



Financial Accounting and Tax Principles

Richie Owens explains why a thorough understanding of the income tax expense – and the related liability on the balance sheet – is a must for paper P7 candidates.

The calculation of a company's income tax expense is a core topic on the P7 syllabus. Identifying a deferred tax movement in order to calculate an income tax expense has featured regularly in past exams as an objective test question in section A. More complex calculations including previous under- or over-provisions and deferred tax movements have been included in five-mark questions in section B. Questions in section C have also invariably incorporated a tax adjustment of some sort: the tax expense in the income statement and the period-end creditor are usually required in a question on published accounts, while the fact that a deferred tax movement has no effect on cash is highly examinable, too.

There are three elements to the income tax expense: a current charge for the period; an under- or over-provision from prior periods; and a deferred tax movement. Typically, candidates struggle most with the deferred tax movement, but it is vital to get the maximum marks on offer for the other two elements as well.

The current charge is often given in the question, but you may sometimes be required to calculate a figure for it. This could involve adjusting profit before tax for items that are allowed or disallowed in the tax computation. A typical example would be depreciation. Most tax regimes disallow depreciation owing to its subjective nature and replace it with tax-allowable depreciation.

Under- / over-provisions often need calculating in a company accounts question. Last period's actual tax paid is likely to have been different from the estimated charge that went through the income statement. The difference needs to be included in this period's tax charge, either as an extra charge (if the tax paid was higher than the charge to the last period's income statement) or as a reduction (if the tax paid was lower). This ensures that the whole tax bill hits retained profits at some point. As an example, say that last year's income statement included a current tax charge of £1.2m. If the tax paid was £1.5m, an extra charge of £300,000 must be put on this year's income statement. This would be shown in the tax note as an "under provision" from the previous year, and it would increase this year's tax charge.

The last element of the income statement charge comes from the movement in deferred tax. IAS12 deals with the calculation and the golden rule to remember is that the standard focuses on the balance sheet. This means calculating the correct provision on the balance sheet and taking the movement on the period to the income statement.

In a company accounts question, the brought forward provision will typically be given (often in a trial balance) and the carry forward will need calculating. The provision to carry forward then sits on the balance sheet in non-current liabilities, while the increase or decrease goes to the income tax expense in the income statement.

This should look strikingly familiar to those candidates who remember doubtful debt provisions from the certificate level Financial Accounting Fundamentals paper, since it really is no different. An increase in a provision is a credit to the balance sheet, so the equal and opposite effect is a debit. This gives the charge to the income statement. It follows that a fall in the provision – a debit – would lead to a reduction in tax expense – a credit – in the income statement.

A fundamental understanding of the principles is always helpful when trying to decide the effects of any movement. To calculate the provision, identify the temporary differences at the period end.

These are the differences between the tax base of an item and the carrying value in the accounts.

Take an item of property, plant and equipment as an example. If an asset that cost £1,000 has been depreciated by £200, it has a carrying (net book) value of £800. A deduction of £200 has been made from accounting profits via depreciation. But let's say the tax jurisdiction has calculated the tax-allowable depreciation as £250. This means that £250 has been deducted from the taxable profits and the tax base is now £750. The difference of £50 (£800 – £750) is a temporary one. This is because it will disappear to zero over time. The tax jurisdiction will eventually allow the whole £1,000 through the tax computation and the accounts will do likewise. The carrying value and tax base will, therefore, eventually both be zero.



Ask yourself another question: is a movement in deferred tax a cash flow? Hopefully, your answer will be "no"



The provision on the balance sheet can then be calculated as the difference (£50) multiplied by the underlying tax rate, which will be provided in the question. For a given tax rate of 30 per cent, the provision here would be £15. This is because we have an obligation to pay more tax in the future. The accounts are still to deduct £800 in future periods, whereas the tax computation will deduct only £750. That means £50 more of taxable income than the accounts show, taxed at the underlying tax rate.

So in the exam you should take the following approach:

- Calculate the temporary differences by comparing the tax value and the accounting value.
- Provide for this temporary difference at the underlying tax rate on the closing balance sheet.
- Compare the closing provision with the opening provision from last year's balance sheet and take the movement to the income statement.

As a general rule, this approach applies not only to the difference between depreciation and tax-allowable depreciation but also to any item that will affect the expected tax bill in future. Take tax losses, for example. It is common for tax jurisdictions to allow losses to be carried forward and set against future taxable profits. This offset will not happen in the accounts, so we have the benefit of paying less tax than we'd expect to in future. In this example we actually have a deferred tax asset – a debit on the balance sheet. But, in line with the recognition criteria in the international framework, we need to be careful before we recognise the asset. Before recognising any asset, we must ensure that it is probable. In this case we need to make sure that we'll have profits that we can offset in the future. Otherwise, the losses are worthless.

A familiarity with the international framework will come in extremely useful in the P7 exam. All international standards apply its fundamental concepts and look to produce information with its desired characteristics. A useful way of revising it for this paper is to try to apply it to each standard as you cover it. IAS12 is no exception. Do you think that the deferred tax balance helps the "understandability" of the accounts? Would the tax charge be "relevant" if it didn't include a deferred tax adjustment? Remember that the framework is part of the syllabus and the most likely exam question on it will require you to link it into one or more standards.

A deferred tax adjustment is likely to feature in a question on cash flow, so considering such an adjustment is a good way to test your understanding of IAS12. The tax paid in the period handily goes into the "tax paid" line of the cash flow statement.

