ACCOUNTING FOR TAXES

Taxes are compulsory levies imposed on individuals and companies by the government. Taxes are charged on incomes/profits of individuals and companies. Certain issues arise when accounting for taxes. This is because a different set of computations has to be done apart from those done for financial accounting purposes, which takes cognisance of the tax laws of the country. Hence giving rise to taxable profits/income, which is different from the profits shown in financial accounts.

Accounting income/profit is the aggregate income or loss for a period, after reducing total expenses from total revenues, as reported in the income statements.

Taxable Income is the amount of income or loss for a period determined in accordance with the rules established by the tax authorities upon which the provisions for taxes payable are determined.

Taxable profits are usually different from accounting profits because:

i. Some items allowed as expenses in arriving at accounting profits are not allowed as expenses for tax purposes. Example fines & penalties, donations to unapproved organisations etc.
   Differences between taxable and accounting profits arising from these are referred to as ***Permanent Differences***. This is because such differences are not reversed in subsequent accounting periods.
ii. Some items are included in taxable profit, which do not coincide with the period in which they are included in accounting profit. Examples include interest receivable accrued in the financial accounts, but not taxed until actually received; and capital allowance (which is sometimes different from depreciation charged to arrive at accounting profit). These give rise to ***Timing Differences***. Timing differences are differences that are temporary in nature as they reverse in subsequent accounting periods.

Timing Difference can be either:

a. Originating Timing Differences: these are timing differences that occur for the first time.
b. Reversing Timing Differences: these are timing differences, which reverse originating timing differences from previous accounting periods.

Current Tax and Deferred Tax

IAS 12 (Income Taxes) makes provision for the treatment of income tax of companies. It covers the two different taxation issues:

1. Current tax: this is defined as the amount of income tax payable, or recoverable, by an entity in respect of its taxable profit, or loss, for a period. [IAS 12.5]

2. Deferred tax: this is an accounting measure rather than a tax levied by government; it represents tax payable or recoverable in future accounting periods in relation to transactions which have already taken place.

Current Tax

IAS 12 does not set out how current tax should be calculated, since this is largely driven by the application of the taxation rules in individual countries. However, IAS 12 requires a tax liability to be

recognised where an entity has unpaid current tax, whether arising from the current or prior periods. Conversely, if an entity has overpaid its tax liability then it should recognise a tax asset for the amount recoverable. [IAS 12.12]

It is sometimes possible for an entity that has made a loss in its current period to recover tax paid in previous periods by carrying the loss back to offset against profits of the earlier period. Where an entity is able to recover tax paid in a previous period, an asset should be recognised in the period in which the loss is made. [IAS 12.13]

The tax rate to be used in determining a current tax asset or liability is the rate that is expected to apply when the asset is expected to be recovered, or the liability to be paid. These rates should be based upon tax laws that have already been enacted (are already part of law) or substantively enacted (have already passed through part of the legal process) by the end of the reporting period. [IAS 12.46]

Usually, the current tax to be paid for a period is not known until the end of that period. Hence there is an estimate/provision made to capture the tax for the period in the financial accounts. This provision is usually shown in the (Current) Taxation account. When the actual amount has been computed and paid in subsequent periods, it is debited to this account. The balance will be either an under-provision (debit balance) or an over-provision (credit balance) in the account.

In Nigeria the tax rate for companies is 30% (of taxable profit) for regular companies; while it is 85% for companies carrying on petroleum operations.

Income Statement

The tax expense recognised in profit or loss comprises an aggregate amount of the current tax expense and the deferred tax expense based on the profit or loss for the period. [IAS 12.5]

Deferred Tax

The current tax liability of an entity is based on both the accounting treatment for transactions and on a number of specific requirements set out in local tax legislation. As a result it may not be possible to calculate the tax charge for a reporting period by reference to an entity's accounting profit or loss reported for that period. Differences may arise because the tax liability occurs in a period different to that in which the underlying transaction is reported. To ensure that the financial statements are internally consistent, an adjustment may be required to the current tax expense, so that the total tax charge is based on an entity's financial reporting profit for the period. This adjustment is referred to as 'deferred tax'. It is important to appreciate that deferred tax does not alter the tax to be paid, only the means by which it is reflected in the financial statements.

IAS 12 requires that deferred tax is calculated using what is commonly referred to as the ***balance sheet liability method***. This method is based on an assessment of temporary differences. A temporary difference is the difference between the carrying amount of an asset or liability in the statement of financial position and the amount of that item for tax purposes, which is called its tax base. [IAS 12.5]

The reason that an entity is required to recognise deferred tax is because:

i. a deferred tax liability will ultimately translate itself into an actual liability by, for example, resulting in a larger tax liability in future periods;

ii. the matching of items recognised in an entity's financial statements is consistent with the requirements of IAS 1 Presentation of financial statements on the preparation of an entity's financial statements; and
iii. ignoring deferred tax may lead to the reported profit in a period being misinterpreted.

In years where capital allowance is higher than depreciation; provision (for deferred taxation) is made to cater for the amount by which the tax has been understated.

Dr. Statement of Profit or Loss
  Cr. Deferred Taxation

And conversely in years where depreciation is higher than capital allowance:

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