Australian Accounting Standard **AAS 3**
November 1989

Accounting for Income Tax (Tax-effect Accounting)

Prepared by the **Public Sector Accounting Standards Board** of the **Australian Accounting Research Foundation** and by the **Accounting Standards Review Board**

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AUSTRALIAN ACCOUNTING STANDARD

AAS 3 "ACCOUNTING FOR INCOME TAX (TAX-EFFECT ACCOUNTING)"

Citation

1 This Standard may be cited as Australian Accounting Standard AAS3 "Accounting for Income Taxes (Tax-effect Accounting)".

Accounting Standards and Commentary

2 The accounting standards set out in this Standard are shown in bold print. Commentary is shown in normal print immediately after the accounting standard(s) to which it relates, as an aid to the interpretation of the accounting standard(s).

Application and Operative Date

STANDARDS

3 **This Standard applies to each non-corporate reporting entity in the private sector and each business undertaking in the public sector in relation to the first reporting period that ends on or after 31 December 1989, and in relation to subsequent reporting periods. This Standard supersedes Australian Accounting Standard AAS 3 "Accounting for Company Income Tax (Tax-effect Accounting) as issued in July 1976 and amended to September 1978.**

Statement of Purpose

STANDARDS

4 **The purpose of this Standard is:**

(a) to specify the method for determining income tax expense, provision for income tax, provision for deferred income tax and future income tax benefit; and

(b) to require disclosure in the financial report of information in relation to income tax expense, provision for income tax, provision for deferred income tax and future income tax benefit;

so that the financial report provides information on the impact of any applicable tax on the income of non-corporate reporting

entities that is useful to users for making and evaluating decisions on the allocation of scarce resources.

COMMENTARY

5 Many non-corporate reporting entities are subject to various forms of income tax. For example, trusts and superannuation plans are subject to income tax under the Australian Income Tax Assessment Act 1936 and some government business undertakings are subject to income tax under their own enabling legislation.

Application of Materiality

STANDARDS

6 **The accounting standards set out in this Standard shall, in accordance with Australian Accounting Standard AAS 5 "Materiality in Financial Statements", apply to general purpose financial reports where such application is of material consequence.**

COMMENTARY

7 In deciding whether an item is material, its nature and amount usually need to be evaluated together.

Definitions

STANDARDS

8 For the purposes of this Standard:

"future income tax benefit" means the estimated amount of future saving in income tax likely to arise as a result of:

(a) the reversal of timing differences; and

(b) the recoupment of carried forward tax losses (which for the purposes of this Standard are dealt with separately from other timing differences);

"income tax expense" means the amount of income tax which would be payable on the pre-tax accounting profit adjusted for permanent differences. The term "income tax benefit" is used to describe this amount where it is a net credit;

"income tax payable" means the amount of income tax calculated on the taxable income of a reporting entity for the reporting period;

"permanent differences" means differences between taxable income or tax loss and pre-tax accounting result/profit or loss arising from the existence of:

(a) particular expenses and particular items of revenue, which, under current income tax legislation, will never be included in the determination of taxable income or tax loss although they are recognised in the profit and loss or other operating statement; and

(b) particular amounts which are allowable deductions or which are assessable income for income tax purposes although these amounts will never be recognised in the profit and loss or other operating statement;

"pre-tax accounting result/profit or loss" means the aggregate of the operating result/profit or loss and the extraordinary items for a given reporting period before charging the related income tax expense or before crediting the related future income tax benefit;

"provision for deferred income tax" means the non-current liability for the estimated amount of income tax expected to be assessed in the future as a result of the reversal of timing differences;

"provision for income tax" means the current liability for the estimated amount of income tax which is assessable on the taxable income of the reporting entity for the current and prior reporting periods (to the extent that such tax has not been already paid);

"taxable income" means the excess of assessable income over allowable deductions calculated according to the provisions of the applicable income tax legislation ("tax loss" means the converse); and

"timing differences" means differences between pre-tax accounting result/profit or loss and taxable income or tax loss for a given reporting period which arise because the reporting period in which some items of revenue and expense are included in the determination of the pre-tax accounting result/profit or loss does not coincide with the reporting period in which they are included in the determination of taxable income or tax loss.

COMMENTARY

9 Each timing difference originates in one reporting period and is reversed, or "turns around", in one or more subsequent reporting periods.

