IAS 12 'INCOME TAXES'

1. Deferred tax

Enquiry: Our client was a manufacturer cum exporter and filing 115 (4) since its incorporation i.e. 2006. Since 2016 and 2017 its exports became around 60:40 but from next year they are again expecting their exports to be more than 80%. Should we calculate and provide for deferred tax provisions in the accounts for tax year 2017?

If yes, the company, since incorporation, is not maintaining fixed assets tax base and therefore it is difficult to calculate deferred tax for 2017. Should they take accounting base of their fixed assets as their tax base?

Opinion: IAS 12, *Income Taxes,* prescribes the accounting treatment of incomes taxes. In relation to the deferred taxation, IAS 12 requires an entity to consider whether it is probable that recovery or settlement of the carrying amount of the asset or liability will result in future tax payments larger (or smaller) than they would be if such recovery or settlement had no tax consequences. If it is probable that such a larger or smaller tax payment will arise, IAS 12 requires an entity to recognise deferred tax liability or deferred tax asset.

The definition of deferred tax contained in IAS 12 is as follows:

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

"Deferred tax assets are amounts of income taxes recoverable in future periods in respect of deductible temporary differences, together with the carryforward of unused tax losses and tax credits."

The temporary difference is defined as follows:

"Temporary differences are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base. ……"

The definition of tax base, contained in IAS 12 is as under:

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

Further, in accordance with paragraph 51 of IAS 12, the deferred tax is measured by reference to the tax consequences that would follow from the manner in which the entity expects, at the end of the reporting period, to recover or settle the carrying amount of the asset or liability to which it relates.

With regard to the enquired scenario the Board would also like to refer to the Institute's Accounting Technical Release (ATR) 27 – *IAS 12 'Income Taxes'* which also provides guidance on the accounting of deferred taxes accounting.

The Board understands that the deferred tax accounting does not apply to those companies whose entire income is subject to deduction of tax at source that is taken as a final tax liability (under any provision of the Income Tax Ordinance, 2001), as there will be no temporary differences.

Conversely, the deferred tax accounting is applicable to those companies whose income is of such nature that it is subject to final tax liability as well as normal tax liability in accordance with the applicable taxation laws. Further, if there is uncertainty about the ratio of income subject to final tax liability and normal tax liability (expected local and export sales) in the future years, a reasonable estimate for sales relating to the normal tax liability (local sales) should be made for the future years and the deferred tax liability provided accordingly.

The tax base is of fundamental relevance in the deferred tax accounting, and accordingly, should be determined with reference to the enquired scenario.

(October 02, 2017)

2. Technical Advice on deferred taxation on investments in subsidiaries, branches and associates and interests in joint arrangements

Enquiry: We are a non-quoted public company and we seek your guidance regarding recognition of deferred tax asset / liability.

We have made long term investments in our associated companies (non-quoted), having same board of directors and shareholding. The income of investor and investee Company, both is taxable under section 169 of the Income Tax Ordinance 2001. The company has been recognising re-measurement gain on long term investments through equity method.

Now the auditors are of the view that we should provide deferred tax liability on these gains.

As per para 38 and 39 of the IAS 12:

Investments in subsidiaries, branches and associates and interests in joint arrangements

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

(a) the existence of undistributed profits of subsidiaries, branches, associa and joint arrangements;

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

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

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

39 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 arrangements, except to the extent that both of the following conditions are satisfied:

(a) the parent, investor, joint venturer or joint operator 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.

We are of the view that we met both the conditions of para 39 and we don't foresee that these differences will reverse in future, so we need not to provide the deferred tax liability.

Further, the guidance available in ICAP selected opinions (17.1.02) suggests that no deferred taxation is to be recognised, when the temporary differences are not expected to reverse in future. Moreover, many listed companies like Nishat Mills Limited, Fuji Fertilizer Company Limited, Mahmood Texilte Mills Limited etc. has not provided deferred taxation liability for long term investment in associates. Kindly give your advise on the issue.

Opinion: The Committee would like to draw your attention to para 38, 39 (reproduced above), 42, 51 and 51A of IAS 12 for guidance:

42 An investor in an associate does not control that entity and is usually not in a position to determine its dividend policy. Therefore, in the absence of an agreement requiring that the profits of the associate will not be distributed in the foreseeable future, an investor recognises a deferred tax liability arising from taxable temporary differences associated with its investment in the associate. In some cases, an investor may not be able to determine the amount of tax that would be payable if it recovers the cost of its investment in an associate, but can determine that it will equal or exceed a minimum amount. In such cases, the deferred tax liability is measured at this amount.

51 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 end of the reporting period, to recover or settle the carrying amount of its assets and liabilities.

51A 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.

The Committee is of the view that as stated in para 42, an investor in an associate does not control the investee entity and is usually not in a position to determine its dividend policy. Therefore, an investor recognises a deferred tax liability arising from taxable temporary differences associated with its investment in the associate, unless there is an agreement requiring that the profits of the associate will not be distributed in the foreseeable future. Further, 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, in accordance with para 51A of IAS 12.

(January 01, 2016)

2. Deferred Tax clarification

Enquiry: Proposition is:

"How the concept of deferred tax shall apply to tax laws in Pakistan i.e. deferred tax vis-à-vis Section 113 of Income Tax Ordinance (Minimum tax on turn over). It is assumed that company always pays tax u/s 113."

1. The spirit of IAS-12 Deferred tax is that every year should bear the burden of tax which is fairly attributable to it.

2. Example below shows that machinery is purchased in year 1 which claims initial allowance. Accounting profits are higher and tax profits are lesser therefore year 1 pays lower tax while year 2 and subsequent years pay higher tax. There will be a deferred tax liability in year 1.

This will happen if tax is calculated as percentage of tax profit.

EXAMPLE

A company (Pvt) Ltd.	Year 1	2
Turnover	300 M	300 M
Profit before dep.	8 M	8 M
Machinery purchased	2 M	-

Initial allowance	25 %	-
Depreciation	10 %	10 %
Rate of Tax	33 %	33 %
Minimum tax (of turn over)	1 %	1 %

PROFIT & LOSS ACCOUNT

Year		**1**		**2**
	A/c Profit	**Tax Profit**	**A/c.**	**Tax**
Turnover	300 M	300 M	300 M	300 M
	=======	=======	=======	=======
Profit (before dep.)	8,000,000	8,000,000	8,000,000	8,000,000
Less Dep.				
Initial allowance	-	500,000	-	-
Depreciation	200,000	150,000	180,000	135,000
	200,000	650,000	180,000	135,000
Net Profit	7,800,000	7,350,000	7,820,000	7,865,000
Tax @ 33%	2,574,000	2,425,500	2,580,600	2,595,450

Deferred tax calculations:

Normal tax	2,425,500	2,595,450
Deferred tax (Liability	148,500	(14,850)
(2574000 – 2425500)		
Total Tax	2,574,000	2,580,600

Deferred tax liability of Rs. 148,500 will be created and carried over to subsequent years and will be adjusted.

TAX LAW IN PAKISTAN

Tax liability is Rs. 2,425,500 and deferred tax Rs. 148,500 while calculating tax as percentage of tax profit.

Tax liability @ 1% of turnover is Rs. 3,000,000/- and actual payment is Rs.3,000,000/-

Company is paying higher tax.

(i) Can there be any deferred tax? (Liability or assets) If so, how much??
(ii) Is there any temporary difference?

SECOND EXAMPLE

If fixed assets are revalued, does it give rise to any deferred tax (liability or assets)? Whereas tax laws in Pakistan does not recognize any revaluation and calculates depreciation on cost (reducing balance).

Let me make the second example more explicit.

Year 3

Fixed Asset – Machinery is re-valued on 1st July to Rs. 3.000 million

	Accounting	Tax
Sales	300,000,000	300,000,000
	=========	==========
Profit	8,000,000	8,000,000
Dep.	300,000	121,500
	=========	==========
Net Profit	7,700,000	7,878,500
Income tax 33%	2,541,000	2,599,905
Sec. 113 – tax	3,000,000	3,000,000

Actual payment of tax is Rs. 3,000,000. Our tax law does not recognize the revaluation of fixed asset. Depreciation is calculated on written down value (initial allowance + dep.). What is the deferred tax?

My understanding is that deferred tax comes into play only and only if tax is calculated as percentage of income. If Sec.113 applies throughout there cannot be any deferred tax (liability or asset). We have to look at the things in the light of our income tax law.

Fixed Asset Schedule

1st Year	**Accounting**	**Tax**
Cost	2,000,000	2,000,000
Initial allowance 25%	-	500,000
Depreciation 10%	200,000	150,000
	200,000	650,000
	=======	=======
W.D. Value	1,800,000	1,350,000
2nd Year		
Depreciation 10%	180,000	135,000
W.D. Value	1,620,000	1,215,000
	=======	=======
3rd Year		
Machinery revalued	3,000,000	1,215,000
Depreciation 10%	300,000	121,500
	2,700,000	1,093,500

======= =======

Opinion: The Committee would like to draw your attention to the following paragraphs of IAS 12 '*Income Taxes*' (underline is ours):

'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).

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

(a) the initial recognition of goodwill; or
(b) the initial recognition of an asset or liability in a transaction which:
(i) is not a business combination; and
(ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

However, for taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, a deferred tax liability shall be recognised in accordance with paragraph 39.

