

# LKAS 12

## Income Tax

**Chartered Accountancy**  
**Corporate Level**  
Financial Reporting and Governance (FRG)

**Sandeepa Jayasekera**

ACA, B.Sc. (Accounting) Sp. Hons., ACMA (SL), SAT, CIMA Passed Finalist,  
Reading for MBA (PIM), CA and CIMA Prize Winner



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# LKAS 12

## Income Tax

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Sandeepa  
Jayasekera



Sandeepa - JMC

- Ranked 11<sup>th</sup> in Sri Lanka and 03<sup>rd</sup> in Colombo District in Advanced Level Commerce Stream
- First Class Degree in Accounting and Gold Medal winner for Best Student from University of Sri Jayewardenepura
- Chartered Accountant (CA Sri Lanka)
- Received First in Order of Merit in the second stage and Subject Prize for Advanced Financial Reporting in the final stage of CA Sri Lanka
- Chartered Management Accountant (CIMA-UK)
- Ranked 1<sup>st</sup> in Sri Lanka and 11<sup>th</sup> in the World in the Final Stage of CIMA-UK

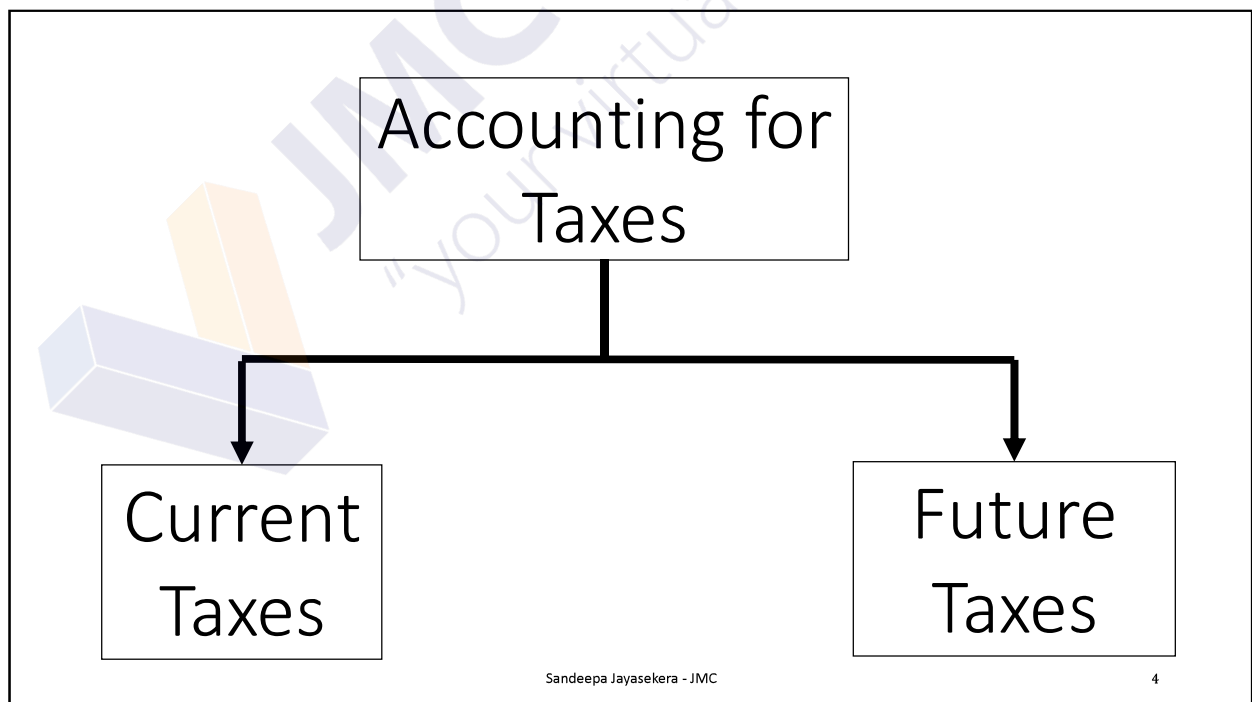
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- Member of the Association of Accounting Technicians of Sri Lanka (AAT Sri Lanka)
- Member of the Institute of Certified Management Accountants of Sri Lanka (CMA Sri Lanka)
- Final stage of the Postgraduate Degree in Management from the Postgraduate Institute of Management (PIM)
- Chief Executive Officer of JMC Jayasekara Management Centre
- Partner of JMC International School Network
- Founder of JMC vLearning unit
- Lecturer at JMC
- Author of the novel "අවිච්ඡාදිත අවසරය"
- Lecturer who has shared knowledge and experience in more than 100 Training and Development Workshops and Motivational sessions



