

Tax reconciliation disclosures

(Lecture B1158 – 13.58 minutes)

FRS 102 requires a note to the financial statements that reconciles the total tax expense (income) included in profit or loss to the profit or loss on ordinary activities before tax multiplied by the 'applicable tax rate'.

This allows users to understand the reasons why the actual tax expense is not equal to the profit before tax figure multiplied by the corporation tax rate in force at the reporting date.

'Applicable tax rate' is not defined by FRS 102. The same phrase is, however, used in International Financial Reporting Standard IAS 12 Income Taxes.

"an entity uses an applicable tax rate that provides the most meaningful information to the users of its financial statements. Often, the most meaningful rate is the domestic rate of tax in the country in which the entity is domiciled, aggregating the tax rate applied for national taxes with the rates applied for any local taxes which are computed on a substantially similar level of taxable profit (tax loss). However, for an entity operating in several jurisdictions, it may be more meaningful to aggregate separate reconciliations prepared using the domestic rate in each individual jurisdiction. The following example illustrates how the selection of the applicable tax rate affects the presentation of the numerical reconciliation."

So there would seem to be a choice of using the domestic (i.e. UK) rate of tax or an average rate of tax for all the jurisdictions in which the entity is liable to tax.

Example

A company operates in the UK and the US and is liable for corporate tax in both jurisdictions. It makes accounting profits of £2,000 in the UK and £1,500 in the US. The UK Tax rate is 19% and the US tax rate is (say) 30%. In the UK, £100 of expense is not tax deductible.

Reconciliation 1 – using UK domestic rate

Accounting profit	£3,500
Tax at domestic rate of 19%	665
Non-deductible expenses (£100 x 19%)	19
Effect of higher tax rates in US (£1,500 x 11%)	<u>165</u>
Tax expense	<u>£849*</u>
* UK adjusted profit £2,100 @ 19%	399
US profits £1,500 @ 30%	<u>450</u>
	<u>£849</u>

Reconciliation 2 –using average applicable rate

Accounting profit	£3,500
Tax at domestic rates in the country concerned	
(£2,000 @ 19% + £1,500 @ 30%)	830
Non-deductible expenses (£100 x 19%)	<u>19</u>
Tax expense	<u>£849</u>

Examples of reconciling items

- Foreign income taxed at different rates to the UK rate
- Disallowable expenditure (including depreciation and amortisation of assets not eligible for capital allowances such as buildings and some goodwill)
- Income which is exempt from tax (such as most dividends received by UK resident companies)
- Effect of unutilised losses where a deferred tax asset has not been recognised
- Other timing differences where a deferred tax asset has not been recognised
- Effect on opening deferred tax balances of a change in tax rate
- Adjustments to prior years' current tax liabilities (assets)
- Utilisation of brought forward losses
- Other taxes levied on the entity which are taxed on profits (such as Petroleum Revenue Tax and the North Sea Supplementary Charge)

Example 1 – total tax reconciliation under FRS 102

A company reports a profit before tax of £190.6 million. The total tax expense in the income statement is £37.35 million (effective rate of 19.60%), broken down as follows:

	£m
Current corporation tax payable*	31.37
Deferred tax expense	<u>5.98</u>
Total tax expense	37.35

Assume that the applicable tax rate for the company is 19%. Analysis of the accounts and tax computations show the following:

1. The company benefited from capital allowances of £35 million
2. Depreciation expense totalled £3.5 million
3. Tax-exempt dividend income of £20 million is included in the profit
4. Other disallowed expenses totalled £26 million

* Adjusted profits are (£190.6 + £3.5m - £35m - £20m +£26m) £165.1m, so corporation tax payable is (19% x £165.1m) £31.37m.

Tax reconciliation	£m
Profit on ordinary activities before tax	190.60
Profit before tax multiplied by applicable tax rate (19% x £190.6)	36.21
Tax exempt income (19% x £20m)	(3.80)
Expenditure not allowable for corporation tax purposes (19% x £26m)	<u>4.94</u>
Total tax expense	<u>37.35</u>

The £35m qualifying for 100% capital allowances does not affect the reconciliation as deferred tax would have been provided against it in arriving at the total tax expense. The deferred tax expense of £5.98m is also included in the total tax expense and so is irrelevant to the reconciliation.

Changes in tax rates

Normally, deferred tax would not feature in a tax reconciliation, but where the rate of tax used for deferred tax is different to the applicable rate for the current period, the effect of the change in tax rates needs to be included in the reconciliation.

Example

In its year ended 31 March 2020 a company makes a profit before tax of £150,000. This includes customer entertainment expenses of £22,000 and accrued pension costs of £10,000 which were paid in April 2020.

The total tax expense under FRS 102 and the tax reconciliation are as follows:

Current tax

Adjusted profit (150,000 + 22,000 + 10,000) = £182,000

Current tax @ 19% = £34,580

Deferred tax

Timing difference on pension accrued, deferred asset/ P&L credit (17% x £10,000)
£1,700 Cr

Total tax expense (34,580 – 1,700) £32,880 with effective rate (32,880 ÷ 150,000) = 21.92%

Tax reconciliation

Tax on profit before tax (150,000 x 19%)	28,500
Disallowed expense (22,000 x 19%)	4,180
Effect of change in tax rate on DT asset [10,000 x (19% - 17%)]	<u>200</u>
Total tax expense	<u>32,880</u>

Investment properties

Where tax rates are changing, the tax reconciliation requires extra care as seen above. It used to be more intricate for investment property gains and losses (which are recognised in profit and loss account under both FRS 102 and IFRS).

Deferred tax on investment property is a function of:

1. Change in FV recognised in P&L; and
2. The indexed cost (which has no link to FV and is not recognised in P&L).

The reconciliation needs to be broken down into its component parts:

1. Change in opening DT due to rate change;
2. Effect of future tax rates on DT on FV change;
3. Effect of change in indexed cost of properties (for periods up to December 2017).

As the indexed cost no longer changes, 3. above should no longer feature in the tax reconciliation which is now much simpler as a result.

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