The Institute of
Chartered Accountants
of Pakistan

HEAD OFFICE

ICAP/DPSC/2007/Circular No. 09 May 21, 2007

ALL MEMBERS OF THE INSTITUTE

Dear Member

DEFERRED TAXATION

During the quality control reviews conducted by the Institute it has been noted that:

Issue # 1:
Deferred tax liability on 'surplus on revaluation of fixed assets' was not charged in accordance with paragraph 20 read with paragraphs 34 and 61 of IAS-12 and paragraph 11 of Appendix A of IAS 12, on the basis that it was off-set against the deferred tax asset due to tax losses available for future periods.

In accordance with paragraphs 74 and 75 of IAS 12, an entity can off-set deferred tax asset calculated on available losses and deductible temporary differences with the deferred tax liability arising on taxable temporary differences, including surplus on revaluation of fixed assets. However, the entity recognizing or adjusting deferred tax asset as discussed above should do so to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profits will be available against which the unused tax losses or unused tax credits can be utilized by the entity.

It is further advised that in entities where there is a history of tax losses and it is evident that sufficient taxable profits will not be available against which the unused tax losses or unused tax credits can be utilized by the entity, then this fact will not preclude the entity not to record deferred tax liability arising on 'surplus on revaluation of fixed assets', as the requirements of the above two paragraphs i.e. paragraphs 34 and 61 are separate and should be complied with.

Members are also advised to refer SRO 45(1)/2003, dated January 13, 2003 issued by the Securities and Exchange Commission of Pakistan in order to ensure consistency in compliance with the requirements of International Accounting Standards (IAS) 16 "Property, Plant & Equipment" and IAS 12 "Income Taxes (Revised)" and provisions of section 235 of the Companies Ordinance, 1984 'treatment of surplus arising out of revaluation of fixed assets'.

Issue # 2:
Deferred tax asset was recorded by entities having history of operational losses without taking into account requirements of paragraphs 24, 34 and 56 of IAS-12 and the auditors also did not obtain sufficient appropriate audit evidence to substantiate the recording of deferred tax asset.

Members in this regard are advised to satisfy themselves for the amount of deferred tax asset appearing on the balance sheet and practicing members are advised to perform / obtain the following additional procedures/ information in order to arrive at a proper audit opinion:

1. Obtain future financial projections from their clients and ensure reliability and reasonableness of the same, to ensure that for the amount of deferred tax asset appearing on the balance sheet, sufficient taxable profit will be available in the future to allow the benefit or part or that entire deferred tax asset to be utilized.

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2. Where on the basis of the audit procedures performed, auditor conclude that sufficient profits will not be available in the future, for the whole or part of the amount then the auditor should discuss the matter with the management and reduce the whole or part of the amount of deferred tax asset.

3. In the case of disagreement with the management on the matter, the auditor should seek guidance from ISA-700 **'The Auditor's Report on Financial Statements'**.

Issue # 3:
Full deferred tax liability was recorded in the financial statements whereas company was assessed under presumptive taxation on the basis of export sales. TR-27 (Revised 2003) issued by the Institute allows a company to recognize deferred tax liability to the extent of company's local sales.

TR-27 (Revised 2003) categorically provides guidance on the issue regarding accounting of deferred tax when whole or part of the entity's sale covered under presumptive tax regime as per the Income Tax Ordinance, 2001. The guidance provided may be summarized as under:

1. The deferred tax accounting does not apply to those companies whose entire income is subject to deduction of tax at source that is taken as a final tax liability, as there will be no temporary differences.

2. In case there is a portion of income subject to deduction or collection of tax and the said deduction or collection is treated as full and final tax liability for the purposes of assessment then the remaining portion of the income attracts assessment under normal provisions of the Income Tax Ordinance, 2001.

   Deferred tax asset or liability should be calculated on remaining portion of the income that attracts assessment under normal provisions of the Income Tax Ordinance, 2001.

   For instance, if the ratio between supplies remains the same year after year, it would be easy to calculate effect of temporary differences but since this ratio is not expected to be the same year after year, effect of temporary differences cannot be calculated with accuracy. In such instance, a reasonable estimate for sales relating to non-supplies should be made for the future years and the deferred tax should be provided accordingly.

   However, if it is not practicable to develop a reasonable estimate for calculation of deferred tax liability / asset then an entity should evaluate the expectation of future turnover by taking into consideration the turnover trend of at-least three years (including the current year) and recognize and provide deferred tax accordingly.

Members are advised to take cognizance of the above while preparing and giving opinion on the financial statements.

Thanking you,

Yours truly,

Muhammad Asif Iqbal
Director
Professional Standards Compliance & Evaluation