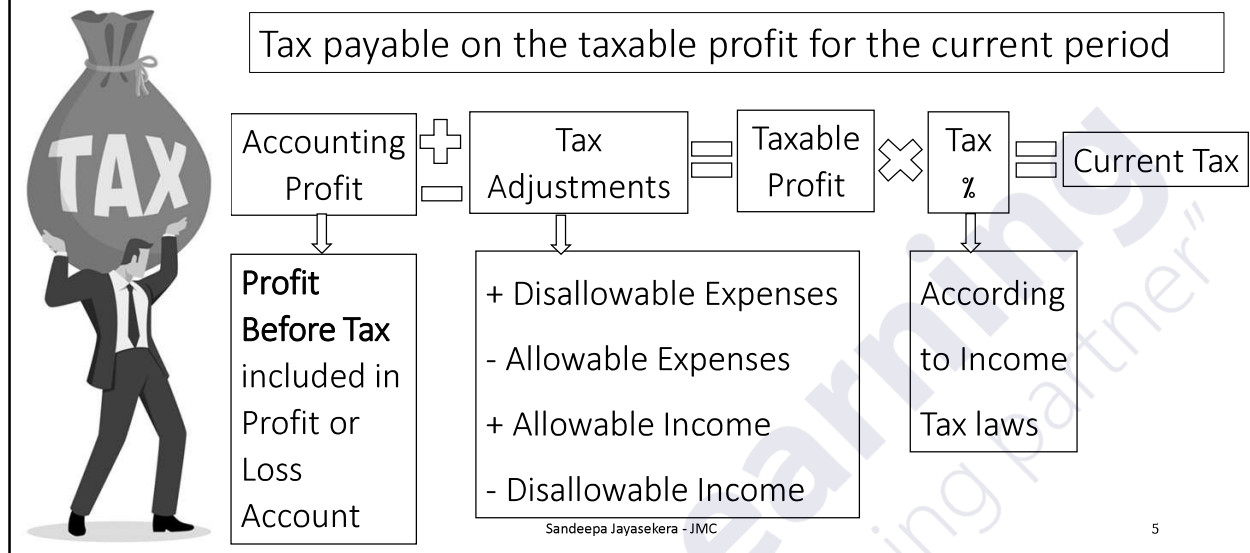
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## Current Tax



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### Illustration 01

The Profit or Loss account of Shalitha PLC for the year ended 31<sup>st</sup> March 20X1 is as follows:

Sales	100,000
Cost of Sales	(600,000)
<b>Gross Profit</b>	<b>400,000</b>
Other Expenses	(150,000)
<b>Profit before Tax</b>	<b>250,000</b>

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## Illustration 01

Cost of the machine is Rs.300,000/-. Useful life is 6 years.  
 The accounting depreciation included under expenses is Rs. 50,000/-.  
 Capital Allowance applicable for those assets is Rs. 60,000/-. (Capital allowance period is 5 years)  
 Gratuity expense is Rs. 40,000/-. It is not allowed to be deducted.  
 Actual Gratuity payment is Rs. 30,000/-. It is allowed to be deducted.  
 Closing gratuity provision is Rs.500,000/-  
 Non-deductible entertainment expenses Rs. 20,000/-.  
 If the Tax rate is 28%,  
 Calculate the tax expense

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		28%
Accounting Profit	250	70
+ Depreciation	50	14
- Capital Allowance	(60)	(16.8)
+ Gratuity Expense	40	11.2
- Gratuity Payment	(30)	(8.4)
+ Entertainment Expense	20	5.6
Taxable Profit	270	75.6