16 It is inherent in the recognition of an asset that its carrying amount will be recovered in the form of economic benefits that flow to the entity in future periods. When the carrying amount of the asset exceeds its tax base, the amount of taxable economic benefits will exceed the amount that will be allowed as a deduction for tax purposes. This difference is a taxable temporary difference and the obligation to pay the resulting income taxes in future periods is a deferred tax liability. As the entity recovers the carrying amount of the asset, the taxable temporary difference will reverse and the entity will have taxable profit. This makes it probable that economic benefits will flow from the entity in the form of tax payments. Therefore, this Standard requires the recognition of all deferred tax liabilities, except in certain circumstances described in paragraphs 15 and 39 **(underline is ours)**.

24 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).

However, for deductible temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, a deferred tax asset shall be recognised in accordance with paragraph 44.

Following paragraphs of ICAP's Technical Release (TR – 27) '*IAS-12, Income Taxes (Revised 2000*)' also supports this fact:

3.1 In case in a particular year, current tax liability is calculated under provisions of Section 113 due to taxable loss the effect of temporary differences should be calculated and deferred tax liability/ asset should be recognized. **(underline is ours)**

3.3 A deferred tax asset should be recognized for the carry forward of unused tax losses and unused tax credits (as allowed under the provisions of the Income Tax Ordinance, 2001) to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilized.

Based on above, the Committee is of the view that calculation and accounting of deferred tax is required when an entity is paying tax under Section 113 of the Income Tax Ordinance, both in the case of temporary differences arising from accelerated depreciation and revaluation of fixed assets.

However, your attention is also drawn to para 24 (reproduced above) and para 27 & 28 of IAS 12:

27 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.

28 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

Keeping in view the above, the Committee is of the view that deferred tax assets will only be recognised when it is probable that taxable profits will be available against which the deductible temporary differences can be utilised.

Therefore, in Committee's opinion deferred tax should be recognized to the extent of deferred tax liability recognized on taxable temporary differences and for any additional recognition of deferred tax asset the conditions as laid down in para 24 of IAS 12 as reproduced above should be satisfied.

The Committee would also like to refer its previous Selected Opinions No 1.13 of Volume 19 '*Deferred Tax*' and Selected Opinion No. 1.9 of Volume 16 '*Deferred tax - revaluation surplus on building*' for your guidance which addresses your issues.

(December 02, 2015)

3. CLARIFICATION ON DEFERRED TAX RATE

Enquiry: Through the Finance Act, 2015 the rate of tax for companies have been reduced to 32% for 2015-2016, 31% for 2016-2017 and 30% for 2017-2018 and onward.

Keeping in view the requirements of IAS 12 "Income Taxes" and also the recommendation of committees (published in selected opinions dated 10 September 2014) our understanding is that to determine the deferred tax liability of the company as on 30 June 2015 the tax rate of 32% will apply for the temporary differences that will be reversing in the year 2016 and 31% will apply on temporary differences that will be reversing in 2017 and 30% on the temporary differences that will be reversing in 2018 and onward.

On practical grounds it seems impossible for a company to determine (as on 30 June 2015) that how much temporary differences will be reversing in year 2016, 2017 and 2018 onwards because there are many variables that are not predictable are involved to determine the value of these temporary differences.

Please guide us how a company that is preparing its financial statements in accordance with IASs can comply with the requirements of IAS 12 and how the deferred tax liability can be calculated?

Opinion: The Committee would like to draw your attention to the following paragraphs of IAS 12 'Income Taxes':

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

(a) the initial recognition of goodwill; or

(b) the initial recognition of an asset or liability in a transaction which:
(i) is not a business combination; and
(ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

47 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 end of the reporting period.

51 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 end of the reporting period, to recover or settle the carrying amount of its assets and liabilities.

51A 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.

IAS 12 states that deferred tax assets and liabilities should be measured based on the tax rates that are expected to apply when the asset/liability will be realised/ settled.

Illustrative Example (IE) No. 2 that accompanies to IAS 12 shows detailed calculation of deferred tax assets and liabilities and illustrative disclosure of its major components.

The Committee is of the view that the ICAP opinion you referred to in your query is self-explanatory and does not need further clarification on the matter.

(August 11, 2015)

4. deferred Tax Impact Of Change In Taxation Rate Of Companies

Enquiry: As you are aware, the taxation rate of Companies has been determined at 34% for the tax year 2014 and 33% for tax year 2015. However, both the mentioned amendments have been introduced as provisos to the main section where taxation rate of the Companies mentions at 35%. In light of the same, we would require clarification as to the rate that should be used for recognition of deferred tax asset/ liability.

Opinion: The Committee would like to draw your attention to the following para of lAS 12 'Income Taxes':

47 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 end of the reporting period.

On the basis of above, the Committee is of the view that the tax rate of 33% shall be applied for temporary differences outstanding as at tax year 2014 that will be reversing in the year 2015.

The Income Tax Ordinance stipulates the rate of 35% for tax years other then 2014 and 2015. Therefore, unless a new rate is announced, the differences outstanding at the year-end that will be reversing in the tax year 2016 and onwards shall be accounted for at 35%.

(September 05, 2014)

5. DEFERRED TAX

Enquiry: ISA 12 states that deferred tax should be provided if there is a difference in accounting profit and taxable profit and timing differences are temporary differences i.e. reverse in one or more subsequent period (certainly not in indefinite period).

Tax laws in Pakistan are mainly based on fixed tax (presumptive tax) and minimum tax U/s 113. Under such provisions of law the accounting profit and taxable profit become immaterial and baseless. Economic conditions in Pakistan are such that almost every company pays minimum tax U/s 113.

Under such circumstances i.e. minimum tax, the concept of timing difference does not apply.

Kindly advise, if a company is paying minimum tax U/s 113 for the last 6 years and expects to pay minimum tax for all the years to come

i) Should that company calculate deferred tax?
ii) Does any provision of deferred tax distort the financial statements?

We understand that under such circumstances no calculation for deferred tax should be made as timing difference does not exist.

Opinion: The Committee considered your query and would like to highlight the following paragraphs of TR- 27:

3.1 In case in a particular year, current tax liability is calculated under provisions of Section 113 due to taxable loss the effect of temporary differences should be calculated and deferred tax liability/ asset should be recognized.

3.3 A deferred tax asset should be recognized for the carry forward of unused tax losses and unused tax credits (as allowed under the

provisions of the Income Tax Ordinance, 2001) to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilized.

Based on above, the Committee believes that the calculation of deferred tax should be made when an entity is paying tax under Section 113.

For recognition of deferred tax asset and deferred tax liability, the Committee would like to draw your attention to the following paragraphs of IAS 12:

15 A **deferred tax liability** shall be recognised for all taxable temporary differences, except to the extent that the deferred tax liability arises from:
(a) the initial recognition of goodwill; or
(b) the initial recognition of an asset or liability in a transaction which:
(i) is not a business combination; and
(ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

However, for taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, a deferred tax liability shall be recognised in accordance with paragraph 39.

16 It is inherent in the recognition of an asset that its carrying amount will be recovered in the form of economic benefits that flow to the entity in future periods. When the carrying amount of the asset exceeds its tax base, the amount of taxable economic benefits will exceed the amount that will be allowed as a deduction for tax purposes. This difference is a taxable temporary difference and the obligation to pay the resulting income taxes in future periods is a deferred tax liability. As the entity recovers the carrying amount of the asset, the taxable temporary difference will reverse and the entity will have taxable profit. This makes it probable that economic benefits will flow from the entity in the form of tax payments. Therefore, this Standard requires the recognition of all deferred tax liabilities, except in certain circumstances described in paragraphs 15 and 39 **(underline is ours)**.

24 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).

However, for deductible temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, a deferred tax asset shall be recognised in accordance with paragraph 44.

25 It is inherent in the recognition of a liability that the carrying amount will be settled in future periods through an outflow from the entity of resources embodying economic benefits. When resources flow from the entity, part or all of their amounts may be deductible in determining taxable profit of a period later than the period in which the liability is recognised. In such cases, a temporary difference exists between the carrying amount of the liability and its tax base. Accordingly, a deferred tax asset arises in respect of the income taxes that will be recoverable in the future periods when that part of the liability is allowed as a deduction in determining taxable profit. Similarly, if the carrying amount of an asset is less than its tax base, the difference gives rise to a deferred tax asset in respect of the income taxes that will be recoverable in future periods.

34 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.

35 The criteria for recognising deferred tax assets arising from the carry forward 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, paragraph 82 requires disclosure of the amount of the deferred tax asset and the nature of the evidence supporting its recognition.

(March 19, 2014)

6. Opinion Regarding Deferred Taxation Rate

Enquiry: Before Finance Act, 2013, the Division II of the First Schedule to the Income Tax Ordinance, 2001 read as under:

"(i) The rate of tax imposed on taxable income of a company for the tax year 2007 and onwards shall be 35%]".

Through Finance Act 2013 the following proviso has been add in the above clause (i): "Provided that the rate of tax imposed on taxable income of a company other than a banking company shall be 34% for the tax year 2014."

The above proviso relate to the tax year 2014 only. Kindly advise at which tax rate the temporary differences as at June 30, 2013 will be converted into

deferred tax. Your advice is particularly required regarding temporary differences outstanding as at June 30, 2013 that will be reversing in the:

01. year ending on June 30, 2014; and
02. years ending on June 30 , 2015 and onwards.

Opinion: The Committee would like to draw your attention to the following para of lAS 12 'Income Taxes':

> 47 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 end of the reporting period.

On the basis of above, the Committee is of the view that the tax rate of 34% shall be applied for temporary differences outstanding as at June 30, 2013 that will be reversing in the year 2014. The differences outstanding as at June 30, 2013, that will be reversing in the year 2015 and onwards, shall be accounted for at the rate of 35%.

