until the entity pays either retirement benefits or contributions to a fund. Similar deductible temporary differences arise



where other expenses, such as product warranty costs or interest, are deductible on a cash basis in determining taxable profit.

Example 2 of Exhibit 2 in section 3.1 sets out that the carrying amount of the interest payable is higher than its tax base and it gives rise a deductible temporary difference of \$100.

2. Accumulated depreciation of an asset in the financial statements is greater than the cumulative depreciation allowed up to the balance sheet date for tax purposes.
3. The net realisable value of an item of inventory, or the recoverable amount of an item of property, plant or equipment, is less than the previous carrying amount and an entity therefore reduces the carrying amount of the asset, but that reduction is ignored for tax purposes until the asset is sold.
4. Research costs (or organisation or other start up costs) are recognised as an expense in determining accounting profit but are not permitted as a deduction in determining taxable profit until a later period.
5. Income is deferred in the balance sheet but has already been included in taxable profit in current or prior periods.

Example of Exhibit 3 in section 3.1 sets out that the carrying amount of the “interest revenue received in advance” is higher than its tax base and the difference result in a deductible temporary difference of \$100.

*Fair value adjustments and revaluations*

6. Financial assets or investment property are carried at fair value which is less than cost, but no equivalent adjustment is made for tax purposes.

The reversal of deductible temporary differences results in deductions in determining taxable profits of future periods. However, economic benefits in the form of reductions in tax payments will flow to the entity only if it earns sufficient taxable profits against which the deductions can be offset. Therefore, an entity recognises deferred tax assets only when it is probable that taxable profits will be available against which the deductible temporary differences can be utilised.

It is probable that taxable profit will be available against which a deductible temporary difference can be utilised when there are sufficient taxable temporary differences relating to the same taxation authority and the same taxable entity which are expected to reverse:

- (a) in the same period as the expected reversal of the deductible temporary difference; or
- (b) in periods into which a tax loss arising from the deferred tax asset can be carried back or forward.

In such circumstances, the deferred tax asset is recognised in the period in which the deductible temporary differences arise.

When there are insufficient taxable temporary differences relating to the same taxation authority and the same taxable entity, the deferred tax asset is recognised to the extent that:

- (a) it is probable that the entity will have sufficient taxable profit relating to the same taxation authority and the same taxable entity in the same period as the reversal of the deductible temporary difference (or in the periods into which a tax loss arising from the deferred tax asset can be carried back or forward). In evaluating whether it will have sufficient taxable profit in future periods, an entity ignores taxable amounts arising from deductible temporary differences that are expected to originate in future periods, because the deferred tax asset arising from these deductible temporary differences will itself require future taxable profit in order to be utilised; or
- (b) tax planning opportunities are available to the entity that will create taxable profit in appropriate periods.

## **1. Initial Recognition of an Asset or Liability**

One case when a deferred tax asset arises on initial recognition of an asset is when a non-taxable government grant related to an asset is deducted in arriving at the carrying amount of the asset but, for tax purposes, is not deducted from the asset's depreciable amount (in other words its tax base); the carrying amount of the asset is less than its tax base and this gives rise to a deductible temporary difference.

Government grants may also be set up as deferred income in which case the difference between the deferred income and its tax base of nil is a deductible temporary difference. Whichever method of presentation an entity adopts, the entity does not recognise the resulting deferred tax asset.

### Examination question

#### Question

Modified from ACCA 3.6H 2004 Jun. Q3(b)

Nette purchased a building on 1 June 2003 for \$10 million. The building qualified for a grant of \$2 million which has been treated as a deferred credit in the financial statements. The tax allowances are reduced by the amount of the grant. There are additional temporary differences of \$40 million in respect of deferred tax liabilities at the year end.

Also the company has sold extraction equipment which carries a five year warranty. The directors have made a provision for the warranty of \$4 million at 31 May 2004 which is deductible for tax when costs are incurred under the warranty. In addition to the warranty provision the company has unused tax losses of \$70 million. The directors of the company are unsure as to whether a provision for deferred taxation is required.

(Assume that the depreciation of the building is straight line over ten years, and tax allowances of 25% on the reducing balance basis can be claimed on the building. Tax is payable at 30%.)

Required:

Explain with reasons and suitable extracts/computations the accounting treatment of the above situation in the financial statements for the year ended 31 May 2004.