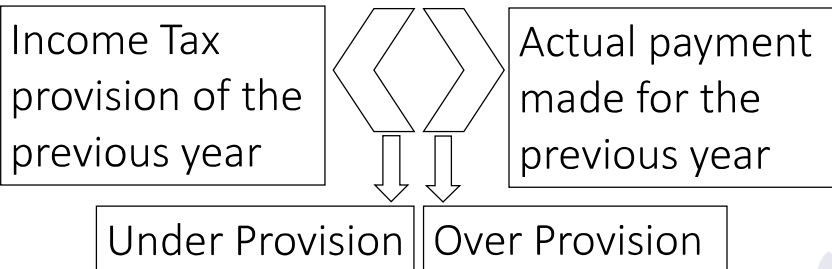
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## Past Tax

Under/Over provision of Income Tax for the previous year



These are changes in accounting estimates.  
Therefore, adjusted to the current year.

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### Illustration 02

Sunanda PLC's financial year ends on 31 December. Following information is relevant for year ended 31 December 20X9.

1. Current tax of Rs.1,000,000 calculated based on proposed new tax rates announced in September 20X9 which are supposed to be enacted. If the old rates were applied the tax expense would be Rs.900,000
2. Current year tax paid is Rs.500,000
3. Previous year tax provision is Rs.400,000 and tax paid for the previous year is Rs.300,000

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## Illustration 02

### Required

Calculate the tax expense and tax payable for 20X9.

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Current year tax expense is Rs.1,000,000

Current year tax payable is Rs.500,000

Prior year over provision is Rs.100,000

Total tax expense is Rs.900,000

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## Future Tax/ Deferred Tax

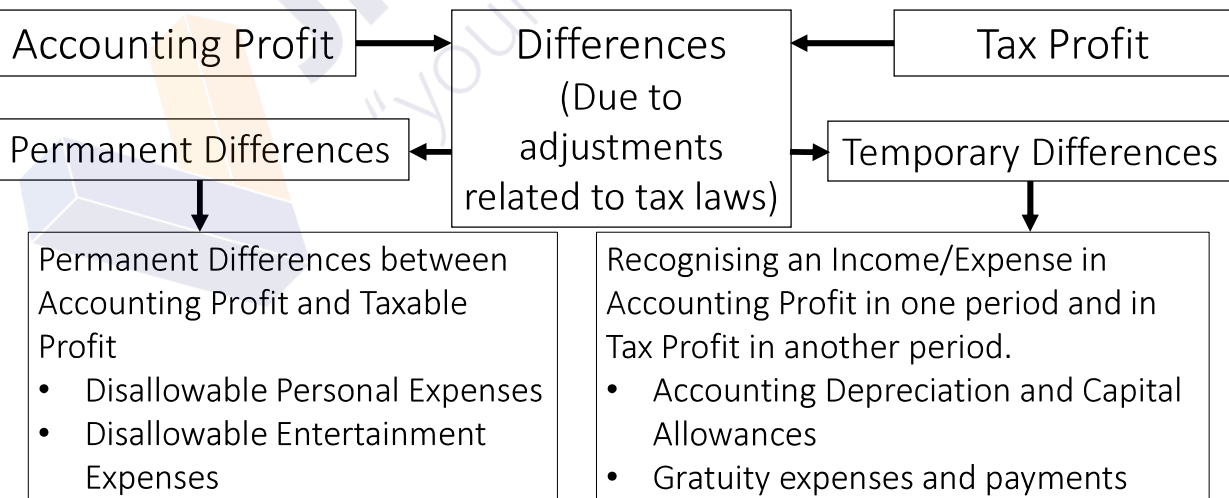


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## Why do Accounting Profit and Tax Profit differ?