(August 29, 2013)

7. Exemption From Disclosure Requirements Of Ias-12 Income Taxes

Enquiry: A request has been received from a Company to a Commission for exemption/ waiver to Company for complying with the provision of IAS-12. The Company has stated that said waiver is requested till its taxable depreciation losses are not fully adjusted against the profits generated. The Company has unabsorbed depreciation loss owing to capitalization in the years 2007-09 and in 2010-11. However the Company expects to pay only minimum tax on turnover and does not normal foresee tax liability to arise in future as the forecasted profits and budgeted capital expenditure are not expected to fully absorb the depreciation loss. As the Company requires building reserves for redemption of preference shares, the aforesaid provisioning is directly affecting its reserves. The Company therefore has requested exemption from disclosure requirements of deferred tax liability as per IAS-12 for as long as its depreciation losses are not fully adjusted against profits generated and the Company has to pay minimum tax only.

With respect to preference shares of the Company, it may be noted that 300 million 13% non-voting cumulative redeemable preference shares of Rs. 10 each, as right shares were issued by the Company in 2009. The main features of said preference shares are summarized below:

a. **Issue size:** Up to PKR 3,100,000,000/-
b. **Proportion:** 4.25 Preference shares for every 1 ordinary share held
c. **Dividend:** Coupon Rate: 13% p.a. on cumulative basis.
d. Preferential cumulative dividends:

- Annual dividends payable when and if dividend declared by the Company but shall be paid on cumulative basis prior to any dividend or other distribution payable to ordinary shareholders.

- Annual dividends payable on accumulated @ 13% per annum on the face value of the preference shares.

e. **Company's redemption option:** The Company shall have the option to redeem the share in full or in part, within ninety days of the end of the completion of any quarter, commencing from the expiry of third anniversary of the issue ("Redemption Period") by giving at least thirty day's notice. A minimum of 1/ 10th portion of the total issue size of the preference shares may be redeemed by the Company during any redemption period. The redemption will be at the option of the Company and subject **to** availability of funds and compliance with the provisions of Section 85 of the Ordinance.

f. Utilization: Proceeds from issuance of preference shares shall he utilized for Company's operations including reduction in its debt obligations and to comply with the terms of the lenders of the Company.

You are requested to provide your comments in light of requirements of IFRS whether, keeping in view the structure as defined by Company, deferred tax liability can be regarded as a mere notional entry however substantially affecting the general reserves. Moreover, you are requested to ascertain if exemption given to the Company from the disclosure requirements of deferred tax liability under IAS-12 shall affect the true and fair view of the financial statements.

Opinion: The Committee would like to emphasize that compliance with accounting standards and local laws result in a true and fair view of financial statements. Disagreement with a particular standard or omitting a requirement due to exemptions received from the regulator does not, on its own, provide grounds from departing from the principles of 'true and fair view'. Almost all true and fair view overrides are due to provisions of law, including exemptions given by the Regulator.

The Committee would like to draw attention to the following paragraph of IAS 12 'Income Taxes':

15 A deferred tax liability shall be recognised for all taxable temporary differences, except to the extent that the deferred tax liability arises from:
(a) the initial recognition of goodwill; or
(b) the initial recognition of an asset or liability in a transaction which:
(i) is not a business combination; and
(ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

The above paragraph requires that all taxable temporary differences (except as stated in (a) and (b) above) should be considered while calculating deferred tax liabilities.

The Committee is of the view that recognition of deferred tax liability is mandatory irrespective of timing of reversal. Non-recognition of deferred tax liability would not only overstate the profits but also understate liabilities and it is not prudent to not recognize one liability to provide for recognition of another liability. The Committee is also of the view that movement in net deferred tax liability and the charge of deferred tax in the profit and loss account is not a notional entry. In fact, it is arising (and will arise in future) as a result of changes in tax bases and accounting bases of assets and liabilities.

However, the Regulator has the powers to provide exemption under the local law. In case such exemption is granted, the accounting standards require certain disclosures, as described in the following paragraphs of IAS 1 'Presentation of Financial Statements':

19 In the extremely rare circumstances in which management concludes that compliance with a requirement in an IFRS would be so misleading that it would conflict with the objective of financial statements set out in the Framework, the entity shall depart from that requirement in the manner set out in paragraph 20 if the relevant regulatory framework requires, or otherwise does not prohibit, such a departure.

20 When an entity departs from a requirement of an IFRS in accordance with paragraph 19, it shall disclose:

a) that management has concluded that the financial statements present fairly the entity's financial position, financial performance and cash flows;
b) that it has complied with applicable IFRSs, except that it has departed from a particular requirement to achieve a fair presentation;
c) the title of the IFRS from which the entity has departed, the nature of the departure, including the treatment that the IFRS would require, the reason why that treatment would be so misleading in the circumstances that it would conflict with the objective of financial statements set out in the Framework, and the treatment adopted; and
d) for each period presented, the financial effect of the departure on each item in the financial statements that would have been reported in complying with the requirement.

Based on the facts provided, the Committee strongly believes that not accounting for the deferred tax liability may provide misleading information regarding profits of the company, and hence, does not support exemptions from the provisions of IAS 12.

(November 28, 2012)

8. Applicable Tax Rate On Share Of Surplus On Revaluation Of Property, Plant And Equipment Of Associate

Enquiry: Company A and B are the associated companies due to common directorship. Company A also has 20% shareholding in Company B and cost of investment is Rs 1,000,000/-. Being associated, the Company A applies equity method of accounting in its books, in accordance with the provision of lAS 28 'Investment in Associate'.

Company B revalues its Plant, Property and Equipment that result in surplus of Rs. 50,000,000/-. Due to this revaluation, Company A accounts for its share of surplus on revaluation of plant, property and equipment of associate in its books, which is Rs 10,000,000/ i.e. 20% of Rs. 50,000,000/- and discloses this amount in its Account under the head "surplus on revaluation of property plant and equipment" in accordance with the provision of Section 235 of the Companies Ordinance.

Normal tax rate on the profits of the Company A is 35%. Company A however, computes deferred tax liability on this surplus at the rate of 10%, instead of 35% and submits its argument that:
"Amount received from investment will be in form of Dividend and the rate of tax on Dividend received by public listed company is 10%, therefore rate of deferred tax on share of associate is considered @ 10%".

Moreover, auditor of the Company also furnished its comments which are as follows:

"In view of the holding period of the investment in associate and absence of evidence intent to sell, management considers that carrying value of investment in associate will be recovered through use (i.e. recovery via dividend). Accordingly applicable tax rate for dividend income received from a company under Division III of Part I of First Schedule of Income Tax Ordinance 2001 should be used to measure the deferred tax on taxable temporary difference on investment in associate."

In view of above, please confirm applicable tax rate (10% or 35%) for computation of deferred tax liability on share of surplus on property plant and equipment of associate?

Opinion: The Committee would like to draw your attention to the following paras of IAS 12 'Income Taxes' (underline is ours):

38 Temporary differences arise when the carrying amount of investments in subsidiaries, branches and associates or interests in joint ventures (namely the parent or investor's share of the net assets of the subsidiary, branch, associate or investee, including the carrying amount of goodwill) becomes different from the tax base (which is often cost)

of the investment or interest. Such differences may arise in a number of different circumstances, for example:
(a) the existence of undistributed profits of subsidiaries, branches, associates and joint ventures;
(b) changes in foreign exchange rates when a parent and its subsidiary are based in different countries; and
(c) a reduction in the carrying amount of an investment in an associate to its recoverable amount.

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

42 An investor in an associate does not control that entity and is usually not in a position to determine its dividend policy. Therefore, in the absence of an agreement requiring that the profits of the associate will not be distributed in the foreseeable future, an investor recognises a deferred tax liability arising from taxable temporary differences associated with its investment in the associate. In some cases, an investor may not be able to determine the amount of tax that would be payable if it recovers the cost of its investment in an associate, but can determine that it will equal or exceed a minimum amount. In such cases, the deferred tax liability is measured at this amount.

47 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 end of the reporting period.

51 The measurement of deferred tax liabilities and deferred tax assets shall reflect the tax consequences that would <u>follow from the manner in which the entity expects, at the end of the reporting period, to recover or settle</u> the carrying amount of its assets and liabilities.

51A In some jurisdictions, the manner in which an entity recovers (settles) the carrying amount of an asset (liability) may affect either or both of:

c. the tax rate applicable when the entity recovers (settles) the carrying amount of the asset (liability); and

d. the tax base of the asset (liability).

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

Based on above, in determining whether tax on the temporary differences arising from an investment in an associate should be provided for on a rate

based on use, or based on disposal, consideration is to be given to the expected manner of recovery of the investment.

If Company A intends not to hold the investment in associate for a long term, then recovery of investment is assumed to be through disposal of shares; which would consequently be liable to tax at rates applicable for capital gains for a company.

Where Company A intends to hold investment in associate for long term then recovery of the investment may be assumed through dividends; consequently chargeable at the rates of dividends.

(May 18, 2012)

9. Recognition Of Deferred Tax Assets

Enquiry: **Background**

Company A is the listed company incorporated under Companies Ordinance 1984. The Company recognized deferred tax assets of Rs 200.667 million (2009: Rs 203.397 million) in its annual audited accounts for the year ended June 30, 2010 on account of deductible temporary difference in respect of unused tax losses. The Company stated the argument that "*deferred tax asset has been recognized based on the projections prepared by the management indicating reasonable profitability that taxable profits will be available in the foreseeable future against which the unused tax losses will be utilized*".