#### Answers

A provision for deferred tax should be made under HKAS 12 Income Taxes as follows:

Building:	Temporary difference	
Tax written down value	(75% x \$8m)	\$m
Net book value	\$9m	\$m
Less: deferred credit	(\$1.8m)	7.2
		1.2
Deferred tax liabilities – temporary differences		40
Total temporary differences – deferred tax liabilities		41.2
Temporary differences – deferred tax assets:		
Warranty		4
Tax losses		70
Total temporary differences – deferred tax assets		74

The company would recognise a deferred tax asset of at least \$41.2 million of the temporary differences of \$74 million at the tax rate of 30%. If the company could prove that suitable taxable profits were available in the future or that tax planning opportunities were available to create suitable taxable profits, then the balance of the deferred tax asset (\$32.8 million at tax rate of 30%) could be recognised.

## 3.3 Unused Tax Losses and Unused Tax Credits

Deferred tax assets also arise from unused tax losses and unused tax credits that tax law allows to be carried forward. Under HKAS 12, *a deferred tax asset shall be recognised for the carryforward 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 utilised.* (HKAS 12 para. 34)

### 3.3.1 To the Extent That Losses or Credits be Probably Utilised

The criteria for recognising deferred tax assets arising from the carryforward of unused tax losses and tax credits are the same as the criteria for recognising deferred tax assets arising from deductible temporary differences.

However, the existence of unused tax losses is strong evidence that future taxable profit may not be available. Therefore, when an entity has a history of recent losses, the entity recognises a deferred tax asset arising from unused tax losses or tax credits only to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that

sufficient taxable profit will be available against which the unused tax losses or unused tax credits can be utilised by the entity. In such circumstances, disclosure of the amount of the deferred tax asset and the nature of the evidence supporting its recognition shall be disclosed (see section 7 below).

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 utilised:

- (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 utilised 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 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 utilised.

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 utilised, the deferred tax asset is not recognised.

### 3.3.2 Re-assessment of Unrecognised Deferred Tax Assets

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

For example, an improvement in trading conditions may make it more probable that the entity will be able to generate sufficient taxable profit in the future for the deferred tax asset to meet the recognition criteria set out above. Another example is when an entity re-assesses deferred tax assets at the date of a business combination or subsequently.

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

*An entity shall recognise a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint 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. (HKAS 12 para. 39)*

### **Exhibit 6: Examples of circumstances in business combination that give rise to taxable temporary differences**

1. The carrying amount of an asset is increased to fair value in a business combination that is an acquisition and no equivalent adjustment is made for tax purposes. On initial recognition, the resulting deferred tax liability may increase goodwill or decrease negative goodwill.
2. Reductions in the carrying amount of goodwill are not deductible in determining taxable profit and the cost of the goodwill would not be deductible on disposal of the business. (Note that point a of section 3.2.1 of the Standard prohibits recognition of the resulting deferred tax liability).
3. Unrealised losses resulting from intragroup transactions are eliminated by inclusion in the carrying amount of inventory or property, plant and equipment.
4. Retained earnings of subsidiaries, branches, associates and joint ventures are included in consolidated retained earnings, but income taxes will be payable if the profits are distributed to the reporting parent. However, HKAS 12 prohibits recognition of the resulting deferred tax liability if the parent, investor or venturer is able to control the timing of the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.

5. Investments in foreign subsidiaries, branches or associates or interests in foreign joint ventures are affected by changes in foreign exchange rates. However, (1) there may be either a taxable temporary difference or a deductible temporary difference; and (2) if the parent, investor or venturer is able to control the timing of the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future, HKAS 12 prohibits recognition of the resulting deferred tax liability.

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

- (a) *the temporary difference will reverse in the foreseeable future; and*
- (b) *taxable profit will be available against which the temporary difference can be utilised.* (HKAS 12 para. 44)

**Exhibit 7: Examples of circumstances in business combination that give rise to deductible temporary differences**

1. A liability is recognised at its fair value in a business combination that is an acquisition, but none of the related expense is deducted in determining taxable profit until a later period. The resulting deferred tax asset may decrease goodwill or increase negative goodwill.
2. Unrealised profits resulting from intragroup transactions are eliminated from the carrying amount of assets, such as inventory or property, plant or equipment, but no equivalent adjustment is made for tax purposes.
3. Investments in foreign subsidiaries, branches or associates or interests in foreign joint ventures are affected by changes in foreign exchange rates. While there may be a taxable temporary difference or a deductible temporary difference; HKAS 12 (as set out above) requires recognition of the resulting deferred tax asset to the extent, and only to the extent, that it is probable that: (a) the temporary difference will reverse in the foreseeable future; and (b) taxable profit will be available against which the temporary difference can be utilised.
4. The non-monetary assets and liabilities of an entity are measured in its functional currency but the taxable profit or tax loss is determined in a different currency.