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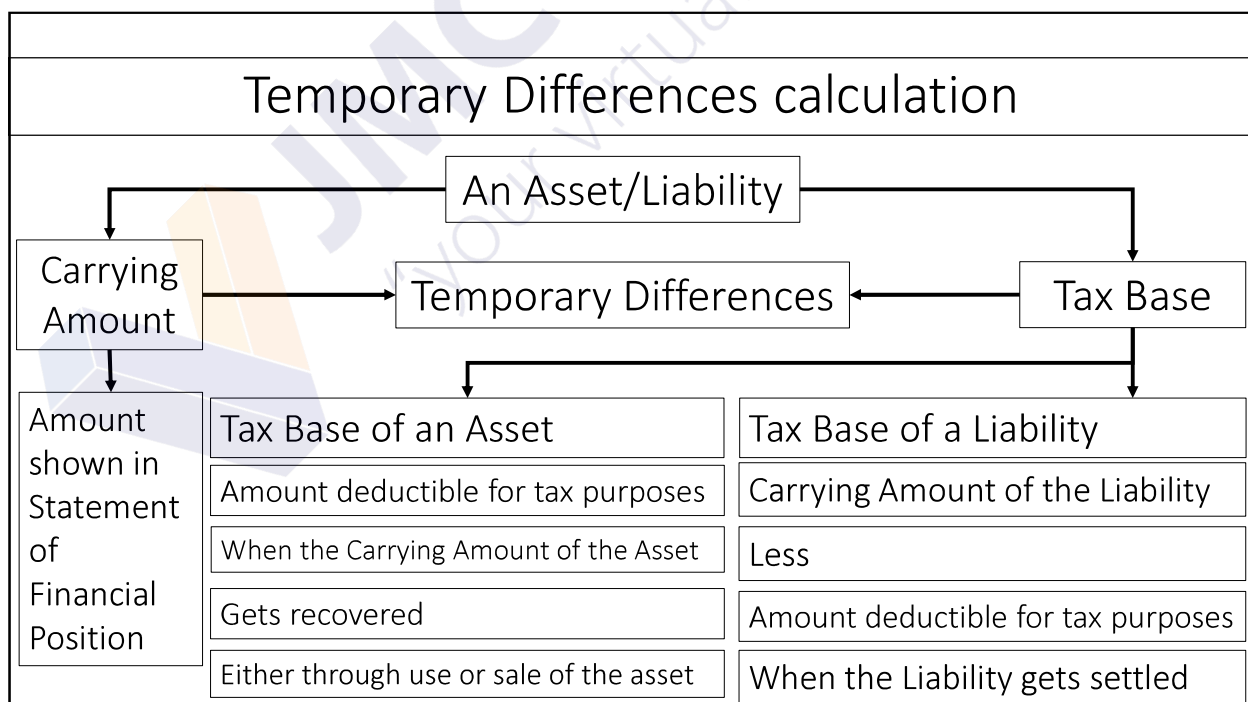
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<h2>Temporary Differences</h2>
<p>Due to this, a particular income or expense recognized in accounting profit in a different period.          It's tax impact will be recognized in another period.          Therefore, it affects the <b>Matching</b> Concept.</p>
There will be <b>Temporary Fluctuations</b> in the Tax Expense
A <b>Deferred Tax</b> Adjustment is made to meet the matching and remove these temporary fluctuations.
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### Illustration 03

1. Cost of the machine is Rs.10,000. The carrying value is Rs.8,000. The capital allowance already claimed is Rs.3,000. The revenue generated from using the machine is taxable. Gains or losses from disposal of the machine is taxable.
2. The interest receivable is Rs.1,000. Interest received in cash is taxable.
3. Prepaid rental expense is Rs.3,000. Rental paid is tax deductible.
4. Land has a cost of Rs.3Mn. Land was impaired by Rs.800,000. Disposal gain of the land is taxable.

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1. Tax base of the machine is Rs.7,000
2. Tax base of interest receivable is Nil
3. Tax base of prepayment is Nil
4. Tax base of land is Rs.3Mn

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## Illustration 04

1. Current liabilities include accrued expenses with a carrying amount of Rs.1,000. The related expense will be deducted for tax purposes on a cash basis.
2. Current liabilities include revenue received in advance with a carrying amount of Rs.10,000. The related expense will be deducted for tax purposes on a cash basis.
3. Current liabilities include accrued expenses with a carrying amount of Rs.2,000. The related expense has already been deducted for tax purpose.
4. Current liabilities include accrued fines and penalties with a carrying amount of Rs.100. Fines and penalties are not tax deductible.