The Auditor of the Company issued modified audit report on the Accounts 2010 stated that *"in our opinion and to the best of our information and according to the explanations given to us, the balance sheet, profit and loss, account, cash flow statement and statement of changes in equity together 'with the notes forming part thereof conform with approved accounting standards as applicable in Pakistan, and, give the information required by the Companies Ordinance,1984, in the manner so required and, except for the fact that deferred tax asset has been recognized despite the availability of unused tax losses, give a true and fair view of the state of the Company's affairs as at 30 June, 2010 and of the profit, its cash flows and changes in equity for the year then ended*".

Upon seeking clarification on modified audit opinion, the Auditor furnished the basis of his modified audit opinion and stated that "Considering the criteria prescribed by lAS 12 Income Taxes, availability of tax losses aggregating Rs 573.335 million and the general tax exemption granted by the federal Government under clause 126F of the second Schedule to the Income Tax Ordinance, the Company should not have recognized deferred tax asset as at June 30, 2010.

Next year ended June 30, 2011, the Company again recognized the deferred tax assets in respect of unused tax losses. However, auditor of the Company issued unmodified opinion on the Accounts for the year ended June 30, 2011, in respect of recognition of deferred tax asset.

Upon clarification auditor of the Company furnished the following justification:

- The Company recognized deferred tax assets based on the guidance available in lAS 12.
- The Company has achieved significant growth in turnover i.e. increase in sale of 26.5% during the year ended June 30, 2011 as compared to the previous year ended June 30, 2010.
- The company earned before tax profit of Rs 27.771 million for the year ended June 2011 as compared to Rs 21.652 million in previous year, thereby showing an increase of 28%.
- The Company during the financial year 2011 generated cash flow from operations aggregating Rs. 158.882 million as compared to Rs 147.786 million in previous year.

Auditors stated the report to the members was not modified on the following basis:

- Company made turn around as it is earning profit since year 2010, whereas Company sustained losses since year 2005.
- We had doubt about the projection made by the company during the year ended June 2010; therefore we modified the auditor's report.
- Profit and gains are exempted for the tax year 2010-12, under clause 126F of the second schedule of Income tax ordinance 2011.
- Auditors' opinion expressed on financial statement of one financial year cannot be compared with that of another year as different circumstances exist in both the years.
- It is the exclusive prerogative of the auditor to apply his professional judgment and express his opinion in accordance with the relevant provisions

QUERY

In view of above, you are requested to confirm the following:

1. Whether the Company should recognize the deferred tax assets on unused tax losses considering the following fact. At this point of time, it is important to point out the following:

- Profits of the Company are exempt for the period of three years from 2010 to 2012, since the general tax exemption has been granted by the Federal Government under clause 126F of the second Schedule to the Income Tax Ordinance.
- The Company sustained losses since year ended June 30, 2005.
- Profit before tax and after tax as on June 30, 2009 and June 30, 2010 of the Company is as follows:

	June 30, 2010	June 30, 2011
Profit before tax	Rs 21.652 million	Rs 27.771 million
Profit after tax	Rs 16.459 million	Rs 6.433 million

- The Company has accumulated losses as on June 30, 2009 and June 30, 2010 as Rs. 226.94 million and Rs 195.256 million respectively.
- The Company has aggregate tax losses of Rs 573.335 million as on June 30, 2010.
- The Company disclosed in its accounts 2010 that tax provision for the year ended June 30, 2010 is made under Section 113 of the Income Tax Ordinance.
- The Company disclosed in its Accounts 2011 that no adjustment has been incorporated in deferred tax asset account as taxable profits will not be available during the tax exemption period against which the deferred tax asset may be utilized.

2. Moreover please also confirm that whether the auditor of the company should:

- issue modified audit report for the year ended June 30, 2010 or not?
- modified his audit report for the year ended June 30, 2011 or not?

Opinion: The Committee deliberated on the issue based on the facts provided to us and is of the opinion that the entity should recognize deferred tax assets 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. The instances, where unused losses expire after a period, or where losses are not allowed to be carried forward to the next period, may inhibit creation of a deferred tax asset.

With regards to your second query, the Committee is of the view that expression of auditor's opinion on the financial statements is based on the professional judgment of the auditor taking in to account substance of the transaction and audit evidences obtained.

(June 27, 2012)

10. Deferred Taxation

Enquiry: Our client is an unlisted public limited company. We seek your advice regarding the recognition of deferred tax asset / liability.

Due to admissible lease rent and substantial amount of unabsorbed tax depreciation losses normal tax is not likely to be payable for a number of years. However, on the other hand due to increase in the rate of minimum turnover tax applicable to the company there will be no benefit to the company in the future years for the aforesaid unabsorbed tax depreciation losses/business losses. The only benefit available to the company in future may be on account of credit for turn over tax paid, provided the same does not expire and there is sufficient taxable profit.

The company has been recognizing deferred tax asset/liability in the past keeping in view the temporary differences between the tax base of assets or liability and its carrying amount in the statement of financial position. Para IN4 of IAS 12 (revised requires the recognition of deferred tax asset when it is probable that taxable profits will be available against which the deferred tax asset can be utilized, there are sufficient taxable differences and there is convincing other evidence that sufficient taxable profit will be available. Para IN6 of the Standard prohibits recognition of such deferred tax liabilities to the extent that the temporary difference will not reverse in the foreseeable future. In case of prohibition resulting in no deferred tax liability only disclosure of the aggregate amount of the temporary differences concerned is required.

In view of the above, we understand that as the timing differences on account of accelerated tax depreciation, lease rental tax expenses etc. will not be reverse, no deferred taxation is to be provided there against. Deferred tax asset to the extent of turnover tax paid should however be recognized to the extent of the amount likely to be offset against tax of future normal taxable income.

We shall be grateful if you will kindly confirm that our above understanding is correct. In such situation when only turnover tax asset adjustable in future will be recognized as deferred tax asset whether separate disclosure for other non-reversible timing differences is also required? Alternatively, what other options are available to the entity to comply with IAS 12.

Opinion: The Committees would like to draw your attention towards the following paragraphs of IAS 12 (revised):

35 The criteria for recognising deferred tax assets arising from the carry forward of unused tax losses and tax credits are the same as the criteria for recognizing 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, <u>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</u>. In such circumstances, paragraph 82 requires disclosure of the amount of the deferred tax asset and the nature of the evidence supporting its recognition.

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

82 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.

Based on above, the Committee is of the view that no deferred taxation is to be recognised when the temporary differences are not expected to reverse in future.

With regard to your second query, the Committee is of the view that separate disclosure for other non-reversible timing differences is not required.

(December 28, 2011)

11. Deferred Tax – Revaluation Surplus On Building

Enquiry: Reference is made to para no. 10 of IAS-12, Income Taxes which is reproduced hereunder:

10 Where the tax base of an asset or liability is not immediately apparent, it is helpful to consider the fundamental principle upon which this Standard is based: that an entity shall, with certain limited exceptions, recognize a deferred tax liability (asset) whenever recovery or settlement of the carrying amount of an asset or liability would make future tax payments larger (smaller) than they would be if such recovery or settlement were to have no tax consequences.

Furthermore, the reference is also being made to sub-section (8) and (13) (d) of Section 22 of the Income Tax Ordinance, 2001 dealing with the matter of disposal of depreciable assets which are reproduced hereunder:

Quote

(8) Where, in any tax year, a person disposes a depreciable asset, no depreciation deduction shall be allowed under this section for that year and-

(a) if the consideration received exceeds the written down value of the asset at the time of disposal, the excess shall be chargeable to tax in that year under the head "Income from Business" or

(b) if the consideration received is less than the written down value of the asset at the time of disposal, the difference shall be allowed as a deduction in computing the person's income chargeable under the head "Income from Business" for that year.

(13)(d) Where the consideration received on the disposal of immoveable property exceeds the cost of the property, the consideration received shall be treated as the cost of the property.

Unquote

The cumulative effect of above provisions of the Income Tax Ordinance, 2001 is such that if there is a situation where cost of the building is Rs.100,000 and the WDV for tax purposes is Rs.80,000 and the building is sold out at Rs.150,000, the gain or loss on disposal will be calculated as follows:

	Rupees
Consideration received	150,000
Consideration received restricted to cost	100,000
Gain or loss on disposal	
Restricted consideration received 100,000	
Less: WDV 80,000	20,000
Thereby what has been claimed as depreciation and initial allowance now been recouped on disposal	

Keeping in view the above illustration, if there is revaluation of the building, we understand that, for the purpose, the revaluation surplus on disposal of the building will be accounted for as excess of the consideration received over the cost which will not provide any tax consequence in the future keeping in view the above provisions of the Income Tax Ordinance, 2001.

Thus, we understand that the revaluation surplus in relation to the building is not subject to calculation of any temporary difference and therefore the deferred tax is not required to be calculated therefore.

You confirmation to the above treatment will be highly appreciated.

Opinion: The Committee would like to draw your attention to the following paragraphs of IAS 12 'Income Taxes':

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

(a) the initial recognition of goodwill; or

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

(i) is not a business combination; and
(ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

20 IFRSs permit or require certain assets to be carried at fair value or to be revalued (see, for example, IAS 16 Property, Plant and Equipment, IAS 38 Intangible Assets, IFRS 9 Financial Instruments and IAS 40 Investment Property). 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.

In view of the above, the Committee is of the opinion that the deferred tax should be recognized.

(April 15, 2011)

12. Deferred Tax From Profit For Determination Of Employee's Incentive

Enquiry: We have some arrangements with our working employees to give some share of profit (after tax) at year end. In this year our Auditor has made provision of deferred taxation over and above of normal tax provision (as per rate pervading to Pvt Companies). As per Income tax return of our company the tax calculated is almost same as normal provision of tax calculated by our auditor.

