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A86045 Accounting and Financial Reporting (2017/2018)

Session 7

Taxation: Direct & Indirect

Paul G. Smith B.A., F.C.A.

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SESSION 17 OVERVIEW AND OBJECTIVES

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Course Overview

	1. Financial reporting under IFRS	14. Construction contracts	
	2. Financial analysis: Ratio analysis	15. Other Non-financial liabilities	
	3. Financial analysis: Segments and EPS	16. Review session	
	4. Review session	17. Mid term test	PGS
	5. Revenues	18. Financial Instruments 1	
PGS	6. Costs and expenses	19. Financial Instruments 2	
	7. Taxation - Direct and Indirect	20. Review session	
	8. Non-current assets - Intangible assets	21. Cash Flow Statement	
	9. Non-current assets - Tangible assets	22. Group accounts/Business comb	PT
	10. Financial leases	23. Review session	
	11. Impairment of assets	24. Review session	
	12. Review session	25. Final test	PGS
PT	13. Inventories		

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Objectives of Session 17

At the end of this session students will:

*a) understand the difference between **direct** and **indirect** taxation and how to account for these taxes under IFRS 12*
*b) be able to perform a simple current **income tax** and **deferred tax** computation, and*
*c) Will be able to complete a simple **reconciliation of tax charge**.*

Overview of Session 7

Types of taxation

- Direct
- Indirect
- Witholding taxes

Value added taxes

Current income taxes

- Taxable income/expense
- Non-taxable income expenses

Deferred income taxes

- Temporary differences
- Permanent differences

Reconciliation of tax charge – Effective tax rate

Uncertain tax positions

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Session 7 Overview

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Value added tax	15
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Session 7 Pre-work

- Reading
  - Melville International Financial Reporting – A Practical Guide :
    - Chapter 14 – Employee benefits
  - IASB Statements
    - IAS 19 Employee benefits
    - IFRS 2 Share-based payments
- Exercises
  - Melville 14.1 – 14.6
  - Melville on-line multiple choice questions for chapter 14
  - Ex 6 Costs and expenses - Exercises
- Research assignment
  - RA 5 Income taxes accounting policies and effective tax rates

RA 5 Income taxes

Company__________

Accounting Policy for income taxes

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RA 5 Income taxes

Company__________

Effective tax rate

Reasons why this is different from the statutory tax rate

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SESSION 6 RECAP AND PRE-WORK SESSION 7

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Session 6 Summary

- Classification of costs/expenses by nature or by destination
- Cost of goods sold
- Other costs/expenses – accruals/deferrals
- Employee expenses
  - Short-term benefits – Wages and salaries
  - Post employment benefits - Pensions
  - Share-based payments - Stock options

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TYPES OF TAXATION

Taxation

"'In this world nothing can be said to be certain, except death and taxes."

Benjamin Franklin (1706-90), in a letter to Jean-Baptiste Leroy, 1789, which was re-printed in The Works of Benjamin Franklin, 1817

