IFRS STANDARDS AND TAXATION: CHALLENGES AND OPPORTUNITIES FOR TAX ADMINISTRATIONS

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SYNOPSIS

Through the adoption of the International Financial Reporting Standards (IFRS®), the measurement of various accounting elements has changed significantly, affecting the taxes based on financial statements. This make indispensable the adjustment of tax regulations to provide tax certainty. This document reflects the author's experience working as an IFRS consultant for tax administrations in tax reforms, implementation and training on IFRS for companies, and as a member of the SMEIG (an advisory group of the International Accounting Standards Board –IASB®). In a friendly format, a clear language and with several illustrative examples, this work provides a framework for the tax administrations to address successfully the challenges and opportunities of this paradigm shift.

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"The future has many names. For the weak is the unreachable. For the fearful, the unknown. For the **brave is the opportunity.*"***

Victor Hugo (1802 - 1885), French poet and novelist.

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INTRODUCTION

For more than 30 years, the financial statements of most companies in Latin America were prepared using the tax rules of each country, and not necessarily financial principles. This distortion has unfortunately created a “hybrid" that is neither properly “financial information”, nor is it properly "tax information", confusing the real objective of the financial statements: to reflect a true image of the transactions for the adequate economic decision making.

With the application of International Financial Reporting Standards (IFRS standards) in Latin America, a greater emphasis is being given to the financial principles for the preparation of financial statements, and consequently, a trend has taken place to *"emancipate"* financial accounting from tax information (i.e. stop applying the tax rules for the preparation of the financial statements).

In his professional practice, through consultancies and trainings to various companies in their processes of implementation of IFRS standards during the last years, the author has noted that business leaders and investors, in the first instance, recognize the benefits of these international standards that aim to reflect the economic reality of the company for a better decision making. However, it has been verified that the uncertainty about tax treatments for new types of income and expenses, among others, implied by the implementation of IFRS is a great constraint, by which many companies do not achieve a full application of these standards. This happen when a country's tax regulations are not yet properly reformed to consider all these accounting changes – specially, as is the case of corporate income tax, which takes as a starting point the profit or loss reported in the financial statements.

Therefore, if the preparation and presentation of such financial statements evolves (by the application of IFRS standards), it is imperative that a country's tax regulations also evolve to consider all new cases and provide tax certainty to companies and investors, of course, always safeguarding the fundamental principles of taxation, such as: tax capacity, legality, and neutrality.

In this way, the companies will be able to apply without reserve the IFRS standards, appreciating then their economic reality for a better decision making and obtaining greater access to loans and credits through high quality financial information. In parallel, companies will also be able to comply properly with the country's tax regulations (since if reformed or updated, they would provide the appropriate clarifications in the tax treatment of the new types of accounting records). With these considerations, the tax administrations, investors and entrepreneurs will have more certainty about the tax effects of the application of the IFRS standards, promoting local and foreign investment, and improving also the tax competitiveness of countries in the Latin American region.

We will move on to address specifically what IFRS standards and their objectives are, in order to differentiate it with the objectives of the tax systems and their regulations. To achieve it, first we will develop each separately (financial and tax aspects), and then contrast them and analyze their differences, with the objective of providing a framework or reference to the tax administrations in their analysis processes of tax effects product of the IFRS standards application in the preparation of taxpayers’ financial statements.

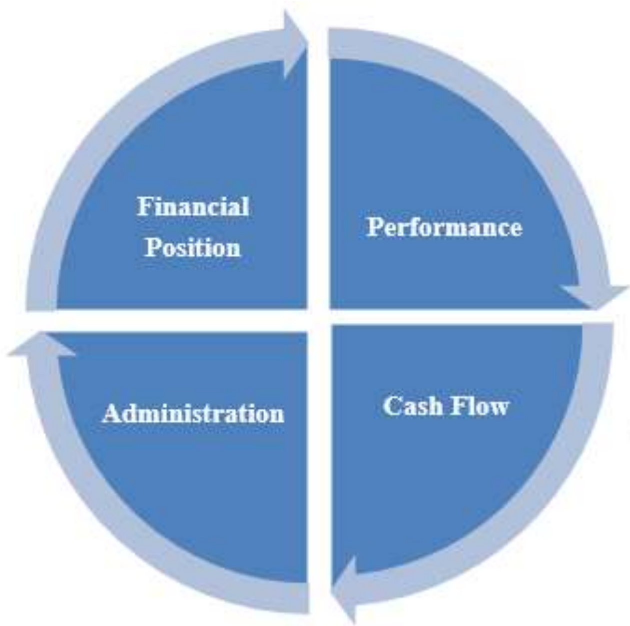
1. THE INTERNATIONAL FINANCIAL REPORTING STANDARDS

The International Financial Reporting Standards (also known as IFRS standards) are a set of principles for the preparation and presentation of **general purpose financial statements**. IFRS standards are issued by the International Accounting Standards Board (IASB).

