PICPA
Tax Implications of New Accounting Standards*
December 1, 2006

Agenda

Introduction
Summary of key changes from old GAAP
PFRS and IFRS moving forward – updates in 2006 and beyond
Application of PFRS – common issues and examples
Questions and answer

Part 1

Introduction

Introduction

- PFRS which is aligned with IFRS has been adopted in the Philippines effective January 1, 2005
- In the region, some countries will fully adopt IFRS effective 2006 and 2007. HK, China, Singapore, Malaysia, Australia, New Zealand now substantially under IFRS.
- US GAAP and IAS/IFRS expected to be substantially harmonized by end of 2007.

For Management

Part 2

Key changes

PFRS 1 – First time adoption of PFRS		
Changes	Accounting Implications	Tax Implications
Requires an entity to prepare a PFRS opening balance sheet at January 1, 2004, the date of transition to PFRS	Certain assets/liabilities from previous GAAP need to be re-measured, recognized and/or derecognized. Adjustments arising need to be adjusted against the opening balance of retained earnings at January 1, 2004 and 2005.	Adjustments resulting from adoption of PFRS have no tax implications.

PFRS 2 – Stock-based compensation		
Changes	Accounting Implications	Tax Implications
Requires recognition of the fair value of the stock options granted to employees at grant date	Employee expense with a corresponding credit to equity or liability is required to be recorded in the financial statements	Grant date: Not deductible (employer), not taxable (employee) *Exercise Date: Employer* - Excess of FMV over exercise price is deductible - Withhold income tax on excess (DA 135-97) - Pay FBT for managerial/ supervisory (DA 255-05) - Conflict to be resolved by BIR? *Exercise Date: Employee* - Excess of FMV over exercise price is taxable

PFRS 3 – Business Combination		
Changes	Accounting Implications	Tax Implications
Allows only the application of purchase method for all business combinations (pooling of interest allowed under old GAAP) Goodwill no longer subject to amortization but now required to be tested for impairment annually Negative goodwill no longer allowed. Negative goodwill will have to be credited to profit and loss. Business combination between entities under common control need to be accounted at cost.	Acquired assets and liabilities need to be measured at fair value at date of acquisition Excess of investment cost over fair value of net assets acquired =goodwill Excess of fair value of net assets acquired over investment cost=negative goodwill	Goodwill not deductible until related assets are sold. Negative goodwill credited to P&L: Not taxable Assets acquired will have the same bases as those in the hands of transferor (acquired) in a tax-free merger or consolidation The term “merger” or “consolidation”, means: - the ordinary merger or consolidation, or - the acquisition by one corporation of all or substantially (80%) all the properties of another corporation solely for stock; provided, that transaction must be undertaken for a bona fide business purpose and not solely for the purpose of escaping the burden of taxation.

Key changes

PFRS 3 – Business Combination		
Changes		Tax Implications
		If transaction is not tax free, tax base of assets acquired shall be net of negative goodwill. Impairment of goodwill - •Not deductible •Deduction may be claimed upon disposal of related assets acquired Transfer of assets and liabilities in a merger or consolidation •Not subject to VAT •Input VAT of acquiree transferable to acquiror (RR No. 16-05) Deferred tax asset •Allowed to be transferred by implication (Rulings DA 661-11-29-99 / DA 621-04)? NOLCO •If transferor of NOLCO owns 75% or more of outstanding shares of assignee, NOLCO will still be allowed as deductions in the hands of assignee

Key Changes

PFRS 5 – Non current assets held for sale and discontinued operations		
Changes	Accounting Implications	Tax Implications
Requires non-current assets to be classified as non-current assets held for sale if its carrying amount will be recovered through sale rather than through continuing use These assets need to be stated at the lower of carrying amount and fair value less cost to sell	• Impairment loss adjustment to bring down the carrying amount to fair value will be charged to profit and loss. • Subsequent recovery of impairment losses needs to be credited to profit and loss only to the extent of cumulative losses previously recognized	• Impairment loss and gain not deductible/taxable at the time of recognition • Impairment loss/gain is temporary difference • Gain/loss to be realized at the time of actual sale (See also Tax Implication of PAS 36, slide no.22)