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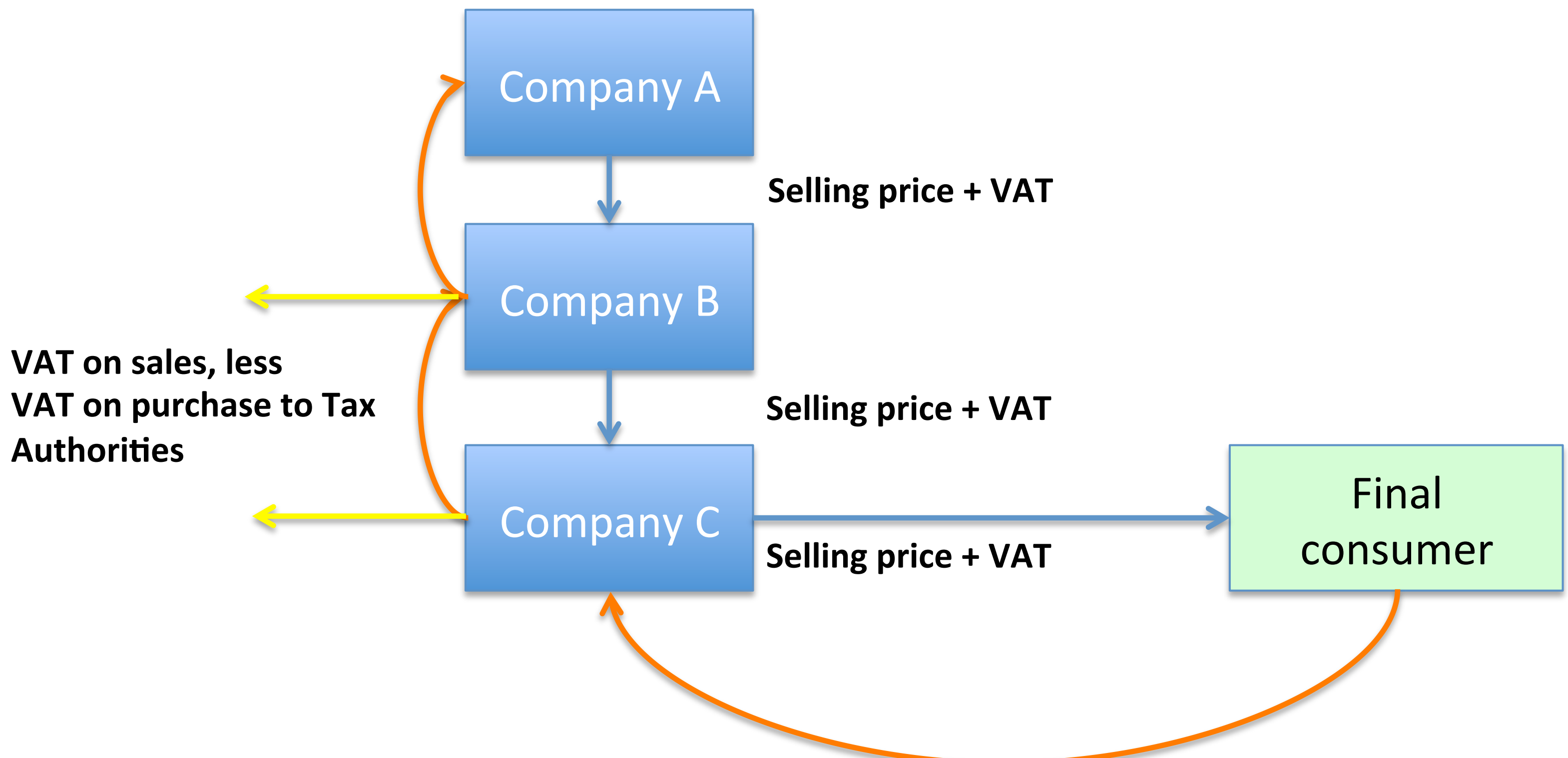
Types of Taxation

Direct	Corporate Income taxes, withholding taxes, capital gains taxes	Taxes on Profits (Can also be imputed)
Indirect	Sales taxes, value added taxes	Company acts as a collection agent for the tax authorities
Other	Stamp duty, registration taxes	Taxes on specific transactions e.g. purchase of a company, land etc.

VALUE ADDED TAX

Value-added tax (VAT)



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Accounting for VAT

1. Record sale of €100 plus 20% VAT
2. Record purchase of €50 plus 20% VAT
3. Record payment to VAT authoritiesn of net amount due

Sales

		100	1

Purchases

2	50		

Accounts receivable

1	120		

Accounts payable

		60	2

VAT Payable

2	10	20	1
3	10		

Cash

		10	3

Sales Invoice

Goods	€100
VAT @20%	€20
Total due	€120

Purchase Invoice

Goods	€50
VAT @20%	€10
Total due	€60

VAT Return

Output tax	20
Input tax	(10)
Balance due	10

VAT – Some common issues

VAT is never reported as part of Sales or Purchases

Export sales

- VAT exempt
- Documentation
- VAT credits
- VAT warehouses
- Habitual exporter status