1.1. Objective of the "general purposes financial statements"

This product obtained by the application of IFRS (which sometimes in practice, we shortened as *"financial statements"'*) aims to provide information of the entity on the following aspects shown in Figure 1:

Figure 1: Information provided in the financial statements



The objective of the financial statements is to satisfy the information needs mainly of investors, lenders and other existing and potential creditors and stakeholders to make decisions about the supply (or not) of economic resources to the entity. That is to say, the financial statements that are prepared under IFRS standards are destined, in fact, to capital providers, mainly for financial decisions (hence their name: *financial* statements).

Therefore, the information prepared and presented under IFRS standards seek to be transparent and timely, showing a true image of economic transactions. It is directed principally to those who have placed their economic resources in the company (some shareholder, or some buyer of bonds or obligations issued by the company, for example), or for a potential capital provider (a foreign investor who is interested in investing in the company, or a bank where we wish to apply for a loan, among others). Therefore, IFRS correspond to a global financial language between the reporting companies and the various capital providers (in other words, they become a communication code between "borrowers" and "providers" of capital).

In short, a company that does not fully apply IFRS will not be able to reflect its true financial position and performance, and will be at a competitive disadvantage to obtain capital if it do not provide transparent and high-quality financial information.

1.2. Basic Principles in IFRS

Among the basic principles included in IFRS for the preparation of the financial statements, the following are highlighted:

Accrual basis: Also known as accumulation base. According to this principle, the effects of transactions and other facts are reflected in the financial statements when they occur, not necessarily when money is received or paid. The financial statements, prepared on an accrual basis, inform users not only of past transactions represented by cash receipts or payments, but also of future payment obligations and of the resources that represent cash receivable in the future. Therefore, such statements provide the type of information about transactions and other past events that are more useful to take economic decisions.

Going concern: The financial statements are normally prepared based on a company that is in operation, and will continue its operation activities in the foreseen future. It is therefore assumed that the company has neither the intention nor the necessity to end or significantly decrease the level of its operations. The going concern principle constitutes the fundamental postulate of the financial information prepared under IFRS. If the reporting entity does not comply with the going concern principle, the financial statements should be prepared on a different basis and, if so, the basis used will be disclosed.

1.3. Convergence process in Latin America

The process of global convergence towards these standards generates new challenges and opportunities for all types of entities that implement IFRS, and of course, also represents challenges and opportunities to the regulators of these entities. Currently more than 140 countries require or allow the application of the Full IFRS for the elaboration and presentation of corporate financial statements; and more than 80 countries have adopted IFRS for SMEs. This process of harmonization of financial information has definitely not been alien to Latin America.

What are the Full IFRS standards and which entities should apply them?

The Full IFRS comprise a set of standards, namely:

- International Accounting Standards (IAS) and their respective interpretations (SIC).
- International Financial Reporting Standards (IFRS) and their respective interpretations (IFRIC).

The content of the Full IFRS currently exceeds 3,000 pages and are applied by companies subject to an obligation of "public accountability". An entity has an obligation of “public accountability” if:

- Its debt or equity instruments are negotiated in a public market or are in the process of issuing these instruments to be negotiated in a public market (either a national or foreign stock exchange, or a market outside the stock exchange, including local or regional markets); or
- One of its main activities is to maintain assets as a fiduciary for a large group of third parties (most banks, credit unions, insurance companies, commissioners and securities intermediaries, investment funds and investment banks would comply with this second criterion).

What are IFRS for SMEs and which entities should apply them?

IFRS for SMEs is a standard based on Full IFRS that must be applied in an autonomous manner. IFRS for SMEs is subdivided into 35 sections, comprising about 300 pages. Entities may apply IFRS for SMEs when:

- They have no public accountability; and
- They publish general purpose financial statements for external users.

Examples of external users are the owners who are not involved in the management of companies, current or potential creditors, and credit rating agencies.

2. THE TAX SYSTEMS AND THEIR REGULATIONS

The tax system in each country is formed by a set of taxes whose first goal is to meet economic objectives. For example, employment, growth and economic equilibrium. A tax system is considered as the main revenue stream that a state needs to be able to cover expenses demanded by citizens, such as education, housing, infrastructure, health, among others.

2.1 Objectives of tax systems and their regulations

The main objectives of tax systems and their regulations are to achieve economic stability, allocate resources appropriately, promote a country's economic growth, ensure employment, provide food sovereignty, and help implement a fair distribution of wealth. Currently, the taxes in each country are regulated by the respective supervisory bodies, through which, via their instruments and regulations, the taxpayers can comply with their tax obligations. The tax regulations correspond to a set of legal bodies that regulate the activities of the taxpayers for the fulfillment of their tax obligations. They aim enabling tax administrations to collect sufficient resources to finance public investment.