Key Changes

PAS 2 – Inventories		
Changes	Accounting Implications	Tax Implications
LIFO no longer allowed Inventory needs to be carried at lower of cost of net realizable value (selling price less cost to sell/completion). Reversal of write-down now allowed by PFRS (not allowed by previous GAAP) Forex loss can no longer be capitalized as part of inventory cost under PAS 21.	Inventories valued at LIFO need to be revalued using acceptable valuation method under IFRS.	LIFO also no longer allowed BIR approval for change must be secured within 90 days from start of taxable year

Key changes

PAS 17 - Leases		
Changes	Accounting Implications	Tax Implications
Capital leases A lease is capital lease if following indicators exist: a) Transfer of ownership of assets to the lessee at the end of the lease term b) Lessee has the option to purchase the asset at a price that is lower than fair value of the asset c) The lease term is for the major part of the economic life of the asset d) Present value of minimum lease payments amounts to or substantially equal to the fair value of the asset e) Leased assets are of such a specialized nature that only lessee can use the asset without modification.	Lessee The leased asset will be recorded as asset measured at present value of minimum lease payments Lessor Will treat the lease as outright sale at the inception of the lease.	• For income tax purposes, such capital lease shall be treated as sale (conditional) • Amounts to be received by lessor/vendor will be considered to be payments of sales price to the extent such amounts do not represent interest and other charges (RR 19-86) • The gain on sale of asset = total lease payments receivable net of interest component less carrying value • Lessee/Vendee shall be allowed to claim depreciation plus interest (if not capitalized) • For GRT, gross receipts of banks and non-bank financial intermediaries shall consist of interest income (RR 9-04) • For VAT, taxable base shall be the total amount to be paid by the lessee/vendee under the contract (RR 16-05)

Key changes

PAS 17 - Leases		
Changes	Accounting Implications	Tax Implications
Operating leases Lease income/cost, including lease incentives such as free rent, to be recognized under the straight-line method over the term of the lease	Impact of lease escalation and free rent will have to be amortized under the straight-line method over the term of the lease Straight-lining of lease income/cost will create temporary difference between the actual amount of cash received/paid and actual amount of income/expense recorded in the accounts	For income tax purposes, gross income of lessor shall consist of: • Rental actually earned but uncollected and • Advance rentals received No rent income to be recognized during rent-free period Allowable deductions to lessee • Rent paid or accrued including all expenses lessee is required to pay to or for the account of the lessor (such as insurance expenses) • Advance payment to be amortized • Amount arising from straight-lining of lease cost/expense not taxable income/deductible expense

Key Changes

IAS 12 – Income tax		
Changes	Accounting Implications	Tax Implications
Requires recognition of deferred income tax liability on appraisal increase arising from revaluation of property, plant and equipment.	The requirement to recognize deferred income tax liability is mandatory whether or not the entity intends to dispose the asset	Appraisal increase not taxable

Key changes

PAS 16 – Property, plant and equipment		
Changes	Accounting Implications	Tax Implications
Asset retirement obligation (ARO) is required to be capitalized at the date of acquisition and/or installation Component accounting Cost of commissioning/testing an asset, net of proceeds from selling any items produced while the asset is being tested such as sample products	ARO asset to be recognized at present value In the balance sheet ARO asset will be depreciated over the estimated useful life of the related assets A corresponding liability (also at present value) is required to be recorded. The accretion cost (the amortization of the difference between the PV and the nominal amount of ARO) is charged to expense over the discount period (should be the same with the life of the asset)	Depreciation on ARO is not deductible for tax purposes. Accretion cost (classified as finance cost) not deductible for tax purposes. Upon ultimate disposal of an asset, unamortized balance of ARO will not be included in the determination of taxable income from disposal. Actual restoration costs deductible when incurred.

Key changes

PAS 16 – Property, plant and equipment		
Changes	Accounting Implications	Tax Implications
Interest on qualifying asset may be capitalized as part of the asset account during the construction period (IAS 23 – Borrowing costs allowed alternative treatment)		Tax impact Depreciation for each of the components of a large asset should be aligned with depreciation for tax purposes. Interest for tax purposes is deductible when paid/incurred or maybe capitalized as part of the asset. Depending on the company policy, this may create temporary difference between accounting and tax base. ARO - Actual restoration costs deductible when incurred.

