

▷ Hong Kong GAAP

Accounting for Income Taxes

A Guide to SSAP 12 (Revised)

Deloitte
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Accounting for Income Taxes

A Guide to SSAP 12 (Revised)

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1 INTRODUCTION

Welcome to Deloitte Touche Tohmatsu's latest guide to Hong Kong GAAP *Accounting for Income Taxes*. This guide has been written with the objective of making life easier for preparers and auditors of financial statements, and financial analysts - indeed, anyone who wants to have a good grasp of the revised SSAP 12 *Income Taxes*, which is effective for accounting periods beginning on or after 1 January 2003.

In adopting the revised Standard, the Hong Kong Society of Accountants (HKSA) has followed its policy of convergence with International Financial Reporting Standards (IFRS). SSAP 12 is generally consistent with the equivalent IFRS, IAS 12. Some divergence in practice is likely to emerge, however, because the HKSA has arrived at a 'Hong Kong solution for a Hong Kong problem' in relation to the deferred tax implications of revaluations of investment properties (see paragraph 6.4.14 for details). In addition, with a view to easing the process of implementation, the HKSA has included significant additional implementation guidance within the body of the Standard.

SSAP 12 covers both current and deferred taxes. While the introduction of recognition and measurement rules for current tax assets and liabilities merely codifies existing accounting practice, readers will find the requirements of the revised Standard in respect of deferred tax to be challenging - new concepts, new terminology and new methodologies have been introduced, and will need to be understood and applied. New information will need to be gathered, and people will need to be trained.

The conceptual base of tax-effect accounting in the revised Standard differs significantly from its predecessor. It adopts a comprehensive balance sheet approach - focussing on temporary differences between the accounting and tax bases of assets and liabilities. Under this approach, deferred tax balances recognised in the balance sheet are likely to increase, because many items will be tax-effected for the first time. For example, revaluations, investments in equity-accounted entities, and business combinations may give rise to deferred tax balances. In addition, the recognition threshold for deferred tax assets is lower under the revised Standard.

In the first year of implementation of the revised SSAP 12, the tax implications of all balance sheet items will require careful analysis. The move to full provisioning, rather than the previous Standard's approach of partial provisioning, will also lead to deferred tax becoming a far more significant component of the balance sheet. Particular difficulties may arise in respect of past acquisitions, where deferred tax balances will need to be recognised and goodwill amounts adjusted retrospectively. In addition, the expanded disclosure requirements will mean that more information will be available to competitors, customers and investors about an enterprise's tax position.

The revised Standard is complex, and we have attempted in this guide to approach the subject from a practical perspective - illustrating the underlying principles with numerous examples, and focussing on issues that are likely to be of most concern in Hong Kong and elsewhere in the People's Republic of China. However, we also include discussion of taxation features that are common in other jurisdictions. Hong Kong based enterprises with overseas operations will need to understand the features of the tax regimes in which their investees operate, in order to arrive at a comprehensive picture of the group's deferred tax position.

Deferred tax has never been an easy subject. The new Standard is certainly not going to make it any easier. Until experience has been gained of its application in practice, specifically in a Hong Kong and PRC context, it is impossible to predict all of the issues that will arise. However, in this book we have attempted to anticipate the issues that will be of most concern and to give realistic guidance. We trust that it will prove a useful source of reference for readers in facing the challenge that is SSAP 12 *Income Taxes*.

Looking to the future, readers may be aware that the IASB is currently in the process of revising IAS 12. Some of the more important changes being discussed are summarised in Appendix IV to this guide. These proposed changes to IAS 12 could also lead to significant revisions to Hong Kong's SSAP 12 over the next couple of years. The basic model is not likely to be altered, but there may be several changes made to the detailed rules. It seems inevitable that a certain amount of re-learning will be required at that time. We invite you to 'watch this space'.

Deloitte Touche Tohmatsu
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2 ABBREVIATIONS

The following abbreviations have been used throughout this publication:

CBA	Commercial Building Allowance
EPS	Earnings Per Share
GAAP	Generally Accepted Accounting Practice
HKSA	Hong Kong Society of Accountants
IAS	International Accounting Standard(s)
IASB	International Accounting Standards Board
IBA	Industrial Building Allowance
IFRS	International Financial Reporting Standard(s)
INT	Interpretation issued by the Urgent Issues and Interpretations Sub-Committee of the HKSA
IRD	Inland Revenue Department
PRC	People's Republic of China
SIC	Standing Interpretations Committee of the IASB
SSAP	Statement of Standard Accounting Practice
TWDV	Tax Written Down Value

3 OVERVIEW

General

- 3.1 SSAP 12 *Income Taxes* is effective for accounting periods beginning on or after 1 January 2003. It should be applied for both annual and interim periods beginning on or after that date. Earlier adoption is encouraged, but not required. On implementation, the Standard is required to be applied retrospectively.
- 3.2 The revised Standard introduces a new basis of accounting for income taxes, and deals with accounting for both current tax and deferred tax. However, because the rules introduced for current tax assets and liabilities essentially codify existing accounting practice, it is the revised requirements for deferred tax which, being fundamentally different from those in the superseded Standard, may result in significant prior period adjustments.

Scope of SSAP 12

- 3.3 SSAP 12 is concerned with accounting for **income taxes**. The Standard defines these as 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 venture on distributions to the reporting enterprise. [SSAP 12.2]
- 3.4 In a Hong Kong context, therefore, the Standard is applicable to Profits Tax, and to withholding taxes suffered on income received (e.g. withholding taxes suffered on overseas investment income). In the PRC, it applies to Income Tax, and to taxes charged on capital profits, such as Land Appreciation Tax. SSAP 12 does not apply to taxes that are levied on gross revenue. For example, in a PRC context, it does not apply to Business Tax, Value Added Tax or Consumption Tax.

Explanatory Guidance and Illustrative Examples

- 3.5 In drafting SSAP 12, the HKSA has incorporated additional explanatory guidance and illustrative examples that are not included in IAS 12. Most of this additional guidance has been extracted from the Australian standard on income taxes, which is also based on IAS 12. The implementation guidance is shown as boxed text in SSAP 12, and does not form part of the Standard. It therefore does not have the same authority as the remainder of the text.

Deferred Tax - The Previous Approach

- 3.6 The previous version of SSAP 12 focussed on the income statement, by recognising the tax effects of “timing differences”, i.e. differences between the accounting and tax profits in the period, arising as a result of the inclusion of certain items of income and expenditure in tax computations in periods different from those in which they are included in financial statements.
- 3.7 The effect of those timing differences was recognised using a “partial provision” approach, under which deferred tax assets and liabilities were only recognised to the extent that they were expected to reverse without replacement by equivalent balances. This introduced a high degree of subjectivity into the process, as preparers of financial statements would frequently anticipate future expenditure in order to justify non-recognition of deferred tax liabilities.
- 3.8 The combined effect of all timing differences was considered, rather than looking at each timing difference separately. To the extent that the combination of timing differences resulted in a net debit balance, it was extremely rare to recognise the resultant asset, since to do so it was necessary to assert that recovery was virtually certain.
- 3.9 As a result of the features discussed in the previous paragraphs, even though Hong Kong has had an Accounting Standard on deferred taxation for many years, deferred tax balances have not generally represented a material component of the financial statements of Hong Kong reporting enterprises. The new Standard will change all that.
- 3.10 Exhibit 3.1 highlights the major areas of change from the previous model brought about by the revision of SSAP 12.

Exhibit 3.1 Principal changes in approach

Superseded Standard

SSAP 12 (Revised)

Only items affecting the income statement were considered - thereby largely ignoring the impact of other significant transactions such as business combinations.

Balance sheet focus - temporary differences are considered in respect of all assets and liabilities on hand at the balance sheet date. Therefore, differences arising on business combinations are clearly identified.

For timing differences such as those arising from different rates of tax depreciation and accounting depreciation, under the partial provision approach, future capital expenditure was anticipated in order to justify non-recognition of deferred tax liabilities, on the basis that timing differences reversing would be continually replaced.

Full provision is required - subject to very limited exceptions. Therefore, there is no available justification for non-recognition of liabilities on the basis that future expenditure will continually postpone the liability.

For asset revaluations, only the tax implications of disposal of the asset were considered. In jurisdictions with no tax on capital gains, this effectively meant that no provisions for deferred tax liabilities were recognised on revaluations. Even in jurisdictions with capital gains tax, the partial provision approach was used to justify non-recognition of the liability on the basis that there were no plans to dispose of the asset in the foreseeable future.

Taxation implications considered on the basis of how the asset is expected to be realised. If the asset is to be used to generate taxable profits (e.g. in a taxable manufacturing activity), then a deferred tax liability is recognised at the time of revaluation, irrespective of the tax consequences on disposal.

Even where liabilities were identified that were expected to crystallise, the 'net balance approach', whereby assets and liabilities were offset, meant that liabilities rarely made it to the balance sheet.

More stringent offset rules mean that the deferred tax position will be grossed up, unless detailed criteria are met.

The thresholds for recognition of deferred tax assets were very high, and were very rarely overcome in practice.

Lower thresholds for recognition. Therefore, deferred tax assets are likely to be recognised more frequently.

Deferred Tax - The New Approach

3.11 The revised Standard focuses on the balance sheet by recognising the tax effects of **temporary differences**, i.e. differences between the carrying amount of an asset or a liability and its tax base. Deferred tax assets and liabilities are calculated using the following formula:

$$\text{Deferred tax asset or liability} = \text{Temporary difference} \times \text{Tax rate}$$

3.12 The recognition of deferred tax, therefore, relies on two central concepts: the notions of **temporary differences** (as defined in paragraph 3.11) and **tax bases**.

- 3.13 The **tax base** of an asset or liability is the amount attributed to that asset or liability for tax purposes. The tax base can be nil, the same as the carrying amount of the asset or liability for accounting purposes, or different from the carrying amount.
- 3.14 There are two types of temporary difference - taxable temporary differences and deductible temporary differences. A **taxable temporary difference** will result in an increase in income tax payable in future reporting periods, and gives rise to a deferred tax liability. A **deductible temporary difference** will result in a decrease in income tax payable in future reporting periods, and gives rise to a deferred tax asset.
- 3.15 A taxable temporary difference will arise where either the carrying amount of an asset *is greater than* its tax base, or the carrying amount of a liability *is less than* its tax base. The most common example of a taxable temporary difference arising in respect of an asset is where an asset is depreciated more quickly for tax purposes than for accounting purposes (i.e. accelerated capital allowances). The most common example of a taxable temporary difference arising in respect of a liability is where an accounting gain has arisen so that the carrying amount of the liability has been reduced (e.g. on the retranslation of a foreign exchange loan), but the gain will not be taxed until the loan is settled.
- 3.16 A deductible temporary difference will arise where either the carrying amount of an asset *is less than* its tax base, or the carrying amount of a liability *is greater than* its tax base. The most common example of a deductible temporary difference arising in respect of an asset is where expenditure is recognised as an expense when it is incurred, but it is allowed for tax purposes over an extended period (e.g. pre-operating costs are expensed when they are incurred under Hong Kong GAAP but, for PRC tax purposes, they are amortised over a five year period). The most common example of a deductible temporary difference arising in respect of a liability is where an expense is accrued once the reporting enterprise has incurred an obligation, but it is not allowed for tax purposes until it is paid (e.g. accrual of interest payable, warranty provisions, restructuring provisions, retirement benefit obligations).
- 3.17 Management's expectations as to how an asset will be recovered, or a liability settled, are used as the basis for measuring deferred taxes. For instance, if the tax consequences of continuing to use an asset (e.g. the generation of taxable trading profits) differ from the tax consequences of disposal (e.g. either no tax, or capital gains tax at a different rate), then the deferred tax asset or liability will be measured according to how management expects that the asset will be realised.
- 3.18 The principal steps in arriving at deferred tax assets and liabilities under the revised Standard can be summarised as set out in Exhibit 3.2.

Exhibit 3.2 Deferred tax in five steps

- | | |
|--------|---|
| Step 1 | Calculate the tax base of each asset and liability in the balance sheet. |
| Step 2 | Calculate the temporary difference (if any) for each asset and liability in the balance sheet. |
| Step 3 | Identify those temporary differences that will give rise to deferred tax assets or liabilities using the recognition criteria laid down in the Standard. |
| Step 4 | Calculate the deferred tax attributable to those temporary differences by multiplying each temporary difference by the tax rate that is expected to apply when the temporary difference reverses. |
| Step 5 | Recognise in the income statement, equity, or as an adjustment to goodwill, the movement between the deferred tax balances in the opening and closing balance sheets. |

Each of these 5 steps is discussed in detail in section 6 of this guide.

Major Impacts

- 3.19 The revised Standard is a major change in the conceptual basis of accounting for income taxes. The following is a summary of some of the more complex areas where the revised Standard will have a significant impact when compared to the superseded Standard.

Asset revaluations

- 3.20 Deferred tax must be recognised when an asset is revalued, irrespective of whether or not there is an intention to dispose of the asset. The deferred tax effects are dealt with in the asset revaluation reserve, rather than in the income statement. Where a deferred tax liability is recognised in respect of an upward valuation, the effect will be to reduce the amount reported in the asset revaluation reserve.
- 3.21 The deferred tax impact will be measured by reference to the expected means of recovery of the revalued asset. In a Hong Kong context, this aspect of the measurement rules will have great significance because of the favourable tax regime for capital gains. Where, for example, it is anticipated that the carrying amount of a property will be recovered through use in a taxable manufacturing activity (resulting in all of the temporary difference arising on revaluation being chargeable to tax), this will result in a much higher deferred tax liability than if the property were expected to be recovered through disposal (where the taxable gain is limited to the amount of tax depreciation previously claimed).

Business combinations

- 3.22 Acquisitions of entities and operations can give rise to deferred taxes where assets and liabilities are recognised at fair value for consolidation purposes. The tax base will not generally be adjusted by an equivalent amount. Therefore, for example, a deferred tax liability will result when the fair value of an asset is greater than its tax base, increasing the amount of goodwill (or decreasing the amount of negative goodwill) that arises on acquisition when compared to the superseded Standard. However, deferred taxes are not generally recognised for goodwill itself.

Compound financial instruments

- 3.23 Although not many Hong Kong enterprises currently follow the IAS 32 requirements regarding split accounting for compound financial instruments, this treatment is expected to become mandatory in the near future with the adoption of the Hong Kong equivalent of IAS 32. Where the liability and equity components of convertible notes and other compound financial instruments are separately recognised for accounting purposes, this leads to a temporary difference. Deferred taxes are recognised in respect of the difference between the amount recognised as a liability for accounting and for tax purposes.
- 3.24 After initial recognition, the liability component is increased for accounting purposes by recognising an interest expense. This reduces the difference between the accounting and tax carrying amounts of the liability, reducing the deferred tax liability and resulting in a reduction in income tax expense.

Investments

- 3.25 In the separate financial statements of an enterprise, deferred tax can arise in respect of investments in securities where the investments are recognised at fair value, but there is no corresponding adjustment to the tax base. Although, in a Hong Kong context, because there is no tax on capital gains, the effect is likely to be restricted to trading investments, the impact may be more significant for investments held overseas where capital gains are taxable.
- 3.26 In consolidated financial statements, additional temporary differences may arise where the group has accounted for its share of profits of subsidiaries, joint ventures and associates. These additional temporary differences represent the tax implications that would arise if the profits accounted for by the group were to be remitted to the investor, whether through distribution of the profits retained by the investees or through disposal of the investments. The effects of such temporary differences are generally required to be recognised. However, an exception is made where the investor is able to control the timing of the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future. The exception will generally be limited to parent/subsidiary relationships and certain joint control arrangements.

Implementation

- 3.27 The revised Standard is effective for accounting periods beginning on or after 1 January 2003. The effect of adopting the revised Standard on its effective date (or earlier) should be recognised under SSAP 2 *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies*. Specific implementation issues are discussed in detail in section 8.7 of this guide.
- 3.28 Due to the wider scope of the revised Standard and the differences in methodology, significant effort will be required in the collation and analysis of the information to be reported, both on initial implementation and in ongoing compliance. The tax implications of all assets and liabilities need to be considered and balances tracked. Accounting and information systems may require modification to collate information that was not previously required.
- 3.29 Reporting enterprises will also need to consider carefully the wider implications of the adjustments made to the financial statements. For example, significant adjustments to balance sheets or income statements may result in breaches of loan covenants, or trigger indemnities under acquisition/disposal agreements, that may require renegotiation.

Ongoing Developments

- 3.30 This guide deals with the areas of accounting that have traditionally had the most significance from a deferred tax perspective. Readers should be alert, however, for newer and more complex Accounting Standards (e.g. SSAP 36 *Agriculture*) where the more frequent use of fair value accounting will present new deferred tax issues.
- 3.31 Readers should also be alert for developments in the international arena. The IASB is already looking at amending the IFRS-equivalent to SSAP 12 (see Appendix IV for details). Other significant projects, such as those dealing with business combinations and financial instruments, are also likely to impact on deferred tax. Given the HKSA's policy of convergence with IFRS, this impact will soon be felt in Hong Kong.

4 CALCULATION OF TAX BALANCES

General

- 4.1 This section outlines some general principles for approaching the calculation of tax balances under SSAP 12. The recommended approach is quite different to that generally taken under the superseded Standard. Simple examples of the current and deferred tax worksheets that will be required are set out in Appendix I to this guide.

Calculation of Tax Balances - The Previous Approach

- 4.2 In the past, current and deferred tax balances were generally calculated as part of the same exercise. Deferred tax balances were effectively derived from adjustments made in the reconciliation of accounting profit to taxable income.
- 4.3 Adjustments made to accounting profit were classified as either 'permanent differences' or 'timing differences'. Timing differences were analysed between those that were recognised as deferred tax assets or liabilities, and those that were not recognised as a result of the partial provision approach.
- 4.4 For the purposes of consolidated financial statements, the deferred tax position was generally the aggregate of the deferred tax positions reflected in the financial statements of the individual group enterprises. Some adjustments did arise where, for example, tax losses could be shared between group enterprises and, therefore, a deferred tax asset might qualify for recognition at a consolidated level that did not qualify for recognition in the individual enterprise. However, no recalculation of deferred tax was performed where assets or liabilities were carried at different amounts in the group and individual enterprise financial statements.

Calculation of Tax Balances - The New Approach

Separate calculations

- 4.5 Under the revised Standard, the notions of current and deferred tax are derived differently. Current tax is the recognition of taxes payable to, or refundable by, the taxation authorities in respect of a particular period. Deferred tax, on the other hand, reflects the future tax consequences of items recognised in the balance sheet. Some items that give rise to deferred taxes (e.g. revaluations of assets) do not impact the calculation of current tax in the current period, or the income statement, in a way that easily permits the calculation of both current and deferred tax at the same time.
- 4.6 Deferred taxes are calculated as at the end of a financial period, and movements in the deferred tax balances since the last financial period are recognised in the income statement, directly in equity, or as an adjustment to goodwill arising on acquisition. Therefore, deferred taxes are effectively directly derived from a 'proof' of book and tax balances (see Appendix I) at the end of each period, not from movements in the reconciliation of accounting profit to taxable income.
- 4.7 Separate calculations need to be performed to determine the current tax payable or refundable, and the future tax consequences of items recognised in the balance sheet. The amounts of current and deferred tax also need to be separately disclosed in the financial statements, requiring the separate tracking of current and deferred taxes.

Current tax

- 4.8 The current tax liability (tax payable) or asset (refund due) is calculated in respect of the current reporting period. This is the amount of income tax due to or from the relevant tax authorities.
- 4.9 The movement in the current tax liability or asset is recognised as a current tax charge or credit in the income statement, except where SSAP 12 requires recognition directly in equity or as an adjustment to goodwill arising on acquisition.
- 4.10 The rules for current tax are dealt with in more detail in section 5 of this guide.

Deferred tax

- 4.11 The starting point for the calculation of deferred tax balances is the determination of the carrying amounts and tax bases of asset and liabilities recognised in the balance sheet and for tax purposes. As outlined at paragraph 3.18 above, the enterprise is required to:
- calculate the tax base of each asset and liability;
 - calculate the temporary difference arising in respect of each asset and liability;
 - identify those temporary differences that should be recognised using SSAP 12's recognition criteria;
 - calculate the deferred tax attributable to those temporary differences; and
 - recognise the movements in deferred tax assets and liabilities in the income statement, in equity, or as an adjustment to goodwill, as appropriate.

Taxable Entity

- 4.12 Current and deferred taxes are calculated by reference to the tax-paying enterprise. This is usually an individual company or other tax-paying entity.
- 4.13 In some jurisdictions, taxes payable or refundable can be determined by reference to a group of entities. In these cases, current and deferred taxes are calculated by reference to the 'tax group' (as the taxable entity), not by reference to the individual enterprises in the group.
- 4.14 In addition, in certain jurisdictions, the tax laws may allow for 'group relief', whereby tax allowances and loss relief may be shared between designated group companies. In these circumstances, the taxable entity in respect of which current and deferred taxes are calculated is the individual company. However, the availability of group relief may mean that there is increased scope for offsetting deferred tax assets and liabilities between group companies.

Consolidated Financial Statements

- 4.15 On consolidation, even in those jurisdictions where tax assessments are raised on individual group enterprises, the deferred tax assets and liabilities will not necessarily be the same as the aggregation of the deferred tax balances in the individual financial statements of group enterprises. Differences may arise for a number of reasons, which are discussed in detail in section 8.2 of this guide.
- 4.16 Therefore, the computation of deferred tax balances at a consolidated level is another separate exercise, which should take the consolidated balance sheet as its starting point.

Interim Financial Reporting

- 4.17 SSAP 25 *Interim Financial Reporting* requires that consistent accounting policies be used in interim and annual financial statements, and that each interim period be treated as a discrete reporting period.
- 4.18 Therefore, the steps outlined above can be followed when calculating tax balances for the purposes of interim financial reports. However, as many items included in taxable income or the income statement are determined by reference to full-year events and balances, there are some additional considerations required when calculating tax balances for an interim period.
- 4.19 SSAP 25 requires the income tax expense/revenue for each interim financial period to be recognised based on the best estimate of the weighted average annual income tax rate expected for the full financial year. [SSAP 25.30(c)] Where there have been earlier interim reporting periods, the income tax expense for the current period is then determined by recognising the movement in the amount calculated since the last interim reporting period.

5 CURRENT TAX

General

- 5.1 SSAP 12 includes, for the first time in Hong Kong accounting literature, specific requirements in respect of the recognition, measurement, presentation and disclosure of current tax. However, the Standard largely codifies existing accounting practice in respect of current taxes and, therefore, will not present many issues for Hong Kong reporting enterprises.
- 5.2 **Current tax** is defined as the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period. [SSAP 12.5] It is the tax that the enterprise expects to pay (recover) in respect of the financial period.

Recognition of Current Tax Assets and Liabilities

- 5.3 Consistent with the general framework for Accounting Standards, SSAP 12 focuses on the balance sheet impact of current tax. The Standard's basic requirement is that, to the extent that it is unpaid, current tax for the current and prior reporting periods should be recognised as a liability. Conversely, any overpayment that is recoverable should be recognised as an asset. [SSAP 12.12]
- 5.4 An asset is similarly recognised in jurisdictions where a tax loss can be carried back to recover the tax of an earlier period. [SSAP 12.13] Thus, if an enterprise has a tax loss in one year, say 20X4, and this is carried back and used to recover tax of an earlier period, say 20X3, the benefit of the recovery is recognised in the income statement in the year in which the loss arises, i.e. 20X4.

Tax losses that are carried back and tax losses that are carried forward are treated differently under SSAP 12:

- losses carried back against the profits of earlier periods are treated as an adjustment to current tax; and
 - losses carried forward against the profits of future periods are treated as an adjustment to deferred tax.
-

- 5.5 Current tax is recognised in the income statement, other than in the circumstances described in paragraphs 5.6 and 5.8 below.
- 5.6 Where the current tax asset or liability arises as a result of a transaction or event that is dealt with in equity (whether in the same or a different period), then the current tax is also dealt with in equity. [SSAP 12.61]
- 5.7 It will be unusual to recognise current tax in equity. However, this treatment will be required where, according to the tax rules in a particular jurisdiction, an item dealt with in equity for accounting purposes gives rise to a current tax charge, for example:
- tax is charged on an exchange gain, and that exchange gain is recognised directly in equity; or
 - a voluntary revaluation of assets gives rise to a current tax charge.
- 5.8 Where the current tax arises from a business combination that is an acquisition, it will be accounted for as an adjustment to the goodwill or negative goodwill arising on acquisition. [SSAP 12.58(b), 66]
- 5.9 In the context of a business combination, a change of ownership may have direct tax consequences for the acquiree (e.g. a change in tax rate, loss of tax incentives). Where those consequences result in an adjustment to current tax assets or liabilities, the revised tax position will be used for the purpose of the fair value exercise, and the adjustment will therefore affect the amount of goodwill or negative goodwill recognised.

Measurement of Current Tax Assets and Liabilities

- 5.10 Current tax liabilities and current tax assets are measured at the amounts that are expected to be paid or recovered, using the tax rates and laws that have been enacted or substantively enacted by the balance sheet date. [SSAP 12.46] Readers should refer to section 6.4 of this guide for a discussion of the issues that arise in respect of the appropriate tax rate to be used.
- 5.11 SSAP 12 does not make any comment as to whether current tax assets and liabilities should be discounted (the prohibition in SSAP 12.53, discussed at paragraph 6.4.25 of this guide, refers only to deferred tax assets and liabilities). Usually, the effect will not be material, since current tax liabilities are generally paid within a relatively short period. However, where an extended payment period longer than the normal settlement period is negotiated with the taxation authorities, it will be appropriate to discount the anticipated cash flows to their present value, because it is practicable to make a reasonable estimate as to when those cash flows will occur.

Changes in the Tax Status of an Enterprise or its Shareholders

- 5.12 The HKSA has released Interpretation 21 (INT 21) *Income Taxes - Changes in the Tax Status of an Enterprise or its Shareholders* dealing with the appropriate accounting for the consequences of such changes. INT 21 is discussed in detail at paragraph 6.5.21 of this guide. Readers should note that it applies equally to current and deferred taxes.

Revisions of Prior Period Amounts

- 5.13 The new Standard has no impact on the appropriate accounting treatment where the eventual current tax liability or refund due in respect of a particular period is greater or less than the amount provided for in the financial statements of a previous accounting period. The adjustment is generally accounted for in the current year. Only where there has been an error that meets the definition of a fundamental error under SSAP 2 *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies* should prior period amounts be restated.
- 5.14 The current HKSA Improvements Project proposes to amend SSAP 2 so as to remove the distinction between 'fundamental' and other errors. Under the proposed revisions to SSAP 2, all material errors in prior period financial statements will be required to be corrected by prior period adjustment.
- 5.15 **Errors** are defined in the HKSA Exposure Draft as "omissions from, and other misstatements of, the entity's financial statements for one or more prior periods that are discovered in the current period and that relate to reliable information that: (a) was available when those prior period financial statements were prepared; and (b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements."
- 5.16 Errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.
- 5.17 Therefore, following the anticipated revisions to SSAP 2, if an adjustment to the previous period's tax liability or asset results from the correction of mathematical errors or misinterpretations of tax rules, and the effect is material, a prior period adjustment will be required.

It may, in certain circumstances, be difficult to distinguish between the correction of errors and changes in estimates in this area, e.g. where tax case law is developing, and the estimates made were appropriate based on the information that was available at the time of preparation of the prior period financial statements. However, what is clear is that, following the anticipated revisions to SSAP 2, it will become more common to adjust prior period's financial statements for the subsequent resolution of areas of dispute in relation to taxes.

Presentation and Disclosure

- 5.18 SSAP 12's rules regarding the presentation of current tax in the balance sheet and income statement, and the disclosure requirements for current tax, are discussed in section 7 of this guide. Illustrative disclosures are presented in Appendix III.

6.1 DEFERRED TAX - TAX BASES

The concept of the **tax base** of an asset or liability is fundamental to the balance sheet approach to deferred taxes. SSAP 12.5 defines the term as “the amount attributed to that asset or liability for tax purposes”. SSAP 12.7 goes on to say that 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 an enterprise when it recovers the carrying amount of an asset”. When we read these descriptions, we instinctively link the concept of tax base with the tax written down value of an asset.

The additional explanatory guidance incorporated into SSAP 12 from the Australian standard (see paragraph 3.5 above) introduces a number of formulae for the calculation of tax bases which are illustrated in this section of the guide. When these formulae are first used, they may seem unnecessarily cumbersome. This is particularly so because we feel that we instinctively understand what a tax base is. However, as readers will note from discussions later in this section, when we use the formulae, in certain situations we will arrive at an unexpected answer.

From our experience to date, the formulae are very useful tools for the implementation of SSAP 12 in complex situations. Although, in simple circumstances, the tax base of an asset can be established intuitively, in more complex situations (e.g. where an asset has been revalued and the tax rules are not straight-forward), we do recommend that the formulae be used. The formulae will always give you a figure for the tax base which will allow you to calculate the correct temporary difference. However, be aware, the ‘tax base’ calculated will not always coincide with the SSAP 12 definitions quoted above.

Our advice is to learn the formulae and use them - they cut through a lot of supplementary work.

General

- 6.1.1 The calculation of temporary differences (and the deferred tax assets and liabilities that they give rise to) is dependent on the appropriate identification of the tax base of each asset and liability in the enterprise’s balance sheet.
- 6.1.2 The **tax base** of an asset or liability is the amount attributed to that asset or liability for tax purposes. [SSAP 12.5]

Assets

- 6.1.3 The tax base of an asset is the amount that will be deductible for tax purposes against the taxable benefits to be received by an enterprise when it recovers the carrying amount of the asset. Those taxable benefits could take the form of proceeds on disposal of the asset, or income earned through the use of the asset (e.g. manufacturing profits).
- 6.1.4 The future tax consequences are always calculated based on the realisation of the asset at its carrying amount. In reality, an enterprise will often generate economic benefits in excess of the carrying amount, through use or sale. For example, a property may have a market value that is substantially greater than its carrying amount. SSAP 12 does not require the preparer of the financial statements to estimate the benefits that will be generated by the asset. Instead, deferred tax is calculated on the assumption that those benefits are equal to the carrying amount of the asset. In other words, the Standard requires tax to be accounted for only in respect of the amounts already recorded in the financial statements.

Remember that it is the *future* tax consequences that are taken into account in order to measure the tax base. The *past* tax consequences associated with each item are irrelevant, because these have already been reflected in the calculation of current tax.