2.2 Basic principles of taxation

The tax principles are the basic elements that a tax should have, among which the following are highlighted:

Legality: This principle indicates the exclusive authority of a state for a tax to be established by law, so that a levy or a tax is not applicable without a law that establishes them, i.e. there is no tax without a previous law.

Equality or equity: this principle requires equitable treatment of all taxable persons, on an equal footing, without benefits or levies in terms of race, color, sex, language, religion, political affiliation, economic position, among others. This principle must be understood as equality for taxpayers in similar conditions.

Tax capacity or Proportionality: under this principle, taxpayers must pay according to their economic capacities. In other words, the taxable persons who maintain a higher economic capacity must pay more; the opposite happens with a taxpayer who receives lower income, because for no reason, a tax can exceed the contributory capacity of taxpayers.

Neutrality: This principle refers to the application of taxes should not alter the economic behavior of taxpayers, that is to say, little interference of taxation in the functioning of the market.

Simplicity: According to this principle, a tax system must have a technical structure that is functional. This generates low costs of compliance by taxpayers and control by the tax administration.

2.3 The income tax

One of the main taxes in the tax regulations is the **income tax**, which is applied on the income obtained by individuals or legal entities, by the application of a rate that can be fixed or progressive, and for this reason, it is considered a direct tax. In general, this tax applies to all economic activities carried out by individuals or legal entities, from which the discounts, costs and expenses attributable to such income can be deduced, in such a way that what we call *taxable base,* in order to calculate the income tax.

At the time of identifying the taxable base for the calculation of the income tax, the corresponding rate is applied under the current legislation of each country, obtaining thus the value of the tax payable. This tax is usually calculated annually, as the taxpayer establishes the taxable base based on taxable revenues minus the deductible costs and expenses that have been obtained during a fiscal period.

3. IFRS STANDARDS AND TAX REGULATIONS: MAIN DIFFERENCES

The financial standards and the tax regulations pursue different objectives. On the one hand, IFRS seek to reflect the economic reality of a company to meet the information needed mainly by its capital providers and, on the other hand, the tax regulations seek to establish rules to safeguard the tax collection goals in order to finance the public investment.

It is important to note that in practice, IFRS are applied through principles. Because IFRS are standards that apply to companies with different economic realities (and including in different latitudes in the world), these standards cannot be intended to reflect a true image of all companies through fixed rules.

Therefore, the IFRS consider the application of principles, requiring the use of professional judgement and the best available information, to reflect the economic reality of a company in the financial statements.

Example: estimation of the useful life and depreciation expense

An example of these principles is the estimation of the useful life of properties, plant and equipment in an entity. IFRS standards define the useful life as the period over which an asset is expected to be available for use by an entity. In addition, the depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.

Consider a company "A", which buys a vehicle and is going to use it intensively in a rural area. Using professional judgement and the best information available, a 3-year useful life is estimated for the vehicle. Consequently, the depreciation expense will be calculated based on that useful life, since it will represent the true wear of the good (i.e. the economic reality of the company "A" in relation to that vehicle).

In parallel, consider another entity, the company "B", which acquires the same vehicle, for the same value and on the same date. However, this company is going to use the vehicle occasionally in an urban area. Using professional judgement and the best information available, a 7-year useful life is estimated for the vehicle. The depreciation expense should therefore be calculated based on that useful life, as it will represent the true wear of that good (i.e. the economic reality of the company "B" in relation to its vehicle).

It is important to emphasize that applying IFRS standards, although the companies "A" and "B" acquired the same vehicle, for the same value and on the same date, their accounting treatments are different, due to the application of principles that reflect their different economic realities . However, it is important to note that, while tax rules are also based on fundamental principles described in the previous section, they are applied in practice usually through rules.[1]

