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Accounting and Financial Reporting Standards: NCRF 25 - Income Taxes

[1]João Santos, [2]Vera Ribeiro, [3]Adalmiro Pereira [4]Tânia Teixeira

[1,2] ISCAP-P Porto

[3,4]ISCAP-P Porto teacher, CEOS Member

ABSTRACT: NCRF 25 is an accounting standard that establishes rules and guidelines for the recognition, measurement, presentation and disclosure of financial instruments in an entity's financial statements. This rule in particular aroused the interest of the authors as they aim to better understand the regulations to which income is subject. Learning about the NCRF is essential to comply with legal and regulatory obligations related to accounting and financial reporting in Portugal, as it is important for entities to comply with current legislation.

KEYWORDS: NCRF 25; Deferred Taxes; accounting normalization; IAS.

1. INTRODUCTION

The standard covers a variety of financial instruments such as stocks and loans, and by gaining an understanding of them we are able to accurately analyze an entity's financial situation. Knowledge of this information facilitates the assessment of the company's performance, which allows informed decisions to be made.

2. ACCOUNTING AND FINANCIAL REPORTING STANDARD 25

Income Taxes

This Standard shall be applied in accounting for income taxes and considers all income taxes all domestic and foreign taxes that are based on taxable profits, as well as other taxes such as withholding taxes (of dividends), which are payable by a subsidiary, associate or joint venture in distributions to the reporting entity.
NCRF 25 considers two fundamental aspects:

The future recovery (settlement) of the carrying amount of assets or liabilities to be recognized in an entity's balance sheet and the transactions and other events of the current period that are recognized in an entity's financial statements. An entity shall recognize a deferred tax liability or a deferred tax asset in the same way that it accounts for its own transactions and other events.

Any tax impact arising from transactions or events that affect the company's results must be recognized in the income statement. Likewise, this applies to the company's capital, any tax impact must be shown on the balance sheet. In addition, the recognition of deferred tax assets and liabilities in a business combination affects the amount of goodwill resulting from that business combination or the recognized amount of the gain on the low price purchase.

For example, when a company acquires another, deferred taxes may affect the value of goodwill resulting from that acquisition, meaning the difference between the company's acquisition value and its book value when the latter is lower. If the opposite happens, the acquisition value is lower than the book value of the acquired company, the deferred tax assets and liabilities may affect the value gained in the transaction.

This standard also deals with the recognition of deferred tax assets arising from unused tax losses, or unused tax credits, and the presentation of income taxes in the financial statements.
To understand the standard there are several concepts to take into account
“5 - The following terms are used in this Standard with the meanings specified:

Deferred tax assets: are the amounts of income taxes recoverable in future periods in respect of:

a) Deductible temporary differences;
b) Reporting unused tax losses; It is
c) Report of unused tax credits.

Tax base of an asset or a liability: is the amount assigned to that asset or liability for tax purposes.
Temporary differences: are differences between the carrying amount of an asset or liability on the balance sheet and its tax base. Temporary differences can be:

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1. **Taxable temporary differences**, which are temporary differences that result in taxable amounts in determining taxable profit (tax loss) for future periods when the carrying amount of the asset or liability is recovered or settled; or
2. **Deductible temporary differences**, which are temporary differences that result in amounts that are deductible in determining taxable profit (tax loss) for future periods when the carrying amount of the asset or liability is recovered or settled.

Tax expenditure (tax income):is the aggregate amount included in determining net profit or loss for the period with respect to current taxes and deferred taxes.

current tax: is the amount payable (recoverable) of income taxes in respect of taxable profit (loss) for a period.

Accounting profit: is the result of a period before deducting the tax expense.

Taxable profit (tax loss):is the profit (or loss) for a period, determined in accordance with the rules established by the tax authorities, on which income taxes are payable (or recoverable).

Deferred tax liabilities: are the amounts of income taxes payable in future periods in respect of taxable temporary differences.

Tax expense/income comprises current tax expense/income and deferred tax expense/income.
This standard allows that when the tax base of an asset or a liability is not evident, an entity must, with certain exceptions, recognize a liability/asset for deferred taxes when the recovery or settlement of the carrying amount of an asset or a liability causes future tax payments to be higher/lower than they would be if such recoveries or settlements had no taxable consequences.