Non-taxable proceeds

- 6.1.5 SSAP 12 states that, where the economic benefits that flow from an asset are not taxable, the tax base of the asset is equal to its carrying amount. [SSAP 12.7] This can be verified using the formula described at paragraph 6.1.7 below.
- 6.1.6 Deferred taxes only arise when the tax base of an asset or liability differs from its carrying amount. Therefore, if the economic benefits that flow from an asset are not taxable, and the tax base of the asset is therefore equal to its carrying amount, then the recovery of the asset will not have any deferred tax consequences.

SSAP 12 Formula

- 6.1.7 The guidance notes in the Standard suggest a simple formula for the calculation of the tax base of an asset.

$$\text{Tax base} = \text{Carrying amount} - \text{Future taxable amounts} + \text{Future deductible amounts}$$

- 6.1.8 Therefore, the tax base of an asset is equal to:

- the carrying amount of the asset in the balance sheet; less
- the portion of the asset's carrying amount that will be taxable when recovered; plus
- the portion of the asset's carrying amount that will be deductible when recovered.

- 6.1.9 For non-taxable proceeds, as discussed at paragraph 6.1.5 above, because the future taxable amounts and the future deductible amounts are both nil, the tax base is equal to the carrying amount.

Examples of the calculation of the tax base of an asset

- 6.1.10 We have set out on the next two pages several examples of the calculation of the tax base of an asset. The objective is not to provide readers with a list to be memorised, but to illustrate the application of the principle. We have used the SSAP 12 formula for the purposes of these calculations - again, with the objective of illustrating its application.

	Tax base	=	Carrying amount	-	Future taxable amounts	+	Future deductible amounts
			<i>Net book amount as reported in the balance sheet</i>		<i>The portion of the asset's carrying amount that will be taxable when recovered</i>		<i>The portion of the asset's carrying amount that will be deductible when recovered</i>
Interest receivable of \$500 that will be taxed when it is received.	Nil	=	500	-	500	+	Nil
Dividends receivable of \$100 that will not be taxable when received.	100	=	100	-	Nil	+	Nil
Inventories on the balance sheet at \$100, deductible for tax purposes when they are sold.	100	=	100	-	100	+	100
Trade receivables of \$500 (no allowance for doubtful debts).	500	=	500	-	Nil	+	Nil
Gross trade receivables of \$500, with specific doubtful debts allowance of \$50 deductible for tax purposes.	450	=	450	-	Nil	+	Nil
Gross trade receivables of \$500, with general bad debts allowance of \$50 not deductible for tax purposes.	500	=	450	-	Nil	+	50
Loan receivable of \$100.	100	=	100	-	Nil	+	Nil
Development expenditure of \$250 deductible for tax purposes when paid, amortised over 5 years for accounting purposes.	Nil	=	250	-	250	+	Nil

	Tax base	=	Carrying amount	-	Future taxable amounts	+	Future deductible amounts
			<i>Net book amount as reported in the balance sheet</i>		<i>The portion of the asset's carrying amount that will be taxable when recovered</i>		<i>The portion of the asset's carrying amount that will be deductible when recovered</i>
Equipment costing \$1,000 with a carrying amount of \$700, and accumulated tax depreciation of \$400.	600	=	700	-	700	+	600
Freehold land costing \$400. No tax depreciation. Taxable gain on disposal equal to proceeds less the acquisition cost.	400	=	400	-	400	+	400
Leasehold land costing \$300, with a carrying amount of \$270. Tax depreciation of \$50 to date.	250	=	270	-	270	+	250
Investment property costing \$500, revalued to \$700. No tax depreciation claimed to date, and no balancing charge on disposal.	700	=	700	-	Nil	+	Nil
Same building. Tax depreciation of \$100 to date. Gain on disposal taxed, but limited to the tax allowances previously claimed.	600*	=	700	-	500	+	400

* This is an example of the circumstances discussed in our opening remarks in this section, where the amount arrived at by using the formula (\$600) does not coincide with our expectations (the TWDV of the property is \$400). Nor does it seem to coincide with SSAP 12's definition of tax base. But, as illustrated in section 8.4 of this guide, the formula gives you the answer you need in order to be able to calculate the correct temporary difference in these circumstances. This is an example of where the use of the formula assists with the calculation of the tax base. In this case, the tax base is not the TWDV, and therefore cannot be identified intuitively.

Liabilities

- 6.1.11 The tax base of a liability is its carrying amount, less any amount that will be deductible for tax purposes in respect of that liability in future periods. In the case of revenue that is received in advance, the tax base of the resulting liability is its carrying amount, less any amount of the revenue that will not be taxable in future periods. [SSAP 12.8]
- 6.1.12 The future tax consequences are always calculated based on the settlement of the liability at its carrying amount. There may be occasions where the settlement of a liability is expected to exceed its current carrying amount - e.g. where a settlement premium is being accrued over the life of a debt instrument. SSAP 12 does not require the preparer of the financial statements to anticipate the expected settlement amount. Instead, deferred tax is calculated on the assumption that the liability is settled at its carrying amount. In other words, the Standard requires tax to be accounted for only in respect of the amounts already recorded in the financial statements.
- 6.1.13 Again, when calculating tax bases of liabilities, it is the *future* tax consequences that are taken into account in order to measure the tax base. The *past* tax consequences associated with each item are irrelevant, as these have already been reflected in the calculation of current tax.

SSAP 12 Formulae

- 6.1.14 There are two formulae for the calculation of the tax base of a liability. Using these formulae will assist in calculating the tax base in complex circumstances.

Liabilities in the nature of revenue received in advance

$$\text{Tax base} = \text{Carrying amount} - \text{The amount of the revenue that will not be taxable in future periods}$$

- 6.1.15 Therefore, in the case of revenue received in advance, the tax base of the liability is the carrying amount of the liability less the portion of the revenue received that has already been taxed.

Other liabilities

$$\text{Tax base} = \text{Carrying amount} - \text{Future deductible amounts} + \text{Future taxable amounts}$$

- 6.1.16 Therefore, the tax base of any liability other than revenue received in advance is equal to:

- the carrying amount of the liability in the balance sheet; less
- the amounts that will be deductible when the liability is settled; plus
- the amounts that will be taxable when the liability is settled.

Examples of the calculation of the tax base of a liability

- 6.1.17 On the next page we have set out a number of examples of the calculation of the tax base of a liability. Again, the SSAP 12 formulae have been used to illustrate their application.

Liabilities in the nature of revenue received in advance

	Tax base	=	Carrying amount	-	Amounts not taxable in future periods
			<i>Carrying amount in the balance sheet</i>		<i>The portion of the income already taxed</i>
Unearned sales revenue of \$500 received in advance. Taxable when recognised in the income statement.	500	=	500	-	Nil
Interest revenue received in advance of \$100. Taxed on cash receipts basis.	Nil	=	100	-	100
Government grant of \$100 - recognised in the balance sheet as deferred income. No tax on receipt of grant, nor on subsequent amortisation. Cost of asset allowed in full.	100	=	100	-	Nil

Other liabilities

	Tax base	=	Carrying amount	-	Future deductible amounts	+	Future taxable amounts
			<i>Carrying amount in the balance sheet</i>		<i>The amounts that will be deductible when the liability is settled</i>		<i>The amounts that will be taxable when the liability is settled</i>
Loan payable of \$300.	300	=	300	-	Nil	+	Nil
Foreign currency loan payable of \$450, originally recognised at \$500. Exchange gains are taxable when realised.	500	=	450	-	Nil	+	50
Provision for warranty costs of \$500 (tax deductible when paid).	Nil	=	500	-	500	+	Nil
Accrued wages of \$100 (tax deductible at the time of expense recognition).	100	=	100	-	Nil	+	Nil
Accrued fines and penalties of \$40 (not tax deductible).	40	=	40	-	Nil	+	Nil

- 6.1.18 It can be seen from the above examples that, where settlement of the liability at its carrying amount would have no tax repercussions, the tax base of the liability is equal to its carrying amount. This will be the case where either the transaction has no taxation implications (e.g. accrual of fines and penalties that are not tax deductible), or where the accounting and tax implications occur in the same period (e.g. accrued wages, where the tax deduction is allowed at the same time as the expense is recognised).

Issue costs netted against loan amount

- 6.1.19 The following example illustrates the analysis of a more complex situation, where it is necessary to break the liability into components.

Example 6.1.1 Issue costs netted against loan amount

Loan payable of \$500, against which issue costs of \$50 (allowed for tax purposes when paid) have been netted. To date, \$40 of the issue costs have been amortised.

In order to arrive at the appropriate answer in these circumstances, it is necessary to view the net carrying amount of \$490 as consisting of two elements - a liability of \$500 and an asset of \$10. Using the guidance for liabilities, the tax base of the liability is \$500. Using the guidance for assets, the tax base of the expenditure already deducted for tax purposes is nil. Therefore, the 'combined' tax base is \$500, which differs from the carrying amount in the balance sheet by \$10.

Tax Bases without an Associated Carrying Amount

- 6.1.20 Some items have a tax base but are not recognised in the balance sheet for accounting purposes. Where a transaction does not give rise to or affect the carrying amount of an asset or liability, but does affect the taxable income of future reporting periods, the tax base is calculated as the amount of the effect on taxable income in future reporting periods. In this case, the carrying amount of the asset or liability associated with the tax base is deemed to be nil for the purposes of calculating temporary differences.
- 6.1.21 For example - under SSAP 29 *Intangible Assets*, pre-operating costs of \$100 are expensed when incurred. But PRC tax law allows a deduction for tax purposes over a five year period. The difference between the tax base of the pre-operating costs (i.e. the amount that the taxation authorities will permit as a deduction in future periods), and the carrying amount of nil, is a temporary difference.

Tax base	=	Carrying amount	-	Future taxable amounts	+	Future deductible amounts
100	=	Nil	-	Nil	+	100

The Impact of Management Expectations

- 6.1.22 The measurement of deferred tax assets and liabilities (and, therefore, tax bases) must reflect the tax consequences that would follow from the manner in which management *expects*, at the reporting date, to recover or settle the carrying amounts of assets and liabilities.
- 6.1.23 Tax consequences can vary according to the manner in which an asset is recovered or a liability is settled. The tax base of an asset may be different depending upon whether it is expected to be recovered through sale or through use, due to the differing tax consequences arising.
- 6.1.24 In various jurisdictions, there may be different tax rates or special tax treatments applicable to capital gains, undistributed profits, unrecognised revaluations etc. In these cases, management's expectations as to the manner of realisation of assets, settlement of liabilities and payment of distributions can have a significant impact on the deferred tax amounts ultimately recognised.
- 6.1.25 The impact of management expectations on the measurement of deferred tax is discussed in further detail in section 6.4 of this guide.

6.2 DEFERRED TAX - TEMPORARY DIFFERENCES

SSAP 12 introduces the concept of temporary differences, whereas the previous version of the Standard focused on timing differences. In order to come to grips with SSAP 12, it is necessary to understand the distinction between these two concepts.

Timing differences are differences between taxable profit and accounting profit that originate in one period and reverse in one or more subsequent periods. Temporary differences are differences between the tax base of an asset or a liability and its carrying amount in the balance sheet.

All timing differences are temporary differences. But there are some temporary differences that are not timing differences, for example, those temporary differences that arise when:

- subsidiaries, associates or jointly controlled entities have not distributed all of their profits to the parent or investor;
- assets are revalued, and no equivalent adjustment is made for tax purposes;
- at the time of a business combination, assets and liabilities are recognised at their fair values, but no equivalent adjustment is made for tax purposes;
- the non-monetary assets and liabilities of a foreign operation accounted for using the temporal method are translated at historical exchange rates; and
- the carrying amount of an asset or liability differs from its tax base when the asset or liability is first recognised.

The most important concept to grasp is the focus on the balance sheet, i.e. that, under the revised Standard, deferred tax balances arise when there are differences between the amounts at which assets or liabilities are carried in the balance sheet and the amounts that are attributed to them for tax purposes.

The new Standard does not have an equivalent for 'permanent differences', i.e. items of income and expense that are never taxable or tax deductible. However, the treatment of such items is essentially the same under the revised Standard. As discussed in section 6.1 above, when the recovery of an asset or settlement of a liability has no tax consequences, then the tax base is equal to the carrying amount, and no deferred tax arises.

General

- 6.2.1 Under the revised Standard, deferred tax balances are recognised in respect of temporary differences. A temporary difference arises where the carrying amount of an asset or liability differs from its tax base. For the vast majority of transactions, there is no difference between the accounting and the tax treatment of the transaction, and therefore no temporary difference (or deferred tax balance) arises.
- 6.2.2 SSAP 12 defines a **temporary difference** as a difference arising between the carrying amount of an asset or liability in the balance sheet and its tax base. [SSAP 12.5] The concept of a tax base is explored in detail in section 6.1 above.

6.2.3 Temporary differences can arise in a number of circumstances, for example:

- when income or expenses are included in accounting profit in one period but included in taxable profit in a different period (these are the familiar 'timing differences' that gave rise to deferred tax balances under the previous version of SSAP 12);
- in a business combination, when the carrying amounts of assets and liabilities are adjusted to their fair values at the date of acquisition, but the tax bases of those assets and liabilities are not affected by the business combination or are affected differently;
- where an asset or a liability is revalued, but the tax base of the asset is not adjusted;
- in respect of goodwill or negative goodwill which is recognised on consolidation, but for which the amortisation (release to income) is not allowed as a deductible expense (taxable income) for tax purposes; and
- on the initial recognition of an asset or liability, for example, if part or all of the cost of an asset will not be deductible for tax purposes.

Because SSAP 12 does have a number of exceptions to its full provision approach, not all of the temporary differences listed at paragraph 6.2.3 will give rise to deferred tax balances - see section 6.3 below for a discussion of the recognition exceptions.

6.2.4 Carrying amounts used in the calculation of temporary differences are determined from the accounting records. Where applicable, carrying amounts are calculated net of any allowances or deductions, such as doubtful debts or impairment losses.

6.2.5 Where an enterprise is preparing consolidated financial statements, temporary differences are calculated using:

- carrying amounts taken from the consolidated balance sheet; and
- tax bases - being whatever the tax authorities use (see paragraph 4.12 above). If the tax authorities calculate tax by reference to each individual company in the group, the tax bases will be taken from the individual companies' tax computations. Where the tax authorities calculate tax using consolidated figures, the tax bases will be taken from the consolidated tax figures.

6.2.6 There are two types of temporary differences - taxable temporary differences and deductible temporary differences. These are discussed in detail in the following paragraphs.

Taxable Temporary Differences

6.2.7 A **taxable temporary difference** is a temporary difference that will result in taxable amounts in determining the taxable profit (or tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled. [SSAP 12.5]

6.2.8 Therefore, taxable temporary differences are differences that will give rise to taxable income in the future. Because they increase future taxable profit, they give rise to deferred tax *liabilities*.

- 6.2.9 In the context of an asset, a taxable temporary difference arises when the carrying amount of the asset exceeds its tax base. For example, an asset is depreciated more quickly for tax than for accounting purposes. As the carrying amount of the asset is recovered, the economic benefits subject to tax (i.e. the profits generated by the use of the asset equal to the carrying amount of the asset) will exceed the future tax deductions available (the tax base). The tax effect of this taxable temporary difference gives rise to a deferred tax liability.

Example 6.2.1 Taxable temporary difference - asset

Equipment: carrying amount \$100; tax base \$80.

On recovering the carrying amount: taxable income \$100; tax deduction available \$80.

If the asset is recovered at its carrying amount, net taxable income of \$20 will arise. Therefore, this is a taxable temporary difference.

- 6.2.10 In the context of a liability, a taxable temporary difference arises when the tax base of the liability exceeds its carrying amount.

Example 6.2.2 Taxable temporary difference - liability

Foreign currency loan: principal \$500; carrying amount \$450; taxable exchange gains \$50 already recognised in accounting income.

On settling the liability: taxable income \$50; tax deduction Nil.

If the liability is settled at its carrying amount, net taxable income of \$50 arises. Therefore, this is a taxable temporary difference.

Deductible Temporary Differences

- 6.2.11 A **deductible temporary difference** is a temporary difference that will result in amounts that are deductible in determining the taxable profit (or tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled. [SSAP 12.5]
- 6.2.12 Therefore, deductible temporary differences are differences that decrease taxable income in the future. They give rise to deferred tax *assets*.
- 6.2.13 In the context of an asset, a deductible temporary difference arises when the tax base of the asset exceeds its carrying amount.

Example 6.2.3 Deductible temporary difference - asset

Portfolio of loans receivable: principal amount \$500; general bad debts allowance \$100 not allowed for tax purposes; carrying amount \$400.

On recovering the carrying amount: taxable income Nil; tax deduction available for actual default \$100.

If the loans are settled at their carrying amount, a net deduction will arise. Therefore, this is a deductible temporary difference.

6.2.14 In the context of a liability, a deductible temporary difference arises when the carrying amount of the liability exceeds its tax base.

Example 6.2.4 Deductible temporary difference - liability

Interest payable accrued: carrying amount \$50. Tax deductible when paid.

On settling the liability: taxable income Nil; tax deduction available \$50.

If the accrual is settled at its carrying amount, a net deduction will arise. Therefore, this is a deductible temporary difference.

If it helps, here's a useful short-cut rule for determining whether temporary differences are taxable or deductible.

	<u>Carrying amount - tax base</u>	<u>Type of temporary difference</u>	<u>Gives rise to...</u>
Asset	+ve	Taxable	Deferred tax liability
	-ve	Deductible	Deferred tax asset
Liability	+ve	Deductible	Deferred tax asset
	-ve	Taxable	Deferred tax liability

6.3 DEFERRED TAX - BALANCE SHEET RECOGNITION

Having identified all of the temporary differences that exist at the balance sheet date, as discussed in section 6.2, the next step is to pinpoint those temporary differences that will give rise to deferred tax assets or liabilities in the balance sheet using the recognition criteria laid down in the Standard.

The previous version of SSAP 12 adopted a partial provision approach, i.e. deferred tax assets and liabilities were only recognised to the extent that they were expected to crystallise. The approach adopted by the revised Standard is quite different - full provision, subject to specific identified exceptions. Therefore, under the revised Standard, the general presumption is that deferred tax assets and liabilities should be recognised in respect of all temporary differences, subject to the exceptions discussed in the following paragraphs.

These exceptions are not based on any single conceptual idea. They have been developed as solutions to specific issues that arise when the general approach is applied.

Requirements for Recognition

Taxable temporary differences

- 6.3.1 A deferred tax liability should be recognised for all taxable temporary differences, unless the deferred tax liability arises from:
- a) goodwill for which amortisation is not deductible for tax purposes; or
 - b) the initial recognition of an asset or liability in a transaction which:
 - i) is not a business combination; and
 - ii) at the time of the transaction affects neither accounting profit nor taxable profit (tax loss); or
 - c) an investment in a subsidiary, branch or associate, or an interest in a joint venture, where:
 - i) the parent, investor or venturer is able to control the timing of the reversal of the temporary difference; and
 - ii) it is probable that the temporary difference will not reverse in the foreseeable future.

[SSAP 12.15, 39]

Deductible temporary differences

- 6.3.2 A deferred tax asset should 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:
- a) negative goodwill which is treated as deferred income in accordance with SSAP 30 *Business Combinations*; or
 - b) the initial recognition of an asset or liability in a transaction which:
 - i) is not a business combination; and
 - ii) at the time of the transaction affects neither accounting profit nor taxable profit (tax loss); or
 - c) an investment in a subsidiary, branch or associate, or an interest in a joint venture, and it is probable that the temporary difference will not reverse in the foreseeable future.

[SSAP 12.24, 44]

Recognition Exceptions

- 6.3.3 From the detailed recognition requirements set out in the previous paragraphs, we can see that deferred tax assets and liabilities should always be recognised except for those arising from:
- goodwill for which amortisation is not deductible for tax purposes;
 - negative goodwill;
 - the initial recognition, other than in a business combination, of an asset or liability which, at the time of the transaction, affects neither accounting profit(loss) nor taxable profit(loss); and
 - certain differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures.
- 6.3.4 In short, no deferred tax is recognised in respect of the first three items listed at paragraph 6.3.3, and a modified approach is taken with the last. These four exceptions are discussed in the following paragraphs and in later sections of this guide.
- 6.3.5 In addition to the exceptions noted, an additional criteria must be met before a deferred tax asset can be recognised in respect of deductible temporary differences - it must be probable that taxable profits will be available against which the deferred tax asset can be utilised. This probability criterion is discussed in detail at paragraph 6.3.17 below.

Goodwill for which amortisation is not tax deductible

- 6.3.6 The deductibility of goodwill amortisation varies by jurisdiction according to the tax laws - it is not a deductible expense in Hong Kong but, for example, it may be deductible in the United States.
- 6.3.7 Where the amortisation of goodwill is not deductible against taxable income, but the economic benefits expected to be generated are taxable, the tax base of the goodwill is nil, and so a taxable temporary difference arises equal to the carrying amount of the goodwill.
- 6.3.8 Although a taxable temporary difference exists, SSAP 12 prohibits the recognition of the resultant deferred tax liability. The underlying rationale for this exception is that, if a deferred tax liability were set up in respect of the goodwill at the time of the business combination, this would decrease the total for the net assets recognised. Since goodwill is always the balancing figure in the fair value exercise, this would further increase goodwill and the increase would also need to be tax effected.
- 6.3.9 Where the amortisation of goodwill is tax deductible, no temporary difference arises at the date of acquisition. The tax base is equal to the carrying amount of the goodwill, thus giving rise to no temporary difference. In future periods, if the amortisation rates for tax and accounting purposes differ, temporary differences will arise and these should be accounted for in accordance with the usual principles.

Negative goodwill

- 6.3.10 Similar to the exception for goodwill discussed in the previous paragraphs, a deferred tax asset cannot be recognised if it arises as a result of negative goodwill that is not taxable, and that is treated as deferred income under SSAP 30. The argument advanced in support of this exception is, as with positive goodwill, that of grossing up a residual.
- 6.3.11 In the unusual circumstances where the release of negative goodwill is taxable, then the tax base at the date of recognition is equal to its carrying amount, and therefore no temporary difference arises.

The initial recognition of an asset or liability

- 6.3.12 Where a temporary difference arises on the initial recognition of an asset or liability, other than in a business combination, and the recognition of the asset or liability affects neither accounting profit(loss), nor taxable profit (loss) at the time of the transaction, SSAP 12 prohibits the recognition of any deferred tax asset or liability in respect of that temporary difference.
- 6.3.13 This exception is discussed and illustrated in detail in section 8.1 of this guide. In essence, where a temporary difference arises in such circumstances, if the related deferred tax were to be recognised, it would either adjust the carrying amount of the asset or liability in the balance sheet, or be dealt with in the income statement at the date of initial recognition. Neither of these outcomes is considered to be desirable, and therefore an exception to the general rule has been created.

Differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures

- 6.3.14 Differences associated with investments in subsidiaries, associates and joint ventures generally arise in consolidated financial statements, because the results of the investee enterprise have been accounted for (whether by consolidation or by equity accounting), and the tax effects of the distribution of those profits (e.g. withholding tax) should also be considered.
- 6.3.15 A detailed discussion of the temporary differences that can arise in respect of investments, including investments in subsidiaries, associates and joint ventures, is included in section 8.3 of this guide. Unlike the other recognition exceptions set out in paragraph 6.3.3, SSAP 12 does not prohibit the recognition of deferred tax assets and liabilities in respect of these differences. Rather, it imposes particular conditions for such recognition.
- 6.3.16 The previous version of SSAP 12 allowed for the recognition of the deferred tax implications in such circumstances on the basis of whether or not it was intended to distribute the profits of the investee. The revised Standard, on the other hand, *requires* that any resultant tax liabilities should be accounted for *unless* the enterprise can ensure that the temporary differences will not reverse in the foreseeable future. Any resultant tax assets are accounted for to the extent that they are expected to reverse in the foreseeable future.

Recognition of Deferred Tax Assets

- 6.3.17 Deferred tax assets can arise from deductible temporary differences (e.g. where the carrying amount of an asset is less than its tax base), or from the ability to carry forward unused tax losses and unused tax credits.
- 6.3.18 Under SSAP 12, subject to the exceptions discussed in the previous paragraphs, deferred tax assets are recognised for all deductible temporary differences and all unused tax losses and tax credits, but only to the extent that it is probable that future taxable profit will be available against which they can be utilised. [SSAP 12.24, 34]
- 6.3.19 Where an enterprise has a deferred tax asset that has not been recognised because it failed this recoverability test, the enterprise is required to reassess the position at each subsequent balance sheet date to see whether the test is subsequently met. Where the test is subsequently met, the asset is recognised at that later date. [SSAP 12.37]
- 6.3.20 Conversely, where a deferred tax asset has been recognised in the balance sheet, its carrying amount should be reviewed at each subsequent balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profit will be available to enable its recovery. [SSAP 12.56]

Availability of future profits

6.3.21 A deferred tax asset represents a future tax deduction. It is therefore valuable only if the enterprise will have future taxable profits against which the deduction can be offset. The important question to answer, therefore, is when can it be considered probable that an enterprise will have sufficient taxable profits available in the future to enable the deferred tax asset to be recovered.

The term “probable” is not defined in the revised Standard. It is subject to varying interpretations. It is clearly less stringent than the ‘beyond reasonable doubt’ criterion included in the superseded Standard. It is also generally agreed to mean at least ‘more likely than not’ (i.e. a probability of greater than 50 per cent). But neither the HKSA nor the IASB has given a more definitive interpretation.

6.3.22 The Standard answers the question posed at paragraph 6.3.21 as follows - it is probable that an enterprise will have sufficient taxable profits available in the future to enable a deferred tax asset to be recovered when:

- there are sufficient deferred tax liabilities, relating to the same taxation authority and the same taxable enterprise, which either are expected to reverse in the same period as the deferred tax asset is expected to reverse, or are expected to reverse in a period into which tax losses (arising from the reversal of the deferred tax asset) can be carried back or forward [SSAP 12.28]; or
- it is probable that the enterprise will have sufficient taxable profits (from sources other than reversing deferred tax liabilities), relating to the same taxation authority and the same taxable enterprise, in the same period as the deferred tax asset is expected to reverse, or a period into which tax losses (arising from the reversal of the deferred tax asset) can be carried back or forward [SSAP 12.29(a)]; or
- when tax planning opportunities which will create taxable profits in appropriate periods are available to the enterprise [SSAP 12.29(b)].

6.3.23 Therefore, when looking for future taxable income to justify the recognition of a deferred tax asset, the enterprise can look to:

- future taxable profit;
- future reversals of existing taxable temporary differences; and
- tax planning opportunities, i.e. actions that the enterprise could take to create or increase taxable profits in future periods so as to utilise the available tax deductions before they expire (see paragraph 6.3.25).

6.3.24 The enterprise is not entitled to take account of future originating temporary differences (e.g. planned future capital expenditure) because those differences will only arise as a result of future events or transactions.

Tax planning opportunities

6.3.25 Tax planning opportunities are actions that the enterprise can take to increase taxable profit in a particular period, so as to utilise deductible temporary differences or losses carried forward. Although such opportunities are future actions, the enterprise is entitled to consider them in justifying the recognition of a deferred tax asset. They can never be used to justify the reduction of a deferred tax liability.

6.3.26 Examples of tax planning opportunities include:

- being able to elect to have an income source taxed at an earlier point, e.g. electing to have interest income taxed on a receivable, rather than a receipts, basis; and
- being able to defer to a future period the claim for certain tax deductible items, e.g. waiving a claim to first year allowances on an item of equipment, and instead taking annual allowances on the full amount in future periods.

- 6.3.27 In order to take such planning opportunities into account, the enterprise must have the ability to implement the chosen tax planning strategies. For example, planning to take a pension holiday in order to boost taxable profits in a particular period so as to utilise tax losses that are about to expire can only be taken into account if the strategy were likely to be accepted by the workforce.
- 6.3.28 The amount of the asset justified by reference to such proposed strategies must be reduced by the cost of the strategies. The actions must be commercially viable and without significant adverse consequences - otherwise, it is unlikely that management would proceed.

Example 6.3.1 Tax planning opportunities

In 20X1, an enterprise has deductible temporary differences arising of \$4,500,000 and is trying to determine whether it can recognise the entire deferred tax effect as an asset. The temporary differences will result in deductions in the tax computation in 20X2 and any losses arising therefrom will be available for carry forward only up to and including the year 20X4.

Taxable temporary differences of \$1,000,000 also arise in 20X1 and will reverse in 20X2.

The reversing taxable differences in 20X2 will utilise \$1,000,000 of the deductible differences. Therefore, in order to justify recognition of the entire tax asset, the enterprise will need to reasonably anticipate additional taxable profits of \$3,500,000 before the end of 20X4, or to have identified tax planning opportunities so that taxable profits can be increased to that amount before the end of 20X4.

Tax losses

- 6.3.29 Where an enterprise has incurred losses in recent years, greater caution should be exercised before a deferred tax asset is recognised.
- 6.3.30 The Standard points out that unused tax losses provide “strong evidence that future taxable profit may not be available”. It goes on to say that, if there are insufficient deferred tax liabilities reversing in appropriate periods and enterprises, there must be “convincing other evidence” that there will be sufficient taxable profits. [SSAP 12.35]
- 6.3.31 Specifically in the area of tax losses, the Standard points out that preparers need to consider whether unused tax losses result from identifiable causes that are unlikely to recur. Where the losses are likely to recur, it is unlikely that a deferred tax asset can be recognised.
- 6.3.32 The very existence of losses calls future profitability into question. However, the source of the losses may have been addressed, for example, through disposal of loss-making operations, restructurings, or reductions of ongoing costs.
- 6.3.33 Particular attention needs to be paid to restrictions on:
- the number of years for which the losses can be carried forward; and
 - the types of profit against which the losses can be offset.
- 6.3.34 Examples 6.3.2 and 6.3.3 illustrate the principles discussed above.

Example 6.3.2 Utilisation of tax losses

In 20X1, an enterprise has tax losses brought forward of \$4,000,000. Under the tax law of the jurisdiction in which the enterprise operates, these can be carried forward for three years only. The enterprise expects taxable profits to be approximately \$1,000,000 per annum for the next three years. However, tax planning opportunities should enable the enterprise to bring forward a further \$500,000 of taxable profit from later years into the three-year period.

Subject to there being suitable evidence to support the anticipated level of future profitability, the enterprise should recognise an asset in respect of \$3,500,000 of the tax losses. The tax asset recognised should therefore be calculated as \$3,500,000 multiplied by the applicable tax rate.

