

Brief facts of the enquiry:

The enquiry relates to a private company established by Government of Punjab. The Company (enquirer) operates a power generation facility and sells electricity exclusively to Central Power Purchasing Agency (CPPA-G), (hereinafter 'the Power Purchaser') under an executed Power Purchase Agreement (PPA). The Company's tariff structure is determined by the national electricity regulator on a cost-plus basis, under which certain defined costs, including income tax, are designated as 'pass-through items' recoverable from the Power Purchaser.

Under the terms of the PPA and the applicable tariff determination framework, the Company is entitled to recover certain costs including income taxes paid by the Company under the Income Tax Ordinance, 2001 from Power Purchaser in respect of its power generation income. The recoverability of such amounts is further supported by a sovereign guarantee issued by the Government of Pakistan in favour of the Company.

Since inception, the Company has not recognised any income tax expense (other than on bank profit income). It has also not recognised deferred tax liability in its statement of profit or loss on the premise that it does not meet objective of IAS-12 which require an entity to recognize deferred tax liability (deferred tax asset) if it is probable that recovery or settlement of that carrying amount will make future tax payments larger (smaller) than they would be if such recovery or settlement were to have no tax consequences.

Instead, income tax payments are recorded directly as a receivable from the Power Purchaser in the statement of financial position, on the premise that the said transaction satisfies the criteria of asset recognition rather than income and economic burden of taxation is borne by the Power Purchaser and that routing such amounts through the income statement would not faithfully represent the commercial reality of the arrangement.

Specific Queries:

1. In a cost-plus tariff regime, where a power generation company pays income tax but is contractually reimbursed by the power purchaser under enforceable terms, and where recoverability of such reimbursement is supported by a sovereign guarantee, is the company still required under IAS 12 to recognize current and deferred tax liabilities in presence of "substance over form" concept (Conceptual Framework) requiring transactions to be recorded on basis of underlying substance and economic reality and not merely on the basis of their legal form? Can the existence of the reimbursement right, sovereign guarantee and substance over form influence the determination of the company's tax base and the requirement to recognize deferred tax to reflect the true and actual state of affairs in the financial statements?
2. In the same factual context, should such reimbursed amounts be accounted for as variable consideration, forming part of revenue under IFRS 15, or may they be treated as passthrough cost recoveries considering taxation implications?
3. In case there is no current tax implication on the Company, what is applicability of deferred tax? Is the entity required to recognize deferred taxation in absence of current taxation considering objective of IAS-12 where there is no probability that recovery or settlement of that carrying amount will make future tax payments larger (smaller) than they would be if such recovery or settlement were to have no tax consequences?
4. Is the applicability of current and deferred tax impact profitability and ultimately impact economic decisions of users of financial statements?

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Opinion:

IAS 12 defines income tax in paragraph 2 as follows:

“For the purposes of this Standard, income taxes include all domestic and foreign taxes which are based on taxable profits. Income taxes also include taxes, such as withholding taxes, which are payable by a subsidiary, associate or joint arrangement on distributions to the reporting entity.”

Paragraph 12 of IAS 12 states as follows:

“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 Objective paragraph of IAS 12 states:

“The objective of this Standard is to prescribe the accounting treatment for income taxes. The principal issue in accounting for income taxes is how to account for the current and future tax consequences of the future recovery (settlement) of the carrying amount of assets (liabilities) that are recognised in an entity's statement of financial position; and transactions and other events of the current period that are recognised in an entity's financial statements.”

The Company is liable to pay tax under Income Tax Ordinance, 2001 (ITO 2001) to Federal Board of Revenue (FBR) in respect of its income from power generation. The contractual arrangement with the Power Purchaser, which provides for reimbursement of income tax, does not alter the Company's primary statutory obligation to discharge its tax liabilities to FBR. This establishes an unconditional obligation to recognise current tax. IAS 12 does not draw a distinction between tax that is economically borne by an entity and tax that is contractually recoverable from a third party.

The substance of each transaction/arrangement needs to be considered separately according to its merits. The nature of the Company's relationship with FBR is that of a primary taxpayer who bears a statutory obligation to pay income tax on its profits. The Company's relationship with the Power Purchaser is that of an electricity supplier with a contractual right to recover certain costs, including tax levied under ITO 2001, from its customer (power purchaser) under the PPA. These are two distinct transactions with two distinct economic characters. Accordingly, the two items i.e. the tax liability to FBR and the receivable from the Power Purchaser, are distinct in legal character and with respect to counterparty involved.