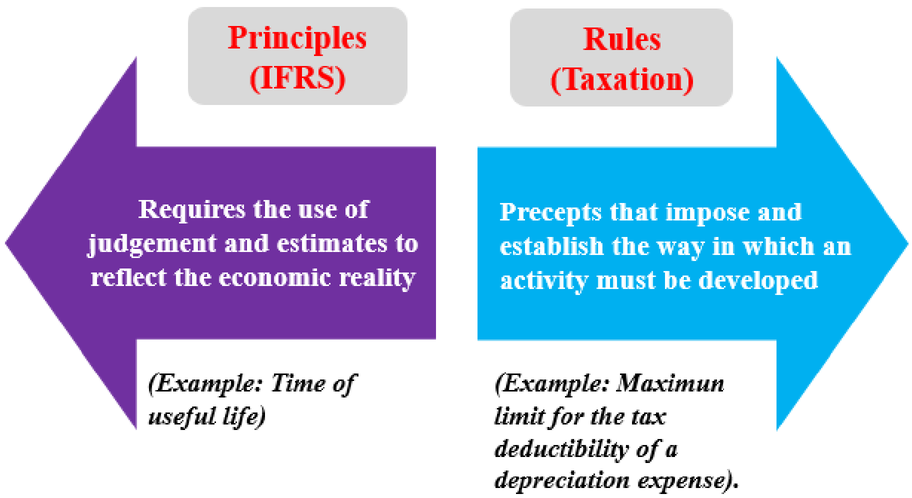
Following the same example of companies "A" and "B", although for purposes of preparation and presentation of financial statements, a company depreciates the vehicle in 3 years and the other in 7 years. For the purposes of the income tax return, a country's tax regulations may allow, for example, an annual tax-deductible expense (for depreciation) up to 20% of the cost of the vehicle. This rule applies in general to the different taxpayers for the purposes of the income tax return, regardless the real depreciation expense recorded in their balance statement by the application of IFRS.[2]

[1] To meet the tax principle of equality or equity among taxpayers, for example.

[2] If taxpayers had simply calculated, recorded and published financial statements with an annual depreciation expense equivalent to 20% of the cost of the vehicle relying directly on the tax rules, that approach would have been wrong, because they would be *turning into tax information* the financial statements, instead of applying the financial principles (this situation has been presented frequently in the majority of entities in Latin America, including large companies). Therefore, using tax rules in the preparation of financial statements, an entity would not necessarily reflect their economic reality in the financial information.

With the foregoing, we do not want to show that a principle is superior to a rule or vice versa, but rather, that the application of principles makes possible to achieve the specific goals of IFRS; and that the application of rules, in the case the tax regulations, can also achieve their objective.

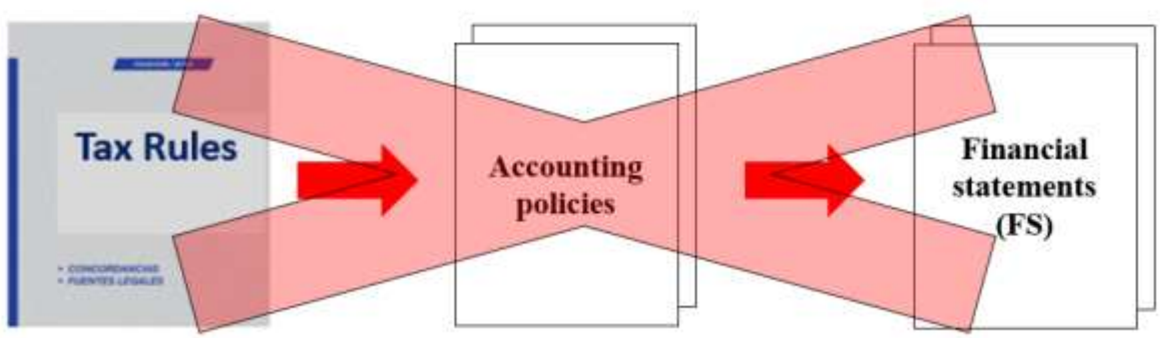
Figure 2: Differences between principles and rules



4. HISTORICAL DISTORTION IN THE PREPARATION OF FINANCIAL STATEMENTS

The objectives of the financial standards and the tax regulations being different, unfortunately for more than 3 decades a historical distortion has been existed in the preparation and presentation of financial statements in Latin America. The tax legislation has often been considered as if it were the source or the basis for the creation of accounting policies, and with these, prepare and publish the financial statements. This conception – shown in Figure 3 – is erroneous.

Figure 3: Historical distortion in the preparation of financial statements in Latin America



As we have noted earlier in this work, tax regulations have not been created with the aim of providing principles or guidelines for the preparation of financial statements (but to preserve the state's tax collection). This distortion has been referred in Latin America as *"tributarizar la contabilidad financiera"*. This "tax-accounting" produces a hybrid, which is not fully a financial information, nor is it completely tax information; failing to reach then the real objective of the general purpose financial statements that is to reflect the economic reality of the entity for the economic decision making of the existing and potential capital providers.[3]

Here we highlight the main causes of this situation:

- A traditional preponderance of tax rules over the financial information.

- The lack of knowledge of accounting and technical principles by the preparers of financial statements.

