COLLEGE OF ACCOUNTING

FINANCIAL REPORTING | ADVANCED

Video Transcription: Tax Rate Reconciliations

A: Intro

Preparing a tax-rate reconciliation is generally an issue that students, and preparers of financial statements, struggle with. This video aims to tackle this issue through answering three questions:

- What (is a tax rate reconciliation)?
- Why prepare one?
- How?

B: Theory + Application

What is a tax rate reconciliation?
Focus on the words - 'tax rate reconciliation'... A reconciliation explains why two numbers are different. Therefore, a tax rate reconciliation explains why two tax rates are different.

In this instance, the tax rate we would expect to apply and the tax rate that actually applies:

- The tax rate that we would expect to apply is the standard rate that the company pays tax at. This is on the assumption that all items included in accounting pre-tax profit, have a tax effect at the company tax rate.
- Whereas the tax rate that actually applies, also known as the company's effective rate, is the income tax line item expressed as a percentage of the accounting pre-tax profit.

Consider the following example – an extract from A Ltd's statement of profit or loss and other comprehensive income:

- Look at A Ltd's profit before tax
- Look at its income-tax expense. Expressed as a percentage of its pre-tax profit, A Ltd's effective tax rate is 25%. In South Africa, the company tax rate is 28%. At a simplistic level, we would expect A Ltd's income tax expense to be 28% of its pre-tax profit. We can see that it isn't. It's effective tax rate and the company tax rate differ.
- The differences between these two numbers are reconciling items i.e. they explain why the standard tax rate and the company's effective tax rate are different. That leads us to our next question.

Why prepare one?
- The objective of financial reporting, is to provide users with information that is useful. Amongst other things, information is only useful if it is understandable i.e. makes sense to a user. To help users understand the relationship between the company's accounting pre-tax profit and its income tax line item, and to understand why the income tax expense is different to what the user would have expected, IFRS requires a company to disclose a tax rate reconciliation.

How?

In answering this question, take a step back and focus on the tools at your disposal. As with any reconciliation, preparing a tax rate reconciliation is a process:

1. Let's get back to A Ltd's statement of profit or loss and other comprehensive income. We are only interested in the profit or loss section.

- This ends with the profit (or loss) for the period. This profit is an after-tax number and is calculated as the difference between the two line items which usually precede it i.e. the 'profit before tax' (or pre-tax) line item less the 'income taxes' line item.
- The pre-tax profit number is based on amounts recognised in profit or loss for the period in accordance with IFRS, before taking into account their respective tax effects. The pre-tax profit is an accounting-based number.

2. Focus on the income taxes' line item, which comprises the company's income taxes for the period in respect of amounts recognised in profit or loss. There are generally two components of income taxes:

- **Current tax, which is based on tax profit**. Tax profit is the profit calculated using the rules set out by the relevant tax authorities. In South Africa, the tax authority is the South African Revenue Service (SARS) and the Income Tax Act is the legislation that sets out these rules. The current tax recognised is therefore the tax payable to SARS in respect of tax profit for the period. To the extent that this current tax relates to amounts recognised in profit or loss, the current tax is presented as part of the income taxes' line item in profit or loss. To the extent that the current tax relates to changes in estimates of prior periods, this is presented separately from the current tax relating to the current period.

- **Deferred tax, which is an accounting-driven number**. Assets and liabilities may be different for accounting and tax (and therefore impact accounting pre-tax profit and tax profit differently). In many instances these differences are temporary i.e they will not last forever. Generally, we recognise deferred tax for all temporary differenes (with limited exceptions). To the extent that the temporary differences arise from amounts that have been included in calculating accounting pre-tax profit (such as depreciation), the deferred tax will also be recognised in profit or loss, specifically as part of the income tax line item.

3. Identify the numbers you are reconciling i.e that standard tax rate and the effective tax rate.

- The standard tax rate presumes that all amounts in accounting profit are taxed or deducted for tax at 28%. (Alternatively put, this assumes that the income tax expense is purely the product of the accounting profit before tax and the company tax rate of 28%. We know from earlier this is not true; it is based on current tax and deferred tax, each calculated and determined separately.)
- The effective tax rate. (This is the income tax expense expressed as a % of the accounting profit before tax).
- *Will there always be a difference? No, if the tax profit and the accounting pre-tax profit are the same then the current tax number will equal the accounting pre-tax profit multiplied by 28%. Or even if there are differences between accounting profit and tax profit, but these differences are temporary and result in the recognition of deferred tax. In this instance, the income tax line item, being the sum of the current and deferred tax, will equal accounting pre-tax profit multiplied by 28%.*

4. Identify which number you are starting with and reconciling to. It probably makes sense to start with the standard tax rate as that is the number most users would expect to see and reconcile this rate to the effective tax rate.