Paragraph 46 of IAS 12 further provides:

“Current tax liabilities (assets) for the current and prior periods shall be measured at the amount expected to be paid to (recovered from) the taxation authorities, using the tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.”

The current tax liability or asset shall be recorded based on the amounts that an entity expects to pay to, or receive from, the tax authorities. The reimbursement right from the Power Purchaser i.e. recover taxes paid, does not affect the recognition or measurement of the current tax obligation under IAS 12 rather it is a separate arrangement to be recognized under IFRS 15. The existence of reimbursement right has no bearing on the recognition or measurement requirements of the current tax expense and related liability/asset.

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Further, paragraph 47 of IFRS 15 defines transaction price as follows:

“The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales taxes). The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both.”

A revenue contract creates two mutually exclusive categories of amounts receivable from a customer:

- Consideration to which the entity is entitled in exchange for goods or services which forms part of the transaction price and is recognised as revenue.
- Amounts collected on behalf of third parties which is excluded from the transaction price and is not revenue (e.g. sales tax collected on behalf of government, if applicable).

The question regarding the tax reimbursement is whether it represents consideration for the transfer of goods or services i.e. electricity supplied under the PPA, or whether the Company is acting as agent to collect amount on behalf of third party.

The term revenue is defined in the glossary of IFRS Accounting Standards

“IFRS 15.A - Revenue: Income arising in the course of an entity’s ordinary activities.”

Paragraph 50 and 51 of IFRS 15 describe the variable consideration of the revenue from contracts with customers as follows:

“50. If the consideration promised in a contract includes a variable amount, an entity shall estimate the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a customer.

51. An amount of consideration can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties or other similar items.”

The Company has a seller-customer relationship with the Power Purchaser in terms of sale of electricity only. The tax reimbursement under Clause 11.3(b) of the PPA is a contractual entitlement in exchange for the supply of electricity. The amount varies based on the Company's tax liability from year to year, rendering it variable in nature. Under paragraph 56 of IFRS 15, variable consideration is recognized only to the extent that it is highly probable that a significant reversal of previously recognized revenue will not occur when the uncertainty is subsequently resolved. Given that recoverability of such tax reimbursement is secured by a sovereign guarantee issued by the Government of Pakistan, it is highly probable that a significant reversal in variable consideration related to tax reimbursement will not occur.

On the other hand, the primary example of 'amounts collected on behalf of third parties' in Pakistan is sales tax where the supplier collects sales tax from its customer and pays that amount to the relevant government authority. The supplier is acting as pure agent i.e. the money flows from customer through supplier to government.

In the present case, the actual flow of transaction is that the Company is liable to pay income tax under Income Tax Ordinance, 2001 to FBR on taxable income earned by it during the year, and has a right to bill such amount to the Power Purchaser as a reimbursement under the PPA. The Company bears a credit risk on amounts due from the Power Purchaser from the time it pays such taxes to FBR until the time it is recovered from the Power Purchaser. It depletes its own liquidity to discharge its own statutory liability. This is not a collection on behalf of a third party, it is payment of the entity's own obligation followed by reimbursement from a contractual counterparty.

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Technically, where a contract allows an entity to recharge expenses to the customer which it has incurred, those recharged amounts are not 'amounts collected on behalf of third parties', they are part of the transaction price. On the contrary, in case of sales tax being an amount collected on behalf of government, a supplier collects the customer's money and remits it directly to the government.

In the present case, in respect of income tax reimbursable to the Company by the customer, the Company bears the associated risks of recovery from the Power Purchaser i.e. management need to assess enforceability, tariff approval, billing disputes, collection history, timing delays, and whether any constraint on variable consideration under paragraph 56 of IFRS 15 applies for this reimbursement.

In view of above, PPA Clause 11.3(b) is an expense recharge clause as regards income tax of the Company i.e. the Company incurs income tax expense as a result of legally assessed tax liability which is recharged to the customer. This recovery of cost from the Power Purchaser form part of the total consideration for supply of electricity. The reimbursement of an expense is no different from any other consideration that the entity collects as part of its transaction price.

Presentation Considerations under requirements of IFRS Accounting Standards

Paragraphs 32 and 33 of IAS 1 state as follows:

“IAS 1.32 - An entity shall not offset assets and liabilities or income and expenses, unless required or permitted by an IFRS.

IAS 1.33 - An entity reports separately both assets and liabilities, and income and expenses. Offsetting in the statement of comprehensive income or the statement of financial position, except when offsetting reflects the substance of the transaction or other event, detracts from the ability of users both to understand the transactions, other events and conditions that have occurred and to assess the entity's future cash flows.”