Imports

Tax point

- Goods – generally the date of delivery
- Services – generally the date of invoicing

VAT rates – These differ by country and by type of goods or services

Financial impact of overdue accounts receivable

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VAT Rates Italy

Rate	Applicable to (examples)
4%	Milk, vegetables, fruit, newspapers, houses, etc.
10%	Meat, eggs, plants, grapes, rice, sugar, chocolate, vinegar, electricity, metano,
22%	Furs, spumante, motorcycles, carpets, most goods and services

CURRENT INCOME TAXES

Current Tax

IAS12 defines current tax as "*the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period.*"

The term "income taxes" refers to any tax which is payable on an entity's profits, regardless of the name given to that tax in the country concerned.

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Income taxes

- Income taxes are levied by governments on income earned by individuals/enterprises.
- The percentage payable and the determination of taxable income are governed by national income tax legislation.
- Tax payable is normally determined annually with the filing of a Tax Declaration.
- IAS 12 (Income Taxes) is the accounting standard that applies in accounting for income taxes, including all domestic and foreign taxes based on taxable profits.
- It also applies to withholding taxes that are payable by a subsidiary, associate or joint-venture on distributions to a reporting enterprise.
- Taxable profit is usually different from accounting profit.

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Accounting Income & Taxable Income

- Accounting profit is defined by IAS 12 as:

"**profit or loss for a period before deducting tax expenses**", where:
accounting profit = revenues – expenses
revenues and expenses are recognised according to accounting standards.

- Taxable profit (or loss) is defined in the same standard as:

"**profit or loss for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable)**", where:

taxable profit = taxable income – deductions allowable for tax against that income.

Current income taxes

Accounting income (loss)	XXX,XXX
+ Amounts to be added back	XXX
- Amounts to be deducted	(XXX)
Taxable income (loss)	XXX,XXX
X Tax rate %	XX%
Income taxes due	XX,XXX

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

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Common add backs/ Deductions

Add backs

- Provisions e.g. warranty, inventory obsolescence, contingencies, etc.
- Non deductible expenses e.g. fines, penalties, entertaining
- Government grants
- Depreciation and amortization greater than allowed for tax purposes
- Accrued financial income/ expense

Deductions

- Actual warranty expenses incurred
- Actual interest income/ expense
- Accelerated tax depreciation
- Bad debt write-offs
- Tax loss carry-forwards

Comparative tax rates

Country	Corp Tax%	Withholding Taxes %			Loss CFwds	Loss CBacks
		Dividends	Interest	Royalties		
Italy	27.9	0/1,2/26	0/12,5/26	0/22,5/30	U/L	-
UK	20	-	20	20	U/L	1yr
USA	15-39	30	30	30	20yrs	2yrs
Brazil	15	-	15	15	U/L	-
Switzerland	12-24	35	0/35	-	7	-
Libya	20 65 (O&G)	-	-		5	-
Japan	23,4	20	15/20	20	9	1
Sweden	22	30	-	-	U/L	-

Source: EY 2017 Worldwide Corporate Tax Guide

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Tax payments - Italy

	Year 20X0	Year 20X1		Year 20X2	
	Tax due €50,000	Tax due €100,000		Tax due €100,000	
		June 16	Nov 30	June 16	Nov 30
Balance Year 20XO		500			
40% of 99% of Prior Year		19,800			
60% of 99% of Prior Year			29,700		
Balance Year 20X1				50,500	
40% of 99% of Prior Year				39,600	
60% of 99% of Prior Year					59,600

100,000

Income tax accounting - Italy

Income Tax Expense

	Debit	Credit	
Year end	100.000		

Cash

	Debit	Credit	
		19.800	June
		29.700	November
		49.500	

Income Tax Payable

	Debit	Credit	
June	19.800	100.000	
November	29.700		
CFwd	50.500		Year end
	100.000	100.000	
BFwd		50.500	

Accounting for income taxes

- If only current tax payable is recorded as an expense, then the profit or loss for the current year will be understated or overstated by the amount of tax or to be paid or received in future years as a result of different treatment for tax. And vice versa in the future years.