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1. Tax base of the accrued expense is Nil
2. Tax base of revenue received in advance is Nil
3. Tax base of accrued expense is Rs.2,000
4. Tax base of accrued fines and penalties is Rs.100

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## What are the Types of Temporary Differences?

Due to Temporary Differences

If **More** taxes must  
be paid in the future

Taxable Temporary  
Differences

If **Less** taxes must be  
paid in the future

Deductible Temporary  
Differences



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## Examples for Taxable Temporary Differences

- Interest income recognized on accrual basis in accounting profit, cash basis on taxable profit
- Property plant and equipment, where carrying value is higher than tax base
- Intangible asset, where carrying value is higher than tax base

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## Examples for Deductible Temporary Differences

- Retirement benefit obligations where provisional expense deducted in accounting profit and paid amounts deductible for taxable profit
- Property plant and equipment, where carrying value is lower than tax base
- Intangible asset, where carrying value is lower than tax base

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## How to Recognise Deferred Tax Liabilities?



Taxable  
Temporary  
Differences



Future  
Tax Rate



Closing  
Deferred Tax  
Liability

Closing  
Deferred  
Tax  
Liability



Opening  
Deferred  
Tax  
Liability



Deferred Tax  
Expense



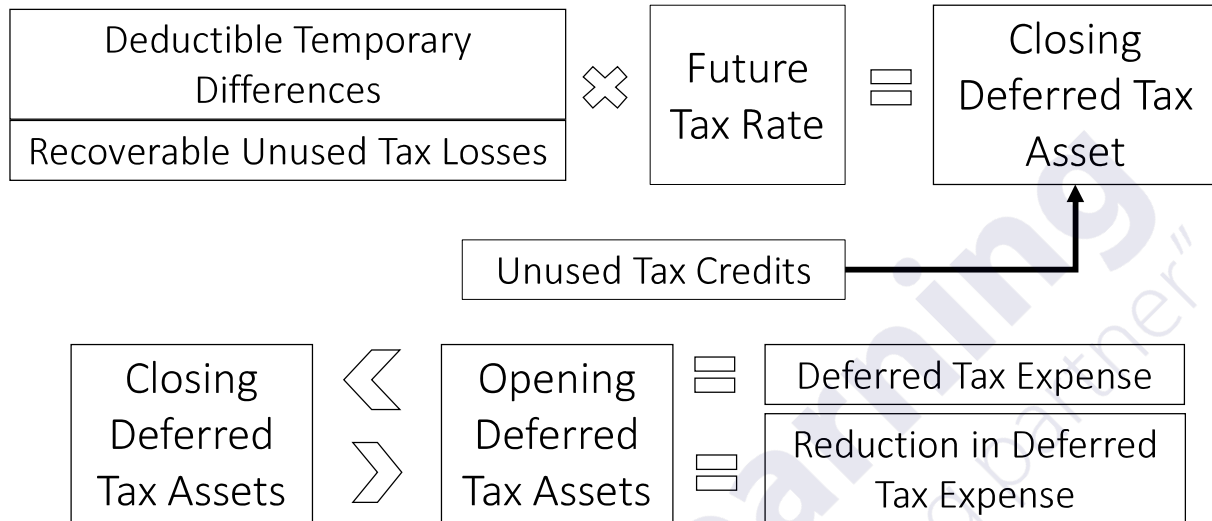
Reduction in  
Deferred Tax  
Expense

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## How to Recognise Deferred Tax Assets?



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## Unused Tax Losses

Unused Tax Losses can be setoff against future tax profits.

Due to tax losses, lesser taxes will be paid in the future

The tax effect of unused recoverable tax losses is a Deferred Tax Asset.