The substance of the arrangement under consideration is that the Company has a statutory tax obligation towards FBR and a separate contractual right to recover that amount from the Power Purchaser under the PPA. These are distinct transactions involving different counterparties and should therefore be recognised and presented separately rather than being netted off against each other.

Further, the accounting treatment of recording income tax payments directly as a receivable with no income statement impact achieves, in economic substance, a netting of the tax expense against the reimbursement income which results in a net zero P&L presentation of two separately recognizable items. IAS 1.32 prohibits this outcome unless an IFRS Accounting Standard explicitly requires or permits it.

IAS 1.33 specifically identifies the risk of inability of users to understand financial statements due to presentation of net figures.

In present case, under current accounting treatment followed by the Company, users of financial statements may lose the ability to assess the scale of the Company's tax exposure to FBR, the associated credit risk embedded in the Power Purchaser receivable, and the timing mismatch risk between tax payment and reimbursement recovery. All of these are material information items for users of financial statements.

Moreover, paragraph 82(d) of IAS 1 states as follows:

“In addition to items required by other IFRSs, the profit or loss section or the statement of profit or loss shall include line items that present the following amounts for the period:

- a) revenue, presenting separately*
 - (i) interest revenue calculated using the effective interest method; and*
 - (ii) insurance revenue (see IFRS 17);*

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d) tax expense

Further, Paragraph 113 of IFRS 15 states as follows:

“An entity shall disclose all of the following amounts for the reporting period unless those amounts are presented separately in the statement of comprehensive income in accordance with other Standards:

(a) revenue recognised from contracts with customers, which the entity shall disclose separately from its other sources of revenue; ...”

The above presentation and disclosure requirements reflect that revenue from contracts with customers and income tax expense are separate line items required to be presented in the statement of profit or loss. The Company need to consider these presentation requirements while preparing its financial statements.

Recognition of deferred tax

Paragraph 7 of IAS 12 states as follows:

“The tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to the entity when it recovers the carrying amount of the asset. If those economic benefits will not be taxable, the tax base of the asset is equal to its carrying amount.”

The tax base of an asset is determined by reference to tax laws i.e. the Income Tax Ordinance 2001. Where the tax base of an asset differs from its accounting carrying amount, a temporary difference arises.

Paragraph 15 of IAS 12 states as follows:

“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;

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

(iii) at the time of the transaction, does not give rise to equal taxable and deductible temporary differences.

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.”

Further, Paragraph 24 of IAS 12 states as follows:

“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;

(b) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss); and

(c) at the time of the transaction, does not give rise to equal taxable and deductible temporary differences.

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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.”

IAS 12 requires the Company to recognize deferred tax liability for all taxable temporary differences and deferred tax asset for all deductible temporary differences to the extent that it is probable that taxable profit will be available.

The above paragraphs establish that difference between accounting treatment and tax treatment of a transaction give rise to a temporary difference which arises automatically from the assets and liabilities recognized in the financial statements of the Company, rather than because of any external arrangement.

In the books of the Company, its assets for instance the power plant and associated equipment, are carried at their accounting carrying amounts determined under IFRS Accounting Standards. whereas their tax bases are determined under the Income Tax Ordinance 2001 based on tax depreciation rates prescribed therein. The difference between these two values generates a temporary difference on which IAS 12 requires recognition of a deferred tax liability/asset. When this difference reverses in later years, the Company will have higher/lower taxable income than accounting income in those periods, resulting in higher/lower tax payments at that future point. It is this future additional tax liability/asset, that must be recognised today as a deferred tax liability/asset under IAS 12, regardless of whether the economic cost of that future tax will ultimately be borne by the Company or recovered from the Power Purchaser under the PPA.

In this regard, paragraph 25 of IAS 12 states as follows:

“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 [Refer: paragraph 2] 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.”

The paragraph 25 of IAS 12 explicitly states that these consequences are inherent in the recognition of assets and liabilities themselves. They are not consequences of the payment of tax liability or the source of reimbursement of that tax liability i.e. those are not consequences of whether the tax cost is ultimately borne by the Company or recovered from the Power Purchaser. They arise at the moment the asset or liability is recognised in the financial statements, because from that moment a divergence exists between accounting carrying amounts and tax bases, and that divergence will have tax consequences when it reverses.

