CHARTA LEARNING · INTERVIEW PREPARATION

Deferred Tax and Tax Accounting

Interview preparation summary · AU track

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INT.TD.1.a · Current and deferred tax

Distinguish current tax from deferred tax, explain how temporary differences create deferred tax assets and liabilities under the balance sheet liability method, and calculate them.

The tax line in the financial statements has two parts. Current tax is the tax payable or recoverable on the taxable profit of the period, worked out on the tax computation. Deferred tax is the tax effect of temporary differences, which are differences between the carrying amount of an asset or liability in the accounts and its tax base, the amount that counts for tax. Under the balance sheet liability method used by IAS 12, and in the same spirit by US ASC 740, deferred tax is found by comparing carrying amounts with tax bases at the reporting date and applying the tax rate expected to apply when they reverse. A taxable temporary difference, such as accelerated tax depreciation, gives a deferred tax liability, because more tax will fall due later. A deductible temporary difference, such as a provision that is deductible only when paid, gives a deferred tax asset. Permanent differences, such as fines that are never deductible, create no deferred tax and change the effective rate. Together the current and deferred charges should equal the rate times accounting profit, adjusted for permanent differences. Interviewers want the two definitions, the direction of each example, and a check that the total makes sense.

WORKED EXAMPLE: HARROWGATE PLANT: CURRENT AND DEFERRED TAX FOR A YEAR

Harrowgate Plant Ltd is invented. Its profit before tax is 2,000. This includes depreciation of 500 and a fine of 40 that is never deductible. Tax allowances on the same equipment are 900, and a new warranty provision of 100 is deductible only when claims are paid. Use an illustrative 25% rate. Work out current tax, the deferred tax balances arising in the year, the total tax charge and the effective rate, and explain the result.

Answer: Current tax is 435 and deferred tax is a charge of 75 (a liability of 100 less an asset of 25), so total tax is 510, an effective rate of 25.5%, which is the statutory rate plus 10 for the fine.

> **Interview tip:** Give both definitions, then the direction of each difference. Finish by checking that the total equals the rate times profit plus the tax on permanent items.

INT.TD.1.b · Current and deferred tax

Calculate deferred tax on common items, including revaluations, fair value adjustments in a business combination and a change in tax rate, and say where each is recognised.

Deferred tax is recognised where the item that creates it is recognised. A revaluation of property or equipment recognised in other comprehensive income creates a temporary difference when the tax base does not move, and the related deferred tax is recognised in other comprehensive income as well, so the surplus is shown net of tax. In a business combination the acquirer recognises identifiable assets and liabilities at fair value. If the tax base does not rise to match, for example for a brand or technology that has no tax value, a deferred tax liability arises. It is recognised in the acquisition accounting and so increases goodwill, not the tax charge. No deferred tax is recognised on the initial recognition of goodwill itself, because the liability would increase goodwill again. When a rate change is enacted or substantively enacted, existing deferred tax balances are remeasured, and the effect goes to profit or loss unless it relates to an item recognised in other comprehensive income or equity. US GAAP follows similar principles but uses enacted rates only. Interviewers want the amount, the direction and where the entry goes.

WORKED EXAMPLE: TOLLAND ESTATES: A REVALUATION, AN ACQUISITION AND A RATE CUT

Tolland Estates plc is invented and uses an illustrative 25% rate. First, it revalues a property from 4,000 to 5,200 and the tax base stays at 4,000. Second, it buys a company for 7,500. The identifiable net assets at fair value are 5,100 before deferred tax, including technology of 1,200 with a nil tax base. Third, a cut in the rate to 20% is substantively enacted, and the opening deferred tax liability on accelerated allowances is 800 on a temporary difference of 3,200. Work out each effect and where it goes.

Answer: The revaluation surplus is 900 net of a 300 liability in OCI, goodwill is 2,700 including 300 for the deferred tax on the technology, and the rate cut gives a 160 credit to the tax charge.