Example 6.3.3 Utilisation of tax losses

At the end of 20X1, an enterprise has tax losses carried forward of \$500,000. If these are not utilised in 20X2, they will be lost. The enterprise expects a loss for tax purposes in 20X2 of approximately \$100,000. In reaching this estimate, however, the enterprise assumed that it would claim capital allowances on machinery of \$900,000. Under the relevant tax laws, the enterprise is entitled to delay its claim for certain of these allowances. Therefore, tax planning opportunities should enable the enterprise to defer some of the capital allowances to 20X3, thus enabling it to utilise the \$500,000 tax losses in 20X2.

However, if the enterprise anticipates further tax losses, for the foreseeable future, and therefore it cannot gain any benefit from its deferral of capital allowances, then it cannot recognise an asset in 20X1 in respect of the tax losses of \$500,000. This is because the enterprise will pay no tax for the foreseeable future irrespective of whether or not the allowances are carried forward and the losses utilised.

As discussed in this section, the hurdles for recognition of deferred tax assets have been lowered under the revised Standard. Theoretically, therefore, we should expect to see more deferred tax assets appearing on balance sheets. However, given the inherent uncertainty in forecasting future results, we anticipate that the majority of deferred tax assets, particularly those arising from tax losses, will remain unrecognised.

6.4 DEFERRED TAX - MEASUREMENT

Following the identification of those temporary differences that will give rise to deferred tax balances, the next step is to calculate the aggregate deferred tax assets and liabilities to be recognised in the balance sheet.

Computation of Deferred Tax Assets and Liabilities

6.4.1 To calculate the amount of a deferred tax asset or liability, SSAP 12 contains the following formula:

$$\text{Deferred tax liability or asset} = \text{Taxable or deductible temporary difference} \times \text{Tax rate}$$

6.4.2 A deferred tax asset can also arise from tax losses that have been carried forward. These deferred tax assets are calculated as follows:

$$\text{Deferred tax asset} = \text{Unused tax losses} \times \text{Tax rate}$$

Example 6.4.1 Computation of deferred tax liability

A Limited purchased an asset at the beginning of 20X1 for \$100,000. The asset is depreciated over 5 years for accounting purposes and 2 years for tax purposes.

	Carrying amount	Tax base	Taxable temporary difference	Deferred tax liability @17.5%
	\$	\$	\$	\$
20X1	80,000	50,000	30,000	5,250
20X2	60,000	0	60,000	10,500
20X3	40,000	0	40,000	7,000
20X4	20,000	0	20,000	3,500
20X5	0	0	-	-

Applicable Tax Rates and Laws

6.4.3 Deferred tax balances are calculated using the tax rates that are expected to apply to the reporting period or periods when the temporary differences reverse, based on tax rates and tax laws enacted or substantively enacted at the balance sheet date. [SSAP 12.47]

6.4.4 Where the rate that will apply when the temporary difference is expected to reverse is not known, then the best estimate will generally be the current tax rate.

6.4.5 Where the tax rates that will apply to the reporting enterprise are expected to vary in coming years (e.g. in start-up situations where tax concessions are granted in the early years), it is necessary to anticipate the year in which the temporary difference will reverse, so that the deferred tax asset or liability can be calculated at the appropriate rate.

Example 6.4.2 Varying tax rates - tax concession period

A PRC joint venture is entitled to tax concessions during its initial years of operation. The standard income tax rate is 30%. However, the joint venture is fully exempted from PRC income tax for 2 years starting from its first profit-making year (i.e. the first year in which there is a taxable profit after deducting all losses brought forward), followed by a 50% reduction in the PRC income tax rate for the next 3 years.

The joint venture has an item of equipment that cost RMB12,000, which is depreciated over 6 years for accounting purposes and 3 years for PRC income tax purposes, using the straight-line method. The first year that the joint venture has taxable profit is 20X1.

The temporary differences arising as a result of the accelerated tax depreciation will reverse during years 20X4, 20X5 and 20X6 as follows:

	Carrying amount	Tax base	Temporary difference	Reversal of temporary difference	Tax rate	Deferred tax liability
	RMB	RMB	RMB	RMB		RMB
20X1	10,000	8,000	2,000	N/A	0%	300 (2,000 × 15%)
20X2	8,000	4,000	4,000	N/A	0%	600 (4,000 × 15%)
20X3	6,000	0	6,000	N/A	15%	1,200 (4,000 × 15%) + (2,000 × 30%)
20X4	4,000	0	4,000	2,000	15%	900 (2,000 × 15%) + (2,000 × 30%)
20X5	2,000	0	2,000	2,000	15%	600 (2,000 × 30%)
20X6	0	0	-	2,000	30%	-

The above table illustrates that, where tax rates vary, it is necessary to estimate the tax rate that will apply when the temporary difference reverses. In the example, it is predictable that the temporary difference arising in 20X1 will reverse in 20X4 and, therefore, the appropriate tax rate for deferred tax purposes is 15% rather than 0%. Similarly, the temporary differences arising in 20X2 and 20X3 will reverse in 20X5 and 20X6, and tax rates of 15% and 30% should therefore be applied for the temporary differences arising in 20X2 and 20X3 respectively.

Substantively Enacted Tax Rates

6.4.6 The Standard requires that deferred tax assets and liabilities be measured based on rates and laws that have been “enacted or substantively enacted” by the balance sheet date. Whether or not a law has actually been enacted by the balance sheet date is a fact that will be immediately clear. However, where a new rate or law is announced at or before the balance sheet date, but the formalities of the enactment process have not been finalised, it will be necessary to determine whether such announcement constitutes substantive enactment.

- 6.4.7 The Standard acknowledges that, in some jurisdictions, the announcement of new tax rates and tax laws by the government may have the substantive effect of enactment, even if formal enactment takes place some months later. In other countries, it may be necessary for virtually all of the legal stages towards enactment to have been completed before the rates can be considered to be substantively enacted.

This is a grey line that may give rise to differing interpretations, particularly in jurisdictions such as Hong Kong where proposals by the Financial Secretary are generally expected to be enacted as proposed. However, there may be occasions where such proposals are amended or withdrawn. Therefore, we consider that it is not generally appropriate to anticipate changes to tax rates or laws before they have actually been enacted. The IASB is currently re-examining this provision in the equivalent IFRS, and is considering the introduction of a more stringent rule.

Post Balance Sheet Changes in Tax Rates

- 6.4.8 Where there is a post balance sheet date change in tax rates or laws, no adjustment is made to the carrying amounts of deferred tax assets and liabilities. However, where the effect of the change is “of such importance that non-disclosure would affect the ability of the users of the financial statements to make proper evaluations and decisions”, disclosure will be required under SSAP 9 *Events After the Balance Sheet Date*. [SSAP 9.20]

Example 6.4.3 Post balance sheet change in tax rate

An enterprise has interest receivable of \$1,000 in its balance sheet as at 31 March 20X3. The interest will be taxed when it is received, which will be during the year ending 31 March 20X4. On 31 March 20X3, the tax rate, which has remained unchanged for several years, is 16%. On 5 April 20X3, it is announced that the tax rate for the year ending 31 March 20X4 will be increased to 17.5%, and this change is enacted on 25 April 20X3. The financial statements for the year ended 31 March 20X3 are authorised for issue on 30 June 20X3.

The taxable temporary difference is \$1,000.

A deferred tax liability of \$160 will be included in the financial statements for the year ended 31 March 20X3 in respect of the interest receivable. Although the enterprise knows by the time that the financial statements are authorised for issue that the tax rate applying to the interest income when it is received will be 17.5%, the revised Standard precludes using the 17.5% to calculate the deferred tax liability, since this rate was neither enacted nor substantively enacted by 31 March 20X3. If the effect of the change were sufficiently important (see paragraph 6.4.8), the enterprise would include note disclosure.

- 6.4.9 Where, on the other hand, the taxation authority issues revised guidance or interpretations after the balance sheet date that impact the enterprise’s estimate of its tax liabilities or assets, we believe that the tax computations should reflect the revised guidance. This is because the guidance or interpretations represent clarification of tax law that was in place at the balance sheet date.

Variations in Tax Rates According to How the Asset will be Utilised/Liability Settled

- 6.4.10 Where the amount of tax payable or receivable is dependent upon how the enterprise recovers the asset or settles the liability, the rate used to calculate the deferred tax impact should reflect the manner in which the enterprise expects to recover the asset or settle the liability. [SSAP 12.51]

Example 6.4.4 Tax rate varies according to manner of recovery of an asset

The carrying amount of an item of machinery is \$400,000 (cost of \$500,000 less accumulated depreciation of \$100,000). The asset's TWDV is \$300,000 (tax depreciation of \$200,000 having been claimed to date).

Income generated by the use of the asset is taxed at 25%, and thus the tax depreciation is deducted from income that is taxable at 25%. If the asset were sold, any excess of the disposal proceeds over the asset's TWDV would be taxed at 30%.

The taxable temporary difference is \$100,000. If the enterprise intends to continue to use the asset in its business, generating taxable income, the deferred tax liability is \$25,000 (\$100,000 at 25%). If, instead, the enterprise intends to dispose of the asset, the deferred tax liability is \$30,000. (\$100,000 at 30%).

Non-depreciable assets

- 6.4.11 A specific issue arises in respect of non-depreciable assets. As stated in paragraph 6.4.10, the rate to be used should reflect the manner in which the enterprise intends to recover the carrying amount of the asset. But where an asset has an infinite life (i.e. it is non-depreciable), the question arises as to how the term 'recovery' should be interpreted. The HKSA has addressed this issue in Interpretation 20 *Income Taxes - Recovery of Revalued Non-depreciable Assets*.
- 6.4.12 The term 'depreciable asset' is not explicitly defined in Hong Kong accounting literature. However, from the language used in SSAP 17.47, the term can be taken to refer to any non-current asset that has a limited useful life. Thus, leasehold land and buildings are depreciable assets. Freehold land is a non-depreciable asset.
- 6.4.13 When an asset has an infinite life, the carrying amount of the asset will be recovered through sale, notwithstanding that the asset is being used by the business and that there is no current intention to sell it. Therefore, INT 20 concludes that, for revalued non-depreciable assets, deferred tax should be measured based on the tax consequences that would follow from recovery of the carrying amount of the asset through sale.

Example 6.4.5 Non-depreciable asset

An enterprise is carrying freehold land at \$900,000, being its current market value. The land originally cost \$500,000 and is used for the storage of the enterprise's raw materials. The tax rate applicable to manufacturing income is 25% but, on disposal of a capital asset, any proceeds in excess of cost are taxed at 30%. There is currently no intention to sell the freehold land.

The taxable temporary difference between the carrying amount and the tax base of the freehold land is \$400,000. Although the asset is being used by the enterprise in the generation of manufacturing income, the value of the land is not being recovered in that way. All of the value of the land will be recovered through its eventual sale and, therefore, the applicable tax rate is 30%, and the deferred tax liability arising is \$120,000.

Investment property

- 6.4.14 INT 20 includes within its scope investment properties carried at revalued amounts that are accounted for under SSAP 13 *Investment Properties*.
- 6.4.15 Therefore, under Hong Kong GAAP, the deferred tax consequences in respect of revalued investment properties will always be assessed on the basis that the asset will be disposed of. This is irrespective of management's intentions as regards the property.

The inclusion of all revalued investment properties within the scope of INT 20 is unexpected. Although investment properties are not generally depreciated under Hong Kong GAAP, they are 'depreciable' because they have a limited useful life.

By expanding the scope of INT 20, the HKSA has introduced a divergence from IFRS. The equivalent interpretation of the IASB (SIC 21) is clear that only investment properties "that would be considered non-depreciable if IAS 16 were to be applied" fall within its scope. This effectively restricts the scope to freehold land.

The impact of this divergence is potentially very significant. Hong Kong's taxation of gains on disposals of investment properties is generally limited to the amount of tax depreciation previously claimed. Therefore, revaluations in excess of historical cost will generally not have any deferred tax implications.

Owner-occupied property

- 6.4.16 For revalued owner-occupied properties, the expected manner of recovery of the asset will also need to be determined for the purposes of measurement of the deferred tax liability.
- 6.4.17 Similar to investment properties, if owner-occupied properties are disposed of in Hong Kong, the taxable gain will generally be restricted to the tax depreciation previously claimed. Therefore, from the perspective of recognising deferred tax liabilities on revalued properties, it may be advantageous for management to assert that their expectation is that the carrying amount of the property will be recovered through disposal rather than through continuing use. This will generally result in the recognition of a lower deferred tax liability.
- 6.4.18 For owner-occupied properties, unless management has taken positive action to market the property, the case for a planned disposal will be difficult to argue, in the light of the likely disruption to the enterprise's activities in the event of such disposal. Therefore, we would expect the deferred tax liabilities recognised in these circumstances to reflect the continuing use of the asset in the generation of taxable profits.

Changes of intention

- 6.4.19 Where there is a change in management's expectation as to the manner in which an asset will be recovered, or a liability settled, the change may impact the quantification of related deferred tax balances.
- 6.4.20 The deferred tax impact should be remeasured based on management's revised intentions - and the adjustment reflected through the income statement or, to the extent that it relates to items previously charged or credited to equity, through equity.

Progressive Tax Rates

- 6.4.21 In some jurisdictions, the tax rate varies according to the amount of taxable profit earned in a period. This creates a potential issue where it is necessary to predict the tax rate that will apply when a temporary difference reverses. The Standard addresses this situation and requires that, in such circumstances, deferred tax assets and liabilities should be measured using the average rates that are expected to apply in the periods in which the temporary differences are expected to reverse. [SSAP 12.49]

Example 6.4.6 Progressive tax rates

An enterprise has an item of equipment in respect of which a taxable temporary difference of \$1,000 has arisen. The temporary difference is expected to reverse in five years time.

In the particular tax jurisdiction, tax is payable at 10% on the first \$1 million of taxable profit earned, 20% on the next \$2 million of taxable profit earned, 30% on the next \$2 million of taxable profit earned, and 40% on the remainder.

In the current year, the enterprise has earned \$4 million taxable profit and therefore paid tax of \$800,000 (average tax rate 20%). However, in five years time, it is expected that the taxable profit will be \$10 million. If the enterprise does earn a taxable profit of \$10 million, then tax of \$3.1 million will be payable (average tax rate of 31%). Therefore, the deferred tax liability will be measured at \$310 (\$1,000 x 31%).

Tax Rate Varies According to Whether or Not Profits are Distributed

- 6.4.22 The Standard also deals with the circumstances where income taxes are payable at a higher or lower rate if part or all of the net profit or retained earnings are paid out as a dividend to shareholders. In such circumstances, SSAP 12 stipulates that the rate to be used for the purposes of measurement of both current and deferred tax assets and liabilities is the tax rate applicable to undistributed profits. [SSAP 12.52A]
- 6.4.23 The tax consequences of a dividend should only be accounted for when the dividend is recognised as a liability in the financial statements. [SSAP 12.52B]

Example 6.4.7 Tax rate varies according to whether or not profits are distributed

An enterprise has interest receivable of \$1,000 in its balance sheet as at 31 December 20X0. The interest will be taxed when it is received, which will be during the year ending 31 December 20X1. Under local tax regulations, income taxes are payable at a higher rate on undistributed profits (50%), and a lower rate on distributed profits (35%). The enterprise has traditionally paid dividends to shareholders equivalent to 25% of the taxable profit for the year. It continues that dividend policy by paying an interim dividend in March 20X1, before the 31 December 20X0 financial statements are authorised for issue.

The taxable temporary difference is \$1,000. A deferred tax liability of \$500 (\$1,000 x 50%) will be included in the financial statements for the year ended 31 December 20X0 in respect of the interest receivable, even though the enterprise knows that a portion of the taxable profit for 20X1 will be taxed at a lower rate. The liability for the 20X1 interim dividend is not recognised in the financial statements for the year ended 31 December 20X0, and therefore the tax consequences of that dividend are not taken into account.

- 6.4.24 Although the timing of the recognition of the rate change is related to the recognition of the dividend in the financial statements, the Standard clarifies that the liability to pay tax is more directly related to the past events and transactions that gave rise to the tax liability than to the distribution. Therefore, the incremental tax effect should not be dealt with in equity (which might be considered appropriate because the dividend is dealt with in equity). Rather, it should generally be dealt with in the income statement, unless it arose as a result of an underlying transaction or event recognised directly in equity, or a business combination, in line with the general rules set out in SSAP 12.58 (see section 6.5 of this guide). Effectively, this means that the incremental tax effect of the dividend is accounted for in the same manner as the original deferred tax liability.

Discounting

- 6.4.25 The previous version of SSAP 12 was silent as to whether deferred tax assets and liabilities should be discounted to their present values. However, such discounting was very rare.
- 6.4.26 The revised Standard explicitly prohibits the use of discounting for the measurement of deferred tax assets and liabilities. [SSAP 12.53]
- 6.4.27 This prohibition is not based on any conceptual argument. Rather, it reflects the practical issues involved in arriving at a reliable determination of deferred tax assets and liabilities on a discounted basis, which would require detailed scheduling of the expected timing of the reversal of every temporary difference. Having concluded that such detailed scheduling would be impracticable or highly complex in many circumstances (and, therefore, that it would be inappropriate to *require* discounting), the Standard also removes the option to discount deferred tax balances, since that would result in deferred tax balances that were not comparable between enterprises.

Rollover Relief

- 6.4.28 In some jurisdictions, an enterprise may be entitled to 'rollover relief' when it disposes of a capital asset for a profit and replaces it with an equivalent asset. In such circumstances, the gain on disposal is not assessed for tax purposes until the replacement asset is disposed of. Since this merely postpones, rather than eliminates, the payment of tax, SSAP 12 requires that a deferred tax liability be recognised in accordance with the usual rules.

Apportionment of Profits

- 6.4.29 In a Hong Kong context, the IRD has in the past allowed relief in respect of certain PRC sub-contracting arrangements, whereby the IRD has agreed to apportion the profits earned on such activities on a 50:50 basis between Hong Kong and the PRC. Effectively, therefore, the Hong Kong enterprise pays tax on only 50% of its profits. A PRC tax liability does not generally arise.
- 6.4.30 This can be thought of as a 50% reduction in the rate of income tax. If taxable profits of \$100 are earned, and the general tax rate is 16%, then tax of only \$8 is payable. This represents an effective tax rate of 8%. Using the general principle, deferred tax assets and liabilities should be calculated using this rate, provided that the relief is expected to continue throughout the period when the temporary differences reverse.

6.5 DEFERRED TAX - RECOGNITION OF THE MOVEMENT BETWEEN THE OPENING AND CLOSING BALANCE SHEETS

By now, we have identified those deferred tax assets and liabilities to be recognised, and we have measured them. The final step is to identify how they should be recognised, i.e. what is the other side of the entry?

General

6.5.1 The movement between the deferred tax in the opening and closing balance sheets should be recognised in the income statement in arriving at the net profit or loss for the period, except for tax arising from:

- a transaction or event which is recognised, in any accounting period, directly in equity, in which case the movement in deferred tax should be accounted for directly in equity; or
- a business combination that is accounted for as an acquisition, in which case the movement in deferred tax is reflected as an adjustment to the goodwill or negative goodwill arising on acquisition.

[SSAP 12.58, 61 & 66]

6.5.2 In this way, the tax effect of a transaction is accounted for in the same place as the original transaction.

Example 6.5.1 Deferred tax reflected in the income statement

An enterprise purchased an asset for \$100,000 at the beginning of 20X1. The asset's expected useful life is 5 years and depreciation of \$20,000 per annum is charged in each of the 5 years.

For tax purposes, the asset's cost is depreciated over 4 years. The tax rate is 30%.

	Carrying amount	Tax base (TWDV)	Temporary difference	Deferred tax liability	Movement in the year
	\$	\$	\$	\$	\$
20X1	80,000	75,000	5,000	1,500	1,500
20X2	60,000	50,000	10,000	3,000	1,500
20X3	40,000	25,000	15,000	4,500	1,500
20X4	20,000	0	20,000	6,000	1,500
20X5	0	0	-	-	<u>(6,000)</u>
					<u>0</u>

The movement in deferred tax in each of the years is recognised in the income statement.

Recognition of Deferred Tax Directly in Equity

6.5.3 In general, deferred tax arising in a reporting period is debited or credited directly to equity if it relates to an amount that is or was directly debited or credited to equity in the current or a previous reporting period.

6.5.4 The most common example of deferred tax debited to equity is on the revaluation of an asset.

6.5.5 However, where the original debit for the deferred tax liability arising on a revaluation was against the revaluation reserve, the subsequent release of that deferred tax liability is *not* credited to the revaluation reserve. It is credited to income.

This is an important principle to remember - the original recognition of the liability is charged to the revaluation reserve. However, the recovery of the asset (via a depreciation charge) is dealt with in the income statement. Therefore, the release of the deferred tax liability (against the current tax liability arising) is also dealt with in the income statement.

Example 6.5.2 Deferred tax liability arising on the revaluation of a property

B Limited revalues a property from a carrying amount of \$100,000 to \$150,000. The tax base of the asset is \$100,000. The carrying amount of the property is expected to be recovered through use. The applicable tax rate is 30%.

A taxable temporary difference of \$50,000 (\$150,000 - \$100,000) arises on revaluation, giving rise to a deferred tax liability of \$15,000 (\$50,000 x 30%). The following entries record the revaluation and the deferred tax liability:

	<u>DR</u> \$	<u>CR</u> \$
Property, plant and equipment	50,000	
Property revaluation reserve		50,000
Property revaluation reserve	15,000	
Deferred tax liability		15,000

In subsequent periods, the property will be depreciated for both accounting and tax purposes, changing the temporary difference. Any movements in the deferred tax liability are recognised in the income statement. For instance, if the carrying amount of the property at the end of the next reporting period is \$120,000 and the tax base is \$90,000, there is a taxable temporary difference of \$30,000 and a deferred tax liability of \$9,000 (\$30,000 x 30%). This movement for the year is recorded as follows:

	<u>DR</u> \$	<u>CR</u> \$
Deferred tax liability (\$15,000 - \$9,000)	6,000	
Deferred tax (I/S)		6,000

6.5.6 A more detailed discussion of the appropriate accounting for deferred tax arising in relation to revaluations of properties is included in section 8.4 of this guide.

6.5.7 Other circumstances where deferred tax will be dealt with directly in equity include:

- the recognition of valuation movements on available-for-sale investments (see section 8.3);
- the translation of the deferred tax balances of self-sustaining foreign enterprises (see section 8.5);
- the initial classification of a compound financial instrument (see section 8.6); and
- an adjustment to opening retained earnings on the initial adoption of a new SSAP (see section 8.7).

Uncertainty regarding the amount to be recognised directly in equity

- 6.5.8 Where an enterprise is unable to determine the amount of deferred tax that relates to items charged or credited directly to equity, the Standard allows the enterprise to base the amount on a reasonable pro-rata allocation or some other method achieving a more appropriate allocation. [SSAP 12.63]
- 6.5.9 Such uncertainty can arise, for example, when:
- there are graduated rates of income tax, and it is not possible to determine the rate at which a specific component of taxable profit (tax loss) has been taxed; or
 - a change in the tax rate or other tax rules affects a deferred tax asset or liability relating (in whole or in part) to an item that was previously charged or credited to equity; or
 - an enterprise determines that a deferred tax asset should be recognised, or should no longer be recognised in full, and the deferred tax asset relates (in whole or in part) to an item that was previously charged or credited to equity.

Recognition of Deferred Tax Arising from a Business Combination

- 6.5.10 Where a business combination is accounted for as an acquisition, deferred tax balances will arise from the following sources:
- existing deferred tax balances of the acquired entity that will be carried through to the consolidation;
 - additional assets or liabilities recognised on acquisition that are not recognised in the financial statements of the acquired entity;
 - potential new deferred tax balances where fair value adjustments on consolidation result in carrying amounts of assets or liabilities in the consolidated financial statements that differ from the carrying amounts in the acquired entity's financial statements and, consequently, from their tax bases; and
 - potential new deferred tax assets where the recoverability criteria can be met at a group level that could not be met at the entity level (e.g. potential for offsetting taxable profits and losses between group entities).
- 6.5.11 The amount of deferred tax arising from each of these sources is recognised and included as part of the identifiable net assets at the date of acquisition. The combined effect therefore impacts on the amount of goodwill or negative goodwill arising on acquisition.
- 6.5.12 Further discussion of deferred tax arising on business combinations is included in section 8.2 of this guide.

Revaluations for Tax Purposes

- 6.5.13 If an asset is revalued for tax purposes, and this is linked to a revaluation for accounting purposes, the resulting changes in deferred tax from the accounting revaluation and the tax revaluation are taken directly to equity in whichever period they occur. [SSAP 12.65]
- 6.5.14 Where there is a revaluation for tax purposes but there has not been, and is not to be, an accounting revaluation, the tax effect is recognised in the income statement. [SSAP 12.65]
- 6.5.15 There are two common examples of a revaluation for tax, but not accounting, purposes. The first is when tax authorities calculate the taxable gain on disposal of a capital asset by reference to a base cost that represents the original cost of the asset uplifted by an allowance to reflect inflation over the period of ownership.

Example 6.5.3 Revaluation for tax purposes

C Limited purchases an investment property for \$10,000 and does not depreciate it. For tax purposes, there is no depreciation allowance. However, the allowable cost for tax purposes is increased by an agreed inflation index in each period. Assume the tax rate for capital profits is 30% and the agreed inflation increment in each period under consideration is 5%.

	<u>Carrying amount</u>	<u>Tax base</u>	<u>Temporary difference</u>	<u>Deferred tax asset</u>
	\$	\$	\$	\$
20X0	10,000	10,000	-	-
20X1	10,000	10,500	(500)	(150)
20X2	10,000	11,025	(1,025)	(308)

And so on, until the asset is disposed of.

The recognition of the resultant deferred tax asset is dependent on the availability of future profits against which the capital loss can be offset.

Where the asset is recognised, the credit is to the income statement. Therefore, at the end of 20X1, the required journal entry is:

	<u>DR</u>	<u>CR</u>
	\$	\$
Deferred tax asset	150	
Deferred tax (I/S)		150

6.5.16 The second example, in a PRC context, is when an enterprise is listed on a stock exchange, certain assets may be revalued for tax purposes, but the enterprise may determine not to reflect the revaluation in its financial statements. In these circumstances, the deferred tax effect caused by the revaluation of the assets for tax purposes is dealt with in income.

Changes in the Carrying Amount of a Deferred Tax Asset or Liability

6.5.17 The carrying amount of a deferred tax asset or liability may change for a reason other than because the temporary difference itself has changed. Such changes might arise as a result of:

- a change in tax rates or laws; or
- re-assessment of the recoverability of a deferred tax asset; or
- a change in the expected manner of recovery of an asset.

6.5.18 The Standard states that, in such circumstances, the change in deferred tax balances is to be recognised in the income statement, unless the underlying item giving rise to the deferred tax was itself recognised in equity. [SSAP 12.60]

6.5.19 So, for example, where a deferred tax amount has previously been charged to a revaluation reserve at the time of the revaluation of an asset, and the deferred tax liability subsequently changes because of a change in tax rates, the adjustment to the deferred tax liability so that it reflects the revised tax rates is also charged or credited to equity.

- 6.5.20 Similarly for a change of intention. For example, where an enterprise has previously estimated the deferred tax liability arising on the revaluation of an owner-occupied property on the basis that it would continue to be used to generate taxable manufacturing profits, and a decision is subsequently made to dispose of the property, thus reducing the deferred tax liability, the adjustment to the deferred tax liability is also reflected in equity.

Changes in the Tax Status of an Enterprise or its Shareholders

- 6.5.21 A change in the tax status of an enterprise or of its shareholders may have consequences for an enterprise by increasing or decreasing its tax assets or liabilities. This may occur, for example, upon the public listing of an enterprise's equity investments, or upon a controlling shareholder's move to a foreign country. As a result of such an event, an enterprise may be taxed differently, which may have an immediate effect on its current and deferred tax assets and liabilities. Interpretation 21 (INT 21) *Income Taxes - Changes in the Tax Status of an Enterprise or its Shareholders* establishes the accounting treatment for such changes.
- 6.5.22 INT 21 requires the current and deferred tax consequences of a change in tax status to be included in the net profit or loss for the period, unless those consequences relate to transactions or events that result, in the same or a different period, in a direct credit or charge to the recognised amount of equity. Those tax consequences that relate to changes in the recognised amount of equity, in the same or a different period, should be charged or credited directly to equity.
- 6.5.23 Effectively, this means that an analysis should be performed of the original accounting for the transactions or events that gave rise to the current and deferred tax balances. To the extent that those transactions or events were recognised in equity (e.g. asset revaluations), the incremental tax effect should also be recognised in equity. Therefore, the cumulative amount of tax charged or credited to equity will be the same amount that would have been charged or credited directly to equity if the new tax status had applied previously.
- 6.5.24 Where there is uncertainty as to the amount that was previously dealt with in equity, it may be necessary to make an allocation on a reasonable basis (see paragraph 6.5.8 above).
- 6.5.25 Note that the Interpretation does not permit the effect on deferred tax balances that arose at the time of a business combination to be dealt with as an adjustment to goodwill or negative goodwill. The change in tax status is a post-acquisition event and, therefore, is accounted for post-acquisition. Since the original deferred tax was not dealt with in equity, the incremental effect must, by default, be dealt with in income.
- 6.5.26 The tax rate applied to an enterprise may change as a result of its being acquired by another entity. In these circumstances, in the individual enterprise's financial statements, the adjustments to deferred tax assets and liabilities will be accounted for in accordance with INT 21, as discussed in the previous paragraphs. However, in the consolidated financial statements, the deferred tax assets and liabilities will be measured using the revised tax rates - and, consequently, the incremental effect of the acquisition will be reflected as an adjustment to goodwill or negative goodwill.

7 PRESENTATION AND DISCLOSURE

General

- 7.1 The previous version of SSAP 12 included some disclosure requirements - essentially requiring the disclosure of the major components of provided and unprovided deferred tax. The disclosure requirements of the revised Standard are more onerous - requiring a detailed explanation of the tax charge arising in the period, of movements on deferred tax balances, and of the expectations for the recoverability of deferred tax assets. For listed enterprises, these disclosure requirements will result in significantly increased information in relation to the enterprise's tax affairs being available for the first time to competitors, analysts and other users of the financial statements.
- 7.2 In the areas of balance sheet presentation, and particularly offset of tax assets and liabilities, the revised Standard also establishes more stringent rules.

Presentation in the Financial Statements

Balance sheet

- 7.3 The rules laid down in the Standard regarding the presentation of both current and deferred tax in the balance sheet are:
- tax assets and liabilities may not be combined with other assets and liabilities, but must be shown separately on the balance sheet;
 - deferred tax assets and liabilities must be presented separately from current tax assets and liabilities; and
 - deferred tax assets and liabilities must be classified as non-current.