- Uncertainty about the tax effects of the application of IFRS.[4]

[3] We have a traditional example of this issue when registering in accounting books the expense of unrecoverable or doubtful accounts (impairment of trade receivables). The entities have used a percentage fixed in the tax legislation (depending on the tax regulation of each country, this percentage has corresponded to 1%, or 2%, for example), instead of conducting a credit analysis of the accounts receivable to record an impairment according to the economic reality of the entity (as required by the IFRS standards). If the analysis is carried out in conformity with IFRS, there will be cases of companies in which no impairment should be recorded (i.e., no expense for unrecoverable accounts) in the accounts receivable (because it is possible that the entity may have healthy accounts receivables, a high rotation, and excellent collaterals).
Another classic example is provided if the depreciation expenditure of companies has been recorded in the accounting books following tax guidelines (for example through a percentage or rate established in the tax regulations). This has been many times the situation of edifices in some countries, whose depreciation has been accounted at a rate of 5% of the cost per annum (which is equivalent to a life of 20 years). There, in the economic reality, most buildings have a useful life much higher than 20 years, and in accordance with IFRS standards, such buildings should be depreciated –for financial information purposes– depending on the period over which an asset is expected to be available for use by an entity (therefore, the accounting depreciation rate should be lower than the one from the tax rule).

[4] By working on the implementation of IFRSs in companies, although the businessman and financial statement preparers recognize the benefits of applying IFRS, for example, in obtaining a bank loan, many companies end up being reluctant to apply certain accounting principles due to the tax contingencies that they can cause. For example, when IFRS standards are being implemented in an agricultural enterprise, the corresponding international standard requires that the accounting balance of the biological assets (live animals and plants used in the agricultural activity) be updated period by period to its 'fair value less costs to sell' (this can be assimilated as adjusting the accounting balance of the biological asset periodically to a current market value). As normally the biological asset grows (biological transformation), it gains physical attributes that make it more appreciable in the market, and therefore increases its fair value. Therefore, the accounting adjustment would normally require increasing the balance of the biological asset and, in turn, recognizing an income for this concept in the income statement. Because of this IFRS requirement, the statement of financial position will present a biological asset to current values (i.e. market values, not merely historical costs), and in addition, the income statement will reflect a profit within the period that is the product of the agricultural activity of the entity. In this sense, the entrepreneur understands and feels comfortable to present financial statements that reflect this economic reality. As our experience has shown, by applying IFRS, some agricultural companies have gained more access to credit lines, and in other cases, their overseas suppliers have increased their credit quotas. This happens when high quality financial information performs its mission: to provide greater access to capital, through transparent, reliable and timely information (however, this has been achieved when the respective tax reforms have been made in the country to clarify that therefore these type income –and the corresponding increase in the biological

- A misinterpretation of the premise: *"In the case of divergence between tax rules and financial standards, tax rules shall prevail."*[5]

5. CORRECT APPROACH IN THE PREPARATION OF FINANCIAL STATEMENTS.

A correct conception in the preparation of financial statements is to consider a financial standards (for example, the Full IFRS or the IFRS for SMEs) as the source or basis for the creation of accounting policies in an entity. Based on such accounting policies, to issue the *general purpose financial statements* whose target audience corresponds to investors, lenders and other existing and potential creditors of the entity, in other words, capital providers. However, if in a country these financial statements are also used for other particular purposes, that is, rather, a *secondary* or *derivative* use of the financial information.[6]

For example, the central bank of a country may find useful information that companies publish in their financial statements for the elaboration of their statistics by economic sectors. Similarly, a tax administration can find useful information published in the financial statements for calculating a tax, as is the case of the corporate income tax.

If the financial statements in a country are also used as a "starting point" or "reference base" for calculating the income tax[7], then it is through the *tax reconciliation* tool, where –once the accounting profit or loss is obtained with the full application of IFRS– additional adjustments are made to prepare the income tax return (called reconciliation items). This allows converting that accounting balance into an income or loss for tax purposes (called taxable base), and in this way, obtain the respective income tax payable.

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assets balances- are not subject of income tax). However, it happens that when the tax regulations of a country do not specifically contemplate the tax treatment of such type of income by updating the balance of the biological asset to its 'fair value less cost to sell', the agricultural entrepreneurs and other investors can become reluctant to apply this IFRS requirement in the measurement of their biological assets, because of tax uncertainties in case that these accounting gains (and increases in the assets balance) are recorded. Therefore, as our experience has shown, the companies consequently 'skew' the application of IFRS standards, and measure their biological assets using the historical cost (i.e., accumulating in the accounting balances historical expenses attributable to the biological asset, instead of a market valuation), losing in this way companies and investors the benefits derived from the full application of IFRS standards.