Further, there may be a case when a Company reports nil current tax in a given period for instance, due to tax losses or a tax holiday period etc. while simultaneously carrying significant deferred tax liabilities in respect of taxable temporary differences that will reverse and generate taxable income in future periods. The recognition of deferred tax under IAS 12 is triggered by the existence of temporary differences in a reporting period, not by whether current tax is payable in the same reporting period. Accordingly, deferred tax must be recognised on all taxable and deductible temporary differences existing at the end of the reporting period regardless of whether a current tax charge arises in the same reporting period.

Considering above, it is important to note that the PPA does not have any effect in either the recognition and measurement of assets and liabilities under IFRS Accounting Standards or the determination of their tax bases under the Income Tax Ordinance 2001.

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So, in instant case, following points are relevant for understanding deferred tax implications:

- (a) the tax expense incurred by the Company is receivable under PPA through contractual reimbursement arrangement;
- (b) A contractual right to recover tax from a third party does not alter the tax base of the Company's assets or extinguish temporary differences;
- (c) Temporary differences are a function of and determined as the difference between accounting carrying amounts and written-down values determined based on tax law (ITO, 2001); and
- (d) the PPA has no bearing on either of these computations. As the temporary difference is the difference between the accounting carrying amount of an asset or liability, and its tax base and both of these are determined by reference to entirely separate frameworks. The accounting carrying amount is determined under IFRS Accounting Standards and the tax base is determined under the ITO 2001. While the PPA is a commercial agreement between the Company and the Power Purchaser governing the price and terms of electricity supply which has no authority to determine the accounting carrying amounts or the tax base of assets or tax liabilities of the Company. Consequently, it does not affect the temporary differences that arise from the comparison of these two figures. The fact that the PPA entitles the Company to recover its tax costs from the Power Purchaser is a billing and recovery mechanism that entirely has no effect on the computation of temporary differences or on the obligation of Company to recognise deferred tax in respect of them.

Conclusion

The Board, based on enquired fact pattern, concluded as follows:

1. Recognition of current and deferred taxes

The Company is required to recognise both current tax and deferred tax in accordance with IAS 12, notwithstanding the contractual reimbursement arrangement and the sovereign guarantee.

IAS 12.12 requires that current tax, to the extent unpaid, be recognised as a liability. IAS 12 does not provide an exception to recognition of tax obligations that are contractually recoverable from a third party. The Company's primary statutory obligation for income tax is towards the government (i.e. FBR) and not to the Power Purchaser. This tax obligation is unaffected by the contractual arrangement between the Company and its customer. The reimbursement right under the PPA gives rise to a separate arrangement, it does not extinguish or defer the recognition of the current tax expense and corresponding liability itself.

On the question of the "substance over form" principle, it is important to consider that the Conceptual Framework requires that transactions be accounted for in accordance with their substance and economic reality. Applying this principle correctly requires identifying the substance of each transaction separately. The substance of the Company's relationship with FBR is that of a primary taxpayer bearing a statutory obligation to pay tax on its income, in both the legal form and the economic substance. The substance of the Company's relationship with the Power Purchaser is that of an electricity supplier with a contractual right to recover certain costs, including income tax, from its customer. These are two distinct transactions with two distinct economic characters.

Accordingly, the substance of the overall arrangement requires the following to be recognised separately in the financial statements:

- current tax expense in the statement of profit or loss
- current tax liability in the statement of financial position
- revenue from variable consideration (tax reimbursement) in the statement of profit or loss
- receivable from the Power Purchaser in the statement of financial position

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The Company's assets and liabilities are recognised and carried at amounts determined under IFRS Accounting Standards as applicable in Pakistan in its books of accounts, whereas, their tax bases are independently determined under the Income Tax Ordinance 2001. The divergence between these two sets of values generates taxable/deductible temporary differences and accordingly a deferred tax liability/asset.

The tax base of an asset is determined by the applicable tax legislation and the manner in which the asset's carrying amount will be recovered or settled for tax purposes. It is not affected by the commercial arrangements between contracting parties regarding the economic burden of a tax.

The PPA does not alter the amount that will be deductible for tax purposes when the Company recovers the carrying amount through use and/or disposal of an asset. Accordingly, it does not alter the temporary differences that arise, nor does it provide a basis for non-recognition of the resulting deferred tax. The contractual reimbursement arrangement has no bearing on either the accounting carrying amounts or the written-down values of the Company's assets and liabilities determined based on tax law (ITO, 2001).

2. Recognition of revenue on variable consideration under requirements of IFRS 15

The income tax reimbursement amounts should be accounted for as variable consideration forming part of revenue under IFRS 15. They do not qualify as pass-through cost recoveries within the meaning of the "amounts collected on behalf of third parties" exclusion present in paragraph 47 of IFRS 15.