- To ensure that the tax effect (expense or benefit) of a transaction is recorded in the appropriate period, IAS 12 requires income tax expense to reflect all tax effects of transactions entered during the years regardless of when the effects occur.

- Therefore two calculations are required at balance date:
  – the calculation of **current tax liability**, which determines the amount of tax payable for the period;
  –the calculation of movements in **deferred tax effects** relating to assets and liabilities recognised in the statement of financial position, which determines the net effect of deferred taxes and deductions from transactions during the year.

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DEFERRED INCOME TAXES

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Deferred income taxes

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

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

a) *deductible temporary differences*;
b) The carryforward of unused tax losses; and
c) The carryforward of unused tax credits.

Temporary differences

Temporary differences are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base.

Temporary differences maybe either:

a) Taxable temporary differences, which are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled; or

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

The tax base of an asset or liability is the amount attributed to that asset or liability for tax purposes.

Temporary and permanent differences between accounting profit and taxable profit

- **Temporary differences** arise when the period in which revenues and expenses are recognised for accounting purposes is different from the period in which they are treated as taxable income and allowable deductions for tax purposes.
- Differences that result in an entity paying more tax in the future are known as *taxable temporary differences*.
- Differences that result in the entity recovering tax via additional deductible expenses in the future are known *as deductible temporary differences*.

- **Permanent differences** arise when the treatment of a transaction by taxation legislation and accounting standards is such that amounts recognised by accounting standards are not recognised by taxation legislation or vice versa. E.g. income exempted from taxation altogether or expenditure incurred by an entity that will never be an allowable deduction.

  No accounting requirements other than disclosure exist for these permanent differences.

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Deferred tax

Some of the income or expenses in an entity's financial statements for an accounting period may be recognized for tax purposes in a different period. IAS12 requires that such "temporary differences" are dealt with as follows:

(a) In a period in which temporary differences cause taxable profits to be lower than accounting profits, the tax expense for the period is increased by recording a deferred tax liability.

(b) In a period in which temporary differences cause taxable profits to be higher than accounting profits, the tax expense for the period is reduced by recording a deferred tax asset.

The balance on the deferred tax account should be shown as a non-current liability (or asset) in the entity's financial statements.

The Tax Base Concept

IAS12 requires that the "tax base" of each asset and liability at the end of the accounting period should be compared with its "carrying amount" (i.e. the amount at which it is "carried" or shown in the financial statements).

The tax base of an asset or liability is defined as "*the amount attributed to that asset or liability for tax purposes*".

If the tax base of an asset or liability is not the same as its carrying amount, this is evidence of a temporary difference and a deferred tax adjustment is required.

Tax base of an asset

IAS12 defines the tax base of an asset as "*the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset* ".

If the economic benefits derived from an asset are not taxable, the tax base of the asset is equal to its carrying amount.

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Tax base of a liability

IAS12 defines the tax base of a liability as "*its carrying amount, less any amount that will be deductible for tax purposes in respect of that liability in future periods*".

The settlement of a liability has no effect on accounting profit and usually has no effect on taxable profit either, so liabilities tend not to cause deferred tax problems.

Carrying amount Vs. Tax base

Assets

- Deferred revenues/income
- Retirement benefit provisions
- Depreciation in excess of tax depreciation
- Inventory provisions
- Bad debt provisions
- Maintenance expense not deductible till later
- Warranty provisions
- Unrealized intercompany profits

Liabilities

- Accrued interest income
- Revenue taxed on a cash basis
- Accelerated tax depreciation
- Capitalized development costs
- Loan amortization costs
- Revaluation of assets
- Fair value adjustments in a business combination
- Retained earnings of subsidiaries and associates