Determination of Income Tax Expense, Provision for Deferred Income Tax and Future Income Tax Benefit and the Liability Method

STANDARDS

10 **The amount of the income tax expense attributable to the transactions included in the profit and loss or other operating statement for a reporting period shall be recognised in that profit and loss or other operating statement irrespective of whether the income tax is currently payable, or has already been paid, or will become payable in the future. The amount of such income tax expense shall be calculated on the pre-tax accounting result/profit or loss, adjusted for permanent differences (if any), by using the liability method of tax-effect accounting. A note in the financial report shall state the general nature of permanent differences and the extent to which they have affected the amount of income tax expense.**

11 **If in respect of a reporting period the income tax payable differs from the income tax expense, the amount of the difference:**

(a) **shall be recognised and disclosed as a liability, described as "provision for deferred income tax", to the extent that the difference arises from timing differences caused by the present deductibility for tax purposes of expenses deferred for accounting purposes and/or the present non-assessability for tax purposes of revenue included in the determination of pre-tax accounting result/profit or loss; and**

(b) **shall, subject to the provisions of paragraphs 18 and 19, be recognised and disclosed as an asset, described as**

"future income tax benefit", to the extent that the difference arises from timing differences caused by the present non-deductibility for tax purposes of expenses included in the determination of the pre-tax accounting result/profit or loss and/or the current assessability for tax purposes of revenue items deferred for accounting purposes.

COMMENTARY

12 The amount of tax levied against an entity is based upon its taxable income or tax loss which will often differ in amount from its pre-tax accounting result/profit or loss because of permanent and timing differences.

Permanent differences

13 Permanent differences alter the incidence of income tax in relation to the pre-tax accounting result/profit or loss of the reporting period in which they occur, but do not affect income tax calculations in respect of subsequent reporting periods. An example of an item creating a permanent difference under present income tax legislation is non-allowable depreciation on buildings.

Timing differences

14 Timing differences will result in the amount of income tax expense being either greater or less than the income tax payable for the reporting periods in which the differences originate and then reverse. Four sets of circumstances give rise to timing differences:

(a) items of revenue included in the determination of pre-tax accounting result/profit or loss before they are included in taxable income or tax loss, for example, gross profits on instalment sales recognised for accounting purposes in the reporting period of sale but assessable for tax purposes in the reporting periods during which the instalments are collected;

(b) expenses deducted in determining taxable income or tax loss before they are deducted in the determination of pre-tax accounting result/profit or loss, for example, research and development costs deducted for tax purposes as incurred but carried forward in the financial report to be charged against future revenue;

(c) items of revenue included in taxable income or tax loss before they are included in the determination of pre-tax accounting result/profit or loss, for example, rents or insurance premiums collected in advance and reported for tax purposes in the reporting period in which they are received but deferred for accounting purposes until later reporting periods when they are recognised as being earned; and

(d) expenses deducted in the determination of pre-tax accounting result/profit or loss before they are deducted in the determination of taxable income or tax loss, for example, provisions for guarantees and product warranties, or provision for long service leave made for accounting purposes on an estimated basis in the reporting period in which the related revenue is recognised, but only allowed for tax purposes in later reporting periods when payment is made or when the liability becomes certain.

15 The liability method (sometimes referred to as the accrual method) is based on the assumption that a provision for deferred income tax arises whenever:

(a) an item of revenue is recognised in the determination of pre-tax accounting result/profit or loss before it is included in taxable income or tax loss; or

(b) an expense is deducted in calculating taxable income or tax loss before it is recognised in the determination of pre-tax accounting result/profit or loss;

and conversely, that an asset in the nature of a future income tax benefit arises whenever:

(c) an item of revenue is included in taxable income or tax loss before it is recognised in the determination of pre-tax accounting result/profit or loss; or

(d) an expense is recognised in the determination of pre-tax accounting result/profit or loss before it is deducted in calculating taxable income or tax loss.

16 The estimated amounts of this liability and this asset are determined by calculating the difference between income tax expense and income tax payable, using the tax rate or rates that are expected to apply when the underlying timing differences reverse. The estimates are later amended if the expected tax rates change or new taxes are imposed.

17 The adoption of the liability method thus results in income tax expense being accrued in the same way as any other expense. Where timing differences have the effect of postponing the payment of tax, the liability method results in both the matching of expense with revenue and the recognition of the liability for income taxes payable in the future. Timing differences which result in the

prepayment of income tax are also recognised as assets in order to avoid overstating expenses in the reporting periods in which the timing differences originate, and understating expenses in the reporting periods in which these differences reverse.

18 Financial reports prepared using the liability method of tax-effect accounting will at all times show any provision for deferred income tax and any future income tax benefit at the tax rates that, at the time the financial report is prepared, are expected to apply when the underlying timing differences reverse. On this basis, provision for deferred income tax and future income tax benefits are generally measured using the current rate of income tax. However, when it is known that a different rate of tax will apply by the time particular timing differences are expected to reverse, the relevant provision for deferred income tax and future income tax benefits are measured using that different rate. An announcement by the Federal Treasurer or other relevant authority of the intention to change the rate of income tax to another specified rate is normally accepted as adequate evidence that a change to that rate will occur.