> **Interview tip:** State for each item where the entry goes. The common slip is putting the acquisition deferred tax through the tax charge instead of goodwill.

INT.TD.1.c · Current and deferred tax

Assess whether a deferred tax asset is recoverable, using the IAS 12 test of probable future taxable profit and the ASC 740 valuation allowance, and say what evidence supports it.

A deferred tax asset is only worth recognising if the business will have taxable profit to use it against. Under IAS 12 an asset is recognised to the extent that it is probable that taxable profit will be available. The sources are taxable temporary differences that will reverse in the right period and in the same tax authority, forecast taxable profit excluding those reversals, and in some cases tax planning opportunities. When an entity has a recent history of losses, it needs convincing other evidence, such as signed contracts or an identified one-off cause, and a forecast alone is not enough. Under US ASC 740 the asset is recognised in full and a valuation allowance reduces it if it is more likely than not, that is, more than 50%, that some or all will not be realised, so the net asset is often the same but the presentation differs. Unused losses may also expire, and some jurisdictions restrict how much profit they can offset. Evidence should weigh heavily on what is objective and be reviewed each year. Interviewers want a clear test, the evidence ranked by strength, and the effect on the tax charge when an asset is recognised or written off.

WORKED EXAMPLE: REDFERN COMPONENTS: HOW MUCH OF A LOSS ASSET TO RECOGNISE

Redfern Components Ltd is invented and has unused tax losses of 900 and a history of losses. At an illustrative 25% rate the gross asset is 225. It has taxable temporary differences of 150 that will reverse while the losses are available. Signed contracts support taxable profit of 120 in year 1 and 190 in year 2, before those reversals. There is no reliable evidence beyond year 2. How much should it recognise under IAS 12 and under ASC 740?

Answer: Recognise 115 under IAS 12, or 225 less a valuation allowance of 110 under ASC 740, with 110 unrecognised. Recognition would credit 115 to the tax charge.

> **Interview tip:** Say that the same judgement is expressed differently: unrecognised under IAS 12, allowance under ASC 740. Name the evidence you would want and say that history of losses raises the bar.

INT.TD.2.a · The tax charge

Prepare and explain an effective tax rate reconciliation, and say which reconciling items are likely to recur.

The effective tax rate is the total tax charge divided by profit before tax. The reconciliation starts from profit before tax multiplied by the statutory rate, the expected charge, and lists the items that move it to the reported charge. Items that raise the rate include expenses that are not deductible, profits in higher-tax countries, losses with no deferred tax asset recognised and under-provisions for earlier years. Items that lower it include profits taxed at lower rates abroad, income that is exempt, enhanced deductions or credits such as R&D relief, recognition of previously unrecognised deferred tax assets, release of provisions on settled audits, and the effect of a rate cut on deferred tax. Both IAS 12 and ASC 740 require this reconciliation or an explanation of the relationship between tax expense and accounting profit. Readers use it to judge what is permanent and what is one-off. Prior-year items, asset recognition and provision releases tend not to recur, so the underlying rate can differ a lot from the reported one. Interviewers want the build-up, the check that it adds up, and a view on what will recur.

WORKED EXAMPLE: COLDWATER FOODS: RECONCILING THE TAX CHARGE

Coldwater Foods plc is invented, with profit before tax of 2,000 and an illustrative 25% statutory rate. It has non-deductible expenses of 120, overseas profits of 400 taxed at 15%, tax-exempt dividend income of 100, an enhanced R&D deduction of 80, an under-provision of 15 from the prior year, and current-year losses of 60 in a subsidiary on which no deferred tax asset is recognised. Prepare the reconciliation and the effective rate, and say which items are likely to recur.

Answer: The reported tax charge is 475, an effective rate of 23.75%, below the 25% statutory rate mainly because of overseas profits, dividends and R&D relief.