Example 1

	Year 1		Year 2		Year 3		Year 4		Total	
	Book	Tax	Book	Tax	Book	Tax	Book	Tax	Book	Tax
Book to Tax Differences										
Deferred revenue (Advance payment)		100	100						100	100
Bad debts (Write-off Year 4)	(50)							(50)	(50)	(50)
Depreciation (4 Year Book/3 Year Tax)	(25)	(33)	(25)	(33)	(25)	(34)	(25)		(100)	(100)
Net Differences	(75)	67	75	(33)	(25)	(34)	(25)	(50)	(50)	(50)

Example 2 – No deferred tax accounting

Tax return		**Year 1**		**Year 2**		**Year 3**		**Year 4**		**Total**
Accounting Income		100		100		100		100		400
Tax differences		67		(33)		(34)		(50)		(50)
Taxable income		167		67		66		50		350
Tax rate		40%		40%		40%		40%		40%
Current tax expense		67		27		26		20		140
Financial statements										
Accounting Income	100		100		100		100		400	
Book adjustments	(75)		75		(25)		(25)		(50)	
Pre-tax income	25		175		75		75		350	
Current tax expense	(67)		(27)		(26)		(20)		(140)	
Net income (loss)	(42)		148		49		55		210	
Effective tax rate	**-268%**		**15%**		**35%**		**27%**		**40%**	

Example 3 – With deferred tax accounting

	Year 1		Year 2		Year 3		Year 4		
Deferred Tax	Gross	Tax effect	Gross	Tax effect	Gross	Tax effect	Gross	Tax effect	
Deferred revenue	100	40							
Bad debts	50	20	50	20	50	20			
Depreciation	(8)	(3)	(16)	(6)	(25)	(10)			
Closing balance	142	57	34	14	25	10	0	0	
Beginning balance		0		57		14		10	
Change in Deferred tax		57		(43)		(4)		(10)	
Income tax expense									
Current tax expense	(67)		(27)		(26)		(20)		(140)
Deferred tax	57		(43)		(4)		(10)		0
Income tax expense	(10)		(70)		(30)		(30)		(140)
Financial statements									
Pre-tax book income	100		100		100		100		400
Book Impact	(75)		75		(25)		(25)		(50)
	25		175		75		75		350
Income tax expense	(10)		(70)		(30)		(30)		(140)
Net income	15		105		45		45		210
Effective tax rate	**-40%**		**-40%**		**-40%**		**-40%**		**-40%**

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Example 4 – Deferred tax accounting method

		Values				Deferred Tax (Asset) Liability	Deferred Tax Income (Expense)
		Book	Tax	Difference	Tax rate		
Year 1	Deferred Revenue	(100)	0	(100)			
	Bad debt reserve	(50)	0	(50)			
	Accumulated depreciation	(25)	(33)	8			
		(175)	(33)	(142)	40%	(57)	57
Year 2	Deferred Revenue	0	0	0			
	Bad debt reserve	(50)	0	(50)			
	Accumulated depreciation	(50)	(66)	16			
		(100)	(66)	(34)	40%	(14)	(43)
Year 3	Deferred Revenue	0	0	0			
	Bad debt reserve	(50)	0	(50)			
	Accumulated depreciation	(75)	(100)	25			
		(125)	(100)	(25)	40%	(10)	(4)
Year 4	Deferred Revenue	0	0	0			
	Bad debt reserve	0	0	0			
	Accumulated depreciation	0	0	0			
		0	0	0	40%	0	(10)

Income taxes - Accounting

IAS 12 requires an entity to account for the tax consequences of transactions and other events in the same way that it accounts for the transaction and other events themselves.

Thus, for transactions and other events recognized in profit and loss, any related tax effects are also recognized in profit or loss.

For transactions and other events recognized outside profit or loss (either in OCI or in equity) any related tax effects are also recognized outside profit and loss.

IAS12 Requirements (Deferred Tax)

- A deferred tax liability must be recognised for all taxable temporary differences.
- A deferred tax asset must be recognised for a deductible temporary difference if it is probable that this temporary difference will be utilised in the future.
- The carrying amount of deferred tax assets must be reviewed at the end of each accounting period.
- Deferred tax assets and liabilities must be measured at the tax rates that are expected to apply to the period in which the asset is realised or the liability is settled.
- Deferred tax assets and liabilities must not be discounted.
- Transfers to or from the deferred tax account should usually be recognised in the calculation of profit or loss.