Now we need your technical advice whether we should calculate incentive to our employee after deduction of normal provision of Income tax or also deduct amount of deferred taxation for calculating their incentive. As they claimed that calculation of deferred taxation is based on timing differences of lives of assets and not actually paid expense of the company. And incentive to employees should be calculated after deduction of normal provision of income tax and not deferred tax calculation is included in this calculation.

You are requested to please give your technical opinion about the status of deferred taxation, application of IAS -12 on private limited companies in Pakistan and also advise either it is deducted by calculating incentive to employees of the company.

Opinion: The determination of incentive will be based on two factors i) framework used for preparation of accounts and ii) provisions of the scheme.

For determining appropriate framework applicable to your Company, your attention is drawn to paragraph 2.4.3 of Technical Release 5 (Revised 2006) which defines the qualifying criteria of the entity as ESE, MSE or SSE. If your Company meets the criteria of ESE then full IFRS is applicable and if it is MSE or SSE then you are required to comply with the requirements of Accounting and Financial Reporting Standards for Medium-Sized Entities or Small-Sized Entities respectively.

The employee incentive is a policy matter of the Company and the method of determination of incentive, including definition of profit and additions/deductions there from, would be defined in the scheme.

Therefore, in the absence of appropriate information about the Company to determine applicable framework and without reviewing the provisions of the scheme the Committee is unable to advice on the deductibility or otherwise of deferred tax from profits for the purposes of determination of incentive.

(April 15, 2011)

13. DEFERRED TAX RESERVES

Enquiry: Please clarify the meaning of term "Deferred Tax Reserves". Please also clarify whether "Deferred Tax Reserves" would only include the Reserves separately shown in equity section as 'Deferred Tax Reserves' or it will also include the

items (like Deferred Tax Asset) routed through Profit and Loss Account and form part of un-appropriated profit/ loss.

It may be mentioned here that "NBFC Rules 2003" (as amended in 2007) define "equity" as:

(xix) "equity" includes paid up share capital, reserves, subordinated loans and un-appropriated profits (minus accumulated losses) excluding deferred tax reserves, Surplus on Revaluation of Fixed Assets Account as described in section 235 of the Ordinance, treasury stocks and redeemable preference shares: (emphasis added)

Thus, it is to be ascertained whether reserves that form part of the un-appropriated profit/ loss account due to recognition of Deferred Tax Assets will be deducted for the purpose of calculating equity as per NBFC Rules 2003. Any reference to IAS/IFRS or local laws where the subject term has been defined/ clarified shall be of great help.

Opinion: The term "Deferred Tax Reserve" is not specially defined in the IFRS. In our local laws (NBFC Rules) the term "Deferred Tax Reserve" was derived from SECP Circular No. 16 of 1999 which was then issued to ensure compliance by the leasing companies with IAS 12 and required to transfer to a capital reserve, amounts equivalent to their deferred tax liability during the period 1 July 1998 to 30 June 2003.

Your attention is drawn to the following paragraphs of IAS 12 "Income Taxes" that deals with recognition of deferred tax liabilities and assets.

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

(a) a transaction or event which is recognised, in the same or a different period, outside profit or loss, either in other comprehensive income or directly in equity (see paragraphs 61A to 65); or

(b) a business combination (see paragraphs 66 to 68).

61A Current tax and deferred tax shall be recognised outside profit or loss if the tax relates to items that are recognised, in the same or a different period, outside profit or loss. Therefore, current tax and deferred tax that relates to items that are recognised in the same or a different period:

(a) in other comprehensive income, shall be recognised in other comprehensive income (see paragraph 62).

(b) directly in equity, shall be recognised directly in equity (see paragraph 62A).

Based on the above the Committee is of the view that reserves that form part of the un-appropriated profit/ loss account due to recognition of Deferred Tax Assets will not be deducted for the purpose of calculating equity.

(July 17, 2009)

14. Deferred Taxation On Investment Property

Enquiry: The Company (public unlisted) is engaged in the Real Estate business that includes but not limited to development and sale of properties such as shopping malls, apartments, commercial building, hotels etc. The properties are also rented out and management of above referred properties is under the control of the Company. The background and reasons of our views are stated hereunder for your consideration.

Background

In the recent economic turmoil being experienced all across the world the Real Estate sector has also been affected which had resulted in lowering the prices of the land at different vicinities. During the year 2007-08, the Company identified a location of land (the "Land") and acquired it at a reasonable price. Due to the economic turmoil the management had decided to only undertake those projects which are currently being developed for sale and not to over-burden the Company with new initiatives, hence the Company has not determined yet that it will use the land as owner-occupied property or for short-term sale in ordinary course of business or for development and sale in accordance with its business plan. The Company is in no position to determine the exact use of the Land, based on the market/economic conditions which in the near future does not seem to correct itself. Therefore, at the year end, in line with para 8 of IAS 40, the Company classified the Land as "Investment Property". The extract of para 8 of IAS 40 is reproduced hereunder:

Para 8 of IAS 40 provides example that land held for a currently undetermined future use. (If an entity has not determined that it will use the land as owner-occupied property or for short-term sale in the ordinary course of business, the land is regarded as held for capital appreciation.)

It may be noted that as per para 35 of IAS 40, on re-measurement of Investment property, any gain or loss arising from a change in the fair value of investment property shall be recognized in profit or loss for the period in which it arises.

It may further be noted that para 20 of IAS 12 provides that IFRS permit or require certain assets to be carried at fair value or to be revalued. For example, IAS 16: (Property, Plant and Equipment), IAS 38: Intangible Assets, IAS 39: Financial Instruments: Recognition and Measurement) and IAS 40: Investment Property.

It is also stated in para 20 of IAS 12 that "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"

Provisions of Income Tax Ordinance, 2001

Though the term "Investment Property" is not defined in the Income Tax Ordinance, 2001 however, Section 22(13)(d) of the Income Tax Ordinance, 2001 states that "where the consideration received on the disposal of immovable property exceeds the cost of the property, the consideration received shall be treated as the cost of the property".

SIC 21 Income taxes- Recovery of revalued non depreciable assets

SIC 21 provides that the deferred tax liability or asset that arises from the revaluation of a non-depreciable asset in accordance with IAS 16.31, shall be measured on the basis of the tax consequences that would follow from recovery of the carrying amount of that asset through sale, regardless of the basis of measuring the carrying amount of that asset.

Accordingly, if the tax law specifies a tax rate applicable to the taxable amount derived from the sale of an asset that differs from the tax rate applicable to the taxable amount derived from using an asset, the former rate is applied in measuring the deferred tax liability or asset related to a non-depreciable asset.

> SIC-21 also applies to investment properties that are carried at revalued amounts under IAS 40.33 but would be considered non-depreciable if IAS 16 were to be applied.

Our View

From the understanding of the provisions of the Income Tax Ordinance, 2001, related paragraphs (as mentioned above) of International Accounting Standards and SIC 21 it seems to be very much clear that in case consideration received exceeds the cost of immovable property, consideration received will be treated as cost of immoveable property for the purpose of tax, therefore there would be a permanent difference. Resultantly no deferred tax liability or asset would be arisen in this case.

Issue/clarification required

The auditors of the Company are of the view that "Deferred Tax" would arise on the changes in fair value gain on Investment Property, whereas the Company is of the view (based on its discussions with its tax consultants/legal advisors) that in the light of the provisions stated in the Income Tax Ordinance, 2001 and International Accounting Standards/IFRS deferred tax does not arise.

Hence guidance based on the facts of the case is requested.

Opinion: The Committee deliberated on the question raised in your enquiry and would like to explain that the amount of tax payable on the profits of a particular period often bears little relationship with the profits as disclosed by the financial statement of the same period. This results from the different basis on which profits are computed for tax purposes and that arrived at in the financial statements. These differences are of two types. Firstly, certain income may be tax exempt or certain expenditure is disallowable giving rise to "other than temporary differences" between taxable and book profits. Secondly, there are items included in the financial statements of a period which may be dealt with differently for taxation purposes giving rise to "temporary differences". As other than temporary differences are differences that originate in the current period and do not reverse in subsequent periods, the question of "deferred tax" on such differences does not arise. The question, therefore, is to determine whether the gain/loss in a particular case is the subject matter of taxation under the Income Tax Ordinance, 2001, if the answer is in the negative, no deferred tax would arise on such gain/loss.

(December 26, 2008)

15. Final Tax Accounting

(After withdrawal of TR 30 'Final Tax Accounting' (issued in May 6, 2008) vide ICAP Circular No. 01 /2012 dated April 13, 2012 it was then decided to place in the Selected Opinions)

The Issue:

The Technical Advisory Committee issued an Accounting Technical Release (TR-27) on April 26, 1996, subsequently revised the same in 2003, to provide guidance on the application of the requirements of IAS – 12 (Income Taxes) in the case of companies which are subject to Final Tax Regime (FTR) as well as Normal Tax Regime (NTR), in the same "tax year", under the applicable provisions of the Income Tax Ordinance, 2001 (ITO 2001). The guidance emphasised that deferred tax accounting does not apply to those companies which are entirely covered under FTR since such companies, it was argued, do not have a temporary difference which is a fundamental basis on which inter-period tax allocation is done through deferred tax accounting.

A member has sought guidance from the Institute with regard to the above TR that in a situation where an entity is taxed under FTR at import stage under the Ordinance and a portion of the imported goods remains unsold at the balance sheet date (held and carried forward as inventory), how should the said final tax be accounted for in the financial statements prepared under the approved accounting standards as applicable in Pakistan i.e. whether:

a) The entire amount of final tax paid at import stage be recognised as expense in the period in which goods were imported; or

b) The final tax paid at import stage be recognized as expense as and when the goods are sold and the related profits are earned.