Key changes

IAS 18 – Revenue recognition

Changes	Accounting Implications	Tax Implications
Revenue recognition should be applied to individual separately identifiable components of a single transaction. For sale of services (i.e. consultancy), revenue recognition should be based on percentage of completion method (revenue recognized by reference to the stage of completion) at balance sheet date. Certain deflators (ie display rental given to retailers) need to be presented as "sales deduction" rather than advertising and promotions. IAS 18 does not deal with sale of real property in details	Individual elements of a sales contract may have different revenue recognition pattern (ex – sale of equipment with free maintenance for 3 years; in this case, a separate revenue should be recorded for maintenance which should be earned over a period of 3 years) For sale of services, fixed fee arrangements need to be accounted either under completed contract method or percentage of completion method) Designing accounting policies on deflators can be challenging Sale of real property in the Philippines has been generally based on conventions and FAS 66. Installment method a common practice. Some are adopting full accrual method for sale of raw lands.	If sale is billed thru a single invoice, entire invoice amount (net of VAT) shall be recognized as revenue for income tax & VAT purposes at time of sale. Sale of services – to be recognized as revenue for income tax purposes when earned (upon billing or accrual) - subject to VAT upon collection of bills. Sale of real properties – for installment or deferred payment plan schemes, under RR 16-2005, if collections for the initial year exceed 25% of the selling price, the entire gross profit is taxable. Otherwise, installment method applies.

Key changes

PAS 19 – Employee benefits (focus on pension plans)

Changes	Accounting Implication	Tax Implication
Annual pension cost charge now composed of: 1) Current service cost 2) Interest cost on liabilities 3) Return on plan asset 4) Recognized actuarial gains and losses 5) Past service costs 6) Amortization of transition liability, if any Past service costs need to be amortized over the vesting period (used to be amortized over the average remaining lives of employees Allows only projected credit method as acceptable valuation model. Profit sharing and bonus can be recognized if present legal or constructive obligation exists	Past service cost amortization is effectively higher compared to previous GAAP. Transition liability need to be recognized at IFRS transition date and can be amortized over a maximum period of five years Transition asset can be recognized at transition date if the asset exceeded the present value of defined benefit obligation.	Deductible pension costs: - Actual contribution for pension liability for current year - One-tenth of reasonable amount paid to the trust to cover pension liability for prior years or to place the trust on sound financial basis All other components of pension cost charge not deductible Transition liability – not deductible for income tax purposes Transition asset – not taxable for income tax purposes. Future refunds from the fund are taxable when refunds are received. Deferred tax liability however needs to be recognized on recognized pension asset arising from future refund.

Key changes

PAS 21 - Effects on changes in foreign exchange rates

Changes	Accounting Implication	Tax Implication
Requires that functional currency be determined by an entity. The functional currency is the basis of recording transactions. Capitalized foreign exchange losses no longer allowed.	General ledger supporting the financial statements need to be maintained using the functional currency. Foreign exchange losses previously capitalized need to be written-off or adjusted against the opening balance of retained earnings.	Taxable income – To be determined by translating functional currency income and expenses on a monthly basis using average exchange PDS rates then adding all the 12 monthly peso equivalents All other taxes – shall be based on historical peso amounts or actual conversion/prevailing PDS rates on transaction days, whichever is applicable; subsidiary records have to be maintained Capitalized forex loss written off – If capitalized loss represents actual loss, choose from two options: - continue claiming depreciation - secure approval from BIR for the change in the accounting/tax treatment? If loss is not realized, write-off upon realization.

Key changes

PAS 24 – Related party disclosure

Changes	Accounting Implications	Tax Implications
Requires disclosure of details of transactions with related parties during the reporting period Requires disclosure of key management personnel compensation in total and the following: • Short term benefits (ie SSS) • Post employment benefits • Other long term benefits • Termination benefits • Share-based payments (stock options)	More detailed disclosure of related party transactions Disclosure of key management personnel benefits has been a sensitive issue since the adoption of PFRS	Disclosure of management personnel benefits will provide wider window for the tax authorities to assess accuracy of taxed earnings

Key changes

PAS 27/28 – Consolidated financial statements /Investments in associates			
	Changes	Accounting Implications	Tax Implications
Interpretation SIC 12	Exemption from the preparation of consolidated financial statements under certain circumstances Cost method for investment be applied to all investment in subsidiaries and associates Special purpose entities need to be consolidated (ie landholding companies)	Restatement of prior year financial statements to apply cost method to all investments. Special purpose entities (SPEs) will have to be consolidated with the entity that controls economic benefits arising from the activities of the SPEs.	None Consolidation and group reporting not allowed. Taxation applicable at entity level