Conditions for Carrying Forward Future Income Tax Benefits and Provision for Deferred Income Tax

STANDARDS

19 **A future income tax benefit referred to in paragraph 10 shall only be carried forward as an asset where realisation of the benefit can be regarded as being assured beyond any reasonable doubt. Realisation shall depend upon:**

(a) the ability of the reporting entity to derive future assessable income of a nature and of sufficient amount to enable the benefit to be realised;

(b) the ability of the reporting entity to continue to comply with the conditions for deductibility imposed by law; and

(c) an expectation that legislation will not change in a manner which would adversely affect the reporting entity's ability to realise the benefit.

20 **In the case of companies which incur losses, any future income tax benefit shall not be recognised as an asset unless realisation of the benefit is virtually certain. Where any part of a future income tax benefit carried forward as an asset is attributable to tax losses, that part shall be separately disclosed by way of note in the financial report.**

21 **Where a provision for deferred income tax exists and a reporting entity incurs a tax loss, the future income tax benefit attributable to the tax loss shall be recognised as a reduction of the provision for deferred income tax to the extent that deferred income tax has already been provided in respect of timing differences which will reverse within the reporting periods during which the tax loss will remain available as a deduction from assessable income. The amount representing the reduction in the provision shall be shown in the financial report by way of note or otherwise and described as "provision for deferred income tax no longer required". The extent to which the provision for deferred income tax is reduced by future income tax benefits attributable to tax losses shall be separately disclosed by way of note in the financial report of each reporting period while the losses remain available as a deduction.**

22 **To the extent that a future income tax benefit attributable to tax losses has not been recognised as an asset or as a reduction in a provision for deferred income tax and there is a possibility that the tax losses will be recouped in accordance with tax legislation, the future income tax benefit expected to arise from the recoupment shall be shown by way of a note in the financial report. The note shall state that the benefit will only be obtained if:**

(a) the reporting entity derives future assessable income of a nature and of an amount sufficient to enable the benefit from the deductions for the loss to be realised;

(b) the reporting entity continues to comply with the conditions for deductibility imposed by tax legislation; and

(c) no changes in tax legislation adversely affect the reporting entity in realising the benefit from the deductions for the loss.

23 **In any reporting period in which past income tax losses are recouped, the income tax expense for that reporting period, determined in accordance with paragraph 10 above, shall be recognised in the profit and loss or other operating statement in the normal way, and:**

(a) to the extent that the future income tax benefit attributable to such losses has not been recognised (or if it had been recognised and subsequently reversed) - the tax benefit derived from the recoupment of those losses

shall be included in the profit and loss or other operating statement;

(b) **if a future income tax benefit had been previously recognised in relation to tax losses - that future income tax benefit shall be reduced by the amount of the realised tax benefit; or**

(c) **if a provision for deferred income tax had been previously reduced or eliminated - the excess of the income tax expense (less the amounts, if any, already dealt with under paragraphs (a) and (b) above) over the income tax currently payable shall be added to the provision for deferred income tax so that when the past tax losses are recouped and income tax becomes payable the provision will be sufficient to cover the income tax which becomes payable as the related timing differences reverse.**

24 **Where differences arise between the amount of the income tax payable in respect of a reporting period and the income tax expense for the same reporting period, and some or all of the differences arise because of reversals of timing differences recognised in prior reporting periods, the differences attributable to such reversals shall be adjusted against the balance shown in the future income tax benefit account, or provision for deferred income tax account. At each reporting date a transfer shall be made from the provision for deferred income tax to the provision for income tax of any portion of the first-mentioned provision which has become a current liability as a result of the reversal of timing differences.**

25 **Subject to paragraph 31, a provision for deferred income tax shall be offset against future income tax benefit recognised, to the extent that income tax covered by the provision is likely to become payable in the same reporting periods as the future income tax benefit is expected to become realisable.**

COMMENTARY

26 Tax-effect accounting procedures can be expected to give rise to provision for deferred income tax in respect of timing differences and future income tax benefits in respect of both timing differences and tax losses. Whilst there would appear to be no reason to question the recognition of provision for deferred income tax attributable to timing differences and the carrying forward of such a provision under tax-effect accounting procedures, it would appear to be necessary and appropriate to examine the asset which arises on the application of tax-effect accounting procedures to determine

whether or not in all cases it is appropriate to carry forward such an asset to future reporting periods.

27 Accounting principles normally require a write-down of assets where they are not expected to realise their carrying amounts. In accordance with these principles, future income tax benefits carried forward as assets are examined to determine whether realisation of the related benefit is assured beyond any reasonable doubt. In considering this matter it should be noted that realisation will take the form of a charge against future pre-tax accounting result/profit or loss and therefore the ability of a reporting entity to earn adequate profits and taxable income in future reporting periods must be assured beyond any reasonable doubt if future income tax benefits are to be recognised as assets. A determination as to the ability of a reporting entity to earn a sufficient level of profits in future reporting periods will be influenced by whether or not a reporting entity has a history of profitable operations and is currently profitable.