Opinion:

IAS – 12 'Income Taxes' is applicable to income taxes which as per its paragraph '2' are based on taxable profits. Taxable profit / (tax loss) has been defined as the profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable).

Section 148 (7) of ITO 2001 (the relevant section for the income tax in case of imports) inter alia states "The tax collected under this section shall be a final tax on the income of the importer arising from the imports". Hence it is clear that the final tax on imports is actually on the income of the importer arising from imports such that the total amount of tax is a percentage of the import value. In other words, it may be seen as a variable tax rate being applicable on the income of the importer from imports that equates the tax on income to a certain percentage of assessed value.

ITO 2001 gives the timing of the payment of tax on income from imports. However, it is established that whatever be the timing, the tax is on the income of the importer from imports and hence, till the time the income does not so arise, it merely is a pre-payment of tax in relation to such income albeit being final is not refundable but entails future economic benefit that will flow to the tax payer as a direct consequence of import stage taxation in the period when the imported goods are sold.

Para 12 of IAS 12 states "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." The Committee is of the view that the word 'due' is used in this para with respect to taxable profit (tax loss).

Based on above, the Committee is of the view that in substance the tax paid at import stage entitles the tax payer to future tax benefit or relief in the shape of no further outflow in the form of taxation of profits that may be earned from the selling of imported goods. Accordingly, any tax paid at import stage in relation to the goods in the inventory at year end should not be recognised as income tax expense rather treated as a pre-payment of tax to be expensed in the period in which such income arises from the sale of these imported goods.

Further, the Committee is of the opinion that the practice of treating final tax as a "period cost" in isolation without undertaking a matching process to determine whether the goods on the value whereof such income tax has been imposed, have been sold or carried over to the next accounting period as inventory negates the very foundation of tax accounting that income taxes are considered to be an expense incurred by the company as a consequence of income earned and therefore, are accrued in the same period as the income to which they relate.

In view of the aforesaid, the Committee is of the considered opinion that the tax paid at import stage under FTR should be recognised as a tax expense in the period in which the related goods are sold. Accordingly, the portion of the tax paid that

pertains to the unsold inventory should be carried forward in the balance sheet as pre-paid tax, subject to the following conditions:

a) it is probable that the sale of imported goods would result in sufficient future taxable profits;

b) the carry forward of tax shall not relate to the inventories written down to net realisable value in accordance with IAS 2 " Inventories";

c) the tax to be carried forward as explained above shall not constitute value of inventories.

If the above conditions are not met, the tax paid under FTR at import stage shall be fully recognised as a tax expense in the period in which the goods are imported and such tax is paid.

The Committee further recommends that TR – 27 shall be read in conjunction with this TR.

(May 6, 2008)

16. DEFERRED TAX

Enquiry A company has unused tax losses amounting to Rs.100 million but deferred tax asset has not been recognized due to non-availability of future taxable profits. However, the company had recorded a surplus on revaluation of fixed assets amounting to Rs. 40 million, but the resultant deferred tax liability was not recorded on the basis of availability of above mentioned tax losses. We would like to seek your guidance whether the deferred tax would be calculated on:

a) net basis, i.e. deferred tax asset of Rs. 60 million or
b) gross basis, i.e. deferred tax liability on surplus to be separately charged to equity.

Opinion Your attention is drawn to the following paragraphs of IAS 12 "Income Taxes" that deals with recognition of deferred tax liabilities on taxable temporary differences

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

(a) the initial recognition of goodwill; or

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

(i) is not a business combination; and

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

The above paragraph requires that all taxable temporary differences (except as stated in (a) and (b) above) should be considered while calculating deferred tax liabilities.

Taxable temporary differences include incremental value of those assets which are revalued and for that no equivalent adjustment is made for tax purposes. (IAS 12.18(b)).

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. (IAS 12.20)

16. It is inherent in the recognition of an asset that its carrying amount will be recovered in the form of economic benefits that flow to the entity in future periods. When the carrying amount of the asset exceeds its tax base, the amount of taxable economic benefits will exceed the amount that will be allowed as a deduction for tax purposes. This difference is a taxable temporary difference and the obligation to pay the resulting income taxes in future periods is a deferred tax liability. As the entity recovers the carrying amount of the asset, the taxable temporary difference will reverse and the entity will have taxable profit. This makes it probable that economic benefits will flow from the entity in the form of tax payments. Therefore, this Standard requires the recognition of all deferred tax liabilities, except in certain circumstances described in paragraphs 15 and 39".

25. It is inherent in the recognition of a liability that the carrying amount will be settled in future periods through an outflow from the entity of resources embodying economic benefits. When resources flow from the entity, part or all of their amounts may be deductible in determining taxable profit of a period later than the period in which the liability is recognised. In such cases, a temporary difference exists between the carrying amount of the liability and its tax base. Accordingly, a deferred tax asset arises in respect of the income taxes that will be recoverable in the future periods when that part of the liability is allowed as a deduction in determining taxable profit. Similarly, if the carrying amount of an asset is less than its tax base, the difference gives rise to a deferred tax asset in respect of the income taxes that will be recoverable in future periods".

Paragraph 34 of IAS 12 lays down the criteria for recognition of deferred tax asset resulting from unused tax losses which are as under;

34. 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.

35. 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, paragraph 82 requires disclosure of the amount of the deferred tax asset and the nature of the evidence supporting its recognition". (Underlining is ours)

Paragraphs 74 and 75 of IAS 12 include presentation of deferred tax assets and deferred tax liabilities that are as follows:

74. 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.

75. To avoid the need for detailed scheduling of the timing of the reversal of each temporary difference, this Standard requires an entity to set off a deferred tax asset against a deferred tax liability of the same taxable entity if, and only if, they relate to income taxes levied by the same taxation authority and the entity has a legally enforceable right to set off current tax assets against current tax liabilities.

Example 2 in Appendix B that accompanies to IAS 12 has shown calculation of net deferred tax liability and illustrative disclosure of its major components.

In view of the above, the Committee is of the opinion that the entity should recognize deferred tax including revaluation surplus 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 and net it against deferred tax liability in accordance with paragraphs 74 and 75 of IAS 12 Income Taxes.

(March 9, 2007)

17. Implementation of IAS-12 Income Taxes

Enquiry:

1. The International Accounting Standard No. 12 (Revised-2000) in respect of income tax has been made effective in Pakistan with effect from 1st January, 2002.

2. The standard provides that:

"A deferred tax asset should be recognized for the carry forward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilized". (IAS 12.34)

3. It is obvious that the creation of a Deferred Tax Asset is based on a **probability** that future tax profits will be available for adjustment against unused tax losses.

4. The application of new standard has brought substantial deceptive variation in the declared results of some of the listed companies. We can understand the distortion being created by a Tax Asset with reference to just one example. The ABC Cement Company Ltd has created a Tax Asset of Rs. 379 Million in its accounts for the year ended on 30th June, 2003. **The company had incurred a loss of Rs. 331 Million during the year but the creation of Tax Asset has converted its loss of Rs. 331 Million to a profit after tax of Rs. 47 Million** as can be seen by the following figures:

Net Loss Before Tax	Rs.	332 Million
Tax Asset	Rs.	379 Million

Net Profit after Tax	**Rs.**	**47 Million**
		========

5. The tax asset, which is a hypothetical asset, based on probable tax credit in future has converted a loss of Rs. 332 Million to a profit of Rs. 47 Million. A potential investor in stock market usually looks at earning per share after tax of a script. We can see from the following calculations the extent of distortion introduced by the creation of Tax Asset in the case of above example.

Loss Per Share Before Tax	(-)	Rs.	(11.92) Per Share	
Earning Per Share After Tax	+	Rs.	1.69 Per Share	

Increased	**+**	**Rs.**	**13.38**	**Per Share**
			======	

6. **It is obvious that this EPS of Rs. 13.38 is not based on any tangible receipt of income to company nor does it represent the operating performance of the company. It is based on PROBABLE expectations in undetermined future years.**

7. I am not aware of the number of companies, which might have created a Tax Asset. I am enclosing a statement showing the particulars of 27 listed companies, who have created Tax Assets during the year ended on 30th June, 2003 and 30th September, 2003 and whose accounts have come to my notice. The statement shows the profit before tax, the amount of tax asset created, and the amount of profit after tax. The statement also shows the earning per share before tax representing the actual operating results of the company and earning per share after tax arrived at by creating a deferred tax.

8. An ordinary investor normally looks at the figures of after tax profit. He can never think of a positive provision for taxation increasing the profit by Millions.

9. The International Accounting Standard however has taken a number of precautions to guard the interests of investors by giving some warnings. For example, it warns the corporate bodies that they have to be very careful in creating an asset based on the expectation of future profits because if you have an history of losses, the chances of profits arising in future years are negligible. Para-35 of the IAS-12 says:

"The existence of unused tax losses is strong evidence that future taxable profit may not be available".

10. Para-36(b) of IAS-12 again raises a very important question and it is for the management of the company and its auditors to answer it:

"Whether it is probable that the enterprise will have taxable profits before the unused tax losses or unused tax credits expire?"

11. This is very important. The management of the company and the auditors have to find out the reasons for the losses suffered by the company in the past and should have a strong reason to assume that the reasons causing losses in the past will not be repeated in coming years.

12. Para-36 (c) again introduces an element of caution:

Whether the unused tax losses result from identifiable causes, which are unlikely to recur; ?

It warns that:-

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

Para-35 discusses the issue in detail:

Therefore, when an enterprise has a history of recent losses, the enterprise recognizes a deferred tax asset arising from unused tax losses or tax credits only to the extent that the enterprise 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 utilized by the enterprise. In such circumstances, paragraph 82 requires disclosure of the amount of the deferred tax asset and the nature of the evidence supporting its recognition.