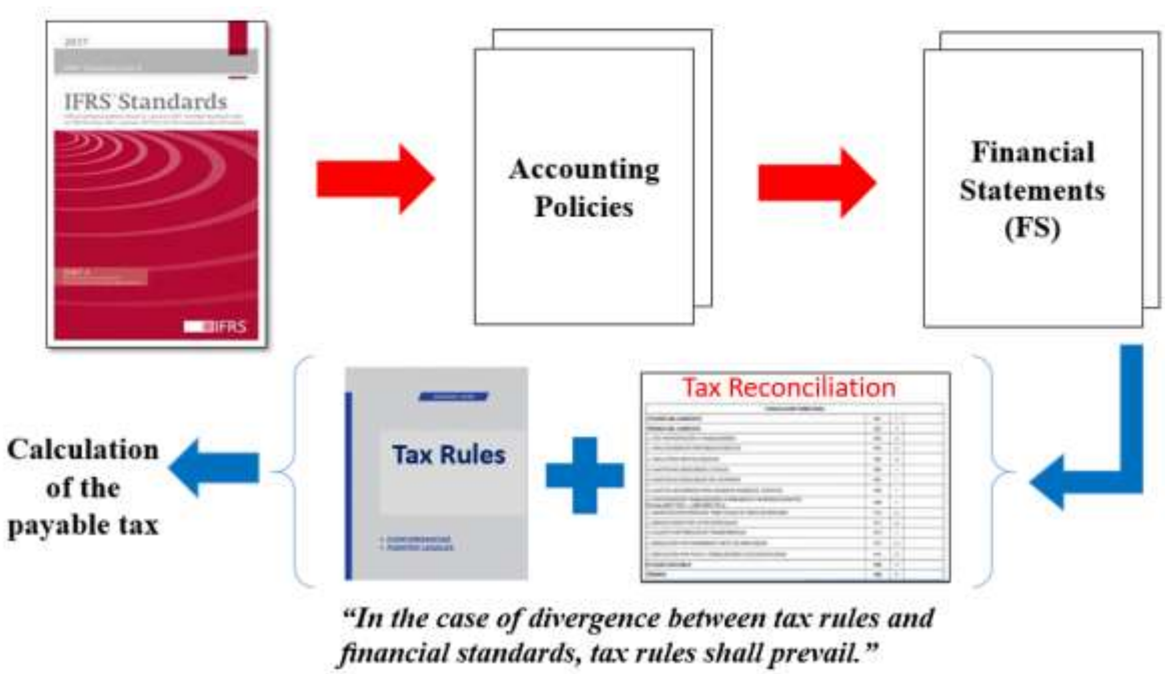
[5] Unfortunately, there has been a misinterpretation of this tax regulations' premise. The scope of this premise is only the process of "tax reconciliation", that is, when the accounting profit or loss (which has been obtained product of the application of IFRS standards) is adjusted in the income tax return (reconciliation items) in accordance with tax regulations to convert the 'accounting profit or loss' in a taxable income or tax loss. Therefore, the scope of this premise should not transcend to the preparation and presentation phase of financial statements (where the financial standards prevail).

[6] Which is to meet the information needs of existing and potential capital providers (investors, lenders and other creditors) of an entity.

[7] As is the case in Latin American countries.

Once the financial statements are prepared in accordance with IFRS standards, note in Figure 4 that it is via a second phase (i.e., when calculating the taxable base through the tax reconciliation) that the tax regulations of a country are rigorously applied and the corresponding tax payable is calculated.

Figure 4: Correct conception in the preparation of financial statements



It is during this second phase that the premise applies: ***"In the case of divergence between tax rules and financial standards, tax rules shall prevail"****,* because at this stage we are no longer preparing financial statements, but calculating the basis for the calculation of a tax, where the tax regulations prevail.

Note then that IFRS standards and tax regulations can coexist. The roles of both do not overlap; rather, they complement each other: the application of the tax rules begins once the application of the financial standards has ended.

5.1 The tax reconciliation

The tax reconciliation is a complementary tool that serves to transform accounting results into tax results. In other words, tax reconciliation is an "extra-accounting" process. By using the term "extra-accounting" in this document we refer to the fact that they are adjustments (increases or decreases) to the accounting profit or loss made on the tax income return only. Therefore, these tax reconciliation adjustments are not recorded in the accounting balances.

Example: Non-deductible accounting expense for income tax purposes

For example, consider a taxpayer who has generated an accounting profit (accounting income minus accounting expenses) of $9,000 in its income statement (product of IFRS standards application). Within the accounting expenses is registered a fine of $1,000 – although it is an expense for financial purposes, it is considered a non-deductible income tax expense in the tax regulations of the country of this example.

This difference between the financial standards and the tax rules established, it is through the process of tax reconciliation where we resolve this divergence. As this expenditure has been deducted at the time of calculating the accounting profit, to annul the effect we will have to "add it back" in the tax reconciliation, as a reconciliatory entry (extra-accounting).[8] In other words, we have reinstated this expense for the fine ($1,000) to the accounting profit ($9,000), in order to obtain a taxable income[9] ($10,000).