Key changes

PAS 32/39 – Derivative financial instruments and hedging		
Changes	Accounting Implications	Tax Implications
Requires measurement and recognition of the fair value of derivatives, including embedded derivatives Financial assets/liabilities need to be measured initially at FV less cost of transaction. Subsequently, assets must be measured at FV as follows: 1) Assets/liabilities at FV through profit and loss – at FV (market) 2) Held to maturity investments – at amortized cost using the effective interest method 3) Loans and receivables – same as 2 above 4) Available for sale financial assets – at FV (market)	Mark to market/derivative losses and gains (unrealized in nature) need to be measured at each reporting date Fair value adjustments of financial assets and liabilities will be charged/credited to operations (except available for sale financial assets which is part of the equity accounts) Application of effective interest method will create temporary difference between actual amount of interest received/paid and amount reported under effective interest method. Tax impact Timing differences and fair value adjustments taxable income/deductible losses?	Temporary differences and fair value adjustments are not taxable income/deductible losses Gain or loss to be recognized upon realization Necessary to determine whether realized gain or loss is capital or ordinary Capital loss deductible only from capital gains Loans to employees without interest or (rate below 12%) will give rise to taxable fringe benefit

Key changes

PAS 32/39 – Derivative financial instruments and hedging		
Changes	Accounting Implications	Tax Implications
Some preferred shares now classified as liability rather than equity	See separate examples	See examples
Equity and liability elements of compound instruments need to be valued and treated separately in the balance sheet	See examples	See examples
Long term financial assets and liabilities which are non-interest bearing need to be stated at present value by discounting the balance using a rate that is implicit to the agreement/balance.	Portion of the non-interest bearing assets/liabilities will be treated either as an interest expense or income using the effective interest method	Accretion income/expense arising from discounting of long term assets and liabilities are not taxable. Note however interest maybe imputed by BIR on non-interest bearing inter-company advances/loans.

Key changes

PAS 36– Impairment of assets		
Changes	Accounting Implications	Tax Implications
Requires long term assets and investments to be tested for impairment. Impairment exist when the carrying value of the asset is less than its recoverable value. Previously recognized impairment losses can be reversed if market conditions improved.	Impairment loss requires to be recognized on the following: • Underutilized and unused assets • Obsolete assets • Investments in subsidiaries that are loss making • Licenses/patents Tax impact Impairment loss deductible for tax purposes? Reversal of impairment losses taxable gain?	Impairment loss – Not deductible as the general rule is losses must be evidenced by close and completed transaction fixed by identifiable event (e.g,. sale) Possible Exceptions (Income Tax Regulations): 1) Loss sustained when the usefulness of the asset is suddenly terminated due to change in business conditions such that the taxpayer discontinues the business or discards the assets permanently from use in such business (Sec. 98).

Key changes

PAS 36– Impairment of assets		
Changes	Accounting Implications	Tax Implications
		2) If the whole or any portion of a physical property is clearly shown as being affected by economic conditions that will result in the asset being abandoned at a prior date prior to end of its normal useful life, so that depreciation deductions are insufficient to return the cost, a reasonable allowance for obsolescence may be allowed, in addition to depreciation (Sec 110). 3) If a patent becomes obsolete prior to its expiration, the remaining proportionate depreciable amount may be deducted subject to CIR approval (Sec. 111). Impairment gain – Recovery of impairment loss not taxable (not realized) Note: Impairment gain/loss shall be treated as temporary difference

Key changes

IAS 37 – Provisions, contingent assets and contingent liabilities		
Changes	Accounting Implications	Tax Implications
Material accruals that are expected to be settled beyond 1 year may need to be discounted at present value	The difference between the present value and the amount of accrual is treated as accretion expense (part of financing costs) in the profit and loss	Mere provisions are not deductible. Accretion expense not deductible for tax purposes.