IAS12 Disclosure Requirements

The tax expense in the statement of comprehensive income must be analysed into:

- the current tax expense (or income) for the period
- any adjustments relating to previous periods
- transfers to or from the deferred tax account
- amounts of tax recognised in other comprehensive income.

The following must also be disclosed separately:

- an explanation of the relationship between the accounting profit for the period and the tax expense for the period
- for each type of temporary difference, the amount of the deferred tax asset or liability recognised in the statement of financial position and the amount of the deferred tax expense or income recognised in the statement of comprehensive income.

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Valuation Allowances

An entity recognizes deferred tax assets only when it is probable that taxable profits will be available against which the deductible temporary differences can be utilized.

It is probable that taxable profit will be available against which a deductible temporary difference can be utilized when there are **sufficient taxable temporary differences** relating to the same taxation authority and the same taxable entity which are expected to reverse:

a) In the same period as the expected reversal of the deductible temporary difference; or
b) In periods into which a tax loss arising from the deferred tax asset can be carried back or forward

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Valuation allowances – cont'd

When there are **insufficient taxable temporary differences** relating to the same taxation authority and the same taxable entity, the deferred tax assets is recognized to the extent that:

a) It is probable that the entity will have sufficient taxable profit relating to the same taxation authority and the same taxable entity in the same period as the reversal of the deductible temporary differences (or in the periods into which a tax loss arising from the deferred tax asset can be carried back or forward)
b) Tax planning opportunities are available to the entity that will create taxable profit in appropriate periods.

Unused tax losses

A deferred tax asset shall be recognized for the carryforward of unused tax losses and unused tax credits only to the extent that it is **probable** that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilized.

The existence of unused tax losses is strong evidence that future taxable profit may not be available. Therefore, when an entity has a history of recent losses, the entity recognizes a deferred tax assets only to the extent that the entity has **sufficient taxable temporary differences** or there is **convincing other evidence** that sufficient taxable profit will be available against which the unused tax losses or tax credits can be offset.

Model for computing deferred taxes

1. Identify (a) the types and amounts of all temporary differences and (b) the nature and amounts of all operating loss and tax credit carry forwards, including the remaining carry forward period.
2. Measure the total deferred tax liability for taxable temporary differences using the applicable rate.
3. Measure the total deferred tax asset for deductible temporary differences and tax operating loss carry-forwards using the applicable tax rate.
4. Measure deferred tax assets for each type of tax credit carry-forward.
5. Reduce deferred tax assets by a valuation allowance, if it is more-likely-than-not (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets will not be realized. The valuation allowance should be sufficient to reduce the deferred tax asset to the amount that is more-likely-than-not to be realized.

Finance Lease

RECONCILIATION OF TAX CHARGE

Reconciliation of tax charge

An explanation of the relationship between tax expense (income) and accounting profit in either or both of the following forms:

i. A numerical reconciliation between tax expense (income) and the product of accounting profit multiplied by the applicable tax rate(s), disclosing also the basis on which the applicable tax rate(s) is (are) computed; or

ii. A numerical reconciliation between the average effective tax rate, disclosing also the basis on which the applicable tax rate is computed.

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Example

In 19X2, an entity has accounting profit in its own jurisdiction (Country A) of 1,500 (19X1: 2,000) and in Country B of 1,500 (19X1: 500). The tax rate is 30% in Country A and 20% in Country B. In Country A, expenses of 100 (19X1: 200) are not deductible for tax purposes.