When this taxable income is multiplied by the applicable tax rate, then the income tax caused is obtained. Figure 5 shown below summarizes the above example and the use of tax reconciliation[10]:

Figure 5: Tax reconciliation and income tax calculation

Accounting profit or loss	**9,000**
Tax reconciliation	
(+) Fine	1,000
(=)Taxable income (tax loss)	**10,000**
Income tax rate	22%
Payable income tax	**2,220**

5.2. The financial statements prepared under IFRS as a "starting point" for the determination of a taxable base

Since the financial statements prepared under IFRS constitute a true image of the financial situation and the performance of a taxpayer, the accounting profit or loss can be considered as a starting point (by adjusting this accounting profit or loss with certain limitations and exceptions established by tax regulations) for the determination of the taxable base for the calculation of the income tax.

[8] On the example, let us assume that all other expenses are income tax deductible, and that all accounting income is taxed from income tax. If in another case, there have been some types of accounting income that are not taxed for income tax purposes, the corresponding amounts should have been 'subtracted ' in the tax reconciliation.

[9] The taxable income is also referred to as "'taxable base", "taxable profit" or "fiscal base".

[10] An applicable 22% income tax rate has been assumed in this example.

However, as the financial standards and tax rules pursue different objectives, it is important that the tax administrations carry out a careful analysis and reform processes in their tax regulations. They must incorporate the new concepts, terminologies, and techniques from financial standards, not to prescribe accounting treatments but to establish the fiscal treatments of the new types of accounting records that come from the application of IFRS standards, considering certain exceptions and limitations of these concepts and techniques, in compliance with the tax policy and ensuring compliance with the fundamentals principles of taxation, such as: legality, equality, tax capacity, neutrality and simplicity.

We have previously emphasized that the mean to achieve the coexistence and full application of both financial standards and tax rules is the tax reconciliation. In addition, it is also necessary to indicate that the so-called **"deferred taxes"** must of course be accounted for in full compliance with both regulations. In other words, at this time we will say that the accounting record of deferred taxes surges from the fulfillment of both the financial standards and the tax regulations.

Figure 6: Deferred tax accounting as product of IFRS standards application and simultaneous compliance with the tax regulations

Hereafter we will explain in detail this concept of “deferred taxes” that we have introduced.

6. PARADIGM CHANGE: THE DEFERRED TAXES RECONCILING THE DIFFERENCES

In accordance with IFRS standards, when the effects of income tax are recorded in the accounting books, they must reflect the *current* and *future* fiscal consequences in the financial statements. The current tax consequences are reflected when we account for the income tax payable each year (also known as “current tax”). On the other hand, the future fiscal consequences are reflected by the registration of the deferred taxes. Deferred taxes may be of two types:

- Deferred tax assets
- Deferred tax liabilities

6.1 Deferred tax assets

In general, a deferred tax asset represents a tax deduction in future fiscal years (through the tax reconciliation), as result of the recovery of an asset or the liquidation of a liability.[11]

To explain the functionality of the deferred tax assets, and how they allows full compliance with IFRS standards and tax regulations simultaneously, let us consider a practical example.

Example: Loss due to inventories impairment

As of December 31, 2018, a part of inventories with a book value of $100,000 has impaired. In compliance with IFRS standards, the entity (taxpayer) has reduced the book balance of that inventory to $70,000, recognizing a loss in the income statement by $30,000. During 2019, the taxpayer sells that inventory for $70,000.

In 2018:

In application of the IFRS standards (accounting technique), the taxpayer must reduce the accounting balance of inventory by a value of $30,000 in 2018, as follows:

Accounts	Debit	Credit
Impairment loss of inventories	30.000	
Accumulated impairment of inventories		30.000

The account "Impairment loss of inventories" is an expense account in the income statement; and the account "Accumulated impairment of inventories" is an allowance account. In this way, the users of the financial statements obtain reliable and timely information, useful for the economic decision-making.

However, if the tax legislation of the country establishes, for example, that this accounting expenditure (corresponding to a partial deterioration of the value or impairment of the inventory) will not be deductible for the purposes of income tax, but until the time when such impaired inventory is sold or self-consumed. Then such expense would have to be adjusted (added back) in the tax reconciliation of fiscal year 2018.[12]

[11] We may also consider that the deferred tax asset symbolizes a tax credit that will be recoverable (through the tax reconciliation) in subsequent fiscal years.

[12] This is appropriate when the tax regulations of the country specifically clarify the tax treatment of losses due to partial deterioration of the value or impairment of the inventory. However, when the tax regulations of a country have not been reformed (clarified or updated) considering the tax treatment of these concepts, then fiscal uncertainty arises, and in the absence of clarity, in practice some taxpayers have considered it directly as a deductible expense of income tax at the time that it is recorded for financial purposes, decreasing the taxable base in the same fiscal period.