Key changes

PAS 38 – Intangible assets		
Changes	Accounting Implications	Tax Implications
Recognize only intangible assets if following are all met: • Identifiable • Probable that economic benefits will flow to the entity • The cost of the asset can be measured reliably Pre-operating expenses/start up costs no longer allowed to be deferred in the balance sheet. Need to be charged to expense as incurred.	All recorded intangible assets that do not meet the criteria of IAS 38 need to be written-off in the financial statements	Research and Development -deductible as ordinary and business expenses provided not chargeable to capital account. Deferred R & D not chargeable to property subject to depreciation or depletion shall be amortized over 60 months or more beginning from the month taxpayer first realizes benefits (Sec. 34 I, Tax Code). Intangibles, the use or value of which is only for a limited period which can be estimated from experience with reasonable certainty may be the subject of a depreciation allowance provided the facts are fully shown in the return to the satisfaction of the CIR. e.g., patents, copyrights and franchises (Sec. 107 – Income Tax Regulations)

Key changes

PAS 38 – Intangible assets		
Changes	Accounting Implications	Tax Implications
		Intangibles the use of which in business is not limited will not usually be a proper subject of depreciation allowance Loss from de-recognition or write-off of the intangible asset shall not be allowed as a deduction unless it qualifies under the exception explained under Impairment Any change in accounting/tax treatment should have prior CIR approval

Key changes

PAS 40 – Investment properties		
Changes	Accounting Implications	Tax Implications
Requires assets that are held for appreciation or for rental be classified as Investment properties. Investment properties can either be carried at cost (with annual depreciation charges) or fair value (subject to annual impairment testing)	At the date of adoption, any appraisal surplus of assets previously classified as fixed assets that now qualify as investment property shall be credited to retained earnings. Any changes in fair value subsequent to adoption date shall be charged or credited to operations	Gain or loss arising from changes in fair value not taxable/deductible Depreciation charge on appraisal surplus not deductible; basis should be historical cost.

Part 3

PFRS and IFRS – Moving forward (updates in 2006 and beyond)

Key changes

Relevant updates in 2006/2007 and beyond		
Changes	Accounting Implications	Tax Implications
Fair values are here to stay • Fair value option under IAS 39 (effective 2006)	The standard permits an entity to designate, on initial recognition financial assets and liabilities to be FV through PL	Gain or loss arising from changes in fair value not taxable/deductible
IFRS 2 – amendments to include an expanded definition of vesting conditions (ie payment of counterpart contributions) – 2007	To impact only in determining the vesting period/condition and the resulting expense recognition	Tax still due upon exercise for the excess of FMV over option price (the cost)
ED on borrowing costs – to require capitalization of interest on qualifying asset (similar to that of FAS 34) – 2008	Capitalization is required where interest cost is incurred in constructing qualifying assets	Refer to same discussion under PAS 16.
ED 7 – Financial instruments: Disclosures – this provides expanded disclosure on classes of performance and position of various financial instruments	Expanded disclosure in the financial statements. To impact heavily those entities with heavy trading of financial instruments/derivatives	No tax implications.

Key changes

Relevant updates in 2006/2007 and beyond		
Changes	Accounting Implications	Tax Implications
Amendments to IAS 19 – extensive disclosures • To include trends in plan assets and liabilities as well as assumptions underlying components of defined benefit costs	No impact except for extensive disclosures. These are ordinarily provided by actuaries	No tax impact on additional requirements. Refer to related discussion in PAS 19.
ED 8 – Operating segments (IAS 14) effective 2007 • Likely to result in increase in the reported segments • See through eyes of management	Complexity of identifying and quantifying operating segments	No tax implication
ED on presentation of financial statements • To converge with FASB • Introduction of Other recognized gains and losses in the equity section • Balance sheet may include opening statement of financial position • To take effect 2008	Presentation of balance sheet only. Balance sheet maybe presented in 3 columns Will benefit those that are listed in the US stock market as this will eliminate differences in the face of the balance sheet and PL	None

Part 4

Application of PFRS – common issues and examples

Measurement - Inventories

Example:

Company A manufactured Product A at cost of P100,000.
Product A is sold at P110,000 at a 5% discount. Delivery costs is estimated to be P10,000.

How much should be the carrying amount of Product A ?