## **4. Measurement of Current Tax Liabilities (Assets) and Deferred Tax Liabilities (Assets)**

***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.*** (HKAS 12 para. 46)

***Deferred tax assets and liabilities shall be measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the balance sheet date.*** (HKAS 12 para. 47)

***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.*** (HKAS 12 para. 51)

In some jurisdictions, the manner in which an entity recovers (settles) the carrying amount of an asset (liability) may affect either or both of:

- (a) the tax rate applicable when the entity recovers (settles) the carrying amount of the asset (liability); and
- (b) the tax base of the asset (liability).

In such cases, an entity measures deferred tax liabilities and deferred tax assets using the tax rate and the tax base that are consistent with the expected manner of recovery or settlement.

### **Exhibit 8: Example**

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

The entity would recognize a deferred tax liability of:

- a. \$8 (\$40 at 20%), if it expects to sell the asset without further use, and
- b. \$12 (\$40 at 30%), if it expects to retain the asset and recover its carrying amount through use.

***Deferred tax assets and liabilities shall not be discounted.*** (HKAS 12 para. 53) The reliable determination of deferred tax assets and liabilities on a discounted basis requires detailed scheduling of the timing of the reversal of each temporary difference. In many cases such scheduling is impracticable or highly complex.

Therefore, it is inappropriate to require discounting of deferred tax assets and liabilities. To permit, but not to require, discounting would result in deferred tax assets and liabilities which would not be comparable between entities. Therefore, this Statement does not require or permit the discounting of deferred tax assets and liabilities.

***The carrying amount of a deferred tax asset shall be reviewed at each balance sheet date. An entity shall reduce the carrying amount of a deferred tax asset to the extent that it is no longer probable that sufficient taxable profit will be available to allow the benefit of part or all of that deferred tax asset to be utilised. Any such reduction shall be reversed to the extent that it becomes probable that sufficient taxable profit will be available.*** (HKAS 12 para. 56)

## **5. Recognition of Current and Deferred Tax**

Accounting for the current and deferred tax effects of a transaction or other event is consistent with the accounting for the transaction or event itself.

***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.*** (HKAS 12 para. 5)

In other word, tax expense (tax income) comprises current tax expense (current tax income) and deferred tax expense (deferred tax income).

### **5.1 Income Statement**

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

- (a) ***a transaction or event which is recognised, in the same or a different period, directly in equity*** (see section 5.2 below); ***or***
- (b) ***a business combination*** (see section 5.3 below). (HKAS 12 para. 58)

Most deferred tax liabilities and deferred tax assets arise where income or expense is included in accounting profit in one period, but is included in taxable profit (tax loss) in a different period. The resulting deferred tax is recognised in the income statement. Examples are when:

- (a) interest, royalty or dividend revenue is received in arrears and is included in accounting profit on a time apportionment basis in accordance with HKAS 18 *Revenue*, but is included in taxable profit (tax loss) on a cash basis; and
- (b) costs of intangible assets have been capitalised in accordance with HKAS 29, *Intangible Assets*, and are being amortised in the income statement, but were deducted for tax purposes when they were incurred.

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 recognised in the income statement, except to the extent that it relates to items previously charged or credited to equity (as discussed below).

## 5.2 Items Credited or Charged Directly to Equity

*Current tax and deferred tax shall be charged or credited directly to equity if the tax relates to items that are credited or charged, in the same or a different period, directly to equity. (HKAS 12 para. 61)*

Certain HKASs require or permit certain items to be credited or charged directly to equity. Examples of such items are:

- a change in carrying amount arising from the revaluation of property, plant and equipment (see HKAS 16 *Property, Plant and Equipment*);
- an adjustment to the opening balance of retained earnings resulting from either a change in accounting policy that is applied retrospectively or the correction of an error (see HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*);
- exchange differences arising on the translation of the financial statements of a foreign operation (see HKAS 21 *The Effects of Changes in Foreign Exchange Rates*); and
- amounts arising on initial recognition of the equity component of a compound financial instrument.

### Exhibit 9: Example on deferred tax credited or charged directly to equity

An asset with a cost of \$100 with an expected residual value of zero was acquired during the year. At year end, its carrying amount of \$80 is revalued to \$150 (i.e. an asset revaluation reserve is credited with an amount of \$70). No equivalent or other adjustment is made for tax purposes. Cumulative depreciation for tax purposes is \$30 and the tax rate is 30%.