5. Identify the reconciling items. It is useful to identify the reconciling items by thinking through the following:

- Amounts that have been included in calculating pre-tax profit but have no have tax effect. For example, a company earns income, which is exempt from tax. The company's accounting profit includes 100% of the income and we would have expected that the company would pay tax on that income at 28%. Because the income is exempt from tax, the company's income tax line item does not include a related tax effect. Therefore the effective tax is lower than what we would have expected. A reconciling item that reduces the standard tax rate to the effective tax rate is therefore required.

- Amounts that have been included in calculating pre-tax profit, but are taxed at a rate other than the standard tax rate. For example, 100% of a profit on a capital asset is included in accounting profit pre-tax, but if the gain is a capital gain only 66.66% is included in the calculation of tax profit. The capital gain may also be different from the profit recognised for accounting, because of how the tax is calculated. In any event, the different effective capital gains tax-rate results in a reconciling item.

- Amounts that have been included in calculating pre-tax profit but have no have tax effect. For example, a company incurs expenditure, which is not deductible for tax. The company's accounting profit is after 100% of the expense and we would have expected that the company would pay less tax at 28%. Because the expense is not deductible for tax, the company's income tax line item does not include a related tax effect. Therefore the effective tax is higher than what we would have expected. A reconciling item that increases the standard tax rate to the effective tax rate is therefore required.

- Amounts that have been included in the income tax line item, but for which there is no corresponding item in the accounting pre-tax profit line that would have been multiplied by 28% to get to this tax effect. For example, a company's current tax for a prior period has been assessed resulting in a decrease in the company's tax profit for that prior period. This is a change in estimate so the current tax is recognised in this period but relates to tax profit earned in a prior period. The income tax line has now been reduced by the tax effect that does relate to an amount recognised in the accounting pre-tax profit for the current period. This will result in a reconciling item that decreases the standard tax rate to the effective tax rate.

C: Recap

Tax rate reconciliations are an important tool in aiding a user's understanding of the relationship between the company's pre-tax profit and its income tax line item presented in profit or loss. They can be challenging to prepare, but it is always useful to come back to:

- What has been recognised in calculating accounting pre-tax profit?
- What does the income tax line item in profit or loss comprise?
- What would we expect the company's tax rate to be?
- What is the company's effective tax rate?
- Are these two different? Why?

D: Critical Thinking (not included in video)

- In the examples above, we prepared the tax rate reconciliation by reconciling the standard tax rate to the effective tax rate. The tax rate reconciliation could also be prepared by reconciling the effective tax rate to the standard tax rate. In this case, the starting point and end point of the tax rate reconciliation have been swopped around. This will not affect the nature of the reconciling items, but how the reconciling items affect the tax rate reconciliation i.e their direction (e.g. a reconciling item that has the effect of decreasing the standard tax rate to the effective tax rate will increase the effective tax rate to the standard tax rate).
- In the examples above, we also prepared the tax rate reconciliation by reconciling tax rates (or percentages). IFRS allows a company to disclose the tax rate reconciliation using amounts rather than percentages. In this case, the company is reconciling the product of the pre-tax profit multiplied by the standard tax rate to the income tax line item recognised in profit or loss, or vice versa. Remember that in this way, you are explaining differences between an amount that is determined using tax rules and accounting principles (i.e the income tax line item in profit or loss) and a purely arithmetic answer (i.e the standard tax rate multiplied by the accounting pre-tax profit).
- Generally, items for which we recognise deferred tax are not reconciling items. However, even though we have recognised deferred tax, there may be instances where this results in reconciling items:
- Using a different tax rate (to the standard tax rate)
- A change in the tax rate
- Amounts that have been included in calculating pre-tax profit and have a tax effect, but that tax effect cannot be recognised. For example, the tax effect of making a tax loss in a given year would be to recognise zero current tax and to recognise a deferred tax asset.

But the recognition criteria of an asset may not be met. Therefore no deferred tax asset is recognised and no resulting deferred tax adjustment to profit or loss is recognised. The income tax line item therefore does not reflect the tax effect associated with the amounts included in pre-tax profit and as such there is a reconciling item.