Measurement - Inventories

Example:

Carrying amount of Product A:
- Cost = P100,000
- NRV = P94,500 (P110,000 – P5,500 discount – P10,000)
- Lower of Cost and NRV = P94,500

Under the above, there is a charge to cost of sales for inventory write-down amounting to P5,500. This is not deductible for tax purposes because cost of sales under the tax rules represents the actual cost of producing/purchasing the inventory

Similarly, any recovery in the value of the inventory will not be a taxable income

Fixed assets

Example of tax treatment of ARO

	IFRS	Tax
Acquisition cost:		
Purchase price	P5,000,000	P5,000,000
Installation costs	100,000	100,000
PV of ARO	200,000	-
Total Initial Cost	P5,300,000	P5,100,000
Annual Depreciation (assuming a 10 year life)	P530,000	P510,000

The related accretion cost of ARO liability (treated as financing cost in the profit and loss) is also not deductible for tax purposes.

De-recognition of assets

PFRS	Tax Impact
An asset is de-recognized when: (a) it is being disposed; or (b) no future economic benefits are expected from its use or disposal. Any impairment loss arising from the de-recognition of a fixed asset is included in profit or loss when the item is de-recognized.	Deduction for loss of useful value of an asset is allowed if due to sudden business changes, an asset has been prematurely discarded, or where new legislation directly or indirectly makes the continued profitable use of the property impossible.

Example – straight-lining of operating lease under PAS 17

Case – Lease with rent-free period

Lease term (inclusive of rent-free period)	5 yrs
Annual rent	P1,000,000
Rent-free period	6 months
Total lease payments	P4,500,000
Annual rent (P4,500,000/5 yrs)	P900,000

Example continued….

Accounting entries under PFRS below:

Lessor	Lessee
Dr. Cash P500,000 Dr. Receivable 400,000 Cr. Rent Income P900,000	Dr. Rent Expense P900,000 Cr. Cash P500,000 Cr. Payable 400,000
Taxable rent income will still be P500,000, the actual amount of rent income due under the lease agreement. The P400,000 will be treated as a temporary difference	Deductible rent expense will be P500,000. The P400,000 will be treated as temporary difference in the accounts

Example - Finance Lease under PAS 17

Case - Finance lease of an equipment

Assumptions:

Lease term	5 years
Total lease payment	P660,000
Annual lease	P132,000
Applicable interest rate	10%
PV of annuity	3.791
PV of MLP	P500,000

If the lease agreement is non-interest bearing, the discount rate will either be the rate implicit to the lease agreement or the lessee's incremental borrowing rate had the asset been financed elsewhere

Example continued

Amortized lease liability/receivable:

Lease liability/balance:

Inception date	P500,000
End of year 1	418,000
End of year 2	327,800
End of year 3	228,600
End of year 4	119,500
End of year 5	0

Example continued…

Payments/receipts applied to interest below:

Interest on Outstanding Liability/Receivable:

Year 1	P50,000
Year 2	41,800
Year 3	32,800
Year 4	22,900
Year 5	12,500
Total	P160,000

Example continued…

PFRS accounting entries at the inception of the lease would be:

Lessor's book		Lessee's Books	
Dr. Lease receivable	P660,000	Dr. Equipment	P500,000
Cr. Equipment	P500,000	Cr. Lease liability	P500,000
Cr. Unearned interest Income	160,000		

Example continued….

PFRS entries subsequently would be (in '000):

Lessor's book			Lessee's Books		
Year 1					
Dr. Cash	P132		Dr. Lease liability	P82	
Cr. Lease receivable		132	Dr. Interest expense	50	
Dr. Unearned Int. Income	90		Cr. Cash		P132
Cr. Interest Income		90			
Year 2					
Dr. Cash	P132		Dr. Lease liability	P90.2	
Cr. Lease receivable		132	Dr. Interest expense	41.8	
Dr. Unearned Int. Income	P41.8		Cr. Cash		P132
Cr. Interest Income		41.8			
Year 3					
Dr. Cash	P132		Dr. Lease liability	P90.2	
Cr. Lease receivable		132	Dr. Interest expense	32.8	
Dr. Unearned Int. Income	P32.8		Cr. Cash		P132
Cr. Interest Income		32.8			

Finance leases – tax considerations

PFRS	Tax impact
Lessee – Initial recognition Lessee shall recognize finance leases as assets and liabilities in its balance sheets at amounts equal to the fair value of the leased property, or if lower, the present value of the minimum lease payments each determined at the inception of the lease.	The cost of the asset will be the difference between the total payments and the interest. (Consistent with PFRS PV) (RR 19-86)

Finance leases – tax considerations

PFRS	Tax Impact
Lessee – Lease payments Each payment will be allocated between lease and interest. The lease payment will be applied against the liability under capital lease. The lessee will also record a regular depreciation expense for the leased asset.	Deduction for tax purposes shall be the depreciation expense on leased asset and interest payments. (Taxpayer has option to expense or capitalize interest). Open tax issue: Implicit interest expense on non-interest bearing agreements – deductible for tax purposes?