[SSAP 12.69, 70]

Offset of tax assets and liabilities

- 7.4 In a similar approach to that taken in SSAP 1 *Presentation of Financial Statements*, the Standard takes a strong line on the extent to which tax assets and liabilities can be offset against one another to present only a net figure in the balance sheet.
- 7.5 The rules as regards offset are as follows:
- current tax assets and current tax liabilities should be offset only where the enterprise has a legally enforceable right to set off the amounts, and the enterprise intends either to settle on a net basis or to realise the asset and settle the liability simultaneously; and
 - deferred tax assets and deferred tax liabilities should be offset only where the enterprise has a legally enforceable right to set off current tax assets against current tax liabilities, and the deferred tax assets and liabilities relate to taxes levied by the same taxation authority on either the same taxable enterprise or group enterprises meeting certain conditions (see paragraph 7.9 below).

[SSAP 12.71,74]

- 7.6 The Standard explains that an enterprise has a legally enforceable right to set off current tax assets against current tax liabilities when they relate to taxes levied by the same taxation authority, and that authority permits the enterprise to make or receive a single net payment. [SSAP 12.72]

- 7.7 Therefore, where an enterprise is preparing consolidated financial statements, current tax assets and liabilities arising from different group enterprises should not be offset unless:
- they relate to the same taxation authority;
 - that authority permits net settlement; and
 - the enterprises intends to settle net, or to recover the asset and settle the liability simultaneously.
- 7.8 Under the rules set out at paragraph 7.5, deferred tax assets and liabilities arising in the same legal entity (which is also a single taxable entity) can generally be offset. However, where, for example, the taxable entity has capital losses carried forward, those losses can only be offset against deferred tax liabilities to the extent that recognised deferred tax liabilities arise from unrealised capital gains.
- 7.9 When preparing consolidated financial statements, a deferred tax asset in one group enterprise can be set off against a deferred tax liability arising in a different group enterprise only if:
- they relate to the same taxation authority;
 - that authority permits net settlement of current tax liabilities and refunds; and
 - the enterprises intend either to settle current tax assets and liabilities on a net basis, or to recover the assets and settle the liabilities simultaneously, in each future period in which significant amounts of the deferred tax balances are expected to be settled or recovered.
- 7.10 In a consolidation situation, the first condition to overcome is the requirement for the balances to be levied by the same taxation authority. This effectively prohibits the offset of deferred tax assets and liabilities arising in different jurisdictions.
- 7.11 Even for enterprises operating within the same jurisdiction, except where there are formal group relief arrangements as described at paragraph 4.14, it will be unusual for the taxation authority to permit net settlement between different taxable entities.
- 7.12 Therefore, in preparing consolidated financial statements, the deferred tax balances of the separate entities will generally be aggregated without further setting off deferred tax balances of one entity against those of another entity.

Income statement

- 7.13 The only presentation rule stipulated in respect of the income statement is that the tax expense or income related to the profit or loss from ordinary activities should be presented on the face of the income statement. [SSAP 12.77]

Disclosure Requirements

7.14 SSAP 12 has extensive disclosure requirements. These are listed in detail in the Presentation and Disclosure Checklist in Appendix II to this guide (with cross-references to the relevant paragraphs in the Standard), and illustrated in Appendix III.

Income statement

7.15 The major components of the tax charge or credit in the income statement are required to be separately identified, including:

- the current tax expense or income;
- adjustments recognised in the current period in respect of earlier periods' current tax;
- the deferred tax expense or income relating to the origination and reversal of temporary differences;
- adjustments to deferred tax resulting from changes in tax rates or the imposition of new taxes;
- the amount of the benefit resulting from a previously unrecognised tax loss, tax credit or temporary difference of a prior period that is used to reduce current or deferred tax expenses; and
- the deferred tax expense arising from the write-down of a deferred tax asset, or the deferred tax income arising from the reversal of a previous write-down of a deferred tax asset, following the annual review of the carrying amount of deferred tax assets (see paragraphs 6.3.19 and 6.3.20).

Reconciliation of tax charge

7.16 SSAP 12 requires the presentation of an explanation of the relationship between the tax charge or credit in the income statement and the accounting profit.

7.17 The explanation is required to be presented in one of the following formats:

- a numerical reconciliation between the tax charge or credit and the product of accounting profit multiplied by the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed (reconciliation in absolute terms); or
- a numerical reconciliation between the average effective tax rate (being the tax expense or income divided by the accounting profit) and the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed (reconciliation in percentage terms).

7.18 Example 7.1 overleaf, taken from Appendix B to the Standard, illustrates these alternative formats. The intention is that this disclosure will enable users of the financial statements to understand the significant factors that have affected the relationship between the tax charge or credit and the accounting profit, and which factors are likely to affect the relationship in the future.

Example 7.1 Reconciliation of tax charge

(i) Reconciliation in absolute terms

	<u>20X1</u>	<u>20X0</u>
	\$'000	\$'000
Accounting profit	8,740	8,775
Tax at the applicable rate of 35% (20X0: 40%)	3,059	3,510
Tax effect of expenses that are not deductible in determining taxable profit	122	480
Reduction in opening deferred tax liability resulting from reduction in tax rate	<u>(1,127)</u>	<u>-</u>
Tax expense	<u>2,054</u>	<u>3,990</u>

(ii) Reconciliation in percentage terms

	<u>20X1</u>	<u>20X0</u>
	%	%
Applicable tax rate	35.0	40.0
Tax effect of expenses that are not deductible in determining taxable profit	1.4	5.5
Effect on opening deferred tax liability of reduction in tax rate	<u>(12.9)</u>	<u>-</u>
Average effective tax rate (tax expense divided by profit before tax)	<u>23.5</u>	<u>45.5</u>

Readers will note that, in our illustrative disclosures in Appendix III, we have presented the reconciliation both in absolute and in percentage terms. We believe that both measures are relevant for users of the financial statements, and they can both be reported by the enterprise for minimal additional cost, and without revealing any additional information. However, readers should note that this dual presentation is not a requirement.

7.19 Given that full provision is generally made for deferred taxation effects, the principal elements that will affect the relationship between the tax charge or credit and the accounting profit are:

- revenue that is exempt from taxation;
- expenses that are not deductible in determining taxable profit or loss;
- the effects of tax losses (e.g. where losses brought forward that had not previously been recognised as deferred tax assets are utilised in the current period, or losses arising in the current period are not recognised as deferred tax assets due to concerns as to their recoverability);
- non-recognition of other deferred tax assets, or allowances made against the carrying amounts of previously recognised deferred tax assets, due to concerns as to their recoverability;
- adjustments to deferred tax balances caused, for example, by changes in tax rates; and
- the effect of differing tax rates, for example, for subsidiaries operating overseas (where the enterprise has not taken the option to present separate reconciliations as discussed in paragraph 7.22 below).

The applicable tax rate

- 7.20 The starting point for the reconciliation (whether in absolute or in percentage terms) is the 'applicable tax rate'. Particularly in group situations, it is important for the enterprise to select an applicable tax rate that gives the most meaningful information. This might be the rate of tax in the reporting enterprise's home country, or in the jurisdiction where the principal operating subsidiaries are located.
- 7.21 While, in many cases, the use of the domestic tax rate in the jurisdiction in which the enterprise is domiciled is appropriate, there will be exceptions. Most notably, in the context of Hong Kong listed enterprises, where the parent company is very commonly incorporated in Bermuda or another offshore jurisdiction, but the operations are carried out in Hong Kong, the most meaningful rate to use will be the Hong Kong Profits Tax rate.
- 7.22 Where the enterprise operates in different jurisdictions, the Standard specifically permits that a reconciliation can be presented for each jurisdiction in which the enterprise operates (using the domestic rate in each jurisdiction), and the separate reconciliations aggregated. This will be the most informative presentation in many circumstances.

Where the group elects not to present a separate reconciliation for each relevant tax jurisdiction, the effect of the differing tax rates will appear as a reconciling item between the 'theoretical' tax charge and the actual tax charge. If this reconciling item is a significant amount, it detracts from the information value of the reconciliation. We therefore believe that, where practicable, the presentation of separate reconciliations is the preferred option, except where the impact of the differing tax rates is not significant.

Where it is not practicable to present separate reconciliations (e.g. for multi-national corporations operating in many jurisdictions), the reconciliation could be supplemented by narrative notes to improve its information value.

- 7.23 Many Hong Kong enterprises have a significant proportion of their operations based in the PRC, and will need to determine whether it is more meaningful to designate the Hong Kong Profits Tax rate or the PRC Income Tax rate as the starting point for this reconciliation. Where the operations are substantially based and taxed in the PRC, then using the PRC rate will be the most meaningful, even if all of the group administration functions are based in Hong Kong. Where there are taxable operations in both jurisdictions, the presentation of separate reconciliations as discussed at paragraph 7.22 above would enhance the transparency of the disclosures.

7.24 Example 7.2 illustrates the presentation of separate reconciliations.

Example 7.2 Separate reconciliations for different jurisdictions

	Hong Kong		PRC		Total	
	20X1	20X0	20X1	20X0	20X1	20X0
Applicable tax rate	17.5%	16%	30%	30%	N/A	N/A
	\$'000	\$'000	\$'000	\$'000	\$'000	\$'000
Accounting profit	5,036	4,972	3,704	3,801	8,740	8,773
Tax at the applicable rate	881	796	1,111	1,140	1,992	1,936
Tax effect of expenses that are not deductible in determining taxable profit	59	23	232	198	291	221
Tax effect of utilisation of losses not previously recognised	-	(122)	(98)	(73)	(98)	(195)
Increase in the opening deferred tax liability resulting from an increase in the tax rate	150	-	-	-	150	-
Tax expense	1,090	697	1,245	1,265	2,335	1,962
Average effective tax rate	21.6%	14%	33.6%	33.3%	26.7%	22.4%

7.25 Using the same figures as in Example 7.2, the following example illustrates a single reconciliation using the Hong Kong Profits Tax rate as the applicable tax rate. Readers will appreciate that it confuses the effects of the various reconciling items.

Example 7.3 Single reconciliation for different jurisdictions

	20X1	20X0
	\$'000	\$'000
Accounting profit	8,740	8,773
Tax at the applicable tax rate of 17.5% (20X0: 16%)	1,530	1,404
Tax effect of expenses that are not deductible in determining taxable profit	194	129
Tax effect of utilisation of losses not previously recognised	(57)	(161)
Increase in the opening deferred tax liability resulting from an increase in the tax rate	150	-
Effect of different tax rates of subsidiaries operating in other jurisdictions	518	590
Tax expense	2,335	1,962

- 7.26 Additionally, in a PRC context, where certain subsidiaries are enjoying temporary tax exemptions or reductions in tax rates (e.g. in the early years of operation), the enterprise will need to consider which is the most effective means of communicating the effect of this relief. Take, for example, a foreign enterprise that would normally pay income tax at 30% but, for the first two profitable years of operation, is exempted from tax and, for next three years, the rate is reduced by half to 15%. One could take the view that the actual tax rate (0% for the first two profitable years, and 15% for the next three years) should be used as the starting point, since those are the applicable tax rates for those years. However, this approach is not very helpful, particularly in the tax-exempt years when the user of the financial statements would receive no information.
- 7.27 An alternative view is that, because the reduction in tax rate is temporary, in order to meet the objective stated in paragraph 7.18 of helping users to understand the expected tax position in the future, it is more meaningful to start with 30% as the applicable rate, and then show the reduction of the tax rate as a temporary tax relief. The decision rests with the reporting enterprise. Our preference is for the second approach (i.e. to use the full tax rate, with the 'relief' shown as a reconciling item), because we believe that it is more informative. However, we do not consider that either is mandated by the Standard, provided that the terms of the relief are fully explained in the financial statements so that a user can understand the implications for the future.
- 7.28 In any case, as noted at paragraph 7.17 above, the basis of calculation of the applicable tax rate is required to be disclosed.

Balance sheet

- 7.29 SSAP 12 requires a detailed analysis of the deferred tax assets and liabilities recognised in the financial statements, and the movements in each of the principal categories of temporary difference during the period. Movements for the comparative period are also required to be disclosed.
- 7.30 Although the previous version of SSAP 12 also included a requirement for an analysis of deferred tax balances by their major components, the wider scope of the new Standard is likely to result in a much more complex analysis and reconciliation of movements. This will require detailed tracking of information, particularly for enterprises with operations in a number of jurisdictions.

Assets recognised by loss-making enterprise

- 7.31 Where an enterprise that has suffered a loss in the current or preceding period recognises a deferred tax asset, the utilisation of which is dependent on future taxable profits in excess of the profits arising from the reversal of existing taxable temporary differences, the amount of that deferred tax asset and the nature of the evidence supporting its recognition are required to be disclosed.

Unrecognised temporary differences

- 7.32 The Standard also requires comprehensive disclosures in respect of unrecognised temporary differences, including:
- the amount (and expiry date, if any) of deductible temporary differences, unused tax losses, and unused tax credits for which no deferred tax asset is recognised in the balance sheet; and
 - the aggregate amount of temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, for which deferred tax liabilities have not been recognised.
- 7.33 In respect of investments in subsidiaries, branches and associates, and interests in joint ventures, the requirement is to disclose the amount of the underlying temporary differences for which deferred tax liabilities have not been recognised, rather than to disclose the amounts of the liabilities themselves, because the computation of the liabilities may be impracticable in many cases. However, where such quantification is practicable, the Standard encourages the disclosure of the amounts of the unrecognised liabilities.

Consequences of dividends

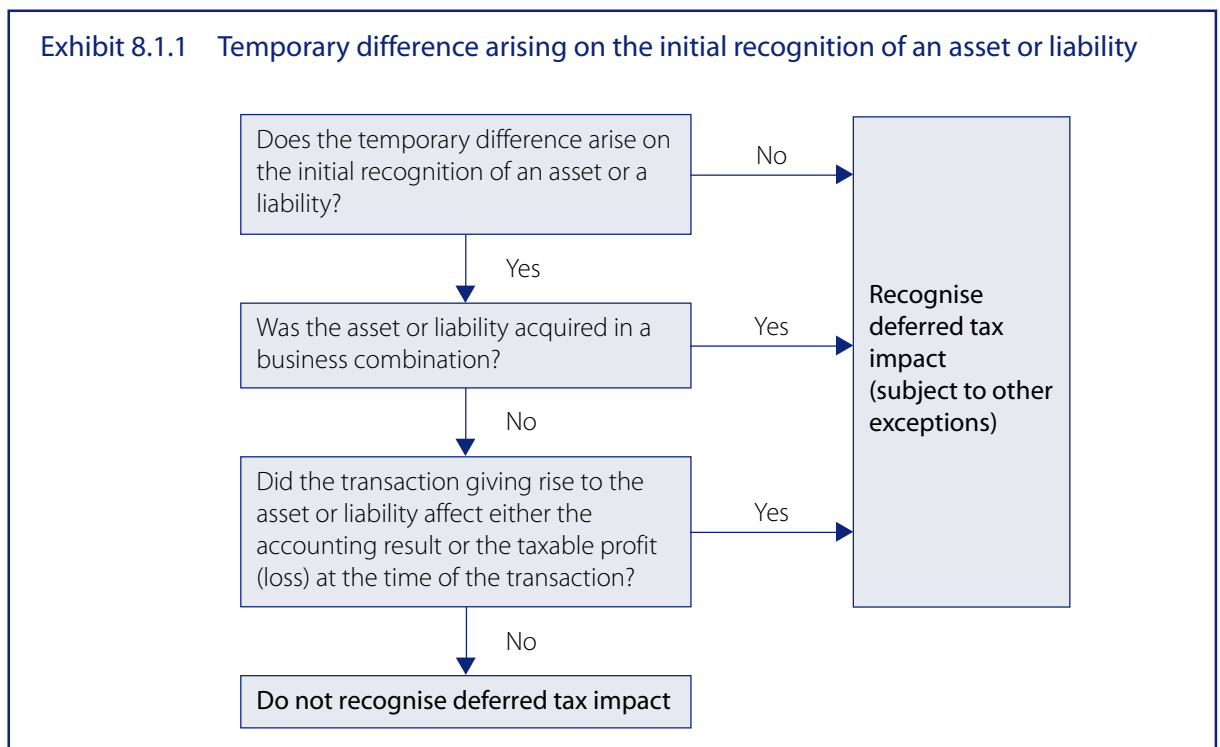
- 7.34 As discussed at paragraph 6.4.23, an enterprise does not account for the income tax consequences of the payment of a dividend until the liability for the dividend is recognised in the financial statements. However, the Standard does require disclosure of the amount of the income tax consequences of dividends that were proposed or declared before the financial statements were authorised for issue, but are not recognised as a liability in the financial statements.
- 7.35 In addition, in circumstances where the tax rate varies according to whether or not profits are distributed, the nature of the potential income tax consequences for the enterprise that would result from the payment of dividends to its shareholders is required to be disclosed. The enterprise should describe:
- the important features of the tax systems concerned, and the factors that will affect the amount of the potential tax consequences of dividends;
 - the amounts of potential income tax consequences to the enterprise from distributing its undistributed earnings, where such amounts are practicably determinable; and
 - whether there are any potential income tax consequences that are not practicably determinable.

Other disclosure requirements

- 7.36 Other disclosure requirements include:
- the aggregate current and deferred tax relating to items that are charged or credited to equity;
 - any tax-related contingent liabilities and contingent assets in accordance with SSAP 28 *Provisions, Contingent Liabilities and Contingent Assets*; and
 - where changes in tax rates or tax laws are enacted or announced after the balance sheet date, any significant impact on the enterprise's current and deferred tax assets and liabilities (see paragraph 6.4.8).

8.1 INITIAL RECOGNITION OF AN ASSET OR LIABILITY

- 8.1.1 SSAP 12 requires the recognition of deferred tax in respect of temporary differences arising, where an asset or liability results from any one of the following:
- a transaction that affects the income statement (e.g. anticipation of income receivable (asset), or accrual of costs payable (liability)); or
 - a transaction that affects taxable income (e.g. expenditure on assets such as computer equipment allowed for tax purposes when paid (asset), or deferral of income recognition in respect of funds that are taxable when received (liability)); or
 - a business combination.
- 8.1.2 However, SSAP 12 prohibits the recognition of deferred tax on the initial recognition of an asset or liability in any other circumstances. Exhibit 8.1.1 illustrates these rules in the form of a flowchart.



- 8.1.3 One example given in SSAP 12 is that of an asset for which the enterprise gets no deduction against taxable profits as it depreciates the asset. Assuming that the enterprise intends to recover the value of the asset through use, the tax base of the asset is nil. Therefore, a taxable temporary difference equal to the cost of the asset arises on initial recognition. However, the Standard does not permit a deferred tax liability to be recognised in such circumstances - it is argued that if a deferred tax liability were recognised, the equivalent amount would have to be added to the asset's carrying amount in the balance sheet, or be charged to income at the date of initial recognition, and this would make the financial statements "less transparent".

This exception is based on pragmatism and the desire to avoid the particular financial statement effects discussed in paragraph 8.1.3, rather than any particular conceptual basis. As will be seen from the following paragraphs, it is quite a significant exception in a Hong Kong context, where a portion of the initial expenditure on properties is very often disallowed for tax purposes.

- 8.1.4 In a Hong Kong context, the most common circumstance in which a difference arises between the cost of an asset on initial recognition and its tax base is the acquisition of a building or structure for which only part of the capital expenditure (i.e. qualifying expenditure) will be eligible for tax deduction. For example, under the Hong Kong Inland Revenue Ordinance, expenditure incurred on the acquisition, preparation and levelling of land is excluded from qualifying expenditure. When a second-hand building is purchased, the qualifying expenditure may be restricted to the construction cost incurred by the original developer.
- 8.1.5 In these circumstances, the deferred tax impact of the temporary difference arising on initial recognition is not recognised. Nor is the deferred tax effect of the subsequent reversal of the temporary difference recognised.

Example 8.1.1 Taxable temporary difference arising on initial recognition of an asset

D Limited purchases an asset for \$100,000. Only \$60,000 is qualifying expenditure for tax purposes. The carrying amount of the asset will be recovered through use in taxable manufacturing operations. The asset is depreciated at 25% for both tax and accounting purposes.

	Carrying amount	Tax base	Temporary difference	Deferred tax
	\$	\$	\$	\$
20X0	100,000	60,000	40,000	-
20X1	75,000	45,000	30,000	-
20X2	50,000	30,000	20,000	-
20X3	25,000	15,000	10,000	-
20X4	0	0	-	-

No deferred tax is ever recognised in respect of the original temporary difference.

- 8.1.6 Subsequent to initial recognition, additional temporary differences may arise in respect of the same asset or liability. In such circumstances, the deferred tax effect of those additional temporary differences is recognised in accordance with the usual rules.

Example 8.1.2 Additional temporary difference arising due to differing depreciation rates

Facts as per Example 8.1.1, but the asset is depreciated at 25% for accounting purposes and 33 $\frac{1}{3}$ % for tax purposes. The tax rate is 17.5%.

	Carrying amount	Tax base	Temporary difference	Unrecognised temporary difference	Recognised temporary difference	Deferred tax liability
	\$	\$	\$	\$	\$	\$
			[A]	[B]	[A]-[B]	
20X0	100,000	60,000	40,000	40,000	-	-
20X1	75,000	40,000	35,000	30,000	5,000	875
20X2	50,000	20,000	30,000	20,000	10,000	1,750
20X3	25,000	0	25,000	10,000	15,000	2,625
20X4	0	0	-	-	-	-

- 8.1.7 Effectively what is required, as is illustrated in Example 8.1.2, is to deduct from the temporary difference at each period end the proportion of the asset's carrying amount that represents the unrecognised temporary difference at the date of acquisition, as reduced by subsequent depreciation.
- 8.1.8 Deferred tax is provided in respect of the remainder of the temporary difference (the recognised temporary difference) in accordance with the usual rules.
- 8.1.9 Additional temporary differences will also arise when the asset is subsequently revalued.

Example 8.1.3 Additional temporary difference arising on revaluation

Facts as per Example 8.1.1 (i.e. depreciation at 25% for both tax and accounting purposes), but assume that the asset is revalued to \$120,000 at the end of the first year.

	Carrying amount	Tax base	Temporary difference	Unrecognised temporary difference	Recognised temporary difference	Deferred tax liability
	\$	\$	\$	\$	\$	\$
			[A]	[B]	[A]-[B]	
20X0	100,000	60,000	40,000	40,000	-	-
20X1	120,000	45,000	75,000	30,000	45,000	7,875
20X2	80,000	30,000	50,000	20,000	30,000	5,250
20X3	40,000	15,000	25,000	10,000	15,000	2,625
20X4	0	0	-	-	-	-

- 8.1.10 The treatment of temporary differences arising on the revaluation of properties, and the subsequent reversal of such temporary differences, is discussed in detail in section 8.4 of this guide.
- 8.1.11 The above examples all deal with deferred tax *liabilities* arising on the initial recognition of an asset. More rarely, deferred tax *assets* can arise in such circumstances. The example cited in SSAP 12 for a deferred tax asset arising on initial recognition is when a non-taxable government grant related to an asset is deducted in arriving at the carrying amount of the asset but, for tax purposes, is not deducted from the asset's depreciable amount (i.e. its tax base). The carrying amount of the asset is less than its tax base, giving rise to a deductible temporary difference. Under SSAP 35, the government grant may also be set up as deferred income, in which case the difference between the deferred income and its carrying amount of nil is a deductible temporary difference. Whichever method of presentation is adopted, the enterprise does not recognise the resulting deferred tax asset.

Amounts Affecting Accounting Profit or Taxable Income

- 8.1.12 To re-emphasise the basic principle set out in paragraph 8.1.1, deferred tax balances are recognised if they arise from a temporary difference related to an asset or a liability that has affected *either* accounting profit or taxable income at the time of initial recognition.
- 8.1.13 The most common examples of this requirement relate to items that are recognised for tax and accounting purposes in different periods. For example, development costs incurred in the PRC are generally expensed as incurred for PRC tax purposes. For Hong Kong reporting enterprises, under SSAP 29 *Intangible Assets*, such expenditure is capitalised, if certain conditions are met, and amortised over its useful life. In this case, the expenditure affects taxable income at the time of the initial recognition of the transaction, but has no effect on the accounting result. Because the expenditure does affect taxable income, the initial recognition exception does not apply, and the deferred tax impact is recognised.
- 8.1.14 The most common examples of items affecting accounting profit but not taxable profit at the time of initial recognition relate to liabilities. For example, interest payable may be accrued for accounting purposes, but not allowed for tax purposes until it is paid. In these circumstances, a liability is recognised and a temporary difference arises on the initial recognition of that liability. The deferred tax effect of that liability is recognised because the transaction has affected accounting profit.

8.2 BUSINESS COMBINATIONS

- 8.2.1 The previous version of SSAP 12 was silent as to the required treatment of deferred tax in respect of business combinations. But the recognition of the deferred tax impact of business combinations is a major principle of the new Standard.
- 8.2.2 For these purposes, we will only be dealing with business combinations that are accounted for as acquisitions. Business combinations that are accounted for using merger accounting (under Hong Kong GAAP, only qualifying group reconstructions under SSAP 27 *Accounting for Group Reconstructions*) will not give rise to any particular deferred tax issues because the consolidated balance sheet under merger accounting merely aggregates the balance sheets of the combining entities.
- 8.2.3 Where deferred tax arises at the time of a business combination, and it has not been recognised by the acquiring or the acquired entity prior to the acquisition, it must be recognised and taken into account in measuring goodwill or negative goodwill on acquisition. Such deferred tax adjustments are not directly debited or credited to goodwill, but are included as part of the identifiable net assets acquired when measuring goodwill or negative goodwill.
- 8.2.4 At the date of acquisition, deferred tax balances may be adjusted, or new deferred tax balances may arise, for the following reasons:
- the carrying amounts of assets and liabilities may be different in the consolidated financial statements due to fair value adjustments made on acquisition;
 - additional assets or liabilities may be recognised at the date of the acquisition;
 - temporary differences between the carrying amounts and tax bases of assets and liabilities which were not recognised by the acquired entity itself due to the initial recognition exception (see section 8.1 of this guide) will be recognised in the consolidated financial statements; and
 - certain deferred tax assets (e.g. those arising from tax losses) which did not qualify for recognition at an individual enterprise level may qualify for recognition at a group level.
- 8.2.5 In the consolidated financial statements, additional deferred tax adjustments may arise due to unrealised profits or losses on intra-group transactions that have been eliminated on consolidation.

Fair Value Adjustments

- 8.2.6 When accounting for a business combination that is an acquisition, the identifiable assets and liabilities acquired are recognised in the consolidated financial statements at their fair value as at the date of acquisition. This will often result in different carrying amounts to those recognised by the entity or operation being acquired. However, the tax bases of the assets and liabilities may not change.
- 8.2.7 For example, where the fair value of an asset at the date of acquisition is higher than its carrying amount in the acquired entity's financial statements, and the asset is recognised at the higher amount for consolidation purposes, the tax base is unlikely to be affected. In these circumstances, a taxable temporary difference arises as a result of the acquisition. The deferred tax liability arising from the taxable temporary difference is recognised in the consolidated financial statements to reflect the future tax consequences of recovering the recognised fair value of the asset.
- 8.2.8 Example 8.2.1 provides a simple illustration. Note that a deferred tax liability arises, and goodwill is increased by an equivalent amount. This effect would not generally have been recognised under the previous version of the Standard.

Example 8.2.1 Assets recognised at fair value on acquisition

H Limited acquires S Limited, which holds two properties and sundry other assets. Properties A and B are, for tax and accounting purposes, depreciated over 10 years and will be recovered through use in taxable manufacturing operations.

Net assets of S Limited	Book value	Fair value	Tax base	Temporary difference	Tax rate	Deferred tax liability
	\$	\$	\$	\$		\$
Property A	100	130	100	30	30%	9
Property B	150	140	150	(10)	30%	(3)
Other net assets	30	30	30	-	-	-
	<u>280</u>	300	<u>280</u>	<u>20</u>		<u>6</u>
Deferred tax arising on acquisition		(6)				
Identifiable net assets acquired		294				
Consideration		<u>350</u>				
Goodwill		<u>56</u>				

Consolidation (at date of acquisition)

	H Limited	S Limited	Consolidation adjustments	Consolidated
	\$	\$	\$	\$
Investment in S Limited	350	-	(350)	-
Goodwill	-	-	56	56
Property A	-	100	30	130
Property B	-	150	(10)	140
Other net assets	-	30	-	30
Deferred tax	-	-	(6)	(6)
	<u>350</u>	<u>280</u>		<u>350</u>
Share capital	(350)	(150)	150	(350)
Retained profits	-	(130)	130	-
	<u>(350)</u>	<u>(280)</u>	0	<u>(350)</u>

Additional Assets or Liabilities Recognised on Acquisition

- 8.2.9 On acquisition, under the rules of SSAP 30 *Business Combinations*, additional assets and liabilities may be identified that are not recognised in the financial statements of the acquired entity. This will commonly be the case, for example, in respect of intangible assets.
- 8.2.10 Where such additional assets or liabilities are recognised, the deferred tax implications should also be recognised. Although this may be the first time that the assets or liabilities are recognised, there is no initial recognition exception (as discussed at section 8.1 of this guide) because the recognition results from a business combination.

Example 8.2.2 Additional asset recognised on acquisition

Facts as per Example 8.2.1. In addition, on acquisition, an intangible asset of \$50 is recognised in respect of patents held by S Limited. The tax base of the patents is nil.

In these circumstances, there is no temporary difference in the financial statements of S Limited. However, a temporary difference does arise in the consolidated financial statements because the carrying amount of the intangible asset differs from its tax base (which is nil).

Net assets of S Limited	Book value	Fair value	Tax base	Temporary difference	Tax rate	Deferred tax liability
	\$	\$	\$	\$		\$
Property A	100	130	100	30	30%	9
Property B	150	140	150	(10)	30%	(3)
Intangible asset	0	50	0	50	30%	15
Other net assets	30	30	30	-	-	-
	<u>280</u>	350	<u>280</u>	<u>70</u>		<u>21</u>
Deferred tax arising on acquisition		<u>(21)</u>				
Identifiable net assets acquired		329				
Consideration		<u>350</u>				
Goodwill		<u>21</u>				

Consolidation (at date of acquisition)

	H Limited	S Limited	Consolidation adjustments	Consolidated
	\$	\$	\$	\$
Investment in S Limited	350	-	(350)	-
Goodwill	-	-	21	21
Intangible asset	-	-	50	50
Property A	-	100	30	130
Property B	-	150	(10)	140
Other net assets	-	30	-	30
Deferred tax	-	-	(21)	<u>(21)</u>
	<u>350</u>	<u>280</u>		<u>350</u>
Share capital	(350)	(150)	150	(350)
Retained profits	-	(130)	130	-
	<u>(350)</u>	<u>(280)</u>	-	<u>(350)</u>

As compared to Example 8.2.1, the goodwill arising on acquisition of \$56 has been reduced by \$35. This is the value of the intangible asset recognised (\$50), net of its deferred tax impact (\$15).