Interview tip: List the items in two groups, up and down, and tick which are permanent. Always say the reconciliation must add up to the reported charge.

INT.TD.2.b · The tax charge

Explain how uncertain tax positions are recognised and measured in outline under IFRIC 23 and under ASC 740, and compare the two approaches.

An uncertain tax position is a treatment in a tax return that the tax authority might not accept. Under IFRIC 23, which applies to income taxes under IAS 12, the entity assumes the authority will examine the treatment and has full knowledge of all relevant information. If it is probable that the treatment will be accepted, the entity accounts consistently with its filing. If not, it reflects the uncertainty using whichever method predicts the outcome better: the most likely amount, or the expected value, which is the sum of the possible outcomes weighted by their probabilities. Under US ASC 740-10 there are two steps. First, a position is recognised only if it is more likely than not to be sustained on its technical merits. Second, the benefit is measured at the largest amount that is more than 50% likely to be realised on settlement, which is judged by cumulative probabilities. The difference is the liability, with interest and penalties shown according to the entity's policy. Positions are reassessed when new information arrives, such as an audit result or a court decision, and the change goes through the tax charge. The detail is complex and differs, so an interviewer expects the outline, not the full rules.

WORKED EXAMPLE: RAVENSMOOR TRADING: A DISPUTED DEDUCTION

Ravensmoor Trading Ltd is invented. It claims a deduction whose tax benefit is 600 at an illustrative 25% rate. It judges the possible outcomes on settlement: the full deduction is allowed, benefit 600, 30% likely; half is allowed, benefit 300, 50% likely; none is allowed, 20% likely. Work out the liability under IFRIC 23 using each method and the unrecognised benefit under ASC 740.

Answer: IFRIC 23 liability is 270 on expected value or 300 on the most likely amount, and the ASC 740 unrecognised benefit is 300.

Interview tip: Name the two steps of ASC 740 and the two methods of IFRIC 23. Say that the liability is the claimed benefit less the amount recognised.

INT.TD.2.c · The tax charge

Explain how an auditor and a tax adviser each look at the tax charge, and how an auditor tests the charge, the balances and the effective tax rate.

The tax adviser and the auditor look at the same numbers for different reasons. The adviser helps the company compute and file its tax and plan its affairs, and often supports the tax provision, the current and deferred tax in the accounts. The auditor forms an opinion on whether the tax charge and the current and deferred tax balances are fairly stated, and does not prepare them. Tax is a judgemental area, so auditors usually involve tax specialists. They test the current tax computation to the accounts and the return, the deferred tax calculation by comparing carrying amounts and tax bases, the recoverability of deferred tax assets against forecasts and history, uncertain tax positions and the reasonableness of the effective rate against expectation. An unexplained difference in the reconciliation is a flag, for example a deferred tax asset recognised on losses that is not supported. Because tax adjustments often increase profit, the auditor watches for management bias. Independence rules restrict some tax services to audit clients, especially public interest entities. Interviewers want the two roles kept distinct and a sensible approach to testing.

WORKED EXAMPLE: TESSEL GROUP: AN ANALYTICAL REVIEW OF THE TAX CHARGE

Tessel Group plc is invented. The audit team expects a tax charge of 25% of profit before tax of 6,000. The reported charge is 1,210. The documented reconciling items are overseas profits at lower rates (100 lower), R&D relief (80 lower), non-deductible expenses (60 higher) and a release of a prior-year provision (50 lower). What difference is unexplained, and what would the auditor and the adviser each do?

Answer: The reported charge of 1,210 is 120 lower than the documented reconciliation supports. The auditor should test its cause, which could be an unsupported deferred tax asset.

Interview tip: Keep the roles clear: the auditor tests and concludes, the adviser computes and advises. Always quantify the unexplained difference.

Summary of the Charta interview-preparation topic. Companies and figures in the examples are invented. Draft content, not yet expert reviewed.