If the asset were to be sold for an amount greater than or equal to cost, the cumulative tax depreciation of \$30 would be included in the taxable amount, but sales proceeds in excess of cost would not be taxable (the asset is not subject to capital gains tax).

#### 1. Assuming the carrying amount of the asset will be recovered through use:

	Carrying amount	Tax base	Temporary difference
Cost	\$100	\$100	
Accumulated Depreciation	<u>20</u>	<u>30</u>	
Net Amount	80	70	\$ 10
Revaluation gain	<u>70</u>	<u>-</u>	<u>70</u>
Net Amount	150	70	80
Tax rate			<u>30%</u>
Deferred Tax Liability			24

If the entity's management expects to recover the carrying amount of the asset through use, it will generate an assessable amount of \$150, but will only be able to deduct depreciation of \$70. On this basis, there is a deferred tax liability of \$24 (as calculated above).

Since the additional deferred tax that arises on the revaluation gain of \$70 is recognized to the asset revaluation reserve, therefore the entry of the recognition of deferred tax liability would be:

Dr	Deferred tax expenses	(\$10 x 30%)	\$ 3
	Revaluation reserves	(\$70 x 30%)	21
Cr	Deferred tax liability		\$ 24

#### 2. Assuming the carrying amount of the asset will be recovered through sale:

The tax base of the asset is -	Carrying amount	\$150
	Less: taxable amount (recouped depreciation)	30
	Add: deductible amount	<u>-</u>
	Tax base	120

The deferred tax liability is therefore \$9, i.e.  $(\$150 - \$120) \times 30\% = \$9$ . The entry of the recognition of deferred tax liability would be:

Dr	Deferred tax expenses	\$ 3
	Revaluation reserves	6
Cr	Deferred tax liability	\$ 6



In exceptional circumstances it may be difficult to determine the amount of current and deferred tax that relates to items credited or charged to equity. This may be the case, for example, when:

- (a) there are graduated rates of income tax and it is impossible to determine the rate at which a specific component of taxable profit (tax loss) has been taxed;
- (b) a change in the tax rate or other tax rules affects a deferred tax asset or liability relating (in whole or in part) to an item that was previously charged or credited to equity; or
- (c) an entity determines that a deferred tax asset shall be recognised, or shall no longer be recognised in full, and the deferred tax asset relates (in whole or in part) to an item that was previously charged or credited to equity.

In such cases, the current and deferred tax related to items that are credited or charged to equity is based on a reasonable pro rata allocation of the current and deferred tax of the entity in the tax jurisdiction concerned, or other method that achieves a more appropriate allocation in the circumstances.

### 5.3 Deferred Tax Arising from a Business Combination

Temporary differences may arise in a business combination. In accordance with HKFRS 3 *Business Combinations*, an entity recognises any resulting deferred tax assets (to the extent that they meet the recognition criteria in section 3.2.2 above) 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, in accordance with point a of section 3.2.1 above, an entity does not recognise 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 recognised before the business combination. For example, the acquirer may be able to utilise the benefit of its unused tax losses against the future taxable profit of the acquiree. In such cases, the acquirer recognises 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 HKFRS 3 for separate recognition when a business combination is initially accounted for but is subsequently realised, the acquirer shall recognise the resulting deferred tax income in profit or loss. In addition, the acquirer shall:

- (a) reduce the carrying amount of goodwill to the amount that would have been recognised if the deferred tax asset had been recognised as an identifiable asset from the acquisition date; and
- (b) recognise the reduction in the carrying amount of goodwill as an expense.

However, this procedure shall not result in the creation of an 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, nor shall it increase the amount previously recognised for any such excess.

However, the acquirer does not recognise negative goodwill, nor does it increase the carrying amount of negative goodwill.

#### **Exhibit 10: Example on deferred tax assets recognized subsequent to date of a business combination**

An entity acquired a subsidiary that had deductible temporary differences of 300. The tax rate at the time of the acquisition was 30%. The resulting deferred tax asset of 90 was not recognised as an identifiable asset in determining the goodwill of 500 that resulted from the business combination. Two years after the combination, the entity assessed that future taxable profit shall be sufficient to recover the benefit of all the deductible temporary differences.

The entity recognises a deferred tax asset of 90 and, in profit or loss, deferred tax income of 90. The entity also reduces the carrying amount of goodwill by 90 and recognises an expense for this amount in profit or loss.