13. The requirement of this paragraph has to be noted because it requires that the enterprise, which has a history of recent losses, must have a CONVINCING EVIDENCE supporting the management's expectation about future profitability. The disclosure required by this para is missing from the annual reports of the companies shown in the annexed statement. **The standard requires disclosure of "nature of the evidence" supporting the recognition of the Asset** but none of the companies has made any disclosure about evidence, which has been relied upon as the basis for creation of the Tax Asset.

14. The disclosure requirements have been specifically dealt with by para-82 of the IAS-12, which says:

An enterprise should disclose the amount of a deferred tax asset and the nature of the evidence supporting its recognition, when;

(a) the utilization 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 enterprise has suffered a loss in either the current or preceding period in the tax jurisdiction to which the deferred tax asset relates.

15. I sincerely feel that distortion in the published accounts being introduced by IAS-12 will be deceptive for many small investors who use the figure of earning per share published in various newspapers as criteria for their investment decisions. They will be misled to make investment in companies, which are not profitable at least presently. Ultimately, it may result in some sort of scandal in Pakistan's Stock market.

16. Pakistan has very low level of education and the disclosure practices being adopted by our listed companies are not still adequate. The adoption of IAS-12 in Pakistan at this stage is likely to have negative impact for the investment climate in Pakistan and may open the doors for deception of small investors.

17. **The Tax Asset being created by listed companies under IAS-12 is directly credited to the income statement and the consequent profit becomes part of general reserves. By tradition, a general reserve is considered as a free reserve available for distribution as dividend.** However, the portion of the general reserve, which consists of a Tax Asset, is not backed by any tangible Asset and the company does not have the means to distribute it among the shareholders. **It is difficult for an ordinary investor to realize and**

appreciate this fact. He is bound to be misled by the figure of the general reserve especially in the following year in which the Tax Asset was created.

18. I earnestly request the Securities & Exchange Commission of Pakistan to kindly suspend the Adoption of IAS-12 with immediate effect and direct all the companies which have created Tax Assets to reverse the entry.

19. In case, the SECP does not find it appropriate to suspend the operation of IAS-12, it may introduce some variation in the methodology of accounting for the credit of Tax Asset. I suggest **that instead of crediting the value of Tax Assets to income statement,** the amount should be credited to an account which can be named as 'TAX RESERVE' or whatever other nomenclature the SECP may like to adopt. I personally feel that it's a very important matter **and need immediate action by SECP and the professional accounting bodies of the country.**

Opinion: First of all the appropriate Committees of the Institute would like to draw your attention towards the following paragraphs of IAS 12 (revised 2000):

35. The criteria for recognizing deferred tax assets arising from the carry forward of unused tax losses and tax credits are the same as the criteria for recognizing 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 enterprise has a history of recent losses, the enterprise recognizes a deferred tax asset arising from unused tax losses or tax credits only to the extent that the enterprise 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 utilized by the enterprise. In such circumstances, paragraph 82 requires disclosure of the amount of the deferred tax asset and the nature of the evidence supporting its recognition.

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

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

(b) whether it is probable that the enterprise 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 or recur; and

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

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

82. An enterprise should disclose the amount of a deferred tax asset and the nature of the evidence supporting its recognition, when:

(a) the utilization 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 enterprise has suffered a loss in either the current or preceding period in the tax jurisdiction to which the deferred tax asset relates.

Keeping in view the above provisions of IAS-12, the Committee is of the opinion that the revised Standard has not left the recognition of deferred tax assets open-ended, instead it has prescribed a number of precautions to guard the interests of investors by setting out various criteria which are to be met religiously before the recognition of defer red tax assets. On the other hand since in the preparation of financial statements the compliance with IAS is mandatory, the Committee is of the firm view that deferred tax asset be recognized as required by IAS 12.

Further the Institute has also issued a Circular No. 03/2004 dated March 25, 2004 in which the members of the Institute have been advised to pay special attention and exercise extra care that the deferred tax assets are measured, recognized and disclosed in accordance with the requirement of IAS-12.

(February 14, 2004)

18. Clarification Regarding Ias-12 (Revised 2000) Paragraph 81 (C)

Enquiry: IAS 12 para 81(c) of IAS 12 (Revised 2000) requires to provide disclosure regarding explanation of relationship between tax expenses (income) and accounting profit.

My question is whether a company which is subject to minimum tax under section 113 of the Income Tax Ordinance, 2001 or subject to PTR (presumptive tax regime) required to give above said disclosure?

I request you or the relevant Committee of the Institute to clarify the above-mentioned situation.

Opinion: The appropriate Committee of the Institute has examined your query and concludes that IAS 12 paragraph 81(c) requires an explanation of the

relationship between tax expense and accounting profit. This explanation, in Committee's views, enables the financial statements users to understand the relationship, whether reconciling items are unusual and to understand the significant factors that could affect relationship in future.

In view of the above, the reconciliation is required to be disclosed in all circumstances.

(November 6, 2004)

19. Applicability Of International Accounting Standards On Non-Listed Companies

Enquiry: Through the Companies (Amendment) Ordinance, 2002, section 234(3)(I) of the Companies Ordinance, 1984 (CO84) has been modified. The amended section 234 (3) (I) now stipulates that such International Accounting Standards and other standards shall be followed by all Companies in the preparation of accounts, balance-sheet and profit and loss account as are notified for the purpose in the official Gazette by the Commission.

However, in accordance with the statutory notifications (SROs) issued by the Securities and Exchange Commission of Pakistan (SECP), the International Accounting Standards (IASs) are mandatory for "listed" companies only. Therefore it may be construed that IAS's are not mandatorily applicable on non-listed companies. We request you to kindly advise whether the IAS's notified by SECP are to be followed mandatorily by our Company (being a non-listed Public Limited Company).

2. Accounting Treatment of Deferred Tax Asset under IAS-12

2.1 In case compliance of IAS's is compulsory for non-listed Public Companies, we seek your approval in respect of an accounting treatment relating to un-recognized net deferred tax asset balance. The details of the subject matter and the proposed accounting treatment is set forth in the following paragraphs.

2.2 ABC Limited is a non-listed public company. The operations of the Company were governed by the Gas Well-head Price Agreement dated 1 July 1982 (the GPA), executed between Government of Pakistan and ABC up till 30 June 2001. The Company was prevented through the requirements of the GPA from accounting for deferred taxation with effect from January 1, 1981 and the deferred tax liability of Rs.9.523 million as at December 31, 1982 was being carried forward in the accounts of the company since then. The Company had not recognized deferred tax liabilities and assets due to the requirements of clause (vi)(c) of Article I of the GPA, which states as follows:

"With effect from January 1, 1982 ABC shall make no provision for deferred tax in the audited accounts".

However, the Company continued to disclose the amounts of the unrecognized deferred tax liabilities and assets in its accounts. Note 3.9.3 to the accounts of the Company for the year ended June 30, 2001 is reproduced below:

"Deferred taxation

Provision in respect of deferred taxation is not being made with effect from January 1, 1982 in the accounts of the Company and the deferred tax liability as at December 31, 1981 amounting to Rs.9.523 million is being carried forward. Had the Company provided for deferred taxation, under the liability method, there would have been a liability of Rs.386.832 million as at June 30, 2001 (2000: Rs.451.027 million).

In addition, a deferred tax asset aggregating Rs.1,788.083 million (2000:Rs. 1,600.052 million) is available for writing off the exploration, appraisal and development drilling expenditure to the profit and loss account when such expenditure is allowable for tax purposes".

The GPA was dismantled effective July 1, 2001 and following its dismantling the Company started accounting for deferred taxation with effect from July 1, 2001 using the balance sheet liability method. However, the Company did not recognize the net deferred tax asset aggregating Rs.1,273.226 million as of June 30, 2002 in its accounts for the year ended June 30, 2002 on grounds of prudence. The deferred tax liability of Rs.9.523 million as stated in the balance sheet of the company as at December 31, 1981 which was being carried forward up to June 30, 2001 due to the requirements of the GPA, as stated above, was reversed in the accounts for the year ended June 30, 2002. These matters were disclosed in note 3.11 to the accounts of the Company for the year ended June 30, 2002, which is reproduced below:

"3.11 Deferred taxation

Pursuant to the requirements of the Agreement, the Company did not account for deferred taxation with effect from January 1, 1982 and the deferred tax liability of Rs.9.523 million as stated in the balance sheet of the Company as at December 31, 1981 was being carried forward up to June 30, 2001. However, consequent to the dismantling of the Agreement, the Company now accounts for deferred taxation with effect from July 1, 2001 using the balance sheet liability method, providing for temporary taxable and deductible differences between the carrying amounts of assets and liabilities for financial reporting purposes and amounts used for taxation purposes. However, as a matter of prudence, the Company does not recognize net deferred tax debit balance in its accounts, which aggregates Rs.1,273.226 million as at June 30, 2002 (2001: Rs.1,410.774 million). Accordingly, the aforementioned deferred tax liability of Rs.9.523 million as at June 30, 2001 has been reversed in these accounts."

2.3 According to clause (a) (ii) of Article II of the GPA the Company adopted a policy to charge off the exploration expenditure in the year in which such expenditure was incurred. However, according to the provisions of the Income

Tax Ordinance, 1979 (now repealed) such expenditure relating to those exploration areas covered under the Fifth Schedule to the Income Tax Ordinance, 1979 was not allowed by the tax assessing authorities as an allowable deduction. Accordingly the current tax charge of the Company was higher in the years up to June 30, 2001 due to the aforementioned disallowance but the Company could not account for the deferred tax credit arising thereon because of the requirements of GPA referred to in paragraph 2 above. Due to this reason deferred tax asset, arising upon disallowance of exploration expenditure, continued to accumulate and as of June 30, 2002 it aggregated Rs.1,637.046 million.