- 8.2.11 Under the current version of SSAP 30, the amount recognised in respect of an intangible asset may be restricted so that it does not give rise to negative goodwill (see SSAP 30.37). In these circumstances, the deferred tax effect on recognition is calculated by reference to the restricted value. This is consistent with the general principle discussed in earlier sections of this guide that deferred tax is accounted for only in respect of amounts recorded in the financial statements.
- 8.2.12 Although the recognition of other assets and liabilities on acquisition may give rise to deferred tax implications, the recognition of goodwill itself does not do so. Conceptually, there is no difference. However, for the reasons discussed in section 6.3 of this guide, the recognition of deferred tax in respect of goodwill for which the amortisation is not tax deductible is prohibited. Where goodwill is tax deductible, no temporary difference arises, and therefore there is no deferred tax impact.

Additional Deferred Tax Balances Recognised on Acquisition

- 8.2.13 In certain circumstances, the deferred tax impact of temporary differences identified by the acquired entity may not have been recognised in the entity's separate financial statements because those differences fell within one of SSAP 12's recognition exceptions. For example, a difference may have arisen on the initial recognition of an asset or liability (see section 8.1 of this guide) and, consequently, may not have been recognised. In these circumstances, the deferred tax impact of such temporary differences should be recognised in the consolidated financial statements, even though it is not recognised by the acquired entity itself.
- 8.2.14 These additional deferred tax balances are recognised on acquisition because, from the group's perspective, the initial recognition of the asset or liability results from a business combination and, therefore, under the rules set out at paragraph 8.1.1 above, the deferred tax impact should be recognised.
- 8.2.15 Example 8.2.3 illustrates this principle.

Example 8.2.3 Additional deferred tax balance recognised on acquisition

Facts as per Example 8.2.2, but the tax base of Property A is \$50. The temporary difference arose on the acquisition of the property by S Limited and, therefore, no deferred tax liability was recognised.

Net assets of S Limited	Book value	Fair value	Tax base	Temporary difference	Tax rate	Deferred tax liability
	\$	\$	\$	\$		\$
Property A	100	130	50	80	30%	24
Property B	150	140	150	(10)	30%	(3)
Intangible asset	0	50	0	50	30%	15
Other net assets	30	30	30	-	-	-
	<u>280</u>	350	<u>230</u>	<u>120</u>		<u>36</u>
Deferred tax arising on acquisition		(36)				
Identifiable net assets acquired		314				
Consideration		<u>350</u>				
Goodwill		<u>36</u>				

Consolidation (at date of acquisition)

	H Limited	S Limited	Consolidation adjustments	Consolidated
	\$	\$	\$	\$
Investment in S Limited	350	-	(350)	-
Goodwill	-	-	36	36
Intangible asset	-	-	50	50
Property A	-	100	30	130
Property B	-	150	(10)	140
Other net assets	-	30	-	30
Deferred tax	-	-	(36)	(36)
	<u>350</u>	<u>280</u>		<u>350</u>
Share capital	(350)	(150)	150	(350)
Retained profits	-	(130)	130	-
	<u>(350)</u>	<u>(280)</u>	-	<u>(350)</u>

As compared to Example 8.2.2, the goodwill arising on acquisition of \$21 has been increased by \$15, being the incremental tax liability arising in respect of Property A.

Tax Assets Not Recognised by the Acquired Entity

- 8.2.16 In some circumstances, deferred tax assets (e.g. in respect of tax losses) may not have been recognised by the acquired entity due to concerns about the recoverability of the assets in the light of anticipated levels of profitability. However, following the acquisition, in some tax jurisdictions, the losses may be available for use by other group entities and, therefore, they are considered to be recoverable. Because the asset is now recoverable from a group perspective, the deferred tax asset is recognised at the time of acquisition.

Example 8.2.4 Tax asset not recognised by the acquired entity

Facts as per Example 8.2.3. In addition, S Limited has tax losses available for offset against the future profits of any group entity amounting to \$20. It is probable that future taxable profits will be available within the group to absorb these losses.

Net assets of S Limited	Book value	Fair value	Tax base	Temporary difference	Tax rate	Deferred tax liability
	\$	\$	\$	\$		\$
Property A	100	130	50	80	30%	24
Property B	150	140	150	(10)	30%	(3)
Intangible asset	0	50	0	50	30%	15
Other net assets	30	30	30	-	-	-
Tax loss carryforward	-	-	-	(20)	30%	(6)
	<u>280</u>	350	<u>230</u>	<u>100</u>		<u>30</u>
Deferred tax arising on acquisition		(30)				
Identifiable net assets acquired		320				
Consideration		<u>350</u>				
Goodwill		<u>30</u>				
Consolidation (at date of acquisition)						
	H Limited	S Limited	Consolidation adjustments		Consolidated	
	\$	\$	\$	\$	\$	\$
Investment in S Limited	350	-		(350)		-
Goodwill	-	-		30		30
Intangible asset	-	-		50		50
Property A	-	100		30		130
Property B	-	150		(10)		140
Other net assets	-	30		-		30
Deferred tax	-	-		(30)		(30)
	<u>350</u>	<u>280</u>				<u>350</u>
Share capital	(350)	(150)		150		(350)
Retained profits	-	(130)		130		-
	<u>(350)</u>	<u>(280)</u>		-		<u>(350)</u>

As compared to Example 8.2.3, the goodwill arising on acquisition of \$36 has been reduced by \$6, being the incremental tax asset recognised in respect of the tax losses.

Tax losses of the acquirer

8.2.17 The Standard specifically addresses the situation where, as a result of an acquisition, the acquirer considers it probable that it will recover its *own* deferred tax asset that was not recognised prior to the business combination. Similar to the case illustrated at Example 8.2.4, the acquirer may be able to utilise the benefit of its unused tax losses against the future taxable profits of the acquired entity. In such cases, the acquirer recognises a deferred tax asset and takes this into account in determining the goodwill or negative goodwill arising on acquisition. [SSAP 12.67] This is an unusual example of the recognition of an additional asset by the acquiring entity affecting the amount of goodwill or negative goodwill arising on acquisition.

Interaction with SSAP 30

8.2.18 SSAP 30 *Business Combinations* addresses the amount that should be attributed to tax assets and liabilities at the date of acquisition. Tax assets and liabilities are required to be recognised at the amount of the tax benefit arising from tax losses, or the taxes payable in respect of the net profit or loss, assessed from the perspective of the combined entity or group resulting from the acquisition. The tax asset or liability is determined after allowing for the tax effect of restating identifiable asset and liabilities to their fair values and is not discounted. The tax assets include any deferred tax asset of the acquirer that was not recognised prior to the business combination, but which, as a consequence of the business combination, now satisfies the recognition criteria in SSAP 12. [SSAP 30.36(i)]

8.2.19 The measurement of the deferred tax impact arising on acquisition will therefore be based on the post-acquisition intentions and tax status of the group.

8.2.20 For example, where the acquired entity has previously recognised a deferred tax liability in respect of a revalued property, because it was intended to continue to occupy the property, but the acquiring entity intends to dispose of the property, then it is the expectation of recovery through disposal that is used to measure the deferred tax liability at the date of acquisition. This will also give rise to an adjustment to the deferred tax balance recognised in the financial statements of the acquired entity, since the control exercised by the parent will ensure that the property is disposed of.

8.2.21 Another example arises where the acquisition (e.g. by an overseas parent) changes the tax status of the acquired entity so that the attributable tax rate changes. The revised tax rates are reflected in the estimation of current and deferred tax assets and liabilities at the date of acquisition. This change in status will also give rise to adjustments in the financial statements of the acquiree.

Post Acquisition Adjustments to the Carrying Amount of Deferred Tax

8.2.22 Where deferred tax balances are recognised at the date of acquisition, they have a consequential effect on the amount of goodwill or negative goodwill arising on acquisition. In some circumstances, the estimate of the deferred tax balances may subsequently change. The question arises as to whether post-acquisition adjustments made to such deferred tax assets or liabilities are also reflected in goodwill.

8.2.23 The general principle for adjustments to previously-recognised deferred tax balances is set out in paragraph 60 of SSAP 12. That paragraph requires that such adjustments should be recognised in the income statement, except to the extent that they relate to items previously charged or credited to equity. Therefore, SSAP 12 does not appear to allow for the possibility that the adjustment will be made against goodwill.

8.2.24 However, SSAP 30.68 contains more explicit rules, as follows:

“Identifiable assets and liabilities, which are acquired but do not satisfy the criteria... for separate recognition when the acquisition is initially accounted for, should be recognised subsequently as and when they satisfy the criteria. The carrying amounts of identifiable assets and liabilities acquired should be adjusted when, subsequent to acquisition, additional evidence becomes available to assist with the estimation of the amounts assigned to those identifiable assets and liabilities when the acquisition was initially accounted for. The amount assigned to goodwill or negative goodwill should also be adjusted, when necessary, to the extent that:

- (a) the adjustment does not increase the carrying amount of goodwill above its recoverable amount, as defined in SSAP 31 *Impairment of Assets*; and
- (b) such adjustment is made by the end of the first annual accounting period commencing after acquisition (except for the recognition of an identifiable liability under SSAP 30 paragraph 30, for which the time-frame in SSAP 30 paragraph 30(c) applied),

otherwise the adjustments to the identifiable assets and liabilities should be recognised as income or expense.”

8.2.25 We believe that this general principle should apply equally to deferred tax balances, so that the rule in SSAP 30.68 should prevail over this aspect of SSAP 12. Therefore, provided that the conditions of SSAP 30.68 are met, adjustments to deferred tax assets and liabilities subsequent to acquisition can be adjusted against goodwill or negative goodwill.

8.2.26 Any changes made after the end of the first full post-acquisition accounting period, or changes made as a result of post-acquisition events, should be reflected in income. Special rules apply to the post-acquisition utilisation of tax assets not recognised at the date of acquisition - see paragraph 8.2.32 below.

Proposals under the IASB’s current project on business combinations will mean that the conditions in SSAP 30.68 will change. The period allowed for adjustments to provisional values determined at the date of acquisition will be restricted to twelve months from the date of acquisition. Such adjustments can be made against the goodwill or negative goodwill arising on acquisition. After that date, only adjustment of ‘errors’ can be recognised. Such errors (as opposed to changes in estimates) should be rare but, if they are identified at any time after acquisition, the goodwill or negative goodwill arising on acquisition will also be adjusted.

8.2.27 Where adjustments are made to goodwill under SSAP 30.68, INT 12 *Business Combinations - Subsequent Adjustment of Fair Values and Goodwill Previously Reported* provides additional guidance.

8.2.28 INT 12 clarifies that the adjustment made should be calculated as if the newly-assigned values had been used from the date of acquisition. Therefore, the adjustment will include both the effect on the original fair values and the effect on depreciation and other changes that would have resulted if the adjusted fair values had been applied from the date of acquisition. If goodwill is adjusted, then amortisation of goodwill or recognition of negative goodwill is also adjusted from the date of acquisition.

8.2.29 Example 8.2.5 illustrates the application of SSAP 30.68 to deferred tax balances arising on acquisition.

Example 8.2.5 Adjustments subsequent to acquisition

Facts as per Example 8.2.4. H Limited has a December 31 year end, and the acquisition occurred in November 20X1. In March 20X2, after the 20X1 financial statements are issued, management receives the results of a valuation study which concludes that the fair value of the intangible asset *at the date of acquisition* was \$60.

The amortisation period for goodwill is 20 years, and for the intangible asset is 5 years. The depreciation period for both Property A and Property B is 5 years, for both tax and accounting purposes. No amortisation or depreciation, and no tax allowances, between November 20X1 and December 20X1. Tax losses recognised in November 20X1 are utilised fully in 20X2.

(i) Recalculation of goodwill based on revised estimate

Net assets of S Limited	Book value	Fair value	Tax base	Temporary difference	Tax rate	Deferred tax liability
	\$	\$	\$	\$		\$
Property A	100	130	50	80	30%	24
Property B	150	140	150	(10)	30%	(3)
Intangible asset	0	60	0	60	30%	18
Other net assets	30	30	30	-	-	-
Tax loss carryforward	-	-	-	(20)	30%	(6)
	<u>280</u>	360	<u>230</u>	110		<u>33</u>
Deferred tax arising on acquisition		(33)				
Identifiable net assets acquired		327				
Consideration		<u>350</u>				
Goodwill		<u>23</u>				

(ii) Deferred tax balance at 31 December 20X2

	Carrying amount	Tax base	Temporary difference	Tax rate	Deferred tax liability
	\$	\$	\$	\$	\$
Based on original estimate					
Property A	104	40	64	30%	19.2
Property B	112	120	(8)	30%	(2.4)
Intangible asset	40	0	40	30%	12.0
Other net assets	30	30	-	-	-
	<u>286</u>	190	96		<u>28.8</u>
Based on revised estimate					
Property A	104	40	64	30%	19.2
Property B	112	120	(8)	30%	(2.4)
Intangible asset	48	0	48	30%	14.4
Other net assets	30	30	-	-	-
	<u>294</u>	190	104		<u>31.2</u>

Example 8.2.5 (cont'd)

(iii) Adjustments

	<u>Based on revised estimate</u>	<u>Based on original estimate</u>	<u>Adjustment</u>
	\$	\$	\$
(1) Goodwill			
On date of acquisition	23.00	30.00	(7.00)
Amortisation for year 20X2	<u>(1.15)</u>	<u>(1.50)</u>	0.35 [A]
On 31 December 20X2	<u>21.85</u>	<u>28.50</u>	<u>(6.65)</u>
(2) Intangible asset			
On date of acquisition	60.00	50.00	10.00
Amortisation for year 20X2	<u>(12.00)</u>	<u>(10.00)</u>	(2.00) [B]
On 31 December 20X2	<u>48.00</u>	<u>40.00</u>	<u>8.00</u>
(3) Deferred tax liability			
On date of acquisition	(33.00)	(30.00)	(3.00)
Utilisation of deferred tax assets	(6.00)	(6.00)	-
Release of the deferred tax liabilities (1/5)	<u>7.80</u>	<u>7.20</u>	0.60 [C]
On 31 December 20X2	<u>(31.20)</u>	<u>(28.80)</u>	<u>(2.40)</u>

Debit to income statement = [A] + [B] + [C] = \$1.05

The required journal entry at 31/12/X2 is

	<u>DR</u>	<u>CR</u>
	\$	\$
Intangible assets	10.00	
Intangible assets - accumulated amortisation		2.00
Goodwill - accumulated amortisation	0.35	
Goodwill		7.00
Deferred tax liability		2.40
Income statement	<u>1.05</u>	
	<u>11.40</u>	<u>11.40</u>

Post-acquisition change in tax rate

8.2.30 Where the adjustment to deferred tax arises as a result of a post-acquisition event, the effect is accounted for post-acquisition.

Example 8.2.6 Post-acquisition change of tax rate

Facts as per Example 8.2.4. H Limited has a 31 December year end and the acquisition took place in November 20X1.

On 1 May 20X2, the tax rate applying to company profits for accounting periods beginning on or after 1 January 20X3 increases to 33%. By 31 December 20X2, \$4 of the original temporary differences of \$100 had reversed (20% of the taxable temporary differences of \$120, less tax losses of \$20). The remaining \$96 should now be accrued at 33% (i.e. \$31.68 rather than \$28.80). The increase of \$2.88 should be charged to the income statement. It cannot be taken to goodwill, since the change was as a result of a post-acquisition event.

Post-acquisition change of intention as to how an asset will be recovered

8.2.31 Where a post-acquisition change of intention as to the means of recovery of an asset results in a change in the deferred tax position, and the change of intention occurs within the hindsight period set out in SSAP 30.68 (see paragraph 8.2.24 above), then we would generally expect the amount to be adjusted against goodwill since the change most likely results from clarification of management's intentions. However, where there is a genuine post-acquisition change of intention, or where the change of intention occurs after the hindsight period, the resultant adjustment is not made against goodwill.

Example 8.2.7 Post-acquisition change of intention

Facts as per Example 8.2.4. H Limited has a December 31 year end, and the acquisition occurred in November 20X1. In November 20X2, as a result of changes in the commercial environment, management determines to sell Property A. No tax liability will arise on disposal.

The required adjustment to the deferred tax liability at 31/12/X2 is calculated as follows:

	\$
Liability arising on acquisition in respect of Property A	24.00
Released to income in 20X2 (assuming that the property is depreciated over five years)	<u>(4.80)</u>
Adjustment required to bring liability to zero	<u>19.20</u>

This amount is credited to the income statement in 20X2.

Post-acquisition recognition of deferred tax assets

8.2.32 SSAP 12 sets out specific rules where potential benefit of an acquiree's tax losses or other deferred tax assets is not recognised at the date of acquisition, due to concerns as to their recoverability, but the benefit is subsequently realised in a later period (e.g. where unrecognised losses brought forward are used to reduce subsequent tax liabilities, or their recoverability is reassessed and they are recognised as an asset).

8.2.33 The rules of the Standard for these specific circumstances are as follows:

- the asset is recognised in the consolidated balance sheet of the acquirer in that later year;
- the deferred tax is credited in the income statement; and
- subject to neither creating nor increasing negative goodwill, the gross carrying amount of the goodwill and the amortisation thereof to date are adjusted to reflect the amounts that would have been recorded had the deferred tax asset been recognised at the date of acquisition, with the movement in the net goodwill figure being expensed in the income statement.

[SSAP 12.68]

8.2.34 The effect of the rules set out in paragraph 8.2.33 is that the amount recognised in the post-acquisition income statement is limited to any excess of the tax credit arising over the amortised carrying amount of goodwill.

8.2.35 There is no time limit on the adjustments required by SSAP 12.68. Therefore, even if the recognition of the asset occurs several years after the acquisition, the carrying amount of goodwill is required to be eliminated. It is important, therefore, that the enterprise maintains appropriate records of such unrecognised assets.

8.2.36 The following example is taken from SSAP 12 and illustrates the requirements of SSAP 12.68.

Example 8.2.8 Post-acquisition recognition of deferred tax assets

An enterprise acquired a subsidiary which had deductible temporary differences of \$300. The tax rate at the time of the acquisition was 30%. The resulting deferred tax asset of \$90 was not recognised as an identifiable asset in determining the goodwill of \$500 resulting from the acquisition, due to concerns as to its recoverability.

The goodwill is amortised over 20 years. Two years after the acquisition, the enterprise assessed that future taxable profit would probably be sufficient for the enterprise to recover the benefit of all of the deductible temporary differences.

The enterprise recognises a deferred tax asset of \$90 (\$300 at 30%) and, in the income statement, deferred tax income of \$90. It also reduces the cost of the goodwill by \$90 and the accumulated amortisation by \$9 (representing 2 years' amortisation). The balance of \$81 is recognised as an expense in the income statement.

The required journal entry is therefore as follows:

	<u>DR</u>	<u>CR</u>
	\$	\$
Deferred tax asset	90	
Income statement		90
Goodwill - accumulated amortisation	9	
Goodwill		90
Income statement	81	

Consequently, the cost of the goodwill, and the related accumulated amortisation, are reduced to the amounts (\$410 and \$41 respectively) that would have been recorded if a deferred tax asset of \$90 had been recognised as an identifiable asset at the date of the business combination.

If the tax rate has increased to 40%, the enterprise recognises a deferred tax asset of \$120 (\$300 at 40%) and, in the income statement, deferred tax income of \$120. However, the adjustments to goodwill do not change because the change in tax rate is a post-acquisition event. Therefore, the cost of goodwill is reduced by \$90 and the accumulated amortisation by \$9, and the net amount of \$81 is charged as an expense in the income statement.

8.2.37 The Standard discusses the scenario where management reaches a decision to recognise the deferred tax asset. It is more likely, where the prediction of profits is difficult, that, for example, tax losses will be utilised without any asset having previously been recognised. In these circumstances, we believe that the rules described at paragraph 8.2.33 above should also be followed.

Example 8.2.9 Post-acquisition utilisation of deferred tax losses

Facts as per Example 8.2.8 but, two years after the acquisition, without prior recognition of a deferred tax asset, tax losses are utilised to offset taxable profits of another group enterprise. The following journal entry will be required:

	<u>DR</u> \$	<u>CR</u> \$
Goodwill - accumulated amortisation	9	
Goodwill		90
Income statement	81	

This charge of \$81 will offset the reduced tax charge that had not previously been anticipated.

Interaction with SSAP 30

8.2.38 SSAP 30's requirements in respect of adjustments to identifiable net assets through goodwill are specifically varied for the situation where a deferred tax asset was not recognised on acquisition but is subsequently realised, consistent with the provisions of SSAP 12.68 as outlined above (see SSAP 30.75).

Eliminations of Unrealised Profit

8.2.39 Where a group enterprise sells goods to another group enterprise, the selling enterprise, as a separate legal entity, records profits made on those sales. However, if those goods are still held in inventory by the buying enterprise at the year end, the profit recorded by the selling enterprise, when viewed from the standpoint of the group as a whole, has not yet been earned, and will not be earned until the goods are eventually sold outside the group. On consolidation, the unrealised profit on closing inventories is eliminated from the group's profit, and the closing inventories of the group are recorded at cost to the group.

8.2.40 Such consolidation adjustments may have a deferred tax impact in the consolidated financial statements. The intra-group elimination is made as a consolidation adjustment and not in the financial statements of any individual reporting enterprise. If tax is charged on the results of individual enterprises, and not on the group, the selling enterprise will pay tax on any profits generated from the intra-group sales, even though some of these profits may be unrealised from the group's perspective. Therefore, the elimination will result in a temporary difference as far as the group is concerned between the carrying amount of the inventories in the consolidated financial statements and the tax base (assumed to be the carrying amount in the buying enterprise's individual financial statements). The deferred tax effects arising in respect of this temporary difference should be recognised in accordance with the usual principles.

- 8.2.41 The tax rate to be used when recognising a deferred tax balance arising from the elimination of unrealised profits on intercompany transactions is determined by reference to the tax jurisdiction where the temporary difference will reverse.

Example 8.2.10 Deferred tax impact of elimination of unrealised profit

G Limited sells inventory costing \$100 to its overseas subsidiary H Limited for \$160. G Limited's tax rate is 30% and H Limited's is 25%. The inventory remains on hand at year end.

G Limited recognises a current tax liability of \$18 (\$60 profit at 30%) but does not recognise any deferred tax balances as there are no future tax consequences from G Limited's point of view.

H Limited is entitled to a future deduction for the \$160 paid for the inventory and this is therefore the asset's tax base from H Limited's perspective. Therefore, in H Limited's individual financial statements, the tax base is equal to the carrying amount, and no temporary difference arises.

However, the carrying amount of the inventory is reduced from \$160 to \$100 on consolidation (due to the elimination of unrealised profit). A \$60 deductible temporary difference arises, representing the difference between the carrying amount (\$100) and the tax base (\$160). A deferred tax asset is calculated by multiplying the temporary difference of \$60 by 25%, as the deduction is available to H Limited at that rate when the unrealised profit is realised outside the group on sale of the inventory by H Limited. The deferred tax asset arising of \$15 is recognised on consolidation.

8.3 INVESTMENTS

General

- 8.3.1 This section examines the deferred tax implications of the treatments commonly adopted for investments under Hong Kong GAAP.
- 8.3.2 For investments in securities, where the assets are Hong Kong investments, deferred tax is not likely to be a significant issue because of Hong Kong's favourable tax regime for investment income and disposals of capital investments. However, where investments are held in less favourable tax jurisdictions, significant temporary differences can arise.
- 8.3.3 In consolidated financial statements, where investments are consolidated or dealt with by equity accounting, additional temporary differences may arise. The previous version of the Standard made reference to deferred tax in respect of the remittance of overseas earnings, and required that it be accounted for using the partial provision approach. Therefore, the differences were accounted for only to the extent that they were expected to reverse. The revised Standard imposes more stringent requirements, which are discussed later in this section.

Recovery of Investments

- 8.3.4 In order to determine the deferred tax implications for various types of investments under the revised Standard, it is necessary to determine how the carrying amount of the investments will be recovered.
- 8.3.5 In the case of equity investments, these will generally have an indefinite life and, therefore, are analogous to non-depreciable assets dealt with under INT 20 *Income Taxes - Recovery of Revalued Non-depreciable Assets* (see paragraph 6.4.11). When an equity investment has an indefinite life, its carrying amount will be recovered through sale, notwithstanding that it may be held for the long-term for the purpose of earning dividend income. Therefore, we believe that the deferred tax liability or asset that arises in respect of such investments should always be measured based on the tax consequences that would arise if the investment were disposed of at its carrying amount.
- 8.3.6 Debt securities, on the other hand, may be recovered through settlement of the principal amount or, where such instruments are traded, through disposal. Where the tax implications of these courses of action differ, management will need to determine the expected manner of recovery.
- 8.3.7 The previous paragraphs refer to temporary differences arising in respect of the principal amounts of investments in securities. Additional temporary differences may arise in respect of the income streams arising from those investments (dividend income, interest income etc.). These should generally be dealt with as separate assets and liabilities, and accounted for using the general principles of SSAP 12.
- 8.3.8 The later paragraphs in this section deal with investments in associates, jointly controlled entities and subsidiaries, where temporary differences may arise because, in consolidated financial statements, the results of such enterprises have been accounted for in advance of the remittance of income. For such interests, the carrying amounts may be recovered either through distribution or through disposal, and the deferred tax implications should be measured on the basis of management expectations in that regard.

Investments in Securities

- 8.3.9 Under Hong Kong GAAP, the appropriate accounting treatment for investments in securities is set out in SSAP 24 *Accounting for Investments in Securities*. The alternative treatments available under that Standard are summarised in Exhibit 8.3.1.
- 8.3.10 Exhibit 8.3.1 also provides a brief summary of the tax treatment of investments under Hong Kong tax rules. The disposal of investments that are clearly capital assets will not have any tax implications. Therefore, neither investment securities (benchmark treatment) nor non-trading securities (alternative treatment) will be expected to give rise to deferred tax balances.

Exhibit 8.3.1 Accounting framework for investments in securities under SSAP 24

	Benchmark treatment		Alternative treatment		Held-to-maturity debt securities
	Investment securities	Other investments	Trading securities	Non-trading securities	
Accounting basis	Cost less impairment	Fair value - movements in income	Fair value - movements in income	Fair value - movements in equity	Amortised cost
Treatment under Hong Kong tax rules	Capital assets - no tax on disposal	Need to distinguish between trading and non-trading assets under the tax rules. For trading, tax will arise on disposal and may be assessed in respect of valuation movements dealt with in the income statement. For non-trading, no tax on disposal.	Trading assets - tax on disposal. May be assessed on valuation movements dealt with in the income statement.	Capital assets - no tax on disposal	Capital assets - no tax on disposal

- 8.3.11 For investments that are clearly trading assets, gains earned by the enterprise are taxable. Fair value movements that are dealt with in income may be assessed on the same basis, or no tax assessment may be raised until the investment is disposed of, according to the particular circumstances of the investor. Where tax is assessed based on fair value movements dealt with in the income statement, there are no deferred tax implications, because the movements are dealt with in the current tax computation. However, where no taxable gain or loss arises until the asset is disposed of, deferred tax balances may arise.

Example 8.3.1 Deferred tax arising on trading investment

I Limited purchases equity investments for trading purposes at a cost of \$100 on 1 September 20X1. On 31 December 20X1, the investments are revalued to \$120, and the valuation movement of \$20 is recognised in income. The investments are sold on 31 March 20X2 for \$150. Tax is charged at 30% and is assessed at the date of disposal.

	<u>DR</u> \$	<u>CR</u> \$
At 31 December 20X1, the following entries are recorded:		
Investments in securities	20	
Income statement		20
Deferred tax charge (I/S)	6	
Deferred tax liability		6
In 20X2, the following entries are recorded:		
Cash	150	
Investments in securities		120
Gain on disposal		30
Current tax charge (I/S)	15	
Current tax liability		15
Deferred tax liability	6	
Deferred tax charge (I/S)		6

- 8.3.12 The 'other investments' category under the benchmark treatment is something of a mixed bag. It will contain some trading investments as discussed in paragraph 8.3.11. It will also contain investments that, although they do not meet the criteria for classification as investment securities under SSAP 24, are not considered to be trading assets for tax purposes and therefore gains and losses arising have no tax impact. The accounting for these non-trading investments will not have any tax implications.
- 8.3.13 As can be seen from the previous discussion, for investments held in Hong Kong, temporary differences are only likely to arise in respect of trading investments where valuation movements are dealt with in income, but tax is not assessed until the investment is disposed of.
- 8.3.14 In other tax jurisdictions where, for example, capital gains tax is charged or withholding tax arises when the proceeds are remitted to the investor, deferred tax effects may also arise in respect of revalued capital investments. Where fair value movements on such capital investments are dealt with in income (benchmark treatment - see paragraph 8.3.12), then the deferred tax impact will also be dealt with in income, as illustrated in Example 8.3.1 above. Where the fair value movements are dealt with in equity, the deferred tax effects are also dealt with in equity, in the same manner as the deferred tax effects of revaluations of other assets as described in section 8.4 of this guide.

Held-to-maturity debt securities

- 8.3.15 Held to maturity debt securities are accounted for at amortised cost. Where the income earned on the debt securities is equal to the nominal interest rate, then no deferred tax balances should arise in respect of the principal amount of the investments. Deferred tax liabilities or assets may arise in respect of the interest earned where, for example, the income is taxed on a receipts basis, but accounted for on an accruals basis.
- 8.3.16 The principal amount of a debt security may give rise to deferred tax balances where, for example, the security is issued at a discount.

Example 8.3.2 Deep discounted bonds

J Limited purchases \$100,000 face value bonds for \$95,000 on 1 January 20X1. The bonds pay interest at 10% per annum, payable at the end of each year. The bonds mature in five years.

The total return on the bonds is : $[\$100,000 + (5 \times 10\% \times \$100,000)] - \$95,000 = \$55,000$.

The effective yield is calculated at 11.37% (approx.). At each reporting date, a portion of the discount is amortised. This will change the carrying amount of the investment, which may have deferred tax implications.