The exclusion for amounts collected on behalf of third parties is a narrow concept designed for arrangements where an entity acts as a pure conduit between its customer and a government authority for example in case of sales tax, where the customer's money passes through the supplier to the revenue authority.

In case of the Company's operations generating taxable income subject to tax under ITO, 2001, FBR's legal claim runs exclusively against the Company. FBR has no legal right against the Power Purchaser in respect of the Company's income tax obligation.

The Company bears credit risk in relation to tax payment under ITO, 2001 from the time of tax payment to government until the time it is reimbursed by Power Purchaser. This is not a collection on behalf of a third party, it is the discharge of the Company's own statutory obligation followed by recovery of that cost from a contractual counterparty.

Amounts of income tax billed to customers as recharges of expenses incurred by the Company under terms of PPA, are not "amounts collected on behalf of third parties" and are no different from any other consideration that the entity collects as part of its transaction price. Accordingly, it forms part of the total consideration received in exchange for supply of electricity. Such amounts must be included in the transaction price and recognised as revenue under IFRS 15. Further, the constraint on variable consideration recognition under paragraph 56 of IFRS 15 is satisfied given that the income tax reimbursement is secured through sovereign guarantee and it is highly probable that a significant reversal of previously recognized revenue will not occur in later period.

3. Recognition of deferred tax in reporting periods when there is no current tax liability

Current tax is the amount of income tax payable or recoverable in respect of the taxable profit or tax loss of a period. Deferred tax, by contrast, arises from temporary differences i.e. the differences between the carrying amounts of assets and liabilities in the financial statements and their respective tax bases, which will give rise to taxable or deductible amounts in future periods.

It is inherent in the recognition of an asset or liability that its carrying amount will be recovered or settled in future periods. When this recovery or settlement makes future tax payments larger or smaller than they would be if such tax consequences did not exist, IAS 12 requires the entity to recognize a deferred tax liability or asset. The existence of deferred tax is not dependent upon the existence of a current tax charge in the same reporting period. A company may report nil current tax in a given year, for example due to tax losses, tax

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credits, tax holidays, minimum tax regimes or other factors, while simultaneously having taxable or deductible temporary differences that will reverse in future periods. IAS 12 requires deferred tax to be recognised based on the existence of taxable or deductible temporary differences and the future tax consequences arising from the recovery or settlement of recognised assets and liabilities. Accordingly, the recognition of deferred tax is triggered by differences between accounting carrying amounts and tax bases, rather than by the amount of current tax payable in a particular year.

In the present case, the temporary differences arise because the carrying amounts of assets and liabilities recognised under IFRS Accounting Standards differ from their respective tax bases determined under the Income Tax Ordinance, 2001. These differences will reverse in future periods and affect future taxable profits and tax payments irrespective of the contractual reimbursement mechanism available under the PPA. Therefore, the existence or absence of a current tax expense in a reporting period does not eliminate the requirement to recognise deferred tax. The contractual right to recover taxes from the Power Purchaser may affect the recoverability of tax costs from a commercial perspective, but it does not affect the determination of tax bases, the existence of temporary differences, or the requirement to recognise deferred tax under IAS 12.

Further, it has been established in the foregoing analysis that the Company is subject to income tax as a matter of law. The contractual reimbursement arrangement under the PPA does not alter or extinguish that statutory obligation, and that current tax must accordingly be recognised in the statement of profit or loss in accordance with paragraph 12 of IAS 12. As a direct and necessary consequence of that conclusion, deferred tax must also be recognised on all taxable/deductible temporary differences in accordance with IAS 12.15, irrespective of the commercial arrangement under which the tax cost is recovered.

4. Impact of applicability of current and deferred tax on economic decisions of users of financial statements

The recognition of current tax, deferred tax and related reimbursement amounts affects the amounts reported in the financial statements, key ratios and, consequently, may influence the economic decisions of users. IFRS Accounting Standards require these items to be recognised and presented separately in the financial statements. IAS 12 requires recognition of current and deferred tax; IAS 1 prohibits offsetting of income and expenses unless specifically permitted and requires separate presentation of revenue and tax expense in the statement of profit or loss. IFRS 15 also requires separate presentation of revenue from contracts with customers. Accordingly, separate recognition and presentation of these items provides users with useful information regarding the Company's tax obligations and financial performance. Further, the disclosure requirements under IAS 12, IFRS 15 and other IFRS Accounting Standards remain applicable and should be complied with by the Company in accordance with its specific facts and circumstances.

(Issued on September 15, 2026)

Disclaimer

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