BLIND FREDDY CONTINUED – COMMON ERRORS WHEN APPLYING AASB 112 *INCOME TAXES*

THE ORIGINAL TITLE OF THIS SERIES WAS 'TEN WAYS TO MATERIALLY MISSTATE FINANCIAL STATEMENTS', HOWEVER IT HAS BECOME VERY OBVIOUS THAT THERE ARE FAR MORE THAN TEN ISSUES THAT CAN TRIP UP ACCOUNTANTS WHEN PREPARING FINANCIAL STATEMENTS. IN THIS ARTICLE WE TOUCH ON 'BLIND FREDDY ISSUES' ON DEFERRED TAX.

When reviewing companies' tax notes that reconcile the theoretical tax rate of 30 per cent to the actual effective tax rate, it is interesting to note how many errors occur from misapplying AASB 112 *Income Taxes*, and also the number of entities that are still trying to apply old AGAAP principles in respect of 'permanent' and 'timing differences'.

Assuming the company does not operate in a jurisdiction with a tax rate below 30 per cent, and the entity is not bringing to account losses previously unrecognised, if AASB 112 is being applied correctly, the effective tax rate should be slightly above 30 per cent. The reconciliation should certainly not include any 'timing differences' and 'permanent differences' but should be mainly limited to non-deductible expenses such as share-based payments, entertainment, fines, etc.

Common errors when applying AASB 112 include:

- Not recognising a deferred tax liability (DTL) for profits in an overseas associate
- Not recognising a DTL on profits in an overseas subsidiary when the group's intention is to repatriate these profits to Australia
- Failing to recognise deferred tax on assets and liabilities acquired in a business combination
- Failing to recognise the deferred tax impact on compound financial instruments
- Forgetting to tax effect account inventory purchased from inter-company
- Failing to recognise DTL's on revalued property or available-for-sale investments
- Failing to recognise DTL's where interest is capitalised into a qualifying asset
- Failing to recognise deferred tax assets on equity raising costs.

Remitting profits from overseas subsidiaries and associates

AASB 112, paragraph 39, contains an exemption from recognising the tax impacts of remitting profits from overseas subsidiaries, associates and joint ventures. This exemption only applies when:

- The parent can control whether a dividend is paid
- It is probable that a dividend will not be paid by the overseas entity in the foreseeable future.

Therefore in the case of an overseas associate (where the entity does not have control or joint control) deferred tax liabilities should be recognised in respect to the impact of exchange rates and the impact of taxation differentials between the overseas jurisdiction and Australia.

It is also important to recognise that the exemption only applies when it is probable that dividends will not flow in the foreseeable future. Thus, if it is the intention to remit dividends back to Australia in the foreseeable future, deferred tax should be recognised.

Failing to recognise deferred tax on assets and liabilities acquired in a business combination

AASB 112 also contains a significant exemption to recognising deferred tax liabilities when circumstances arise upon acquisition of an asset such that its tax base is different from its carrying value. This is known as the 'initial recognition' exemption, typically applying to acquisition of expensive motor vehicles. This 'initial recognition' exemption does NOT apply when assets other than goodwill are acquired in a business combination.

Example:

Company X is acquired by Company Y. As part of the business combination, $1,000 is attributed to a customer list. This amount is not deductible for tax purposes.

Entries on initial recognition are:

Dr	Intangible	$1,000	
Cr	DTL		$300
Cr	Cash paid		$700

Assuming the intangible is amortised over three years, entries in each of the three years are:

Dr	Amortisation expense	$333	
Cr	Intangible (accumulated amortisation)		$333
Dr	DTL	$100	
Cr	Tax expense		$100

Revalued assets

A common error highlighted on tax reconciliation notes is the tax consequences of disposing of land and buildings or other property. This arises either through not accounting for the revaluation correctly, or not correctly calculating the tax base, taking into account indexation and property acquired under previous tax rules.

The basic principle to apply when generating deferred tax entries is that the tax entry follows the 'revaluation'. In the case of revalued property, plant and equipment and available-for-sale financial assets (AFS), the corresponding tax entry is to the revaluation reserve, not to the income statement.

Example – Available-for-sale investments:

An available-for-sale investment is revalued by $1,000. Journal entry is:

Dr	AFS investment	$1,000	
Cr	AFS reserve		$1,000
Dr	AFS reserve	$300	
Cr	DTL		$300

The same principle applies when accounting for compound financial instruments.

Example – Compound financial instruments:

A convertible note is issued for $1,000. The equity component is $100. Initial journal entries are:

Dr	Cash	$1,000	
Cr	Liability		$900
Cr	Equity		$100

This journal entry MUST be tax effected to reflect the fact that the carrying value of the liability and its corresponding tax base is different.

Dr	Equity	$30	
Cr	DTL (($1,000-$900)*30 per cent)		$30

In Year 1, assuming an effective interest charge of $33, the entries are:

Dr	Interest charge	$33	
Cr	Liability		$33
Dr	DTL	$10	
Cr	Income tax expense		$10

Interest capitalised into a qualifying asset

Similar errors occur when interest is being capitalised into a qualifying asset.

Example:

A qualifying asset is being constructed and costs excluding interest are $1,000 (all deductible for tax), plus $100 of capitalised interest.

The entries to capitalise the interest are:

Dr	Deferred tax expense (income statement)	$30	
Cr	DTL		$30

As the asset is amortised over ten years, entries in each year would be:

Dr	Amortisation charge	$110	
Cr	Accumulated depreciation		$110
Dr	DTL	$3	
Cr	Deferred tax expense (income statement)		$3

Capital raising costs

AASB 132 *Financial Instruments: Presentation* requires that costs directly associated with raising equity are offset against the equity raised. These costs are not usually deductable immediately but are instead deductible as 'black hole' expenses over five years.

Provided the entity is profitable, a deferred tax asset (DTA) should be recognised and the corresponding entry goes against equity.

Example:

Company A raises equity and incurs $1,000 equity raising costs which are debited to equity in accordance with AASB 132. The correct entries are as follows:

Dr	Equity	$1,000	
Cr	Cash		$1,000
Dr	DTA	$300	
Cr	Equity		$300

An additional $60 is deductible for tax purposes at the end of each year in the five year 'black hole' deduction period. The entries each year would be:

Dr	Deferred tax expense (income statement)	$60	
Cr	DTA		$60

Conclusion

Before giving final clearance on your financial statements, it is worthwhile doing a sanity check on the tax reconciliation note. Items popping up other than non-deductibles could indicate some of the failings highlighted in this article, which means that you need to revisit your deferred tax calculations to ensure all deferred tax is appropriately recognised.