Finance leases – tax considerations

PFRS	Tax impact
Lessor – Lessor shall recognize assets held under a finance lease in their balance sheets and present them as a receivable at an amount equal to the net investment in the lease. Income from the sale of the asset is the difference between the total lease payments receivable, excluding interest charges, and the cost of the asset	Lessor shall recognize a gain on the sale of the asset and deferred interest income. Taxable income from sale of asset consistent with PFRS.

Leases – sale and leaseback tax considerations

PFRS	Tax
Lessor Sale/leaseback transactions - If finance lease, any excess of selling price over the carrying amount shall be deferred and amortized over the lease term. If loss is compensated by future lease payments at below market price, it shall be deferred and amortized in proportion to the lease payments over lease term.	Gain/Income from the sale shall already be taxed in full at point of sale. Similar to ordinary sale. Loss shall be deductible, regardless of the impact of future lease payments.

PAS 32/39 examples - Liability vs. Equity instruments

Financial Liability -a contractual obligation to deliver cash or another financial asset to another entity or exchange financial asset or liability to another entity that are potentially unfavorable to the entity.

Tax: a legal obligation. Normally covered by PN, Notes, etc

Equity Instrument under PFRS - when it represents a residual interest in the net asset of the issuer

Tax: control or ownership.

Example continued

Example:

Company A issued on August 1, 2005 preferred shares with 10% dividend per year and are redeemable on July 30, 2010.

PFRS: The preferred shares will be treated and presented as liabilities because they represent contractual obligations of the company to deliver cash at a fixed maturity date. Dividend payments will be treated as interest expense in the statement of income.

Tax : The preferred shares are treated as equity. Payout is dividend.

Financial Liabilities vs. Equity Instruments - examples

Instrument	PFRS	Tax	Dividend vs. Interest
Common shares	Equity	Equity	Dividends
Redeemable preferred shares with fixed dividend each year subject to availability of distributable profits	Liability	Equity	Accounting: Interest Tax: Dividends
Convertible bond which an option to convert into fixed number of shares	Liability for bond and equity for option	Liability	Accounting: Interest and Dividend Tax: Interest
Convertible bond which converts into shares equal to the value of the liability	Liability	Liability until converted to shares	Interest Upon conversion, dividend

Compound Instruments

Classification

The issuer of a financial instrument that contains both a liability and an equity should classify the instrument's component parts separately.

Compound Instruments: Measurement

PFRS:

(1) the liability component is to be valued first;
and (2) the difference between the liability and the fair value of the entire instrument is assigned to the residual value of equity component.

Tax:

FI is either a liability or equity. Tax rules do not recognize hybrid instruments.

Discounting of financial assets - example

Case: Non-interest bearing notes receivable of P45,000 due in the three yearly installments of P15,000. Imputed interest rate is 10%.

Face amount of Notes	P45,000
Less: Present value of NR (P15000 x 2.4869)	37,304
Discount on Notes	P 7,696

Under PFRS, the discount will be amortized under the effective interest method for 3 years. For tax purposes, imputed interest income is not taxable (the transaction has been taxed at the date of the underlying sales transaction

Derivatives – tax aspects

PFRS	Tax
Derivatives are measured at fair values Gains or losses on re-measurement to fair values are included in profit and loss unless the derivatives designated as cash flow hedges or hedge of net investment in a foreign operation which is recognized as part of equity.	Income/losses from derivatives and hedging instruments shall be recognized only when the underlying transaction/commodity covered by the instrument has been settled. Fair value adjustments (ie mark to market losses) at balance sheet date on outstanding derivatives not a taxable income/deductible expense (ie unrealized)