Dr	Deferred tax assets	\$90	
Cr	Deferred tax income		\$90
Dr	Expenses	\$90	
Cr	Goodwill		\$90

Consequently, the cost of the goodwill is reduced to 410, being the amount that would have been recognised had the deferred tax asset of 90 been recognised as an identifiable asset at the acquisition date.

If the tax rate had increased to 40%, the entity would have recognised a deferred tax asset of 120 (300 at 40%) and, in profit or loss, deferred tax income of 120. If the tax rate had decreased to 20%, the entity would have recognised a deferred tax asset of 60 (300 at 20%) and deferred tax income of 60.

In both cases, the entity would also reduce the carrying amount of goodwill by 90 and recognise an expense for that amount in profit or loss.

## 6. Presentation

### 6.1 Offset

*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 recognised amounts; and*
- (b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously. (HKAS 12 para. 71)*

*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:*
  - (i) the same taxable entity; or*
  - (ii) different taxable entities which intend either to settle current tax liabilities and assets on a net basis, or to realise 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. (HKAS 12 para. 74)*

### 6.2 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. (HKAS 12 para. 77)*

## 7. Disclosures

*The major components of tax expense (income) shall be disclosed separately. (HKAS 12 para. 79)*

*The following shall also be disclosed separately:*

- (a) the aggregate current and deferred tax relating to items that are charged or credited to equity;*
- (b) an explanation of the relationship between tax expense (income) and accounting profit in either or both of the following forms:*
  - (i) a numerical reconciliation between tax expense (income) and the product of accounting profit multiplied by the applicable tax rate(s), disclosing also the basis on which the applicable tax rate(s) is (are) computed; or*

- (ii) *a numerical reconciliation between the average effective tax rate and the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed;*
- (c) *an explanation of changes in the applicable tax rate(s) compared to the previous accounting period;*
- (d) *the amount (and expiry date, if any) of deductible temporary differences, unused tax losses, and unused tax credits for which no deferred tax asset is recognised in the balance sheet;*
- (e) *the aggregate amount of temporary differences associated with investments in subsidiaries, branches and associates and interests in joint ventures, for which deferred tax liabilities have not been recognised (see section 4.4. above);*
- (f) *in respect of each type of temporary difference, and in respect of each type of unused tax losses and unused tax credits:*
  - (i) *the amount of the deferred tax assets and liabilities recognised in the balance sheet for each period presented;*
  - (ii) *the amount of the deferred tax income or expense recognised in the income statement, if this is not apparent from the changes in the amounts recognised in the balance sheet; and*
- (g) *in respect of discontinued operations, the tax expense relating to:*
  - (i) *the gain or loss on discontinuance; and*
  - (ii) *the profit or loss from the ordinary activities of the discontinued operation for the period, together with the corresponding amounts for each prior period presented; and*
- (h) *the amount of income tax consequences of dividends to shareholders of the entity that were proposed or declared before the financial statements were authorised for issue, but are not recognised as a liability in the financial statements. (HKAS 12 para. 81)*

*An entity shall disclose the amount of a deferred tax asset and the nature of the evidence supporting its recognition, when:*

- (a) *the utilisation of the deferred tax asset is dependent on future taxable profits in excess of the profits arising from the reversal of existing taxable temporary differences; and*
- (b) *the entity has suffered a loss in either the current or preceding period in the tax jurisdiction to which the deferred tax asset relates. (HKAS 12 para. 82)*

*In the circumstances described in paragraph 52A (of HKAS 12), an entity shall disclose the nature of the potential income tax consequences that would result from the payment of dividends to its shareholders. In addition, the entity shall disclose the amounts of the potential income tax consequences practicably determinable and whether there are any potential income tax consequences not practicably determinable. (HKAS 12 para. 82A)*

## Examination question

### Question

*Modified from CPA QP FPE 2003 Dec Paper II Case 2b*

You are auditing WTL's financial statements for the year ended 30 September 2003. The following is an exchange between Miss Lee and your assistants during a meeting reviewing the draft financial statements prepared by Miss Lee:

Assistants: We notice that your company's policy is to carry office for own use at valuation. The opening gross carrying amount was based on the valuation made four years ago. The market value of Office A at 30 September 2003 was HK\$32 million. The original cost of Office A was HK\$2 million and the tax written down value at 1 October 2002 was HK\$500,000. During the year ended 30 September 2003, capital allowance claimed was HK\$100,000. Depreciation charged for the year was HK\$1.5 million and the opening carrying amount was HK\$38 million. At a tax rate of 16%, there would be a very significant deferred tax implication for this year's financial statements.