	<u>Annual yield*</u>	<u>Interest received</u>	<u>Carrying amount of bond</u>
	\$	\$	\$
20X0	-	-	95,000
20X1	10,801	10,000	95,801
20X2	10,892	10,000	96,693
20X3	10,994	10,000	97,687
20X4	11,107	10,000	98,794
20X5	<u>11,206</u>	<u>10,000</u>	100,000
	<u>55,000</u>	<u>50,000</u>	

* Carrying amount of bonds multiplied by the effective yield

- 8.3.17 In Example 8.3.2, tax may be assessed as the annual yield is accounted for, in which case no deferred tax arises. However, where the tax base of the investment remains at \$95,000 and no tax is assessed until the investment is disposed of, there may be deferred tax implications.

Investments in Associates

- 8.3.18 In the separate financial statements of the investor, investments in associates will be accounted for either at cost or in accordance with the rules of SSAP 24, as discussed in the previous paragraphs. The considerations discussed above in respect of investments in securities will also apply to investments in associates.
- 8.3.19 In consolidated financial statements, investments in associates are generally accounted for using the equity method of accounting.
- 8.3.20 Under the equity method, the investment is originally recorded at cost and the carrying amount is then increased by the investor's share of profits of the investee. The tax arising in respect of profits earned by the investee will already have been recognised in the financial statements of the investee, and will therefore be reflected in the net result accounted for by the investor. The tax arising on any dividends paid will also be reflected in the investor's own financial statements. However, there might be additional tax implications if the investor were to realise the investment - whether through distribution of the retained profits of the investee, or through disposal. For example, dividend income might be taxable or partially taxable in the hands of the investor. Withholding taxes might be applied in the associate's country of operation. Capital gains tax might be payable on disposal of the investment. In any of these circumstances, a temporary difference may exist.

Example 8.3.3 Temporary difference arising in respect of an investment in an associate

K Limited has an associate, APlus Limited, which operates in Z Land. At 31 December 20X1, K Limited had accounted for \$20,000 profits of APlus Limited, using the equity method of accounting.

During the period, APlus Limited had paid dividends of \$5,000 to K Limited. No tax arises in K Limited's country of operation on receipt of the dividends. However, under the laws of Z Land, tax is withheld at 25% of dividends paid, and is not recoverable.

Assuming that it is anticipated that the investment in APlus Limited will be recovered through distributions, in accounting for the incremental profits of \$15,000 in its consolidated financial statements, K Limited should also recognise the tax consequences if those profits were remitted as dividends. A deferred tax liability of \$3,750 ($\$15,000 \times 25\%$) should therefore be recognised in the financial statements to 31 December 20X1.

- 8.3.21 Under the requirements of SSAP 12, as discussed in section 6.3 of this publication, temporary differences associated with investments in associates should generally be accounted for. For taxable temporary differences arising in respect of investments, SSAP 12 only permits non-recognition if the investor controls the timing of the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future. Since an investor/associate relationship does not involve control, the investor should recognise deferred tax arising on the undistributed profits of the associate, unless there is an irrevocable agreement that profits will not be distributed in the foreseeable future.
- 8.3.22 For deductible temporary differences arising in relation to investments, it is not necessary to consider the investor's ability to control distributions from the investee. Recognition of the deferred tax asset is only permitted if it is probable that the temporary difference will reverse in the foreseeable future.

Investments in Jointly Controlled Entities

- 8.3.23 Under SSAP 21 *Accounting for Interests in Joint Ventures*, the accounting treatment for investments in jointly controlled entities is the same as that described in the previous paragraphs for investments in associates. Therefore, the same considerations will apply in respect of deferred tax.

As regards the recognition of taxable temporary differences, however, the question as to who controls the timing of the reversal of the temporary difference is not as clear-cut. Investments in jointly controlled entities involve joint control - i.e. there is a contractual agreement to share control and no venturer exercises unilateral control.

The arrangements for distributions or disposals of shareholdings are generally dealt with in the joint venture agreement. In most cases, although the venturer cannot unilaterally declare a dividend, neither can such dividend be declared without the venturer's agreement. Therefore, the venturer has the ability to prevent distributions and to prevent the reversal of the temporary difference. If this is the case, we believe that no deferred tax liability is recognised if the venturer does not anticipate that such distributions will be authorised in the foreseeable future.

Investments in Subsidiaries

- 8.3.24 In the separate financial statements of the parent, investments in subsidiaries will be accounted for either at cost or in accordance with the rules of SSAP 24, as discussed earlier in this section. The considerations discussed above in respect of investments in securities will also apply to investments in subsidiaries.
- 8.3.25 In consolidated financial statements, additional deferred tax implications may arise. Similar to the situation for associates discussed earlier in this section, these deferred tax implications typically arise where the subsidiary has undistributed profits. The temporary difference arising generally represents the difference between the net investment accounted for in the financial statements (effectively the group's share of the subsidiary's net assets) and the tax base of the investment.
- 8.3.26 A parent/subsidiary relationship involves the parent controlling its subsidiary, including the subsidiary's dividend policy. Accordingly, the Standard provides that when a parent has stipulated that undistributed profits in a subsidiary or branch will not be distributed for the foreseeable future, the parent does not recognise deferred tax on those undistributed profits. In practical terms, evidence would be required to support management's intentions in respect of dividend policy. This might include documented resolutions by the management of the parent and subsidiary, formal communication to minority shareholders and approval of budgets and projections for both entities on the basis that undistributed profits in the subsidiary will remain so for the foreseeable future. The same considerations apply to investments in branches.

8.4 REVALUATIONS OF PROPERTIES

General

- 8.4.1 When a property is revalued, its carrying amount is increased or decreased, but there is generally no effect on the tax base of the property. As a result, revaluations affect the amounts of temporary differences and, consequently, the deferred tax balances are recognised.
- 8.4.2 Generally, the recognition of deferred tax arising on a revaluation is consistent with the treatment of the revaluation itself. Where deferred tax relates to an amount charged or credited directly to equity, the deferred tax is also recognised directly in equity.

Upward Revaluations

- 8.4.3 The upward revaluation of a property generally gives rise to a deferred tax liability. By increasing the carrying amount of the property, the reporting enterprise is acknowledging that it expects to generate returns in excess of the original carrying amount, which will lead to future assessable income, and so tax payable.
- 8.4.4 When an upward valuation is recorded, the deferred tax liability arising, calculated by reference to the expected manner of recovery of the property, is recognised as a charge to the property revaluation reserve.
- 8.4.5 Over the period when the temporary difference reverses, the release of the deferred tax liability is credited to the income statement (see paragraph 6.5.5).

Example 8.4.1 Revaluation of property

A property is acquired for \$1,000. It is depreciated for tax and accounting purposes over 5 years. At the end of the third year, it is revalued to \$1,200. The value of the property is expected to be recovered through use in a taxable manufacturing activity. The tax rate is 30%.

	Carrying amount	Tax base	Temporary difference	Deferred tax liability	Movement for the year
	\$	\$	\$	\$	\$
20X0	1,000	1,000	-	-	-
20X1	800	800	-	-	-
20X2	600	600	-	-	-
20X3	1,200	400	800	240	240
20X4	600	200	400	120	(120)
20X5	0	0	-	-	(120)

The required journal entries in 20X3 are:

	DR	CR
	\$	\$
Property, plant and equipment	200	
Property, plant and equipment - accumulated depreciation	600	
Revaluation reserve		800
Revaluation reserve	240	
Deferred tax liability		240

In both 20X4 and 20X5, the following entry will be recorded, to reflect the reversal of the temporary difference arising on revaluation.

	DR	CR
	\$	\$
Deferred tax liability	120	
Deferred tax (I/S)		120

8.4.6 As illustrated in Example 8.4.1, the portion of the deferred tax liability that is charged to equity is not affected by subsequent reversals. The recognition of the revaluation in the financial statements represents the anticipation of future economic benefits to be earned from the property. The deferred tax liability recognised at the date of revaluation represents a provision for the tax expected to arise on those benefits. The release of the deferred tax liability to the income statement over the period in which those future economic benefits are earned offsets the current tax charge in those years to the extent that it was anticipated at the date of the revaluation.

Example 8.4.2 Impact of release of deferred tax liability

Facts as per Example 8.4.1. The revaluation of the property to \$1,200 in 20X3 is an acknowledgement by the enterprise that it expects to generate returns of at least that amount from the asset. The liability for deferred tax recognised at revaluation represents a provision for the taxes that will be payable on those returns.

Assuming a breakeven situation, in both 20X4 and 20X5 the enterprise earns \$600 from the property. In each year, a tax deduction of \$200 is available, resulting in a taxable profit of \$400. The current tax charge on that profit, at 30% tax rate, is \$120. The release of the deferred tax liability against the current tax charge reduces the annual tax charge to nil, representing the anticipated breakeven position.

The tax charge recognised in each of 20X4 and 20X5 will be as follows:

	\$
Economic benefits earned from use of the property	600
Tax deduction	<u>(200)</u>
 Taxable profit	 <u>400</u>
 Current tax charge (at 30%)	 120
Deferred tax credit	<u>(120)</u>
 Tax expense	 <u>0</u>

It is also interesting to compare the tax charged over the life of the property with the actual tax paid.

	Economic benefits earned	Tax allowance	Taxable profit	Tax payable	Current tax charge	Deferred tax Equity	I/S
	\$	\$	\$	\$	\$	\$	\$
20X1	200	(200)	-	-	-	-	-
20X2	200	(200)	-	-	-	-	-
20X3	200	(200)	-	-	-	240	-
20X4	600	(200)	400	120	120	-	(120)
20X5	600	(200)	400	<u>120</u>	<u>120</u>	-	<u>(120)</u>
				<u>240</u>	<u>240</u>	<u>240</u>	<u>(240)</u>

Although income tax of \$240 tax is paid over the life of the property, this has effectively by-passed the income statement by crediting it directly to the revaluation reserve. This amount is then transferred directly to retained earnings when the reserve is realised (see below).

Realisation of the revaluation reserve

8.4.7 As illustrated in Example 8.4.2, the effect of the treatment of deferred tax arising on revaluation is that it by-passes the income statement and is charged directly to retained earnings.

- 8.4.8 Under SSAP 17.41, when the revaluation reserve is realised, it is transferred to retained earnings. This transfer can be done by means of an annual transfer, over the useful life of the property, or as a lump sum on the disposal of the property. Whichever method is selected, it should be applied consistently, and the transfer should be made on a net of tax basis.
- 8.4.9 If an annual transfer is made, in the circumstances described in Example 8.4.2, in each of the years 20X4 and 20X5, depreciation of \$600 is charged to the income statement. The difference between this depreciation charge and the depreciation charge based on historical cost is \$400. The \$400 is therefore transferred from the revaluation reserve to retained earnings in both 20X4 and 20X5, but on a net of tax basis (i.e. a net transfer of \$280 is made each year). This means that the net balance on the revaluation reserve of \$560 (\$800 - \$240) is eliminated over the remaining useful life of the property.

Downward Revaluations and Impairment Losses

- 8.4.10 The write down of a property for accounting purposes can give rise to a deferred tax asset, or a reduction in a deferred tax liability, depending on the tax base of the property. Any deferred tax asset arising can only be recognised to the extent that it is probable that sufficient taxable amounts will be available in the future to allow the benefit of that deferred tax asset to be recovered.

Example 8.4.3 Downward revaluation of property

Facts as per Example 8.4.1. But in 20X3, the property is written down to its estimated recoverable amount of \$200.

	Carrying amount	Tax base	Temporary difference	Deferred tax asset	Movement for the year
	\$	\$	\$	\$	\$
20X0	1,000	1,000	-	-	-
20X1	800	800	-	-	-
20X2	600	600	-	-	-
20X3	200	400	(200)	(60)	(60)
20X4	100	200	(100)	(30)	30
20X5	0	0	-	-	30

The entries required in 20X3 are:

	DR	CR
	\$	\$
Impairment loss (I/S)	200	
Property, plant and equipment - accumulated depreciation and impairment losses		200
Deferred tax asset	60	
Deferred tax (I/S)		60

In both 20X4 and 20X5, the following entries will be recorded to reflect the reversal of the temporary difference arising on impairment :

	DR	CR
	\$	\$
Deferred tax (I/S)	30	
Deferred tax asset		30

8.4.11 In Example 8.4.3, because there is no available revaluation reserve, the impairment is reflected in the income statement. A deferred tax asset is recognised, and a corresponding credit to the income statement, assuming that there will be sufficient future taxable profits.

Example 8.4.4 Impact of release of deferred tax asset

Facts as per Example 8.4.3. The reduction of the carrying amount of the property to \$200 in 20X3 is an acknowledgement by the enterprise that it expects to generate returns of only \$200 from the property.

Assuming a breakeven situation, in both 20X4 and 20X5, the enterprise earns \$100 from the property. In each year, a tax deduction of \$200 is available. The tax credit arising in respect of the resultant tax loss of \$100, at 30% tax rate, is \$30. The release of the deferred tax asset against the current tax credit reduces the overall tax position to nil, representing the anticipated breakeven position.

8.4.12 Where a property has previously been revalued, and a downward valuation subsequently occurs, the deferred tax effects recognised in equity are reversed through equity.

Example 8.4.5 Downward valuation of previously revalued property

A property is acquired for \$1,000. It is depreciated for tax and accounting purposes over 10 years. At the end of the third year, it is revalued to \$1,050. The value of the property is expected to be recovered through use in a taxable manufacturing activity. At the end of the sixth year, it is revalued downward to \$200. The tax rate is 30%.

	Carrying amount		Tax base	Temporary difference	Deferred tax liability (asset)	Movement for the year	Recognised in	
	Historical cost	Revaluation uplift					Equity	I/S
	\$	\$	\$	\$	\$	\$	\$	\$
20X0	1,000	-	1,000	-	-	-	-	-
20X1	900	-	900	-	-	-	-	-
20X2	800	-	800	-	-	-	-	-
20X3	700	350	700	350	105	105	105	-
20X4	600	300	600	300	90	(15)	-	(15)
20X5	500	250	500	250	75	(15)	-	(15)
20X6	200	-	400	(200)	(60)	(135)	(105)	(30)
20X7	150	-	300	(150)	(45)	15	-	15
20X8	100	-	200	(100)	(30)	15	-	15
20X9	50	-	100	(50)	(15)	15	-	15
20Y0	0	-	0	-	-	15	-	15
							0	0

Example 8.4.5 (cont'd)

	<u>DR</u> \$	<u>CR</u> \$
The required journal entries in 20X3 are:		
Property, plant and equipment	50	
Property, plant and equipment - accumulated depreciation	300	
Revaluation reserve		350
Revaluation reserve	105	
Deferred tax (B/S)		105
The required journal entries in 20X6 are :		
Revaluation reserve	350	
Impairment loss (I/S)	50	
Property, plant and equipment		400
Deferred tax (B/S)	135	
Revaluation reserve		105
Deferred tax (I/S)		30

Properties to be Recovered through Disposal

- 8.4.13 As discussed in earlier sections of this guide, the deferred tax implications of a revaluation can vary according to whether it is planned to recover the carrying amount of the property through use or through disposal.
- 8.4.14 The previous examples in this section have assumed that the surplus arising on revaluation is to be recovered through consumption of the property in a taxable activity (e.g. manufacturing). Assuming that the manufacturing profits are taxable at a single rate, the deferred tax liability initially recognised is equal to the revaluation uplift multiplied by that tax rate.
- 8.4.15 Where it is anticipated that a revalued property will be disposed of, the tax consequences may be more complex. It may be that any profit on disposal of the property will be fully taxable, in which case the deferred tax liability is equal to the revaluation uplift multiplied by the tax rate. However, more commonly, the taxation of capital gains is on a different basis.
- 8.4.16 In a Hong Kong context, when non-trading properties are disposed of, the taxable gain arising is generally limited to the amount of tax allowances previously claimed. This is often referred to as a 'claw back' of tax allowances.
- 8.4.17 As discussed at 6.4.14, under current Hong Kong GAAP, the deferred tax balances arising in respect of investment properties carried at revalued amounts are always estimated based on the tax consequences on disposal of the property. This is irrespective of whether the enterprise intends to continue to hold the property for rental purposes.
- 8.4.18 Example 8.4.6 illustrates the tax calculations required in the circumstances where tax allowances are to be clawed back, in the absence of any asset revaluation.

Example 8.4.6 Deferred tax arising in relation to an investment property - no revaluation

An investment property is acquired for \$1,000. It is not depreciated for accounting purposes. At the end of the first year, the market value of the property is not materially different from its historical cost. Therefore, no revaluation surplus arises at the end of the first year.

The property is depreciated for tax purposes over five years. If the property were disposed of, the taxable gain arising would be limited to the amount of tax depreciation previously claimed. The tax rate is 30%.

At 31/12/X1 : Carrying amount = \$1,000
 TWDV = \$800

$$\text{Tax base} = \text{Carrying amount} - \text{Future taxable amounts} + \text{Future deductible amounts}$$

$$= \$1,000 - \$1,000 + \$800$$

$$= \$800$$

$$\text{Temporary difference} = \text{Carrying amount} - \text{Tax base}$$

$$= \$1,000 - \$800$$

$$= \$200$$

$$\text{Deferred tax liability} = \text{Temporary difference} \times \text{Tax rate}$$

$$= \$200 \times 30\%$$

$$= \$60$$

Therefore, at the end of 20X1, a deferred tax liability of \$60 is recognised. Because the property has not been revalued, there is no option to charge the deferred tax to equity. It is therefore charged to income.

8.4.19 In Example 8.4.6, the effect of the recognition of the deferred tax charge in the income statement is to offset the tax allowance claimed in the period. Effectively this recognises that, were the property to be disposed of, the tax allowance would be clawed back.

8.4.20 Example 8.4.7 illustrates the tax implications where the property is subsequently revalued.

Example 8.4.7 Deferred tax arising on revaluation of an investment property

Facts as per Example 8.4.6. At the end of the second year, the investment property is revalued to \$1,500.

At 31/12/X2 : Revalued amount = \$1,500
 TWDV = \$600

$$\begin{aligned}
 \text{Tax base} &= \text{Carrying amount} - \text{Future taxable amounts} + \text{Future deductible amounts} \\
 &= \$1,500 - \$1,000 + \$600 \\
 &= \$1,100^*
 \end{aligned}$$

* As discussed at paragraph 6.1.10, the tax base calculated using the SSAP 12 formula in these circumstances is not the same as the property's TWDV. However, it is the amount that is required to calculate the correct temporary differences.

$$\begin{aligned}
 \text{Temporary difference} &= \text{Carrying amount} - \text{Tax base} \\
 &= \$1,500 - \$1,100 \\
 &= \$400
 \end{aligned}$$

$$\begin{aligned}
 \text{Deferred tax liability} &= \text{Temporary difference} \times \text{Tax rate} \\
 &= \$400 \times 30\% \\
 &= \$120
 \end{aligned}$$

Therefore, at the end of the second year, an additional deferred tax liability of \$60 is recognised. The required journal entries in 20X2 are as follows:

	DR \$	CR \$
Investment property	500	
Investment property revaluation reserve		500
Deferred tax (I/S)	60	
Deferred tax liability		60

- 8.4.21 As illustrated in Example 8.4.7, although the investment property has been revalued, the incremental deferred tax liability is dealt with in the income statement. Because the taxable gain is effectively limited by reference to the historical cost of the property, none of the deferred tax liability relates to the revaluation uplift.
- 8.4.22 An alternative way of looking at this is that the temporary difference would have increased even if the property had not been revalued (as illustrated in Example 8.4.6). Therefore, the difference is not related to the revaluation, and, consequently, it is required to be dealt with in the income statement.
- 8.4.23 Example 8.4.8 illustrates the entries recorded on disposal of the investment property.

Example 8.4.8 Disposal of investment property

Facts as per Example 8.4.7. The property is disposed of on 31/12/X3 for \$1,800. The following journal entries are recorded :

	<u>DR</u> \$	<u>CR</u> \$
Cash	1,800	
Investment property		1,500
Investment property revaluation reserve	500	
Gain on disposal of investment property		800
Deferred tax liability	120	
Deferred tax (I/S)		120
Current tax (I/S)	180	
Current tax liability		180

The gain recorded for the disposal of the property has not been affected by the recognition of the deferred tax liability.

Disposal of Revalued Owner-occupied Property

- 8.4.24 Earlier in this section, we discussed the deferred tax implications of the revaluation of an owner-occupied property that is used in taxable activities. The revaluation reserve is reduced by the amount of the deferred tax liability arising, and the deferred tax liability is released to the income statement as the property is depreciated.
- 8.4.25 Where a decision is subsequently taken to dispose of the revalued owner-occupied property, then the deferred tax implications will need to be re-examined. Because the temporary difference is calculated on the basis of management expectations as to manner of recovery of the property, when those expectations change, the deferred tax position may also change.

Example 8.4.9 Disposal of an owner-occupied property

A property is acquired for \$1,000 for use in manufacturing activities. It is depreciated over 5 years for both tax and accounting purposes. At the end of the second year, it is revalued for accounting purposes to \$1,800. A deferred tax liability of \$360 (\$1,200 x 30% applicable tax rate) is recognised on revaluation, and charged to the revaluation reserve.

At 31/12/X3, the carrying amount of the property is \$1,200. Its TWDV is \$400. A decision is taken to dispose of the property. The taxable gain on disposal is limited to allowances previously claimed.

$$\begin{aligned}
 \text{Tax base} &= \text{Carrying amount} - \text{Future taxable amounts} + \text{Future deductible amounts} \\
 &= \$1,200 - \$1,000 + \$400 \\
 &= \$600
 \end{aligned}$$

$$\begin{aligned}
 \text{Temporary difference} &= \text{Carrying amount} - \text{Tax base} \\
 &= \$1,200 - \$600 \\
 &= \$600
 \end{aligned}$$

$$\begin{aligned}
 \text{Deferred tax liability} &= \text{Temporary difference} \times \text{Tax rate} \\
 &= \$600 \times 30\% \\
 &= \$180
 \end{aligned}$$

Therefore, once the decision has been made to dispose of the asset, the deferred tax liability is reduced to the liability anticipated to arise on disposal. The revaluation reserve is adjusted by the same amount.

Capital Gains Tax

- 8.4.26 The previous examples have considered the general Hong Kong situation where tax allowances are clawed back when a property is disposed of. Example 8.4.10 illustrates a tax effect common in other jurisdictions, where capital gains tax is assessed by reference to an indexed cost figure.

Example 8.4.10 Capital gains tax arising on disposal

A property is stated at its carrying amount of \$4,000 (cost of \$5,000 less accumulated depreciation of \$1,000). The TWDV is \$3,000 (tax depreciation of \$2,000 having been charged to date). The enterprise intends to sell the property. On the balance sheet date, the asset is revalued to \$7,000.

Any sale proceeds in excess of a base amount are taxed at 30%. The base amount is historical cost uplifted by the Retail Price Index (RPI). Assuming that the RPI for the period since the property was purchased is 8%, the base amount if the asset is sold will be \$5,400 (being the cost of \$5,000 multiplied by 1.08). In addition, tax allowances are clawed back.

If the enterprise were to sell the asset for its carrying amount of \$7,000, the tax base and deferred tax liability would be calculated as follows:

Tax base	=	Carrying amount	-	Future taxable amounts	+	Future deductible amounts
		=		=		=
		=		=		=

$$= \$7,000 - \$1,600^* - \$2,000^{**}$$

$$= \$3,400$$

* For capital gains tax: future taxable amounts (\$7,000) - future deductible amounts (\$5,400) = \$1,600.

** For claw back of allowances: future taxable amounts (\$5,000) - future deductible amounts (\$3,000) = \$2,000.

Temporary difference	=	Carrying amount	-	Tax base
		=		=
		=		=

$$= \$7,000 - \$3,400$$

$$= \$3,600$$

Deferred tax liability	=	Temporary difference	x	Tax rate
		=		=
		=		=

$$= \$3,600 \times 30\%$$

$$= \$1,080$$

Therefore, a deferred tax liability of \$1,080 is recognised at the date of revaluation.

Disposal at Residual Value

8.4.27 An enterprise will often anticipate using an asset for a portion of its useful life and subsequently disposing of it at its residual value. Example 8.4.11 illustrates the deferred tax computations in these circumstances.

Example 8.4.11 Disposal at residual value

A property is stated at its carrying amount of \$4,000 (cost of \$5,000 less accumulated depreciation of \$1,000). The TWDV is \$3,000 (tax depreciation of \$2,000 having been charged to date). On the balance sheet date, the asset is revalued to \$7,000. At the date of valuation, the enterprise intends to use the asset for a further five years and then sell it. The enterprise expects to sell the asset for its carrying amount in five years time of \$3,500. The TWDV at the date of disposal will be nil. On disposal, the taxable gain is restricted to a claw back of allowances.

The difference of \$3,500 between the revalued amount of the property and its estimated residual value represents the taxable income that the enterprise expects to earn from the asset over the next five years. Allowances of \$3,000 will be available over the same period. Therefore, a deferred tax liability of \$150 ($\$500 \times 30\%$ applicable tax rate) should be recognised in respect of this portion of the anticipated economic benefits to be earned from the property.

On disposal, the taxable gain will be calculated as \$3,500 (claw back of allowances limited to sales proceeds). An additional deferred tax liability of \$1,050 ($\$3,500 \times 30\%$) is therefore required to be recognised.

In each of the next five years, assuming a breakeven situation, taxable profit of \$100 will arise (\$700 economic benefits, \$600 tax deduction). The resultant current tax charge of \$30 will be offset by the release of an equivalent amount of deferred tax.

On disposal of the asset, the current tax payable of \$1,050 ($\$3,500 \times 30\%$) will be offset by the release of the remainder of the deferred tax liability.

Transfers between Categories of Properties

8.4.28 Where properties are transferred between categories, the reclassification may have consequences for the deferred tax balances recognised. In addition, where a property is transferred between categories, and the deferred tax balance recognised in respect of that property changes subsequent to the transfer, particular issues arise in respect of the appropriate recording of the movement in the deferred tax balance. The following paragraphs consider these different scenarios.

Transfer from investment property to property, plant and equipment

8.4.29 As discussed elsewhere in this guide, the deferred tax asset or liability recognised in respect of a revalued investment property is always calculated on the basis that the property will be disposed of. For owner-occupied property, the deferred tax asset or liability is most commonly calculated on the basis that the enterprise will recover the carrying amount of the property through use in a taxable activity. Under Hong Kong tax rules, because the taxable gain arising on disposal of an investment property is generally restricted to the amount of tax depreciation previously claimed, an increased deferred tax liability is generally required to be recognised at the date of transfer from investment property to property, plant and equipment.

8.4.30 The increased liability represents a change in the deferred tax liability without, necessarily, any equivalent change in the carrying amount of the asset. In accordance with the principles set out in SSAP 12.60, the movement in the deferred tax liability is dealt with in equity to the extent that it relates to a revaluation of the asset previously dealt with in equity.

Example 8.4.12 Transfer from investment property to property, plant and equipment

An investment property was acquired for \$1,000. At the end of the first year, the property was revalued to \$1,500. The asset is not depreciated for accounting purposes, and is depreciated over 5 years for tax purposes. On disposal, any taxable gain is limited to the capital allowances previously claimed. The tax rate is 30%.

The following entries are recorded at 31/12/X1:

	<u>DR</u> \$	<u>CR</u> \$
Investment property	500	
Investment property revaluation reserve		500
Deferred tax (I/S)	60	
Deferred tax liability (\$200 x 30%)		60

On 1/1/20X2, the property is occupied by the reporting enterprise. The fair value at the date of transfer is equal to the carrying amount of the property. It is anticipated that the carrying amount of the property will be recovered through use.

The deferred tax liability therefore increases to \$210 [(\$1,500 - \$800) x 30%].

The following entries are recorded at the date of transfer:

	<u>DR</u> \$	<u>CR</u> \$
Property, plant and equipment	1,500	
Investment property		1,500
Investment property revaluation reserve	150	
Deferred tax liability		150

SSAP 12 is clear that, in these circumstances, the basis of computation of the liability is changed based on management's revised expectations. What is not explicitly stated in the Standard is the extent to which the investment property revaluation reserve is available to absorb the increased liability.

We believe that the most appropriate treatment is to charge the incremental liability to the investment property revaluation reserve. SSAP 12.60 is clear that the incremental liability should be dealt with in equity to the extent that it relates to items previously credited to equity. As a general rule, where properties are transferred between categories, no further adjustments are made to the revaluation reserve recognised under the original classification, because the value at the date of transfer is deemed to be the cost under the new classification. However, we do not consider that this prohibits using the original revaluation reserve to absorb adjustments to the deferred tax liability.

If, in the circumstances described in Example 8.4.12, the increase were not dealt with in the investment property revaluation reserve, then it would either have to be added to the carrying amount of the property, or dealt with in the income statement, which, as is discussed elsewhere in SSAP 12, is considered to make the financial statements "less transparent".

An alternative view of the circumstances described in Example 8.4.12 is that the transfer to property, plant and equipment represents the initial recognition of a "new" asset. If this approach were taken, then the incremental liability arising on transfer would not be recognised, under the initial recognition exception discussed in section 8.1 of this guide. We do not support this approach, since it would result in the omission of further deferred tax liabilities. We believe that it is more appropriate to recognise the increased liability, and to debit the increase to the revaluation reserve under the previous classification.

Transfer from property, plant and equipment to investment property

8.4.31 Where a revalued property is transferred from property, plant and equipment to investment property, the deferred tax liability will generally decrease. In these circumstances, consistent with the discussion in the previous paragraphs, we believe that the decrease in the deferred tax liability should be credited to the revaluation reserve under the previous classification.

Example 8.4.13 Transfer from property, plant and equipment to investment property

An owner-occupied property was acquired for \$1,000. It is depreciated for both tax and accounting purposes over 5 years. At the end of the first year, the property is revalued to \$1,600. The tax rate is 30%.

The following entries are recorded at 31/12/X1:

	<u>DR</u> \$	<u>CR</u> \$
Depreciation charge	200	
Property, plant and equipment - accumulated depreciation		200
Property, plant and equipment	600	
Property, plant and equipment - accumulated depreciation	200	
Property revaluation reserve		800
Property revaluation reserve	240	
Deferred tax liability		240

On 31/12/X2, the property is transferred to investment property. The fair value at the date of transfer is equal to the carrying amount. On disposal of the property, the taxable gain would be restricted to the capital allowances previously claimed.