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## Tax Credits



Taxes paid in advance

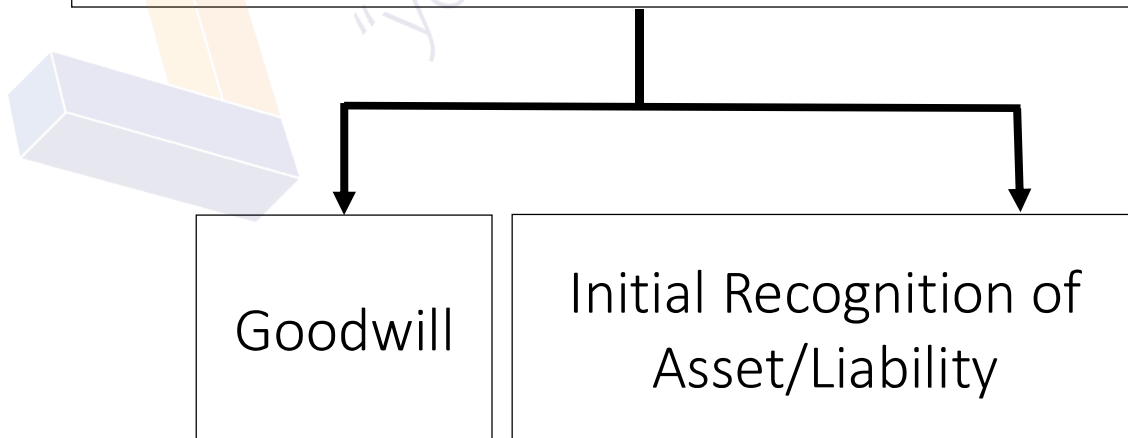
It is also a Deferred Tax Asset.