Miss Lee: Fine. Please go on.

Assistants: We noticed that at 30 September 2003, your company held some inventories acquired for distribution to FPI. Since the expected distribution agreement with FPI did not materialise and the goods have been made to FPI's specific requirements and USA standards, you may need to write-off the inventories if you are not able to sell them at a price above their cost before the approval of the financial statements. This is also consistent with your company's established policy to write-off all goods with an age over six months at the balance sheet date.

We also noticed the surveyors' report on the current open market values of the offices, including Office A. Professional valuations of Office C (which is an investment property) and Office D (which is held for resale) as at 30 September 2003 were HK\$23 million and HK\$28 million respectively, while their carrying amounts at that date was HK\$25 million and HK\$30 million respectively. We consider that these values should be reflected in this year's financial statements, since they account for more than 30% of your company's total assets.

Miss Lee: I am not sure I agree with you. The inventories at cost of HK\$7 million were purchased for FPI and we are in the process of claiming from FPI for the losses we suffered. We are also contacting other buyers in the USA to try to sell these specialised goods. Some of them may be willing to take the inventories although we don't know whether this will happen at this moment.

Regarding Office A, as our company has always been making profit since incorporation. We estimate that the recoverable amount for Office A is higher than its carrying amount based on the previous valuation. Regarding Office C, we have already secured a rental agreement at a rent above the current market rate. Therefore, I don't think you should refer to the surveyor's report. As for, Office D, since it has been newly acquired and remained idle since acquisition, we will state it at cost. There is no impairment at all for any of these offices.

Required:

As the auditor of WTL, explain to Miss Lee the key deferred taxation implications arising from the issues identified if WTL had already adopted HKAS 12 at the year ended 30 September 2002. (13 marks)

### Answers

#### Introduction

Under HKAS 12, it is inherent in the recognition of an asset that the reporting enterprise expects to recover the carrying amount of that asset through receipt of cash or other assets, through use, through sale, or through use and subsequent sale. These expected future economic benefits associated with an asset are generally taxable and the enterprise's investment in the asset is deductible against this taxable income under the relevant tax jurisdiction.

If the carrying amount of the recognised asset at a given date is higher than the deductible amount for income tax purposes at that date, a net taxable amount will result in future periods when the carrying amount of the assets is recovered, i.e. a taxable temporary difference arises.

If the carrying amount of the recognised asset at a given date is lower than the deductible amount for income tax purposes at that date, a net deductible amount will result in future periods when the carrying amount of the assets is recovered, i.e. a deductible temporary difference arises.

HKAS 12 requires that deferred tax charges or credits should be recognised as income or an expense and included in the net profit or loss for the period. However, deferred tax charges or credits should be charged or credited directly to equity to the extent that the tax arises from a transaction or event which is charged, in the same or a different period, directly in equity.

HKAS 12 does not set out specific transitional arrangement, therefore, it should be applied retrospectively in accordance with HKAS 2 when it is first adopted, unless this is not practical.

#### Office A

In this case, the opening carrying amount of Office A is HK\$38 million, the opening tax written value is HK\$500,000. Therefore, there was an opening taxable temporary difference associated with Office A of HK\$37.5 million.

At a tax rate of 16%, an opening deferred tax liability associated with Office A of HK\$6 million should be recognised and the reserves should be reduced by the same amount. (That is: debit "Property, Plant and Equipment Revaluation Reserve - Office A – Deferred tax" by HK\$6 million and credit "Deferred Tax Liabilities" by HK\$6 million.)

During the year, the carrying amount before reflecting the 2003 valuation was reduced by HK\$1.5 million to HK\$36.5 million while the tax written down value was reduced by HK\$100,000 to HK\$400,000, resulting in a taxable temporary difference of HK\$36.1 million.

At a tax rate of 16%, the deferred tax liability associated with Office A was reduced by HK\$224,000 as a result of the tax and accounting depreciations. Therefore, a deferred tax credit should be recognised in WTL's income statement for the year ended 30 September 2003. (That is: debit "Deferred Tax Liabilities" by HK\$224,000; credit "Tax Expense – Deferred tax" by HK\$224,000.)

When Office A was stated at its open market value at the balance sheet date of HK\$32 million, the taxable temporary difference at 30 September was further reduced by HK\$4.5 million to HK\$31.6 million and the deferred tax liability further reduced by HK\$720,000 to HK\$5,056,000.