The following entries are recorded at 31/12/X2 :

	<u>DR</u> \$	<u>CR</u> \$
Depreciation charge	400	
Property, plant and equipment - accumulated depreciation		400
Deferred tax liability	60	
Deferred tax (I/S)		60
Investment property	1,200	
Property, plant and equipment		1,600
Property, plant and equipment - accumulated depreciation	400	
Deferred tax liability	60	
Property revaluation reserve		60

At 31/12/X2, for investment property classification:

Tax base = \$1,200 - \$1,000 + \$600 = \$800
 Temporary difference = \$1,200 - \$800 = \$400
 Deferred tax liability = \$400 x 30% = \$120

8.4.32 If, in the circumstances described in Example 8.4.13, the property had been classified as an investment property from the date of purchase, the deferred tax liability of \$120 at 31/12/X2 would all have been charged to the income statement. As illustrated at Example 8.4.7, where the taxable gain on disposal is restricted by reference to historical cost, the deferred tax is charged to the income statement. In the circumstances illustrated in Example 8.4.13, however, the deferred tax liability of \$120 has effectively by-passed the income statement, consistent with the usual effect for owner-occupied property (see Examples 8.4.1 and 8.4.2 above).

Movements in deferred tax balance subsequent to transfer

8.4.32 Where a property has been transferred between categories, and the deferred tax asset or liability recognised in respect of that asset is increased or decreased by an event that occurs after the transfer, the question arises as to the extent to which the change in the deferred tax balance should be dealt with in equity.

Example 8.4.14 Subsequent change in deferred tax balance

Facts as per Example 8.4.12. Subsequent to the transfer from investment property to property, plant and equipment, the tax rate is increased to 40%. Ignoring subsequent depreciation movements, the deferred tax liability therefore increases to \$280 [(\$1,500 - \$800) x 40%].

The following journal entry is recorded:

	<u>DR</u>	<u>CR</u>
	\$	\$
Investment property revaluation reserve	50	
Deferred tax (I/S)	20	
Deferred tax liability		70

8.4.34 The adjustment to deferred tax reflects the original recognition of the liability. Therefore, because the original deferred tax liability was charged to both the income statement (\$60) and the investment property revaluation reserve (\$150), the adjustment is charged in the same ratio.

Deficit arising on the revaluation reserve

8.4.35 In some circumstances, charging the full amount of a deferred tax liability to equity would result in a deficit on a property revaluation reserve. Although not explicitly discussed in SSAP 12, in line with the general principles of SSAP 17 *Property, Plant and Equipment* and SSAP 13 *Accounting for Investment Properties*, we believe that the recognition of such deficits is not appropriate. Therefore, to the extent that a deferred tax liability exceeds the available revaluation reserve in relation to the specific asset (for property, plant and equipment) or on a portfolio basis (for investment property), it should be charged to income.

8.5 FOREIGN CURRENCY TRANSLATION

- 8.5.1 Under the superseded version of SSAP 12, the translation of the financial statements of overseas subsidiaries or associates was not regarded as creating a timing difference. Gains and losses arising on the translation of an enterprise's own overseas assets (including investments in subsidiaries and associates) and liabilities could give rise to timing differences depending on the tax impact of the gains or losses.
- 8.5.2 The revised Standard adopts a different approach, under which the translation of the financial statements of foreign enterprises may, in certain circumstances, give rise to temporary differences that are required to be recognised.

Assets or Liabilities Held Directly

- 8.5.3 Where an enterprise holds a foreign-currency denominated monetary asset or liability directly, retranslation at each period end will result in a change in the carrying amount for accounting purposes, and a foreign exchange gain or loss that is generally dealt with in income. Where the tax regulations do not allow for an equivalent change in tax base, and a gain on disposal would be taxable, a temporary difference arises on retranslation which is required to be recognised. In most circumstances, the related deferred tax is charged or credited in the income statement. However, where the retranslation itself is dealt with in equity (e.g. where foreign currency assets are financed by foreign currency borrowings or hedged by forward contracts - see SSAP 11.25), the deferred tax is also dealt with in equity.
- 8.5.4 Where the enterprise holds a non-monetary asset that is located overseas, the asset is recorded at its historical cost, being the original foreign currency purchase price translated at the rate on the date of purchase. Where the realisation of that asset will give rise to tax consequences in the foreign country, the tax base of the asset changes as the exchange rate changes, giving rise to temporary differences because the recognised carrying amount of the asset does not change. This effect is consistent with the circumstances arising on the translation of overseas financial statements using the temporal method (see paragraph 8.5.13).

Consolidated Financial Statements

- 8.5.5 Where a reporting enterprise includes foreign enterprises in its consolidated financial statements (whether by equity accounting or consolidation), special deferred tax considerations apply. A foreign enterprise is defined as a subsidiary, associate or branch whose operations are based in a country other than that of the investing company, or whose assets and liabilities are denominated mainly in a foreign currency. [SSAP 11.6] Although not contemplated at the time that SSAP 11 *Foreign Currency Translation* was issued, the same issues arise in relation to overseas jointly controlled entities that are accounted for using equity accounting.
- 8.5.6 Once a foreign enterprise's own financial statements have been prepared in its local currency, they must then be translated into the reporting currency of the investing enterprise or group, before they can be incorporated into the group's consolidated financial statements. SSAP 11 requires that one of two methods should be used to translate the financial statements of each foreign enterprise, i.e. either:
- the net investment method; or
 - the temporal method.

The net investment method

- 8.5.7 The net investment method is the most commonly used method of translation and it is used to translate the local currency financial statements of those foreign enterprises in the group which operate as separate or quasi-independent entities. This method recognises that the investment made is in the net worth of the foreign enterprise rather than in the individual assets and liabilities. The objective of the translation is for the translated financial statements to closely reflect the results and relationships as measured in the foreign currency.
- 8.5.8 Under the net investment method, the balance sheet amounts of a foreign enterprise are translated using the closing rate of exchange. The income statement of the foreign enterprise is translated at an average rate for the period. Exchange differences arising are dealt with in equity.

- 8.5.9 From a deferred tax perspective, the translation of the financial statements of a foreign enterprise using the net investment method should not give rise to any additional temporary differences associated with the assets and liabilities of the foreign enterprise. This is because the carrying amounts and the tax bases of the assets and liabilities of the foreign enterprise are all translated using the same year-end exchange rate, and any deferred taxes will have already been recognised by the foreign enterprise.
- 8.5.10 Of course, there may be circumstances where the foreign enterprise does not account for deferred taxation under its local GAAP, and where the deferred tax balances will be introduced on consolidation. Even in these circumstances, however, the adjustments will be calculated first in the local currency of the foreign enterprise and will be translated using the closing exchange rate. Therefore, consistent exchange rates are used for both the carrying amounts in the financial statements and the tax bases of the asset and liabilities.
- 8.5.11 Movements in the deferred tax balances of these foreign enterprises due to changes in the exchange rates used to translate them are treated in accordance with SSAP 11, and recognised directly in the foreign currency translation reserve.
- 8.5.12 Although temporary differences do not result directly from the translation of the financial statements of these foreign enterprises, temporary differences can still arise on their consolidation due to differences between the translated net investment accounted for in the consolidated financial statements (effectively the group's share of the net assets of the foreign enterprise), and the tax base of the investment itself in the parent enterprise (see section 8.3 of the guide).

The temporal method

- 8.5.13 The temporal method is used to translate the financial statements of foreign enterprises where the trade of the foreign enterprise is more dependent on the economic circumstances of the investing company's reporting currency than on its own reporting currency. [SSAP 11.31] The use of this method is not common under Hong Kong GAAP.
- 8.5.14 Under the temporal method, the non-monetary assets and liabilities of a foreign enterprise are translated using historical exchange rates. The tax bases of those assets and liabilities are translated using the year-end exchange rate (because that gives the best estimate of the amount that will be deductible in future years from the group's perspective). Consequently, in the consolidated financial statements, temporary differences arise between the carrying amounts and the tax bases of the assets and liabilities due to their translation using different exchange rates.
- 8.5.15 Therefore, on translation of these foreign enterprises, a deferred tax asset or liability will arise in respect of these temporary differences and be recognised. These temporary differences are related to the underlying assets and liabilities of the foreign enterprise and not the parent's investment in the enterprise. Therefore, the recognition exceptions for investments (see section 8.3 of this guide) are not applicable for any deferred tax balances arising.
- 8.5.16 The deferred tax expense or income arising in these circumstances is recognised in the income statement, because the associated foreign exchange gain/loss is recognised in the income statement when realised.

Example 8.5.1 Temporal method of translation

L Limited purchases M Limited, a company in Z Land, for 12,000 Currency Units of Z Land (CU12,000). M Limited's only asset is a property that has a tax base under local tax law of CU12,000. The exchange rate is 0.60 at the acquisition date of 30 November 20X0, and 0.80 at 31 December 20X0. The financial statements of M Limited are translated using the temporal method. The tax rate in Z Land is 25%, and the local tax rate is 17.5%.

At 31 December 20X0, a temporary difference arises in respect of the property as follows:

	CU	Exchange rate	HK\$
Carrying amount	12,000	0.60	20,000
Tax base	<u>12,000</u>	0.80	<u>15,000</u>
Taxable temporary difference	-		<u>5,000</u>
Deferred tax liability (at 25%)	-		<u>1,250</u>

Although there is no deferred tax recognised in the books of M Limited, on translation into Hong Kong dollars, a deferred tax liability arises due to the difference between the rates used to translate the carrying amount of the property and its tax base. This deferred tax liability is calculated on translation and is recognised in the income statement.

If the asset were realised at its carrying amount at the balance sheet date of HK\$20,000, this is equivalent to realising the asset for CU16,000 using the year end exchange rate of 0.80. This would give rise to a taxable gain of CU4,000 (CU16,000 - CU12,000) and tax payable of CU1,000 (CU4,000 at the Z Land of 25%). This tax is recognised as a deferred tax liability of HK\$1,250 (CU1,000 at year end rate of 0.80).

Example 8.5.2 Temporal method of translation - subsequent years

Facts as per Example 8.5.1. At 31 December 20X1, the exchange rate is 1. The average rate for 20X1 is 0.9. The property is depreciated over 10 years for accounting purposes, and five years for tax purposes.

At 31 December 20X1, the temporary difference is as follows:

	CU	Exchange rate	HK\$
Carrying amount:			
Cost	12,000	0.6	20,000
Depreciation	<u>(1,200)</u>	0.9	<u>(1,333)</u>
Tax base	10,800	-	18,667
	<u>9,600</u>	1	<u>9,600</u>
Taxable temporary difference	<u>1,200</u>	-	<u>9,067</u>
Deferred tax liability (at 25%)	<u>300</u>		<u>2,267</u>

Again, if the asset were realised at its carrying amount at 31 December 20X1 of HK\$18,667, this is equivalent to realising the asset for CU18,667, using the year end exchange rate of 1. This would give rise to a taxable gain of CU9,067 (CU18,667 - CU9,600), and tax payable of CU2,267 (25% tax rate). The liability (translated at the year end exchange rate of 1) is recognised as a deferred tax liability in the consolidated financial statements of L Limited.

8.6 COMPOUND FINANCIAL INSTRUMENTS

- 8.6.1 The IFRS on which SSAP 12 is based, IAS 12, contains guidance on calculating deferred tax in relation to compound financial instruments that are accounted for under IAS 32 *Financial Instruments: Disclosure and Presentation*. Because there is currently no Hong Kong equivalent of IAS 32, the guidance has been deleted from the main body of SSAP 12. However, in a footnote to the Standard, the HKSA has indicated that, where the requirements of IAS 32 have been followed by way of best practice, the consequential requirements of IAS 12 should be followed. This section therefore outlines the IAS 12 requirements. This divergence is temporary, in any case, since there is a current Hong Kong Exposure Draft based on IAS 32, which is likely to be finalised during 2003.
- 8.6.2 Compound financial instruments, such as convertible bonds, contain both a liability and an equity component. In the case of a convertible bond, the separate components are a liability component, that represents borrowing with an obligation to repay, and an equity component, representing the embedded option to convert the liability into equity of the enterprise.
- 8.6.3 Under IAS 32, the equity and liability components of a compound instrument are accounted for separately - the proceeds of issue are allocated between the separate elements. Therefore, the amount recognised as a liability is the face value of the instrument as reduced by any amount classified as equity, and will always be less than or equal to the face value of the compound instrument. For example, \$100 proceeds from the issue of a convertible bond could be allocated \$90 to debt and \$10 to equity. Therefore, the carrying amount of the liability component (\$90) is less than the face value of the instrument (\$100).
- 8.6.4 Generally, the tax base of a compound financial instrument is its face value. If the instrument were settled at an amount equal to the carrying amount of its liability component (which is generally less than the face value and therefore less than the tax base), in some jurisdictions, a taxable gain arises, and so a deferred tax liability arising from this taxable temporary difference is recognised. In the example cited in the previous paragraph, if the bond were settled for \$90 (its carrying amount), a gain of \$10 would arise which could be taxable.
- 8.6.5 In jurisdictions where any gain on settlement of the liability would not be taxable, the tax base of the liability is always equal to its carrying amount, and so no temporary difference arises.

Readers will note that the temporary difference appears to arise on the initial recognition of the liability and, therefore, under the exception discussed in section 8.1 of this guide, it seems inappropriate that it should be recognised. However, IAS 12 argues that the temporary difference arises not from the initial recognition of the liability, but from the recognition of the equity component separately from the liability component. As a result, IAS 12 concludes that the initial recognition exception does not apply.

- 8.6.6 Because the equity component of the compound financial instrument is recognised directly in equity, the deferred tax liability arising is also dealt with in equity (i.e. as a reduction in the carrying amount of the equity component).
- 8.6.7 However, as the discount associated with the liability component of the compound financial instrument unwinds, the reduction of the associated deferred tax liability is recognised in the income statement and not directly in equity, under the specific requirements of IAS 12. The recognition in the income statement of the deferred tax credit is consistent with the recognition of the associated discount expense in the income statement.
- 8.6.8 Example 8.6.1 illustrates the application of the principles discussed in the previous paragraphs.

Example 8.6.1 Compound financial instrument

N Limited issues a convertible note with a face value of \$10,000 that matures in three years. There is no coupon interest payable during the period, but the note is optionally convertible to shares at the end of the three-year period.

Under the principles of IAS 32, because this is a compound financial instrument, it is split into its liability and equity components. Using a discount rate of 9%, the present value of the instrument is \$7,722. This is taken to be the value of the liability component, giving rise to an amount recognised directly in equity of \$2,278.

The tax base of the instrument is assumed to be \$10,000. This is based on there being no tax consequences if the note is repaid at its face value, and a taxable gain arising if the note is settled for less than its face value. The tax rate is 17.5%.

If the liability were settled at its carrying amount (\$7,722), a taxable profit would arise. Therefore, on the initial separation of the liability and equity components, a taxable temporary difference of \$2,278 arises. This gives rise to a deferred tax liability of \$399 (\$2,278 x 17.5%). This amount is netted against the amount recognised in respect of the equity component of the note.

The following entries are recorded at the date of issue of the convertible note:

	<u>DR</u> \$	<u>CR</u> \$
Cash	10,000	
Convertible note payable		7,722
Equity (capital reserve)		2,278
Equity (capital reserve)	399	
Deferred tax liability		399

Each year, imputed interest on the liability will be recognised, increasing the carrying amount of the liability component, and reducing the associated deferred tax liability. The reduction in the deferred tax liability is recognised in the income statement.

The movements over the life of the convertible note can be summarised as follows:

	<u>20X0</u> \$	<u>20X1</u> \$	<u>20X2</u> \$	<u>20X3</u> \$
<u>Liability and interest</u>				
Opening liability		7,722	8,417	9,174
Imputed interest (at 9%)		695	757	826
Closing liability	<u>7,722</u>	<u>8,417</u>	<u>9,174</u>	<u>10,000</u>
<u>Deferred tax liability</u>				
Convertible note carrying amount	7,722	8,417	9,174	10,000
Tax base	<u>10,000</u>	<u>10,000</u>	<u>10,000</u>	<u>10,000</u>
Taxable temporary difference	<u>2,278</u>	<u>1,583</u>	<u>826</u>	-
Deferred tax liability (at 17.5%)	<u>399</u>	<u>277</u>	<u>145</u>	-

8.7 IMPLEMENTATION AND PRIOR PERIOD ADJUSTMENTS

Implementation Date

- 8.7.1 SSAP 12 is effective for periods beginning on or after 1 January 2003. Earlier adoption is encouraged, but not required. If an enterprise adopts SSAP 12 for periods beginning before 1 January 2003, that fact is required to be disclosed. [SSAP 12.89]
- 8.7.2 Under SSAP 25 *Interim Reporting*, changes in accounting policies that are to be reflected in the next annual financial statements are also required to be reflected in interim financial statements prepared in accordance with that Standard. Therefore, implementation of SSAP 12 for interim reporting periods beginning on or after 1 January 2003 is mandatory for both Main Board and GEM listed enterprises.

Retrospective Application

- 8.7.3 SSAP 12 contains no explicit transitional provisions. Therefore, the general principles of SSAP 2 *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies* come into play.
- 8.7.4 On initial adoption, unless the amount of the impact on prior periods is not reasonably determinable, the change in accounting policy should be applied retrospectively. Any resulting adjustment should be reported as an adjustment to the opening balance of retained earnings or reserves, as appropriate. [SSAP 2.45]
- 8.7.5 Where the amount of the adjustment to the opening balance of retained earnings or reserves cannot be reasonably determined, the change in accounting policy should be applied prospectively. [SSAP 2.48]

The requirements of SSAP 2 mean that historical information and transactions will need to be reviewed, to the extent practicable, so that the correct deferred tax implications are recognised. The more common areas that are likely to give rise to adjustments are discussed later in this section. In practice, in Hong Kong, the two areas that are likely to give rise to the most complex calculations are past business combinations, and revalued properties.

Restatement of Comparatives

- 8.7.6 Under the requirements of SSAP 2, comparative information should be restated on the new basis, unless it is impracticable to do so. [SSAP 2.45] Where it is considered impracticable to restate comparative information, that fact should be disclosed. [SSAP 2.49(d)]
- 8.7.7 The requirements of SSAP 2 effectively mean that, where practicable, opening balance adjustments need to be calculated at both the beginning of the financial year in which the revised Standard is first adopted, and the beginning of the previous financial year.
- 8.7.8 SSAP 5 *Earnings Per Share* deals with the restatement of earnings per share (EPS) information. SSAP 5 requires that basic and diluted EPS for all periods presented should be adjusted for the effects of changes in accounting policies. Unlike the general rules for restatement under SSAP 2, SSAP 5 does not include an exception to the requirement to restate comparative EPS information on the basis of impracticability. However, we interpret the SSAP 5 requirement to only require restatement of EPS information where the income statement for the same period has been restated. Where an income statement has not been restated, because it is impracticable to do so, we do not consider that there is a requirement to restate EPS information.
- 8.7.9 Listed enterprises will also need to consider the impact on the five years summaries of financial information presented under the Listing Rules/GEM Rules. Although SSAP 2 requires restatement of "any other information with respect to prior periods, such as historical summaries of financial data", because these summaries are generally presented outside the financial statements, they are not subject to the SSAP 2 rules. The Listing Rules/GEM Rules do not contain any explicit requirements in respect of the restatement of such summaries for retrospective application of accounting policies. It is certainly general and best practice to restate all five years' information. However, where such restatement is not practicable, that fact should be stated in the notes to the financial summary.

Adjustments on Implementation

8.7.10 Throughout this guide, we have discussed the impact of the new Standard on various balance sheet components. The following paragraphs focus on initial implementation and the areas that are likely to give rise to adjustments. This is not an exhaustive list, and enterprises will need to perform a thorough review of their own balance sheets to ensure that they have identified all of the components requiring adjustment.

Past acquisitions

8.7.11 Where an enterprise has in the past been involved in business combinations that were accounted for as acquisitions, adjustments are likely to be required.

8.7.12 As discussed at section 8.2 of this guide, deferred tax balances are likely to arise at acquisition for the following reasons:

- the carrying amounts of assets and liabilities may be different in the consolidated financial statements due to fair value adjustments made on acquisition;
- additional assets or liabilities may have been recognised at the date of the acquisition;
- temporary differences between the carrying amounts and tax bases of assets and liabilities that have not been recognised by the acquired entity itself due to the initial recognition exception (see section 8.1 of this guide) will be recognised in the consolidated financial statements; and
- certain deferred tax assets (e.g. those arising from tax losses) may qualify for recognition at a group level that did not qualify at an individual enterprise level.

8.7.13 For each past acquisition, the enterprise will be required to:

- recognise the deferred taxes balances that would have arisen at the date of acquisition had the rules of the revised Standard been applied at that date;
- remeasure the gross amount of goodwill or negative goodwill on acquisition, taking into account the deferred tax balances not previously recognised; and
- where applicable, recalculate goodwill amortisation (release of negative goodwill) and deferred tax movements to the implementation date, and recognise the impact as an opening retained earnings adjustment.

8.7.14 Where the adjustments have given rise to a higher goodwill figure, as will commonly be the case where additional deferred tax liabilities are identified, it will be necessary to consider whether this higher carrying amount is recoverable, or whether an impairment loss should be recognised. Any impairment loss related to the opening balance will also be reflected as a prior period adjustment.

8.7.15 It is important to remember that the adjustments made should reflect tax rates and laws enacted or substantively enacted at the date of the acquisition. The effect of subsequent changes in tax rates or laws should not impact the calculation of goodwill, but should be reflected in adjustments to retained earnings or other reserves subsequent to the acquisition.

8.7.16 In respect of goodwill or negative goodwill that has been retained in reserves under the transitional relief provided under SSAP 30 *Business Combinations*, the amount of the gross goodwill or negative goodwill arising on acquisition should be adjusted as discussed above. Where the adjustment results in a higher goodwill figure, the recoverability of that higher amount will also need to be considered (see paragraph 8.7.14). However, because no systematic release to the income statement is required in respect of such goodwill/negative goodwill, no further adjustment will generally be required.

Property, plant and equipment

8.7.17 For property, plant and equipment, aside from differences arising on acquisition (see above) or revaluation (see below), the most common deferred tax impact relates to accelerated depreciation allowances. In the past, such differences may not have been recognised on the basis that they were not expected to reverse without replacement by equivalent balances. This basis for non-recognition is not available under the revised Standard. Therefore, on implementation of SSAP 12, it is likely that additional deferred tax liabilities will need to be recognised.

8.7.18 The enterprise will need to:

- calculate the temporary differences arising on all items of property, plant and equipment, based on the manner in which the enterprise expects to recover the carrying amounts of the assets; and
- recognise deferred tax liabilities and deferred tax assets in accordance with the requirements of the new Standard, irrespective of future capital expenditure plans that may give rise to replacement temporary differences.

8.7.19 These calculations are performed at the date of implementation of the revised Standard. It is not strictly necessary to reperform all of the computations back to the date of acquisition of each asset. However, in order to identify those differences at the date of implementation that arose on initial recognition of the assets (and, therefore, that are to be excluded from the deferred tax balances recognised), it may be necessary to identify the gross differences arising at acquisition and their subsequent reversal up to the date of implementation.

Revaluations

8.7.20 Revaluations of both investment properties and property, plant and equipment are likely to give rise to adjustments. As discussed in section 8.4 of this guide, deferred tax will generally be recognised on the basis that the property will be disposed of (investment property) or recovered through use (property, plant and equipment).

8.7.21 The steps that will be required on implementation of SSAP 12 are as follows:

- estimate the amount of the temporary differences at the time that any initial upward revaluation was recognised, based on the manner in which the enterprise expects to recover the carrying amount of the revalued properties;
- calculate the amount of deferred tax arising. Deferred tax liabilities will be recognised either in retained earnings or in the revaluation reserve (see section 8.4);
- recognise, to the extent that their recovery is considered probable, the deferred tax assets arising on past impairment losses and downward revaluations, and reflect the adjustment through the appropriate asset revaluation reserve (if applicable) and opening retained earnings;
- calculate the amount of the deferred tax charge/credit relating to past recovery of revalued properties through use, between the date of the initial recognition of the revaluation and the date of implementation, and adjust the amount against opening retained earnings; and
- any adjustment that would reduce the balance on the property revaluation reserve relating to specific assets (for property, plant and equipment) or on a portfolio basis (for investment properties) below zero should be recognised in opening retained earnings.

Deferred tax assets (tax losses)

8.7.22 The likelihood of recovery of deferred tax assets, including those arising from tax losses, will need to be re-assessed to determine the extent to which they are considered “probable” (see paragraph 6.3.17 above).

8.7.23 Where the tax losses relate to a subsidiary that was acquired in a business combination, the resultant adjustment is made to goodwill or negative goodwill arising on that acquisition. Where the goodwill or negative goodwill is accounted for in accordance with SSAP 30 *Business Combinations*, retrospective amortisation/release to income will also be required.

Foreign enterprises accounted for using the temporal method

8.7.24 The following steps will be required:

- calculate the temporary differences arising from translating the carrying amounts and tax bases of non-monetary assets of such enterprises at different exchange rates (section 8.5); and
- recognise the deferred taxes arising and adjust opening retained earnings.

Investments and interests

8.7.25 Calculate any temporary differences arising between the carrying amounts and the tax bases of investments in securities (see section 8.3). The deferred tax liabilities or assets will be adjusted against retained earnings or the investment revaluation reserve, as appropriate.

8.7.26 On a consolidated basis, calculate any temporary differences arising between the carrying amounts of the net assets of each subsidiary, associate and jointly controlled entity, and the tax base of the parent's/investor's investment (see page 74).

8.7.27 Determine whether any of the recognition exceptions apply in circumstances where the parent/investor has the power to control the reversal of taxable temporary differences arising in respect of investments in subsidiaries, associates and jointly controlled entities.

Compound financial instruments (accounted for under the principles of IAS 32)

8.7.28 Calculate the temporary difference arising between the carrying amount of the liability component and the instrument's tax base as at the date of issue.

8.7.29 Recognise the deferred tax liability initially arising from this temporary difference as an adjustment to the amount recognised directly in equity (see paragraph 8.6.6).

8.7.30 Calculate the movement in the deferred tax liability from the issue date until the implementation date, and recognise the movement as an adjustment to opening retained earnings.

Other balance sheet components

8.7.31 Other balance sheet components that may give rise to deferred tax assets/liabilities are:

- trade receivables - allowances for bad debts;
- prepayments - where a tax deduction is obtained at the time of payment;
- provisions - where no tax deduction is obtained until the amounts are actually paid; and
- deferred income - which is taxed on receipt.

APPENDIX I - EXAMPLE TAX WORKSHEETS

Overview

- A1.1 The following examples illustrate the layout and format of worksheets that can be used to calculate current and deferred taxes for a reporting period. Exhibit A1.1 sets out some general principles to remember in structuring these worksheets.

Exhibit A1.1 Calculation tips for tax worksheets

- Separate worksheets should be prepared for current and deferred tax calculations.
- To detect errors, these calculations should enable a 'cross-check' of amounts that affect both calculations.
- Deferred taxes should be calculated by reference to the balance sheet to ensure that all items are taken into account.
- There will often be amounts that affect deferred taxes but not current taxes, the income statement or the tax return in the same period - these should be tracked and used to reconcile the total income tax expense.
- Deferred taxes recognised in the income statement, equity or as an adjustment to goodwill arising on acquisition should be separately calculated and tracked to make future calculations easier and to allow for the disclosure of the breakdown of deferred tax balances.

Current Tax

- A1.2 The current tax calculation is performed by adjusting profit or loss before income tax for differences between the accounting treatment of items and the equivalent tax treatment.
- A1.3 The current tax expense is broken down into separate components representing where each item is recognised (income statement, directly in equity, or on acquisition). The amount recognised in the income statement is further broken down to provide a 'cross check' against the movements in the deferred tax balances (see next page).

Example A1.1 Current tax worksheet

	Current tax liability	Recognised directly in equity	Recognised on acquisition	Recognised in income statement	
				Impacts deferred taxes	Other
	HK\$'000	HK\$'000	HK\$'000	HK\$'000	HK\$'000
(Profit)/loss before tax	(125,081)	-	-	-	125,081
Non-deductible expenses:					
Donations	(240)	-	-	-	240
Other	(71)	-	-	-	71
Movements in intangible assets:					
Book amortisation of development costs	(850)	-	-	850	-
Tax allowance (100%)	4,000	-	-	(4,000)	-
Movements in depreciable assets					
Properties - book depreciation	(30,289)	-	-	24,289	6,000
Properties - tax allowances	45,603	-	-	(45,603)	-
Plant and equipment - book depreciation	(73,742)	-	-	73,742	-
Plant and equipment - tax allowances	121,502	-	-	(121,502)	-
Interest on convertible loan note					
Interest accrued for the period	(1,260)	-	-	1,260	-
Interest paid in the period	938	-	-	(938)	-
Retirement benefit obligations					
Charge recognised in income statement	(3,402)	-	-	3,402	-
Contributions paid	5,247	-	-	(5,247)	-
TAXABLE AMOUNT	(57,645)	-	-	(73,747)	131,392
Tax payable at 17.5%	(10,088)	-	-	(12,906)	22,994

(Agrees to deferred tax worksheet)

Journal Entry:

	DR	CR
	HK\$'000	HK\$'000
Current tax expense	10,088	
Current tax liability		10,088

Deferred Tax

- A1.4 As deferred taxes are calculated by applying the applicable tax rate to temporary differences, a schedule of carrying amounts, tax bases, temporary differences and tax rates is often the easiest means of presenting a deferred tax calculation.
- A1.5 The deferred tax balances should be split into those components recognised in the income statement, directly in equity (and on acquisition where appropriate), and those not recognised due to the recognition exceptions or failing to meet the probable criterion for recognition of deferred tax assets.
- A1.6 Once these balances have been determined, then the detailed movements for the year can be established by comparison to the equivalent balances from the prior period.