The deferred tax asset of Rs.1,637.046 million as of June 30, 2002 represents exploration expenditure incurred by the Company up to that date which has been charged off in the accounts of the Company and has not been allowed by the income tax authorities. This amount will be realized in future years either when the Company declares a 'dry hole' or surrenders the Licensed area and claims the related exploration expenditure as 'abortive cost' or when a commercial discovery is made and the exploration expenditure incurred is allowed over the post commercial discovery period according to the requirements of the Income Tax Ordinance, 2001. The requirements of the Income Tax Ordinance, 2001 and the Income Tax Rules, 2002 in this respect have been set forth in paragraph 2.4 below.

2.4 According to Rule 2 of Part 1 of the Fifth Schedule to the Income Tax Ordinance, 2001 any expenditure, under the agreement entered into by an undertaking with GOP for exploration or production of petroleum in Pakistan, on searching for or on discovering and testing a petroleum deposit or winning access thereto, but the search, exploration or enquiry upon which the expenditure is incurred is given up before the commencement of commercial production, the expenditure allocable to a surrendered area or to the drilling of a dry-hole shall be deemed to be lost at the time of surrender of the area or the completion of the dry-hole, as the case may be allowed against any income of such undertaking in either of the following two ways, as may be provided for in the agreement, namely;

(a) the said loss in any year shall be set off against the income of that year chargeable under the head "Income from Business" or any income (other than income from dividends) chargeable under any other head and where the loss cannot be holly set off in this manner, the portion not so set off shall be carried forward to the following year and set off in the same manner and so on but no loss shall be carried forward for more than six years; or

(b) the said loss in any year shall be set off against the income of such undertaking of the income year in which commercial production has commenced and where the loss cannot be wholly set off against the income of such undertaking of that year, the portion not so set off against the income, if any, of such undertaking of that year, and if it cannot be wholly so set off the amount of loss not so set off shall be carried forward to the following year, and so on, but no loss shall be carried forward for more than ten years.

Further, sub-rule 4 of the said rule states that after the commencement of commercial production, all expenditure incurred prior thereto and not deemed to be lost expenditure and not represented by physical assets in use at time of the commercial production shall be allowed as a deduction, so, however, that the portion of such deduction to be so allowed in any year shall be such amount not exceeding ten percent of the aggregate amount deductible in respect of inshore areas.

3. APPROVAL REQUESTED

3.1 The Company intends to comply with the requirements of all the IASs (if IASs are applicable to it) and account for the temporary taxable or deductible differences between the carrying amounts of assets and their respective tax base, arising subsequent to June 30, 2002. However, as the net deferred tax asset of Rs.1,273.226 million as of that date (i.e. June 30, 2002) represents the cumulative effect of the temporary differences that have arisen over a long period of time during which the Company was not allowed to recognize deferred tax, the Company intends to freeze that balance as of that date.

3.2 The recognition of this net deferred tax asset amount as of June 30, 2002 in the accounts of the Company for the year ended June 30, 2003 would not be appropriate as this amount has been accumulated over a number of years due to operation of GPA. The fact that the net deferred tax asset as of June 30, 2002 has not been recognized in the accounts shall continue to be disclosed in the accounts of the Company for the year ended June 30, 2003 and thereafter until the entire amount is reversed through actual tax credits in respective years.

3.3 However, the deferred tax assets or liabilities arising after July 1, 2002 due to originating taxable and temporary differences after that date shall be accounted for in the accounts of the Company for the year ended June 30, 2003 and thereafter in accordance with the requirements of IAS-12.

In view of the matters set out in paragraphs 2 and 3 above, we request your kind approval for the Company's proposed accounting treatment for not recognizing the net deferred tax asset of Rs.1,273.226 million as of June 30, 2002 in its financial statements (Paragraph 3.1 to 3.3 above).

Opinion: The Institute of Chartered Accountant of Pakistan has already recommended to the SECP to notify certain International Accounting Standards including IAS 12 under Section 234(3) of the Companies Ordinance, 1984 for application to non-listed companies. However, for the application of IAS 12 we have recommended that a three year transitory period should be allowed in which the non-listed companies be required to provide for deferred taxation equally each year. If that recommendation is approved by the SECP then you may provide for deferred tax assets accordingly.

This Institute would not like to agree with your suggestions in paragraph 3 of your letter under reference. The Company should comply with all the

requirements of IAS 12 as may be notified by SECP including three years transitory period if agreed to by them.

(August 9, 2003)

20. Computation Of Deferred Tax Liability

Enquiry: Kindly refer to the SECP Circular No. 16 dated September 9, 1999 on the subject.

Pursuant to the requirement of the above circular, our Company has been providing the deferred tax liability at the applicable tax rate. At 31st December 2002, the total provision made for deferred tax liability amounted to Rs.12.085 million.

It is submitted that the IAS 12 (revised) does not specifically deal with the issues confronted by a leasing company nor does it provide sample calculations directly applicable to a leasing business. However for working out deferred tax liability in a leasing company, methods of computations have been devised by experts by drawing inferences there from. In this connection the two approaches of computation given in an article published in Leasing Association of Pakistan yearbook 1999 are precisely as under: -

A Profit & Loss Approach

Deferred tax liability for the year = Tax rate x (Tax depreciation – Principal portion of lease rentals for the period)

B Balance Sheet Approach

Accumulated Deferred tax liability =Tax rate x (Net Investment in Lease – Tax Written Down Value of Assets at year end

It has been proved in the article referred to above that the two approaches give the same result. While theoretically, the aforesaid conclusion may be correct, the deferred tax liability worked out separately under the two approaches on the basis of actual data of our Company is grossly divergent with each other. The analysis made to ascertain reasons for variances has led to the conclusion that the results under two approaches can agree only when all rentals are fully realized as has been assumed in the Article. Since this cannot hold true in the long run, the balance sheet approach gets adversely affected and the results of two approaches do not remain in harmony with each other. The reasons stated in detail, are as under: -

i) The amount of rentals for profit and loss approach are the total lease rentals irrespective of whether these are actually paid or payable by the lessee. But the "Net Investment in Leases" (NIL) taken in the Balance Sheet approach is worked out on the basis of actual rentals realized by the leasing company. The necessity of taking into account unrealized rentals along with realized rentals for current taxation / profit & loss approach for deferred

taxation is covered by the tax law which requires to include total rentals (both paid or payable) as revenue for the purpose of tax computations. Obviously if different amounts of rentals are taken into account in the two approaches, the figures of deferred tax liability determined under each approach is bound to differ.

ii) When rentals are in default, less amount is adjusted against net investment in leases (NIL). The result is that NIL remains higher than it would have been if the rentals had not been in default. This in turn, leads to higher difference between NIL and TAX WDV, which results in extra amount of deferred tax liability. This extra liability could have been avoided if there had been no rentals in default. The principal portion of rentals in default in our case as at 31st December 2002 amounted to Rs.27.260 million and their non-adjustment against NIL has increased our deferred tax liability by Rs.9.54 million.

iii) Apart from non-adjustment of principal portion of rentals in default, as discussed at (ii) above, residual value of leased assets (RVs) against the defaulting lessees remain unadjusted. This also makes the "NIL" to remain higher than the figures, which would have emerged if the RVs had been adjusted. The figures of such RVs in our case as of 31st December 2002 amounted to Rs.3.9 million and their non-adjustment against NIL has increased our deferred tax liability by Rs.1.36 million.

In nutshell, while Tax WDV of assets in leasing business is identical to Tax Base" referred to in IAS-12 (revised), the "NIL" is not exactly comparable to carrying cost of assets in the other businesses for the reasons stated above. Thus the difference between the two (NIL and Tax WDV) is not representative of temporary differences envisaged under the IAS. The balance sheet approach of working out deferred tax liability, in leasing companies in which defaults are high, is bound to bloat deferred tax liability unjustifiably.

We have also compared our up to date current plus deferred tax provisions with similar calculations of a few other leasing companies. It transpires that our total tax provisions as percentage of pretax profits are quite close to these companies on the basis of their published data.

In view of above it is requested that the whole position may kindly be examined in the light of the points raised above and we may be given necessary guidelines for working out appropriately the deferred tax liability in consultation with other leasing companies, if considered necessary.

Opinion: The appropriate Committee of the Institute has examined the issue of arriving at different figures of deferred tax liabilities following the profit and loss approach and the balance sheet approach, and would like to draw your attention to Introduction to IAS-12 revised which states that "the original IAS 12 required an enterprise to account for deferred tax using either the deferral method or a liability method which is sometimes known as the income statement liability method. IAS 12 (revised) prohibits the deferral method and

requires another liability method, which is sometimes known as the balance sheet liability method.

The income statement liability method focuses on timing differences, whereas the balance sheet liability method focuses on temporary differences. Timing differences are differences between taxable profit and accounting profit that originate in one period and reverse in one or more subsequent periods. Temporary differences are differences between the tax base of an asset or liability and its carrying amount in the balance sheet. The tax base of an asset or liability is the amount attributed to that asset or liability for tax purposes.

Furthermore, there are some temporary differences, which are not timing differences, for example those temporary differences that arise when: -

(c) the carrying amount of an asset or liability on initial recognition differs from its initial tax base".

Unquote---

The temporary differences in case of a leasing company fall under (c) above.

The Committee is, therefore, of the opinion that leasing companies should follow balance sheet method for calculating their deferred tax liability.

(*August 9, 2003)*