Short-Term Benefits under PAS 19

Profit-sharing and Bonus Plans are recognized when

- Company has present legal or constructive obligation (explicit on the employment contracts or bonus pay been given as a matter of policy)
- Reliable estimate of the obligation can be made

Short term benefits – tax considerations

PFRS	Tax
Profit-sharing and Bonus Plans (due within 12 months after the end of the period in which the employee rendered the related benefits) A liability shall be recognized if the entity has a present legal or constructive obligation to make such payments as a result of past events, and a reliable estimate of the obligation can be made.	Deduction to be claimed in the year when bonus is paid or the expense incurred/obligation determine (although BIR may raise issue on withholding tax)

IAS 18 – Example
Percentage of completion

Issue	Background	Solution under PFRS
Progress payments and advances received from customers often do not reflect the work performed [IAS18R.24] [IAS11.30]. On what basis should management assess a project's percentage of completion?	Entity A entered into a contract with entity B to construct a power station. The cost of the station is estimated at 150,000 The total revenue from the contract is estimated at 200,000. Entity A will take 3 years to construct the power station. At the end of year 1 entity A incurred costs of 60,000. The customer was invoiced for 50,000 at the end of year 1. Payment of this progress billing is due, early in year 2, in accordance with the normal credit terms that A offers. Management estimated the stage of completion as 33%, based on the amount invoiced.	The percentage of completion should be determined from: the proportion of costs incurred to date; the percentage of physical work complete; or services performed to date. Amounts invoiced to customers do not necessarily influence the stage of completion. Based on the relationship between the costs incurred to date and total estimated costs, the contract is 40% (60,000/150,000) completed at the end of year 1. Revenue of 80,000 (40% of 200,000) should be recognised at the end of year 1. Issue – tax basis?

IAS 18 – Example of multiple deliverables

Company A sells airconditioning unit with free 1 year maintenance service. Total selling price is P10,000. Company A can sell the maintenance service separately for P1,000.

How does Company A book the revenue?

Selling price be allocated between the unit (P9,000) and the service (P1,000). The P9,000 is recognized at the date of delivery. The P1,000 is recognized for a period of 1 year as maintenance is rendered.

For tax purposes, the basis of VAT and income is P10,000, the cash price reflected in the invoice.

IAS 18 example - Bill and hold sales

Issue	Background	Solution
Revenue from bill and hold sales is recognized when the buyer takes title provided certain conditions are met. Revenue is not recognised when there is simply an intention to acquire or manufacture the goods in time for delivery [IAS18R Appendix 1] How should management recognise revenue from a bill and hold sale?	Entity W entered into a contract on 31 December 20x2 to supply video game consoles to customer A. The contract is for 100,000 game consoles at 50 each. The wholesaler has a stock of 120,000 consoles at 31 December 20X2. The contract contains specific instructions with regard to the timing and location of the delivery. Entity W must deliver the consoles to the customer in the following reporting period at a date to be specified by the customer.	The conditions for revenue recognition have been met (as below) and entity W can recognise 100,000 game consoles as sold. The criteria for recognition of revenue in a bill and hold sale are: a) That delivery has been delayed at the buyer's request; b) It is probable that delivery will made; c) The item is on hand, identified and ready for delivery and cannot be used to satisfy other orders; d) The buyer specifically acknowledges the deferred delivery instructions in writing; and the seller's usual payment terms apply.

Sale subject to installation and inspection

Issue	Background	Solution
Revenue is normally recognised when the buyer accepts delivery, and installation and inspection are complete [IAS 18 Appendix A Example 2 (a)]. At what point is it appropriate for entity C to recognize revenue in the following example?	Entity C manufactures and installs cable TV satellite dishes at customers' premises on behalf of cable TV operator B. Entity B placed an order with entity C to manufacture and install 100 dishes at its customers' premises on 1 August 20X2. Entity C has the dishes on stock and expects to install them by the 14 September 20X2. Payment is due 14 days after installation of the dishes. Entity C expects to complete most of the installations successfully in one visit.	Entity C should recognize revenue when the installation is complete. The installation is critical to customer acceptance and payment from entity B. The sale of goods is often made subject to satisfactory installation, and the installation is rarely perfunctory or incidental, as it is usually essential to the functionality of the delivered goods. When to recognize the sale for tax purposes? Basis of VAT?

Part 4

Question and answer

Thank you.

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