1 PARTIAL FINANCIAL STATEMENTS

	2005	2006
Balance sheet	£000	£000
Tax payable	50	60
Deferred tax provision	7	11
Income statement		
Income taxation expense		30

The key to getting it right is to remember that it's tax paid, not payable, so the figure you put in there must be purest cash.

Ask yourself another question: is a movement in deferred tax a cash flow? Hopefully, your answer will be "no". Again, remembering the double entry will help you here. A deferred tax charge comes from an increase in the provision, so it's credit the provision and debit the income statement. There's no cash movement in sight. If it's a deferred tax credit, it's credit the income statement and debit the provision – still no cash. Thinking of the double entry in this way will help with any movement you're thinking of putting through the cash flow.

All of this means that you'll have to strip out the deferred tax movement from the income statement before taking the figure anywhere near the cash flow. As an example, consider the partial financial statements in panel 1, above. The starting point for dealing with this situation is the figure from the income statement: a charge of £30,000. But this is accruals-based, so

P7 Recommended reading

- T Rolfe, *Financial Accounting and Tax Principles Learning System* (2007 edition), CIMA Publishing, 2006.
- D Alexander, A Britton and A Jorissen, *International Financial Reporting and Analysis*, Thomson Learning, 2003.
- S James and C Nobes, *The Economics of Taxation*, Pearson Education, 2000.
- D Chitty, *IFRS Model Financial Statements*, ABG Professional Information, 2004.
- B Mackenzie, *International Accounting Standards: A Guide to Preparing Accounts* (third edition), ABG Professional Information, 2001.
- E McLaney, *Business Finance – Theory and Practice* (fourth edition), Pitman Publishing, 1994.



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first of all you need to strip out the effect of the movement in the tax payable.

We owed £50,000 at the start of the period and another £30,000 for the period, making a total of £80,000, but we still owe £60,000 at the period end. This suggests a payment of £20,000, but we must also adjust for deferred tax. Although our income statement shows a charge of £30,000, not all of that was actually a tax bill. Some of it was simply a movement in deferred tax, which is not cash. In this case it must be a charge of £4,000: the movement in the provision from £7,000 brought forward to £11,000 carried forward. So our true tax bill was only £26,000 – ie, the charge shown less the non-cash deferred tax charge.

In fact we can calculate the tax actually paid as the brought forward tax payable of £50,000 plus the actual tax bill for the period of £26,000, giving a total of £76,000, less the £60,000 we still owe at the period end: a cash payment of £16,000.

As a short cut, you can reach the same answer by simply including the deferred tax provision brought forward and carried forward along with your tax payable, and then calculating using the full tax charge from the income statement. In this case, brought forward in total would be £57,000. Adding the full charge for the period of £30,000 gives £87,000. Subtracting the carry forward combined total of £71,000 again leaves a cash paid figure of £16,000.

The key to understanding IAS12 is to grasp the fundamentals behind each element of the tax charge, particularly the deferred tax, and then apply them by practising examples like the one above. The deeper your understanding, the easier it will be to pick the right figures in any type of question. Then you will be able to apply the short cuts. **FM**

Richie Owens is a senior CIMA tutor at FTC Kaplan.

■ The CIMA certificate in business accounting: new 2006 syllabus

This is an entry requirement for the CIMA professional qualification and a recognised qualification in its own right.

The institute launched the new certificate syllabus at its lecturers' conference in March 2006. It has revised and refreshed all five subjects and introduced new content on ethics and corporate governance. By introducing ethics at this level, CIMA has signalled the importance it places on the subject in the daily work of a professionally qualified management accountant.

Certificate assessments based on the new 2006 syllabus have been available concurrently with assessments based on the old 2000 syllabus at CIMA-approved assessment centres since October 2, 2006. But from March 2 the only assessments available will be those based on the new syllabus.

Each of the five assessments under the 2006 syllabus lasts two hours. The pass mark for each is 50 per cent. You will receive your results and a certificate of achievement immediately afterwards. If you are unsuccessful, you will receive some feedback on your performance.

The full syllabus for the new certificate subjects are available to download from www.cimaglobal.com/certificate2006.

If you passed any of the assessments, or were awarded exemptions, from the 2000 syllabus before March 2, 2007, you will be given credits for subjects within the 2006 syllabus (*see panel below*).

Study guides are available to identify similarities and differences between the 2000 and 2006 syllabus subjects. If you have been studying a 2000 syllabus subject and have transferred over to one of the new subjects, we recommend that you look at the relevant study guide and the new syllabus to ensure that you have no gaps in your knowledge before sitting the assessment.

Recommended reading lists and suggested study routes for the new syllabus subjects are also available at www.cimaglobal.com/studyresources.

■ May 2007 exam entry for the professional qualification

May's exams will be held on Tuesday 22, Wednesday 23 and Thursday 24.

Online entry for these exams has been available at www.cimaglobal.com/examentry since February 1. The standard

OLD AND NEW CERTIFICATE SYLLABUSES COMPARED

2000 subjects

- C1 Management Accounting Fundamentals
- C2 Financial Accounting Fundamentals
- C3 Business Mathematics
- C4 Economics for Business
- C5 Business Law

2006 subjects

- C01 Fundamentals of Management Accounting
- C02 Fundamentals of Financial Accounting
- C03 Fundamentals of Business Mathematics
- C04 Fundamentals of Business Economics
- C05 Fundamentals of Ethics, Corporate Governance and Business Law