Example A1.2 Deferred tax worksheet

	Carrying amount	Tax base	Temporary difference taxable / (deductible)	Tax rate	Deferred tax balance	(Liability)		Asset	Not recognised	Notes
						I/S	Equity	I/S		
						HK\$'00	HK\$'000	HK\$'000		
	HK\$'000	HK\$'000	HK\$'000		HK\$'000	HK\$'00	HK\$'000	HK\$'000		
Cash	5,609	5,609	-	-	-	-	-	-	-	
Receivables	188,907	188,907	-	-	-	-	-	-	-	
Inventories	117,895	117,895	-	-	-	-	-	-	-	
Other financial assets	60,786	60,786	-	-	-	-	-	-	-	
Deferred development costs	3,150	-	3,150	17.50%	551	(551)	-	-	-	a
Properties	497,788	277,960	219,828	17.50%	38,470	(6,854)	(10,616)	-	(21,000)	b
Plant and equipment	173,815	117,072	56,743	17.50%	9,930	(9,930)	-	-	-	c
Total assets	1,047,950	768,229								
Payables	(141,949)	(141,949)	-	-	-	-	-	-	-	
Interest-paying liabilities										
Convertible debt										
- initial recognition	(24,005)	(25,000)	995	17.50%	174	-	(174)	-	-	d
- unwinding	(322)	-	(322)	17.50%	(56)	56	-	-	-	
Other	(500,660)	(500,660)	-	-	-	-	-	-	-	
Provisions	(8,550)	(8,550)	-	-	-	-	-	-	-	
Retirement benefit obligations	(12,788)	-	(12,788)	17.50%	(2,238)	-	-	2,238	-	e
Total liabilities	(688,274)	(676,159)								
DEFERRED TAX BALANCES AT END OF PERIOD						(17,279)	(10,790)	2,238	(21,000)	
DEFERRED TAX BALANCES AT BEGINNING OF PERIOD						(4,696)	(6,802)	2,561		
AMOUNT CHARGED TO INCOME STATEMENT						(12,583)	-	(323)		
AMOUNT CHARGED TO EQUITY							(3,988)			

Journal Entry:

	DR	CR
	HK\$'000	HK\$'000
Deferred tax expenses (12,583 + 323)	12,906	
Equity (equity component of bond)	174	
Properties revaluation reserve	3,814	
Deferred tax liability (12,583 + 3,988)		16,571
Deferred tax asset		323
	<u>16,894</u>	<u>16,894</u>

Notes:

- Development costs are amortised over five years for accounting purposes, but are allowed for tax purposes when they are paid.
- The temporary difference on properties is attributable to (1) accelerated tax allowances; (2) revaluation surplus; and (3) difference arising on initial recognition of assets, which is not recognised.
- The temporary difference on plant and equipment is all attributable to accelerated tax allowances.
- The convertible debt is a convertible note issued in the period with a face value of \$25 million, with \$995,000 recognised directly in equity. As the discount unwinds, the movement is recognised in income, not equity.
- Pension contributions are allowed for tax purposes when they are paid.

A1.7 Exhibit A1.2 includes some additional tips for deferred tax worksheets.

Exhibit A1.2 Deferred tax worksheet tips

General

- Deferred taxes should be analysed according to where they are recognised (income statement, equity, on acquisition) or why they are not recognised (recognition exception, failing 'probable' criterion for deferred tax assets).
- The movement in the amount recognised in the income statement should then reconcile to the equivalent breakdown in the current tax calculation (where applicable).
- This approach will also allow the easy compilation of many of the disclosures required, including the breakdown of deferred taxes and movements, the reconciliation of income tax, etc.

Compound financial instruments

- The deferred tax liability arising on the initial recognition of a compound financial instrument should be included in the 'recognised directly in equity' column and not subsequently changed.
- As the discount unwinds, deferred tax arising is recognised in the income statement.

Other items

- In some cases, there may be items that impact deferred taxes although they do not impact current taxes or the income statement and tax returns in the current period.
- This can result from capital gains tax indexation, special tax allowances and treatments, or changes in expectations as to the way in which an asset will be recovered or a liability settled.
- It may be necessary to split the effects of these items out in a separate column when performing the deferred tax calculation, so that the 'cross-check' between current and deferred tax can still be performed.
- This will also permit the breakdown and reconciliation of total income tax expense to be more easily determined.

**APPENDIX II - PRESENTATION AND DISCLOSURE CHECKLIST
SSAP 12 (REVISED) INCOME TAXES**

Ref.	Presentation/Disclosure Requirement	Source
	Tax Expense/Income	
12001	The tax expense (income) related to profit or loss from ordinary activities should be presented on the face of the income statement.	SSAP 12.77
12002	The major components of tax expense/income should be separately disclosed.	SSAP 12.79
12003	The aggregate current and deferred tax relating to items that are charged or credited to equity should be separately disclosed.	SSAP 12.81(a)
12004	The tax expense (income) relating to extraordinary items recognised during the period should be separately disclosed.	SSAP 12.81(b)
12005	An explanation should be provided of the relationship between the tax expense/income and the accounting profit in either or both of the following forms: a) a numerical reconciliation between the tax expense/income and the product of accounting profit multiplied by the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed; or b) a numerical reconciliation between the average effective tax rate and the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed.	SSAP 12.81(c)
12006	The following should be disclosed: a) an explanation of changes in the applicable tax rate compared to the previous accounting period; and b) in respect of discontinuing operations, the tax expense relating to: i) the gain or loss on discontinuance; and ii) the profit or loss from the ordinary activities of the discontinuing operation for the period, together with the corresponding amounts for each prior period presented.	SSAP 12.81(d) SSAP 12.81(h)
12007	For each type of temporary difference, and each type of unused tax losses and unused tax credits, the enterprise should disclose the amount of the deferred tax income or expense recognised in the income statement, where not readily apparent from the changes in the amounts recognised in the balance sheet.	SSAP 12.81(g)
	Tax Assets and Liabilities	
12008	The following principles should be applied in the presentation of tax assets and liabilities: a) tax assets and tax liabilities should be presented separately from other assets and liabilities in the balance sheet; b) current tax assets and liabilities should be distinguished from deferred tax assets and liabilities; and c) when the enterprise distinguishes between current and non-current assets and liabilities in its financial statements, deferred tax assets (liabilities) should not be treated as current assets (liabilities).	SSAP 12.69 SSAP 12.69 SSAP 12.70
12009	Current tax assets and current tax liabilities should be offset if, and only if, both of the following conditions are satisfied: a) there is a legally enforceable right to set off the recognised amounts; and b) it is intended either to settle on a net basis, or to realise the asset and settle the liability simultaneously.	SSAP 12.71

Ref.	Presentation/Disclosure Requirement	Source
12010	<p>Deferred tax assets and deferred tax liabilities should be offset if, and only if, both of the following conditions are satisfied:</p> <ul style="list-style-type: none"> a) there is a legally enforceable right to set off current tax assets against current tax liabilities; and b) the deferred tax assets and the deferred tax liabilities relate to income taxes levied by the same taxation authority on either: <ul style="list-style-type: none"> i) the same taxable entity; or ii) different taxable entities which intend either to settle current tax liabilities and assets on a net basis, or to realise the assets and settle the liabilities simultaneously, in each future period in which significant amounts of deferred tax liabilities or assets are expected to be settled or recovered. 	SSAP 12.74
12011	<p>The following should be disclosed:</p> <ul style="list-style-type: none"> a) the amount (and expiry date, if any) of deductible temporary differences, unused tax losses and unused tax credits for which no deferred tax asset is recognised in the balance sheet; b) the aggregate amount of temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, for which deferred tax liabilities are not recognised; and c) the amount of the deferred tax assets and liabilities recognised in the balance sheet for each period presented in respect of each type of temporary difference, and in respect of each type of unused tax losses and unused tax credits. 	<p>SSAP 12.81(e)</p> <p>SSAP 12.81(f)</p> <p>SSAP 12.81(g)</p>
12012	<p>When the utilisation of a deferred tax asset is dependent on future taxable profits in excess of the profits arising from the reversal of existing taxable temporary differences, and the enterprise has suffered a loss in either the current or the preceding period in the tax jurisdiction to which the deferred tax asset relates, the amount of such asset and the nature of the evidence supporting its recognition should be disclosed.</p>	SSAP 12.82
12013	<p>Where current and deferred tax assets and liabilities are measured at the tax rate applicable to undistributed profits, but the net income taxes payable will be affected if part of the retained earnings is paid out as a dividend to shareholders, the enterprise should disclose:</p> <ul style="list-style-type: none"> a) the nature of the potential income tax consequences that would result from the payment of dividends to its shareholders; b) the amounts of the potential income tax consequences that are practicably determinable; and c) whether there are any potential income tax consequences that are not practicably determinable. 	SSAP 12.82A
12014	<p>Effective Date and Transition</p> <p>If SSAP 12 (Revised) <i>Income Taxes</i> is applied for an accounting period beginning before 1 January 2003 (its effective date), that fact should be disclosed.</p>	SSAP 12.89

APPENDIX III - ILLUSTRATIVE DISCLOSURES

A3.1 The presentation and disclosure requirements of SSAP 12 are listed in full in Appendix II above. In this Appendix, we have illustrated the most common disclosures and how they might appear in the financial statements. The presentation suggested will not, however, be the only possible presentation to meet the requirements of SSAP 12, and should be adapted, as necessary, to suit the particular circumstances of the reporting enterprise. For the purposes of these illustrations, the reporting enterprise is assumed to have a 31 December year end, and to be implementing SSAP 12 from 1 January 2003.

Income Statement (not illustrated)

A3.2 The tax expense for the period to be presented on the face of the income statement.

Balance Sheet (not illustrated)

A3.3 Tax assets and liabilities to be presented separately from other assets and liabilities.

A3.4 Deferred tax assets and liabilities to be presented separately from current tax assets and liabilities.

A3.5 Offset of current taxes assets and current tax liabilities, and deferred tax assets and deferred tax liabilities, only in accordance with the conditions set out in SSAP 12.

A3.6 Where a distinction is drawn between current and non-current assets and liabilities, deferred tax assets and liabilities to be classified as non-current.

Disclosures on Implementation

A3.7 Under the general rules of SSAP 2 *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies*, disclosure is required of the impact of implementation. We suggest a separate note detailing changes in accounting policies, in which the effects of the implementation of SSAP 12 should be discussed, as follows:

2. CHANGES IN ACCOUNTING POLICIES

Income Taxes

In the current period, the Group has adopted SSAP 12 (Revised) *Income Taxes*. The principal effect of the implementation of SSAP 12 (Revised) is in relation to deferred tax. In previous years, partial provision was made for deferred tax using the income statement liability method, i.e. a liability was recognised in respect of timing differences arising, except where those timing differences were not expected to reverse in the foreseeable future. SSAP 12 (Revised) requires the adoption of a balance sheet liability method, whereby deferred tax is recognised in respect of all temporary differences between the carrying amounts of assets and liabilities in the financial statements and the corresponding tax bases used in the computation of taxable profit, with limited exceptions. In the absence of any specific transitional requirements in SSAP 12 (Revised), the new accounting policy has been applied retrospectively. Comparative amounts for 2002 have been restated accordingly. Opening accumulated profits at 1 January 2002 have been reduced by HK\$1.47 million, which is the cumulative effect of the change in policy on the results for periods prior to 2002. The balance on the Group's properties revaluation reserve at 1 January 2002 has been reduced HK\$7.452 million, representing the deferred tax liability recognised in respect of the revaluation surplus on the Group's properties at that date. The effect of the change is an increased charge to income taxes in the current year of HK\$2.64 million (2002: HK\$1.05 million).

Accounting Policy

- A3.8 Under the general rules of SSAP 2, the accounting policy followed in respect of taxation will generally be disclosed.

3. ACCOUNTING POLICIES

Taxation

Income tax expense represents the sum of the tax currently payable and deferred tax.

The tax currently payable is based on taxable profit for the year. Taxable profit differs from net profit as reported in the income statement because it excludes items of income and expense that are taxable or deductible in other years, and it further excludes income statement items that are never taxable and deductible.

Deferred tax is the tax expected to be payable or recoverable on differences between the carrying amounts of assets and liabilities in the financial statements and the corresponding tax bases used in the computation of taxable profit, and is accounted for using the balance sheet liability method. Deferred tax liabilities are generally recognised for all taxable temporary differences, and deferred tax assets are recognised to the extent that it is probable that taxable profits will be available against which deductible temporary differences can be utilised. Such assets and liabilities are not recognised if the temporary difference arises from goodwill (or negative goodwill) or from the initial recognition (other than in a business combination) of other assets and liabilities in a transaction that affects neither the tax profit nor the accounting profit.

Deferred tax liabilities are recognised for taxable temporary differences arising on investments in subsidiaries and associates, and interests in joint ventures, except where the Group is able to control the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.

The carrying amount of deferred tax assets is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow all or part of the asset to be recovered.

Deferred tax is calculated at the tax rates that are expected to apply in the period when the liability is settled or the asset realised. Deferred tax is charged or credited in the income statement, except when it relates to items charged or credited directly to equity, in which case the deferred tax is also dealt with in equity.

Notes to the Income Statement

- A3.9 The notes to the income statement should disclose the major components of the income tax charge and expense.
- A3.10 The tax charge for the year should be reconciled to the expected tax charge based on the accounting profit multiplied by the applicable tax rate. The basis on which the applicable tax rate is computed should also be disclosed.

12. INCOME TAX EXPENSE

	Year ended 31/12/03 HK\$'000	Year ended 31/12/02 HK\$'000
Current tax:		
Hong Kong	5,700	1,994
Other jurisdictions	7,972	1,426
	<u>13,672</u>	<u>3,420</u>
Deferred tax (note 36):		
Current year	6,046	838
Attributable to increase in tax rate	188	-
	<u>6,234</u>	<u>838</u>
Taxation attributable to the Company and its subsidiaries	19,906	4,258
Share of taxation attributable to associates	270	112
	<u>20,176</u>	<u>4,370</u>

Hong Kong Profits Tax is calculated at 17.5 per cent (2002: 16 per cent) of the estimated assessable profit for the year. The Profits Tax rate has been increased with effect from the 2003 year of assessment. Taxation for other jurisdictions is calculated at the rates prevailing in the respective jurisdictions.

Of the charge to income tax, approximately HK\$1.8 million (2002: HK\$0.4 million) related to profits arising in the toy division, which was disposed of during the year. No tax charge or credit arose on the disposal of the relevant subsidiary.

The charge for the year can be reconciled to the profit per the income statement as follows:

	Year ended 31/12/03 HK\$'000	Year ended 31/12/02 HK\$'000	%	%
Profit before tax	<u>130,006</u>	<u>28,272</u>		
Tax at the domestic income tax rate of 17.5% (2002: 16%)	22,751	4,524	17.5	16.0
Tax effect of expenses that are not deductible in determining taxable profit	301	46	0.2	0.2
Tax effect of utilisation of tax losses not previously recognised	(1,090)	(300)	(0.8)	(1.1)
Increase in opening deferred tax liability resulting from an increase in Hong Kong Profits Tax rate	188	-	0.1	-
Effect of different tax rates of subsidiaries and associates operating in other jurisdictions	<u>(1,974)</u>	<u>100</u>	<u>(1.5)</u>	<u>0.4</u>
Tax expense and effective tax rate for the year	<u>20,176</u>	<u>4,370</u>	<u>15.5</u>	<u>15.5</u>

In addition to the amount charged to the income statement, deferred tax relating to the revaluation of the Group's properties and to the equity component of convertible bonds issued during the period has been charged directly to equity (see note 36).

Notes to the Balance Sheet

- A3.11 A comprehensive analysis is required of balance sheet components and the movements thereon. In consolidated financial statements, this analysis will be required for both the group and the company balance sheets (illustrated for group only).
- A3.12 The movements are required to be disclosed for both the current and prior periods.

36. DEFERRED TAX

The following are the major deferred tax assets and assets recognised by the Group and movements thereon during the current and prior periods:

	Accelerated tax depreciation	Deferred development costs	Revaluation of properties	Convertible bond - equity component	Retirement benefit obligation	Tax losses	Total
	HK\$'000	HK\$'000	HK\$'000	HK\$'000	HK\$'000	HK\$'000	HK\$'000
At 1 January 2002							
- as previously reported	1,821	-	-	-	(2,795)	-	(974)
- adjustment on adoption of SSAP 12 (Revised)	1,960	-	7,452	-	-	(490)	8,922
- as restated	3,781	-	7,452	-	(2,795)	(490)	7,948
Charge (credit) to income for the year	995	-	-	-	192	(349)	838
Charge (credit) to equity for the year	-	-	(650)	-	-	-	(650)
Exchange differences	(80)	-	-	-	42	-	(38)
Balance at 1 January 2003	4,696	-	6,802	-	(2,561)	(839)	8,098
Charge (credit) to income for the year	4,748	551	-	(56)	214	589	6,046
Charge to equity for the year	-	-	10,368	174	-	-	10,542
Acquisitions/disposals	(140)	-	-	-	141	(391)	(390)
Exchange differences	317	-	8	-	65	-	390
Effect of change in tax rate							
- charge (credit) to income	309	-	-	-	(97)	(24)	188
- charge to equity	-	-	292	-	-	-	292
At 31 December 2003	9,930	551	17,470	118	(2,238)	(665)	25,166

For the purposes of balance sheet presentation, certain deferred tax assets and liabilities have been offset in accordance with the conditions set out in SSAP 12. The following is the analysis of the deferred tax balances for financial reporting purposes:

	31/12/03 HK\$'000	31/12/02 HK\$'000
Deferred tax liabilities	25,586	9,078
Deferred tax assets	(420)	(980)
	<u>25,166</u>	<u>8,098</u>

Additional Disclosures

A3.13 Details are required in respect of deferred tax assets that have not been recognised.

36. DEFERRED TAX (cont'd)

At the balance sheet date, the Group has unused tax losses of HK\$11.23 million (2002: HK\$16.53 million) available for offset against future profits. A deferred tax asset has been recognised in respect of HK\$3.86 million (2002: HK\$5.08 million) of such losses. No deferred tax asset has been recognised in respect of the remaining HK\$7.37 million (2002: HK\$11.45 million) due to the unpredictability of future profit streams. Included in unrecognised tax losses are losses of HK\$2.38 million (2002: HK\$3.29 million) that will expire in 2005. Other losses may be carried forward indefinitely.

A3.14 Details are also required in respect of temporary differences arising on investments in subsidiaries, associates and joint ventures that have not been recognised.

36. DEFERRED TAX (cont'd)

At the balance sheet date, the aggregate amount of temporary differences associated with undistributed earnings of subsidiaries for which deferred tax liabilities have not been recognised was HK\$7.9 million (2002: HK\$6.3 million). No liability has been recognised in respect of these differences because the Group is in a position to control the timing of the reversal of the temporary differences and it is probable that such differences will not reverse in the foreseeable future.

Temporary differences arising in connection with interests in associates and jointly controlled entities are insignificant.

APPENDIX IV - INTERNATIONAL COMPARISON

A4.1 This Appendix provides a comparison of SSAP 12 with the equivalent standards under IFRS, US GAAP and UK GAAP.

International Financial Reporting Standards

A4.2 SSAP 12 is based on the equivalent IFRS, IAS 12, and is generally consistent with that Standard.

A4.3 In drafting SSAP 12, three principal amendments have been made to the text of IAS 12:

- IAS 12 contains guidance on the deferred tax implications of compound financial instruments that are accounted for under IAS 32 *Financial Instruments: Disclosure and Presentation*. Because there is currently no Hong Kong equivalent of IAS 32, the guidance has been deleted from the main body of SSAP 12. However, in a footnote to the Standard, the HKSA has indicated that, where the requirements of IAS 32 have been followed by way of best practice, the consequential requirements of IAS 12 should be followed (see section 8.6 of this guide for discussion). This divergence is temporary, in any case, since there is a current Hong Kong Exposure Draft based on IAS 32, which is likely to be finalised during 2003;
- in establishing the conditions for offsetting current tax assets and liabilities, IAS 12 makes reference to the general conditions for offsetting established in IAS 32. Because there is currently no Hong Kong equivalent for IAS 32, the reference has been deleted. However, the conditions established for offsetting of tax assets and liabilities in IAS 12 and SSAP 12 are consistent; and
- IAS 12 contains a number of references to the allowed alternative treatment for corrections of fundamental errors and voluntary changes of accounting policy under IAS 8 *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies*. Because that allowed alternative treatment is not available under Hong Kong GAAP, the references have been deleted.

A4.4 In addition, the explanatory guidance and illustrative examples contained in SSAP 12 are more extensive than those provided in IAS 12. The additional material has been extracted from Australian Standard AASB 1020 *Income Taxes*.

A4.5 Although SSAP 12 is generally consistent with the equivalent IFRS, the HKSA has introduced a significant divergence by expanding the scope of INT 20 *Income Taxes - Recovery of Revalued Non-depreciable Assets* to cover all investment properties carried at revalued amounts (see paragraph 6.4.14). As a result, under Hong Kong GAAP, the deferred tax impact arising in respect of revalued investment properties is always assessed by reference to a potential disposal of the property, whereas, under IFRS, other than for non-depreciable investment property (essentially, freehold land), the impact will be assessed by reference to management's expectations as to the manner of recovery of the property.

A4.6 The IASB is currently re-examining IAS 12 as part of its project for convergence with US GAAP. Significant proposals for change have been discussed, including:

- the removal of the general 'initial recognition' exception (see section 8.1 of this guide);
- the removal of the recognition exception in respect of temporary differences arising in relation to goodwill and negative goodwill (see section 6.3 of this guide);
- the removal of the recognition exception in respect of temporary differences arising in relation to associates and equity-accounted joint ventures (see section 8.3 of this guide), but retaining the equivalent exception for subsidiaries;
- the clarification of the rules regarding recognition of changes to tax rates and laws that are substantively enacted (see paragraph 6.4.6 of this guide), so that the enactment of such changes must be regarded to be virtually certain;

- the clarification of the meaning of 'probable' in the context of the recognition criteria for deferred tax assets as 'more likely than not' (see paragraph 6.3.21 of this guide); and
- the introduction of a requirement to classify deferred tax assets and liabilities as either current or non-current, based on the balance sheet classification of the related non-tax asset or liability.

A4.7 The IASB is aiming to have the revised IFRS resulting from the convergence project effective in 2005. If the proposed changes materialise, and the HKSA wishes to maintain convergence with IFRS, this will result in a substantial revision to SSAP 12 over the next couple of years.

US GAAP

A4.8 The United States Statement of Financial Accounting Standards 109 (SFAS 109) *Accounting for Income Taxes* adopts an approach to accounting for income taxes that is largely consistent with the comprehensive balance sheet method used in SSAP 12.

A4.9 While the approaches adopted by both the Hong Kong and the US standards have been derived from the same conceptual basis, there are some differences in terminology, accounting treatment and disclosures between the two.

A4.10 Readers should also refer to the discussion in paragraphs A4.6 and A4.7 above in respect of the IASB's current project for the revision of IAS 12 with a view to convergence with US GAAP. These proposed changes would eliminate many of the US GAAP differences identified below.

A4.11 Exhibit A4.1 outlines some of the major differences between SFAS 109 and SSAP 12. This is not intended to be an exhaustive list, but rather an indication of the most significant differences. It does not incorporate certain exceptions under SFAS 109 (or other US accounting pronouncements) that relate to specific industries (such as regulated enterprises) or certain types of transactions (such as leveraged leases).

Exhibit A4.1 Comparison between SSAP 12 and SFAS 109

	<u>SSAP 12</u>	<u>SFAS 109</u>
Excess of the carrying amount of a subsidiary, associate or jointly controlled entity over its tax base	Deferred taxes arising are recognised unless the investor controls the timing of distributions and it is probable that the temporary difference will not reverse in the foreseeable future. Therefore, deferred tax liabilities are not generally recognised in respect of subsidiaries, and they are required to be recognised in respect of interests in associates. For jointly controlled entities, the accounting will depend on the specific contractual arrangement. No distinction is drawn between overseas and domestic investments.	No deferred tax liability is recognised in respect of interests in foreign subsidiaries, or joint venture entities, unless it becomes apparent that the associated temporary difference will reverse in the foreseeable future. For domestic subsidiaries and joint venture entities, and for all associates, provision is required where the temporary difference arose after 15 December 1992.
Intercompany sales of inventories between enterprises in different tax jurisdictions	Deferred taxes arising from the temporary differences are recognised using the buying enterprise's relevant tax rate.	Deferred tax <i>assets</i> arising from the difference between the tax base of the inventories in the buyer's tax jurisdiction and their cost as reported in the consolidated financial statements are prohibited from being recognised.
Foreign currency non-monetary items translated at historical rates.	Deferred tax is recognised.	In certain circumstances, deferred tax arising from temporary differences resulting from the translation of assets and liabilities using historical exchange rates is not recognised.
Initial recognition of a single asset or liability where the tax base differs from the acquisition cost	Recognition of deferred tax arising is prohibited, unless it is a business combination, or the transaction affects pre-tax profit or loss or taxable income at the time of recognition.	No equivalent prohibition. Asset purchases (other than as part of a business combination) in which the amount paid differs from the tax base of the asset should not result in immediate income statement recognition of the deferred tax. The 'simultaneous equation' method is used to record the assigned value of the asset and the related deferred tax asset or liability in certain circumstances.
Government grants and investment tax credits	Excluded from the scope of SSAP 12. However, if government grants and tax credits are accounted for as a reduction in an asset's carrying amount, the deferred tax asset arising from the temporary difference would not be recognised as it results from the initial recognition of an asset.	Deferred tax assets arising from the deductible temporary differences are recognised.

Exhibit A4.1 (cont'd)

	<u>SSAP 12</u>	<u>SFAS 109</u>
Recognition of items directly in equity	Current and deferred taxes are required to be debited or credited directly to equity if the tax relates to an amount <i>that is or was</i> debited or credited directly to equity in the current or a prior period.	Current and deferred tax only recognised directly in equity for items debited or credited directly to equity during the current year. Allocation to equity of current year deferred tax related to items that were recognised in equity in prior years is prohibited.
Changes in tax rates	Taken into account where changes are enacted or substantively enacted by the balance sheet date.	Taken into account only once enacted.
Subsequent recognition of deferred tax assets arising on an acquisition	Recognised in the income statement. Goodwill and associated amortisation are retrospectively restated and recognised as an expense in the income statement. Therefore, effectively, net credit to income once the goodwill balance has been eliminated.	Recognised as a reduction in goodwill first, then non-current intangible assets and then to income tax revenue. Therefore, the balance is used to eliminate any other intangible assets related to the acquisition before increasing income.
Recognition of deferred tax assets	Recognised to the extent that it is probable that future taxable amounts will be available to utilise the benefits of the deferred tax asset.	Recognised in full, and reduced by a valuation allowance if it is more likely than not that some portion or all of the deferred tax asset will not be realised.
Classification of deferred tax liabilities and assets	Must be classified as non-current where a current/non-current distinction is maintained in the balance sheet.	Classification is split between current and non-current, based on the classification of the asset or liability that gives rise to the temporary difference.
Reconciliation of actual and expected tax expense	Required for all reporting enterprises.	Required for listed enterprises only. Non-public enterprises must disclose the nature of the reconciling items, but not the amounts.

UK GAAP

A4.12 The United Kingdom has separate standards for *Current Tax* (FRS 16) and *Deferred Tax* (FRS 19).

A4.13 Exhibit A4.2 highlights the principal differences between SSAP 12 and those standards.

Exhibit A4.2 Comparison between SSAP 12 and FRS 16/19		
	<u>SSAP 12</u>	<u>FRS 16/19</u>
Current tax	Detailed rules on the calculation of current tax. No discussion of the treatment of withholding tax.	Limited guidance on the calculation of current tax. Specifies rules on accounting for the tax consequences of outgoing or incoming dividends or other distributions.
Deferred tax model	Full provision (subject to specified exceptions) for <i>temporary</i> differences (balance sheet liability method).	Full provision for <i>timing</i> differences (income statement liability method).
Revaluation of assets	Recognise deferred tax liability in respect of temporary difference.	No sale of asset envisaged - no recognition of liability. Binding commitment to sell, and the resulting gain/loss on disposal is recognised in the financial statements - liability is recognised, unless rollover relief is anticipated. Financial instruments marked to market, and movements recognised in the income statement - liability is recognised.
Fair value adjustments on acquisition of a business	Recognise deferred tax impact, except in relation to non-deductible goodwill (or non-taxable negative goodwill).	No recognition on adjustment of assets to market value. Only where the general rules require recognition (e.g. binding sales contract) should the liability be recognised.
Assessment of deferred tax position at time of business combination	Deferred tax positions of both the acquirer and the acquiree to be considered from group perspective - may result in adjustments for both against goodwill.	Only the position of the acquiree is reassessed. Any changes to the tax position of the acquirer cannot be adjusted against goodwill.
Unremitted earnings of subsidiaries, associates and joint ventures	Provide for deferred tax liabilities unless the investor controls the timing of the reversal, which is not anticipated in the foreseeable future.	Recognise deferred tax liabilities only to the extent that dividends have been accrued, or if there is a binding agreement to distribute past earnings.
Discounting	Not permitted.	Optional.

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DELOITTE TOUCHE TOHMATSU - OFFICES IN CHINA

Beijing

Deloitte Touche Tohmatsu CPA Ltd.
Beijing Branch
11/F Deloitte Tower
Sun Dong An Plaza
138 Wangfujing Dajie
Beijing 100006, PRC
T + 86 (10) 6528 1599
F + 86 (10) 6528 1598

Guangzhou

Deloitte Touche Tohmatsu CPA Ltd.
Guangzhou Branch
23/F Jianlibao Tower
410 Dongfeng Road Central
Guangzhou 510030, PRC
T + 86 (20) 8393 6339
F + 86 (20) 8348 7156 / 7157

Macau

Deloitte Touche Tohmatsu
14/F Nam Kwong Building Apartment I
223-225 Av. Dr. Rodrigo Rodrigues
Macau
T + (853) 712 998
F + (853) 713 033

Shanghai

Deloitte Touche Tohmatsu CPA Ltd.
30/F Bund Center
22 Yan An Road East
Shanghai 200002, PRC
T + 86 (21) 6335 0202
F + 86 (21) 6335 0003

Tianjin

Deloitte Touche Tohmatsu
Tianjin Branch
Room 2308 Tianjin International Building
75 Nanjing Road
Tianjin 300050, PRC
T + 86 (22) 2332 1671
F + 86 (22) 2332 2840

Dalian

Deloitte Touche Tohmatsu CPA Ltd.
Dalian Branch
14/F Senmao Building
147 Zhongshan Road
Xigang District
Dalian 116011, PRC
T + 86 (411) 360 9292
F + 86 (411) 360 3297

Hong Kong

Deloitte Touche Tohmatsu
26/F Wing On Centre
111 Connaught Road Central
Hong Kong
T + (852) 2852 1600
F + (852) 2541 1911

Nanjing

Deloitte Touche Tohmatsu CPA Ltd.
Nanjing Branch
Room 1812 & 1818
18/F Suning Universal Building
188 Guangzhou Road
Nanjing 210024, PRC
T + 86 (25) 331 5606
F + 86 (25) 663 3915

Shenzhen

Deloitte Touche Tohmatsu CPA Ltd.
Shenzhen Branch
Units 09-16, 19/F Shun Hing Square
Di Wang Commercial Centre
5002 Shennan Road East
Shenzhen 518008, PRC
T + 86 (755) 8246 3255
F + 86 (755) 8246 3186 / 3222

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