Since the revaluation deficit was debited to reserves directly in accordance with SSAP 17, the deferred tax credit should be credited to reserves directly. (That is: debit "Deferred Tax Liabilities" by HK\$720,000 and credit "Property, Plant and Equipment Revaluation Reserve - Office A – Deferred tax" by HK\$720,000.)

#### Office C

Assuming that the depreciation allowances for Office C during the year were not material, total deductible temporary differences of HK\$2 million would arise for these investment properties when they were stated at their open market value at 30 September 2003.

*Interpretation 20 takes the position that the carrying amount of a non-depreciable asset, such as investment properties Office C, will be recovered only by its sale and deferred taxes associated with the non-depreciable asset should reflect the tax consequences of selling the asset. Accordingly, the tax rate applicable to the taxable amount derived from the sale of Office C should be applied in measuring the deferred tax asset related to them.*

*Since capital gains on disposal of Office C will not be taxed, that is, the applicable tax rate is zero, no deferred tax asset is recognised in relation to Office C as a result of the revaluation deficits. (Superseded by HK(SIC) 21)*

#### Office D

If WTL is able to claim deduction in respect of the diminution in value of Office D as trading stock, there will be no temporary difference since the carrying amount was the same as the tax deductible amount when WTL recovers Office D in future periods.

If WTL is not able to claim deduction in respect of the diminution in value of Office D, there will be a deductible temporary difference of HK\$2 million in respect of Office D since the tax deductible amount of Office D was higher than its carrying amount by HK\$2 million.

#### Inventories

If the inventories ordered for FPI were written off and if the write-off was not recognised for deduction for income tax purpose until a later year, a deductible temporary difference of HK\$7 million would arise.

HKAS 12 requires that a deferred tax asset should be recognised for such deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised.

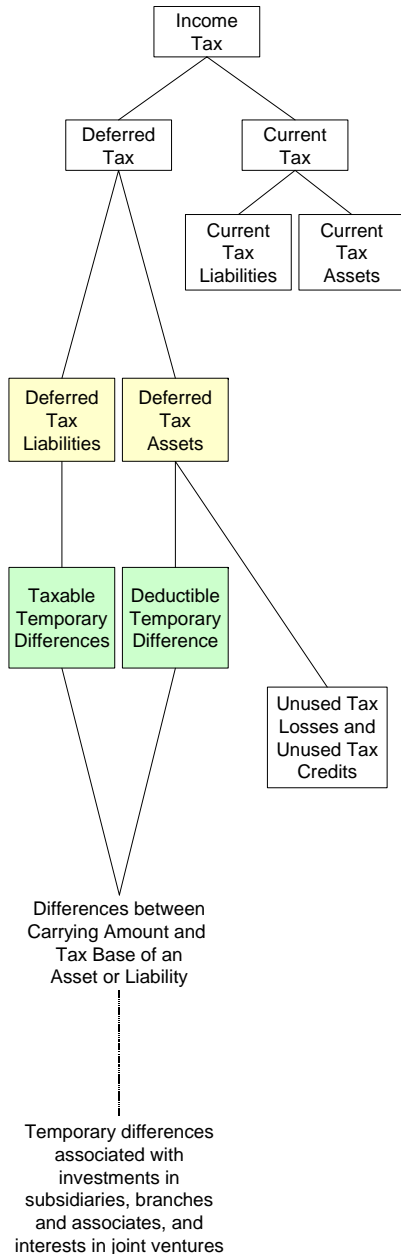
It is probable that taxable profit will be available against which a deductible temporary difference can be utilised when there are sufficient taxable temporary differences relating to the same taxation authority and the same taxable entity which are expected to reverse in the same period as the expected reversal of the deductible temporary difference or in periods into which a tax loss arising from the deferred tax asset can be carried back or forward.

Since the taxable temporary difference at 30 September 2003 relating to Office A was HK\$31.6 million, it is likely that WTL would satisfy these conditions and could recognise the full amount of deferred tax asset of HK\$1.12 million (HK\$7 million x 16%) in relation to the inventories (and the possible deferred tax asset of HK\$0.32 million (HK\$2 million x 16%) in relation to Office D).

Since the deferred tax assets arise as a result of the recognition of a cost of sales during the year in accordance with HKAS 2, the deferred tax credit should be recognised in WTL's income statement for the year ended 30 September 2003. (That is: debit "Deferred Tax Assets" by HK\$1.12 million; credit "Tax Expense – Deferred tax" by HK\$1.12 million.)