	19X1	19X2
Accounting profit	2,500	3,000
Tax at the domestic rate of 30%	750	900
Tax effect of expenses that are not deductible for tax purposes	60	30
Effect of lower tax rates in Country B	(50)	(150)
Tax expense	760	780
Effective tax rate	30.4%	26.0%

UNCERTAIN TAX POSITIONS

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Uncertain Tax Positions

IFRS
An entity discloses any tax-related contingent liabilities and contingent assets in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

US GAAP
The provision in ASC 740 for the accounting for uncertainty in income taxes utilizes a two-step approach for evaluating tax positions. Recognition (Step 1) occurs when an entity concludes that a tax position, based solely on its technical merits, is more likely than not to be sustained upon examination. Measurement (Step 2) is only addressed if Step 1 has been satisfied (i.e., the position is more likely than not to be sustained). Under Step 2, the tax benefit is measured as the largest amount of benefit, determined on a cumulative probability basis, that is more likely than not to be realized upon ultimate settlement.

IFRIC 23 Uncertainty over income tax treatments. November 2017. Effective 1.1.2019

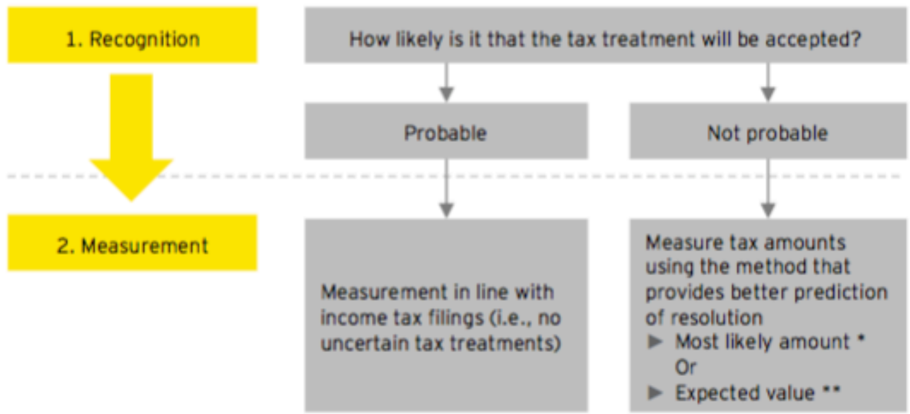
Tax avoidance vs. tax evasion

Uncertain tax positions

- Multinational companies at greatest risk
  - Management fees
  - Transfer prices
  - Interest on intercompany loans
  - Royalties
  - Thin capitalization
  - EU challenge of advance rulings and country deals
  - Assets lives

IFRIC 23

The following diagram summarises the approach taken in IFRIC 23 to assess how uncertain tax treatments are measured:



* Better predicts resolution of uncertainty if the possible outcomes are binary or are concentrated on one value.

** Better predicts resolution of uncertainty if there is a range of possible outcomes that are neither binary nor concentrated on one value.

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OVERVIEW, REQUIRED READING AND ASSIGNMENT FOR NEXT SESSION

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Research Assignment RA 6 Intangibles

Nature of Intangible assets

Accounting Policy (ies) for these

N.B. Ignore Impairment

Session 8 Pre-work

- Reading
  - Melville International Financial Reporting – A Practical Guide :
    - Chapter 15 – Taxation in Financial Statements
  - IASB Statements
    - IAS 12 Income Taxes
- Exercises
  - Melville 15.1 – 15.7
  - Melville on-line multiple choice questions for chapter 15
  - Ex 7 Income Taxes - Exercises
- Research assignment
  - RA 6 Intangible assets - accounting policies for, and nature of intangibles

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Session 8 Intangibles Overview

- Intangibles definition/examples
- Criteria for recognition and measurement
- Finite vs. Indefinite and useful life considerations
- Different Types
  - Acquired
  - Goodwill and business combinations
  - Internally generated
  - Government grant, exchanges (Fair Value)
- Industry comparison

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SUMMARY AND VALIDATION

Summary Session 7

Types of taxation

Value added taxes

Current income taxes

Deferred income taxes

Reconciliation of tax charge

Uncertain tax positions

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Session 7 Validation

- What are the three main types of taxation?
- How does a company account for VAT
- How are imports and exports treated for VAT?
- What is the basic equation for calculating current income tax?
- What are deferred income taxes?
- What is a valuation allowance and when is it needed?
- What types of things do we find in the reconciliation of tax charge?