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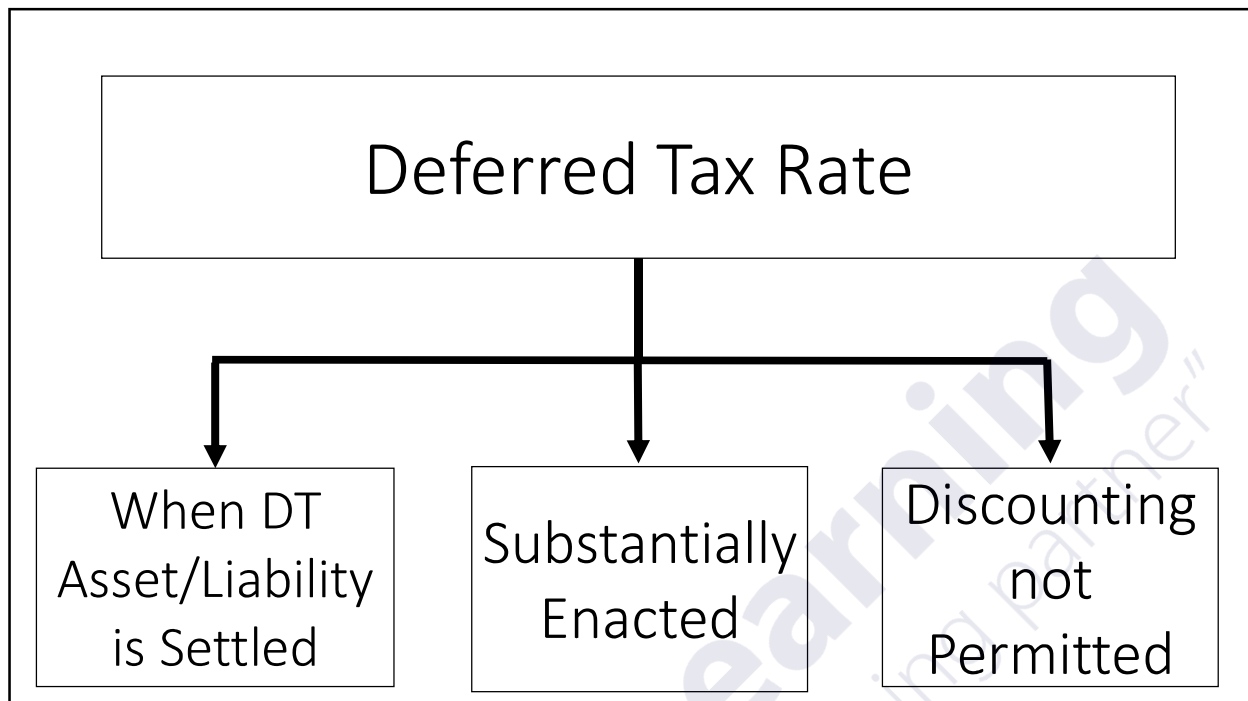
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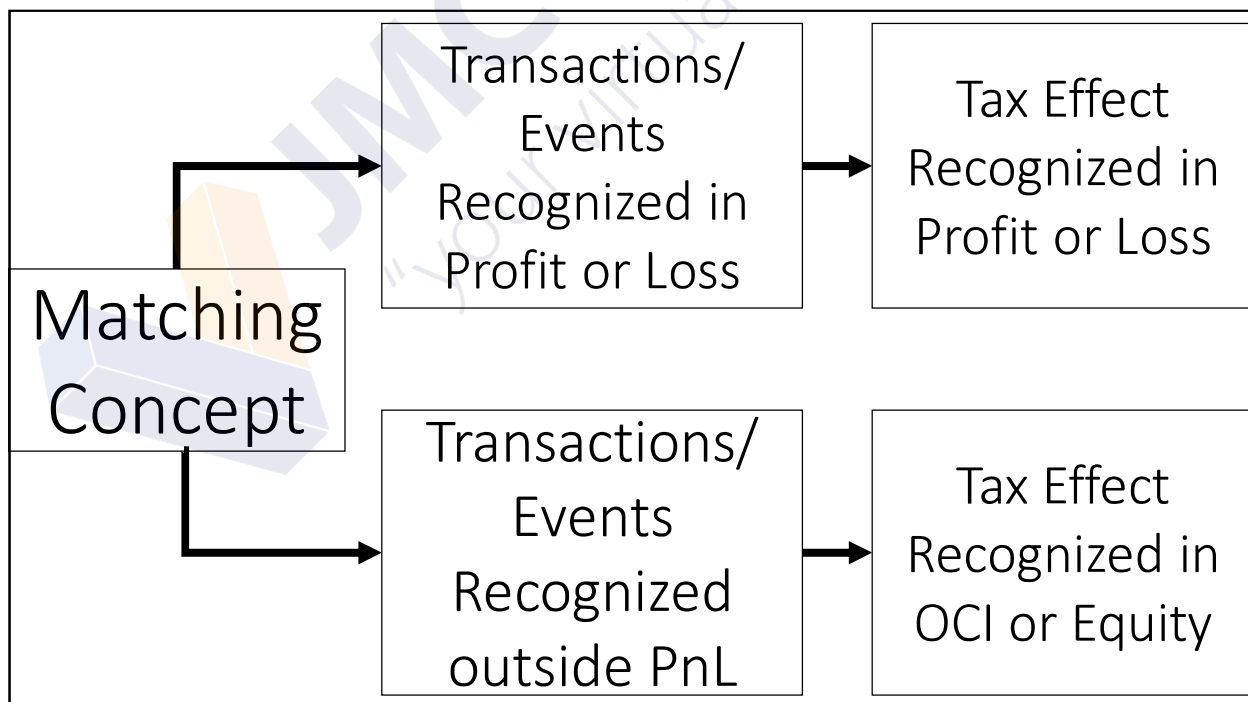
## Exceptions to Recognize Deferred Tax Liabilities/Assets



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## Illustration 05

Following information is relevant for Moorthi PLC.

Project period 4 years

Cost of Machine Rs. 100/-

Depreciation 25%

Capital Allowance Rate 50%

Tax Rate 10%

Profit Before Tax is Rs. 200/- each year

Calculate the Deferred Tax adjustment for each year.