28 Where a reporting entity incurs a tax loss, significant doubts must arise as to the ability of such a reporting entity to realise the related future income tax benefit and in these circumstances it is considered that it would be imprudent to recognise as an asset the future income tax benefit attributable to the tax loss unless realisation of the benefit is virtually certain. It is considered that this test of virtual certainty will only be met in rare and exceptional cases. However, where a reporting entity incurs a tax loss, realisation of the future income tax benefit can, to some extent, be regarded as virtually certain where there is already in existence as a liability, a provision for deferred income tax. The extent to which realisation can be regarded as virtually certain is the extent to which deferred income tax has already been provided in respect of timing differences which will reverse in the reporting periods during which the tax loss will remain available as a deduction. In these circumstances, when a loss is incurred, the benefit of the tax loss arising therefrom can be treated as effectively realised (and can be recognised in the form of a reduction in the provision for deferred income tax) on the basis that the tax provided as a cover against the future reversal of timing differences will not become payable whilst the tax loss remains unrecouped and available as a deduction from future assessable income.

29 Since it is not appropriate to draw a distinction between:

(a) the ability of a reporting entity which incurs a loss to realise the future income tax benefit attributable to the loss; and

(b) the ability of such a reporting entity to realise a future income tax benefit attributable to timing differences;

it would be appropriate in the case of such a reporting entity to apply the same test of virtual certainty as to realisation in determining whether the reporting entity should recognise as an asset any future income tax benefit, whether the benefit is attributable to current or past timing differences or to tax losses.

30 Where a reporting entity which incurs a tax loss has either not recognised a future income tax benefit attributable to that loss or has written off future income tax benefits brought forward in relation to timing differences, there would be no reason to preclude such a reporting entity from recording such benefits as assets in a later reporting period should it return to profitable operations and meet the requirement as to virtual certainty of realisation.

Consolidated Financial Reports

STANDARDS

31 **A future income tax benefit recognised by one reporting entity in a consolidated group of entities shall not be offset against a provision for deferred income tax recognised by another reporting entity in the consolidated group of entities, when drawing up a consolidated financial report.**

Taxes on Distribution of Profits and Reserves

STANDARDS

32 **Where a financial report includes profits and reserves of branch operations or subsidiaries which, on distribution to the reporting entity, will be subject to overseas withholding tax or to further Australian income tax, the reduction which this future tax will impose on the amount ultimately available to the reporting entity shall be recognised as provision for deferred income tax in the financial report unless there is evidence that the reporting entity or parent entity intends to leave those profits and reserves indefinitely in the hands of the branch operations or subsidiaries.**

Changes in Income Tax Rates

STANDARDS

33 **Whenever there is a change in the income tax rate, either or both of the provision for deferred income tax and the future**

income tax benefit brought forward from the previous reporting period shall be adjusted accordingly. The corresponding amount recognised in the profit and loss or other operating statement shall be disclosed.

Transitional Provision

STANDARDS

34 **Where the accounting treatments required by this Standard are not already being applied at the date this Standard is first applied they shall be applied retrospectively. Where this gives rise to initial adjustments, the net amount of these adjustments shall, in accordance with paragraph 10 of Australian Accounting Standard AAS 1 "Profit and Loss or other Operating Statements", be adjusted against retained profits or accumulated losses at the beginning of the reporting period in which this Standard is first applied.**

Revaluations and Disposals of Depreciable Assets

COMMENTARY

35 Where a revaluation of an asset which is depreciable for income tax purposes has resulted in an increase in the amount at which that asset is carried in the financial report, this increase is depreciated over the remaining useful life of the asset. As the additional depreciation charge is not an allowable deduction for income tax purposes, the revaluation results in a permanent difference in subsequent reporting periods between pre-tax accounting result/profit or loss and taxable income or tax loss which is taken into account in determining the amount of income tax expense.

36 Where the amount received on the disposal of a depreciable asset exceeds its depreciated value, a liability for income tax may arise in respect of all or part of the excess. Where an election is made under sub-section 59(2A) of the Income Tax Assessment Act 1936 or other relevant legislation to reduce the cost, for the purpose of calculating depreciation allowable under this Act or other relevant legislation, of other units of property by the assessable portion of the excess, that amount is treated as a timing difference.

Interim Financial Reports

COMMENTARY

37 The calculation of the income tax expense to be shown in interim financial reports is based on the tax rate expected to be applicable for the full reporting period, and reflects the incidence of any permanent differences and timing differences which have been caused by transactions or events during the period covered by the interim financial reports.

COMPATIBILITY WITH INTERNATIONAL ACCOUNTING STANDARD IAS 12

The accounting standards set out in this Standard are consistent with those set out in IAS 12 "Accounting for Taxes on Income".