In summary, a deferred tax asset is the amount of tax on future recoverable income. This occurs when the tax benefits the company and a deferred tax liability concerns the increase in the amount of income tax payable in the future.

Measurement is carried out at amounts expected to be paid or recovered from tax authorities using rates approved at the balance sheet date. This applies to current taxes or deferred taxes. In the case of deferred tax liabilities or assets, they must reflect the tax consequences resulting from the way in which the entity foresees; at the balance sheet date, recover or settle the carrying amount of its assets or liabilities.

In certain cases, the entity must use the new tax base, consistent with the recovery defined by amounts that differ positively or negatively from the carrying amount.

These deferred tax assets and liabilities should not be discounted because reliably determining deferred tax assets and liabilities on a discounted basis is either impractical or highly complex. Therefore, discounting of deferred assets and liabilities is not required. Allowing but not requiring the discount would result in deferred tax assets and liabilities that would not be comparable across entities.

In the case of consolidated financial statements, temporary differences are determined by comparing the carrying amounts of assets and liabilities with the appropriate tax base. The tax base is determined by reference to a consolidated tax return in jurisdictions where such a statement is filed, or, in other cases, the tax base is determined by reference to the tax returns of each entity in the group.

Accounting for the current and deferred tax effects of a transaction or other event is consistent with accounting for the transaction or event itself. Paragraphs 52 to 64 implement this principle:
“Demonstration of results
52 - Current and deferred taxes must be recognized as income or as an expense and included in net income for the period, except to the extent that the tax arises from:
a) A transaction or event that is recognized, in the same or a different period, directly in equity (see paragraphs 55 to 59); or
b) A concentration of business activities (see paragraphs 61 to 64).
53 Most deferred tax liabilities and deferred tax assets arise when income or expenses are included in accounting profit in one period, although they are included in taxable profit (tax loss) in a different period. The resulting deferred tax is recognized in the income statement.

54 The carrying amount of deferred tax assets and liabilities may change even if there is no change in the amount of the related temporary differences. This can result, for example, from:

a) A change in tax rates or tax laws;
b) A reassessment of the recoverability of deferred tax assets; or
c) A change in the expected manner of recovering an asset.

The resulting deferred tax is recognized in the income statement, except to the extent that it relates to items previously charged or credited to equity (see paragraph 57). Items credited or debited directly to equity

55 Current tax, or deferred tax, must be charged or credited directly to equity if the tax relates to items that are credited or charged, in the same or a different period, directly to equity.

56 Accounting and Financial Reporting Standards require or permit certain items to be credited or debited directly to equity. Examples of such items are:
a) A change in the carrying amount arising from the revaluation of property, plant and equipment (see NCRF 7);
b) An adjustment to the opening balance of retained earnings resulting from a change in accounting policy applied retrospectively or from the correction of an error (see NCRF 4 - Accounting Policies, Changes in Accounting Estimates and Errors); or
c) Exchange differences resulting from translating the financial statements of a foreign operation (see NCRF 23);

57 - In exceptional circumstances it may be difficult to determine the amount of current and deferred taxes that relate to items credited or charged to equity. This may be the case, for example, when:
a) A change in the tax rate or other tax rules that affects a deferred tax asset or liability relating (in whole or in part) to an item that was previously charged or credited to equity; or
b) An entity determines that a deferred tax asset should be recognized, or not recognized in full, and the deferred tax asset relates (in whole or in part) to an item that was previously charged or credited to equity.

In such cases, the current and deferred tax relating to items that are credited or charged to equity is based on a reasonable pro rata allocation of the entity's current and deferred tax, or other method that achieves a more appropriate allocation in the circumstances.

58 - NCRF 7 specifies that an entity must annually transfer the revaluation surplus (reserve) to retained earnings for an amount equal to the difference between the depreciation or amortization of a revalued asset and the depreciation or amortization based on the cost of that asset. The amount transferred must be net of any related deferred taxes. Similar considerations apply to transfers made on the disposition of an item of property, plant and equipment.