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## Current Year Tax Expense

Year	1	2	3	4	Overall
Profit Before Tax	200	200	200	200	800
+ Depreciation	25	25	25	25	100
(-) Capital Allowance	(50)	(50)	0	0	(100)
Taxable Profit	175	175	225	225	800
Tax at 10%	17.5	17.5	22.5	22.5	80

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## Carrying value

Year	1	2	3	4
Cost	100	100	100	100
Accumulated Depreciation	(25)	(50)	(75)	(100)
Accounting Carrying Value	75	50	25	0

## Tax Base

Year	1	2	3	4
Cost	100	100	100	100
Tax Depreciation	(50)	(100)	(100)	(100)
Tax Base	50	0	0	0

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## Deferred Tax

Year	1	2	3	4
Carrying Value	75	50	25	0
(-) Tax Base	(50)	0	0	0
Temporary Difference	25	50	25	0
Type	TTD	TTD	TTD	-
Closing Deferred Tax Liability at Tax Rate 10%	2.5	5	2.5	0
Opening Deferred Tax Liability	0	2.5	5	2.5
Deferred Tax Expense/Reversal	2.5	2.5	(2.5)	(2.5)

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## Total Tax Expense

Year	1	2	3	4
Current Year Tax Expense	17.5	17.5	22.5	22.5
Deferred Tax Expense	2.5	2.5	(2.5)	(2.5)
Total Tax Expense	20	20	20	20

## Profit After Tax

Year	1	2	3	4
Profit Before Tax	200	200	200	200
Tax Expense	(20)	(20)	(20)	(20)
Profit After Tax	180	180	180	180

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## Illustration 06

Darshana purchased a machine worth of Rs. 200/- on 1<sup>st</sup> January 20X5. Its useful life of 5 years.

Capital Allowance Rate is 25%.

Deferred Tax Asset as at 31<sup>st</sup> December 20X4 was Rs. 10/.  
Company has a legally enforceable right to net off tax liability against the tax assets.

Balances as at 31<sup>st</sup> December 20X5 and 20X6 are as follows:

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## Illustration 06

Description	31/12/05	31/12/06
Gratuity Provision	100	80
Brought Forward Tax Losses	50	10
Future Expected Taxable Profit	40	80
Tax Rate	10%	10%

- 5.1 Calculate the Carrying Amount of the Machine at the end of each year.  
 5.2 Calculate the Tax Base of the Machine at the end of each year.  
 5.3 What is the Recoverable Unused Tax Losses for each year?  
 5.4 Calculate the Deferred Tax Adjustment and show the double entries.

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## Carrying value

Year	X5	X6
Cost	200	200
Accumulated Depreciation	(40)	(80)
Accounting Carrying Value	160	120

## Tax Base

Year	X5	X6
Cost	200	200
Tax Depreciation	(50)	(100)
Tax Base	150	100

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## Tax Base of Gratuity

Year	X5	X6
Carrying Value	100	80
(-) Amount deductible for tax purpose when liability is settled	(100)	(80)
Tax Base of Gratuity	0	0

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## Recoverable Unused Tax Losses

Year	X5	X6
Carried Forward Tax Losses	50	10
Future Expected Taxable Profit	40	80
Recoverable Unused Tax Losses	40	10

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## Deferred Tax 31/12/X5

Year	PPE	Gratuity	Tax Loss	Total
Carrying Value	160	(100)	0	
(-) Tax Base	(150)	0	(40)	
Temporary Difference	10	(100)	(40)	(130)
Type	TTD	DTD	DTD	DTD
Closing Deferred Tax Asset at Tax Rate 10%				13
Opening Deferred Tax Asset				10
<b>Deferred Tax Reversal</b>				<b>3</b>

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## Deferred Tax 31/12/X6

Year	PPE	Gratuity	Tax Loss	Total
Carrying Value	120	(80)	0	
(-) Tax Base	(100)	0	(10)	
Temporary Difference	20	(80)	(10)	(70)
Type	TTD	DTD	DTD	DTD
Closing Deferred Tax Asset at Tax Rate 10%				7
Opening Deferred Tax Asset				13
<b>Deferred Tax Expense</b>				<b>6</b>

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## Illustration 07

Lahiru PLC acquired 80% of the ordinary shares of Kumara PLC on 01<sup>st</sup> of January 2020. Kumara PLC's stated capital was Rs.10Mn and the retained earnings was Rs.2Mn.

The machine was fair valued and a fair value excess of Rs.1Mn was identified. The machines has remaining useful life of 5 years.

Tax rate is 28%.

Show the accounting adjustments relevant to deferred tax.

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