If the write-off of inventories was recognised for tax deduction purpose in determining the assessable profit for the year, no temporary difference would arise and therefore no deferred tax asset should be recognised.

**Appendix – Summary of Definitions and Recognition of Income Taxes**



Definitions of HKAS 12	Recognition
<p><b>Tax expense (tax income)</b> is the aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax. <i>(HKAS 12 para. 5)</i></p>	<p>Current and deferred tax shall be recognised as income or an expense and included in the profit or loss for the period, except to the extent that the tax arises from: (a) a transaction or event which is recognised, in the same or a different period, directly in equity; or (b) a business combination that is an acquisition. <i>(HKAS 12 para. 58)</i></p> <p>Current tax and deferred tax shall be charged or credited directly to equity if the tax relates to items that are credited or charged, in the same or a different period, directly to equity. <i>(HKAS 12 para. 61)</i></p>
<p><b>Current tax</b> is the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period. <i>(HKAS 12 para. 5)</i></p>	<p><b>Current tax</b> for current and prior periods shall, to the extent unpaid, be recognised as a <b>liability</b>. If the amount already paid in respect of current and prior periods exceeds the amount due for those periods, the excess shall be recognised as an <b>asset</b>. <i>(HKAS 12 para. 12)</i></p> <p>The benefit relating to a tax loss that can be carried back to recover current tax of a previous period shall be recognised as an <b>asset</b>. <i>(HKAS 12 para. 13)</i></p>
<p><b>Deferred tax liabilities</b> are the amounts of income taxes payable in future periods in respect of taxable temporary differences. <i>(HKAS 12 para. 5)</i></p>	<p>A <b>deferred tax liability</b> shall be recognised for all <b>taxable temporary differences</b> (except for temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures)<sup>1</sup>, except to the extent that the deferred tax liability arises from:</p> <ul style="list-style-type: none"> <li>(a) the initial recognition of goodwill; or</li> <li>(b) goodwill for which amortisation is not deductible for tax purposes; or</li> <li>(c) the initial recognition of an asset or liability in a transaction which:               <ul style="list-style-type: none"> <li>(i) is not a business combination; and</li> <li>(ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss). <i>(HKAS 12 para. 15)</i></li> </ul> </li> </ul>
<p><b>Deferred tax assets</b> are the amounts of income taxes recoverable in future periods in respect of:</p> <ul style="list-style-type: none"> <li>(a) deductible temporary differences;</li> <li>(b) the carryforward of unused tax losses; and</li> <li>(c) the carryforward of unused tax credits. <i>(HKAS 12 para. 5)</i> </li></ul>	<p>A <b>deferred tax asset</b> shall be recognised for all <b>deductible temporary differences</b> (except for temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures)<sup>1</sup> to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised, unless the deferred tax asset arises from:</p> <ul style="list-style-type: none"> <li>(a) is not a business combination; and</li> <li>(b) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss). <i>(HKAS 12 para. 24)</i></li> </ul> <p>A <b>deferred tax asset</b> shall be recognised for the carryforward of <b>unused tax losses</b> and <b>unused tax credits</b> 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. <i>(HKAS 12 para. 34)</i></p>
<p><b>Definitions of Temporary Differences</b></p> <p><b>Temporary differences</b> are differences between the <b>carrying amount</b> of an asset or liability in the balance sheet and its <b>tax base</b>. Temporary differences may be either:</p> <ul style="list-style-type: none"> <li>(a) <b>taxable temporary differences</b>, 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</li> <li>(b) <b>deductible temporary differences</b>, 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.</li> </ul> <p>The <b>tax base</b> of an asset or liability is the amount attributed to that asset or liability for tax purposes. <i>(HKAS 12 para. 5)</i></p>	
<p><sup>1</sup> <b>Recognition for temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures</b></p> <p>An entity shall recognise a <b>deferred tax liability</b> for all <b>taxable temporary differences</b> 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:</p> <ul style="list-style-type: none"> <li>(a) the parent, investor or venturer is able to control the timing of the reversal of the temporary difference; and</li> <li>(b) it is probable that the temporary difference will not reverse in the foreseeable future. <i>(HKAS 12 para. 39)</i></li> </ul> <p>An entity shall recognise a <b>deferred tax asset</b> for all <b>deductible temporary differences</b> 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:</p> <ul style="list-style-type: none"> <li>(a) the temporary difference will reverse in the foreseeable future; and</li> <li>(b) taxable profit will be available against which the temporary difference can be utilised. <i>(HKAS 12 para. 44)</i></li> </ul>	