59 - When an asset is revalued for tax purposes and that revaluation relates to an accounting revaluation of a prior period, or one that is expected to be carried out in a future period, the tax effects of the revaluation of the asset and the adjustment of the tax base are credited or debited to equity in the periods in which they occur.

60 - When an entity pays dividends to its shareholders, it may be required to pay a portion of the dividends to the tax authorities on behalf of the shareholders (withholding tax). Such amount paid, or payable, to the tax authorities is charged to equity as part of dividends.

Deferred taxes arising from a business combination

61 - As explained in paragraph 19, temporary differences may arise in a business combination. In accordance with NCRF 14 - Business Combinations, an entity recognizes any resulting deferred tax assets (to the extent that they satisfy the recognition criteria in paragraph 25) or deferred tax liabilities, as identifiable assets and liabilities at the date of acquisition. Consequently, those deferred tax assets and liabilities affect the goodwill or bargain-price gain that the entity recognises. However, in accordance with paragraph 15(a), an entity does not recognize deferred tax liabilities arising from the initial recognition of goodwill.

62 - As a result of a business combination, the likelihood of realizing a pre-acquisition deferred tax asset from the acquirer could change. An acquirer may consider it probable that it will recover its own deferred tax asset that was not recognized prior to the business combination. For example, the acquirer may be able to use the benefit of its unused tax losses against the acquiree's future taxable income. Alternatively, as a result of the business combination, it may no longer be probable that future taxable profit will allow the deferred tax asset to be recovered. In such cases, the acquirer recognizes a change in the deferred tax asset in the period of the business combination, but does not include it as part of accounting for business combinations. Therefore, the acquirer does not take it into account when measuring the goodwill or gain on the bargain purchase that it recognizes in the business combination.

63 - The potential benefit of carrying forward the acquiree's tax losses or other deferred tax assets may not satisfy the NCRF 14 criteria for separate recognition when a business combination is initially accounted for, but may

be subsequently realized. An entity shall recognize vested deferred tax benefits that it realizes upon a business combination as follows:

a) Acquired deferred tax benefits that are recognized at the completion of initial accounting in the measurement period and that result from new information about facts and circumstances that existed at the acquisition date shall be applied to reduce the carrying amount of any goodwill relating to that acquisition. . If the carrying amount of that goodwill is zero, any remaining deferred tax benefits shall be recognized in profit or loss;

b) All other accrued deferred tax benefits that are realized shall be recognized in profit or loss (or, where this Standard requires, directly in equity).

64 - However, this procedure should not result in the creation of an excess of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities above the cost of the combination, nor should it increase the amount previously recognized for such an excess."

A company must offset current and deferred tax assets/liabilities if it intends to settle or realize those assets/liabilities. The standard requires that this be included in the income statement. This also applies to deferred foreign taxes these can be classified as deferred tax expense/income in the income statement.

3. UNDERLYING PROBLEM

The problem underlying this standard is based on the difficulty in measuring certain assets and liabilities. To determine the fair value of certain assets, an estimate may be necessary, whereas carrying amounts are predetermined. Thus, it becomes difficult to standardize the measurement of financial statements from company to company.
This difference between the tax base and the book value can lead to underestimations or the opposite.
Another issue has to do with the fact that this whole rule requires the practice of a certain futurism. Deferred taxes are somewhat a speculative and fallible consideration.

4. ACCOUNTING APPLICATION

Let's assume that a company, the company CFA25, acquired a property for €150,000 and that the fair value of that property amounted to €250,000, assuming a nominal rate of IRC and Municipal Surcharge of 27%. In view of this valuation of an asset, the following should be considered for accounting purposes:

421 – Investment Properties – Buildings and Other Constructions
D – €100,000

773 – Gains from increase in fair value – Buildings and Other constructions
C – €100,000

8122 - Deferred Tax
D – 27000€

2742 - Deferred tax liability
C - 27000

5. CONCLUSION

Studying NCRF 25 is important, as it provides specific guidance on accounting for financial instruments, which contributes to the transparency and comparability of financial statements. Learning about the referenced standard also gives you a greater understanding of international standards, which can be beneficial for companies operating in different jurisdictions that need to comply with international standards.

In short, it is important to be aware of this standard in order to ensure compliance and compliance with ethical and professional requirements.

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