Consequently, for the fiscal year 2018, although it is true that the company has recorded the impairment of the inventories in accordance with IFRS standards (accounting technique), it has not yet been sold or consumed. For this reason, the taxpayer must consider such accounting expense, for the moment, as a non-deductible expense in the tax reconciliation with the expectation that it can be deductible later for fiscal purposes when the conditions required in the tax regulations are fulfilled.

Consequently, within the tax reconciliation, the impairment loss of $30,000 should be considered as an increase in the taxable basis (as a non-deductible income tax expense) in the 2018 tax return:

Accounting Profit	**XXXX**
Tax reconciliation	
(+) Impairment loss of inventories	30,000

A temporary difference is generated between the financial and the tax treatment, since, for fiscal purposes, the entity expect to deduct the $30,000 later (when the asset is recovered, i.e. when the inventory is sold or self-consumed)[13]. The taxpayer must register the respective deferred tax asset (the tax rate that is considered valid for the fiscal year in which the temporary difference is reversed is 22%). The deferred tax asset is $6,600 (i.e.: $30,000 * 22%):

Accounts	**Debit**	**Credit**
Deferred tax asset	6,600	
Income tax		6,600

This "Deferred tax asset" registered as of December 31, 2018, represents the taxpayer's right to deduce this concept (through the tax reconciliation) in future fiscal years when calculating the income tax. The accounting record of this asset is made against the "Income tax" (income statement) that should reflect not only the current fiscal consequences, but also the future fiscal consequences (i.e. the effects of deferred taxes).[14]

Although we have already accounted intuitively for the deferred tax asset, it is formally calculated using a methodology called the *"balance sheet liability method"*. This methodology compares the "book value" of the different assets and liabilities of a company (which must be valued by applying the corresponding international standard) against their respective "tax base" (which is the value attributed for tax purposes on such assets and liabilities). If there is a difference between the book value and the tax base, a difference (called "temporary difference") will be generated, which is multiplied by the tax rate that is expected to be in force in the future (when the differences are reversed), generates a

[13] In IFRS standards, this difference is called 'deductible temporary difference '.

[14] Our main objective in this section is to develop in the reader a notion or intuition about the concept of deferred tax, explaining the reasoning behind this accounting record, because, in practice, for an appropriate domain and application of the deferred taxes, it is quite compelling -in the first instance- to understand the logical aspect that underlies the accounting of these concepts.

deferred tax (which may be a deferred tax asset or liability). We proceed to calculate the respective deferred tax asset using the “balance sheet liability method”:

Book value	Tax Base[15]	Temporary difference	Deferred tax
70.000	100,000	(30.000)	(6.600)

In 2019:

In the following fiscal year, in 2019, when the taxpayer sells its impaired inventory, the following accounting records (according to the example's background, the inventory was effectively sold at $70,000) should be made:

Accounts	Debit	Credit
Cash	70,000	
Revenue		70,000

Accounts	Debit	Credit
Cost of sales	70,000	
Accumulated impairment of inventories	30,000	
Inventories		100,000

In such a way that the impaired inventory has been completely derecognized (including the allowance account), and the respective revenue and cost of sales are recognized.[16] It is to note that in 2019, the income statement did not report a profit or loss from this transaction, since the $70,000 recorded as “Revenue” from the sale are automatically compensated with the $70,000 recognized as "Cost of sales".

However, the taxpayer has now complied with the conditions to deduct the $30,000 that were recorded in the previous year and that was recognized as a non-deductible expense for fiscal purposes, so how can it make deductible -for fiscal purposes- this concept now in 2019?

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[15] According to the IFRS, the tax base of an asset is the amount that will be deductible for tax purposes from the taxable economic benefits that the entity obtains in the future, when it recovers the carrying amount of that asset. If such economic benefits are not taxable, the tax base of the asset shall be equal to the amount in the books. In our example, for tax purposes, the entire cost of $100,000 of the inventory (i.e., the impaired part of $30,000, plus the remaining cost of $70,000) may be deductible later, at the time the sale or self-consumption occurs.

[16] IFRS does not include specifications on the accounting record of sales of impaired inventories. In practice, the use of an allowance account (for the accumulation of the impairment of the inventory in the statement of financial position) is optional. However, it is recommended to use it. Another alternative may be to decrease directly the historical cost from the inventory's account. In any of the cases, when the impaired inventory is sold, its balance must be derecognized taking into account its impairment. Consequently, in the cost of sales (income statement) the net effect (historical cost less accumulated impairment) will be recognized at the sale of the previously impaired inventory.

Let us remind that in fiscal year 2018, the taxpayer registered a deferred tax asset, which represents the possible deduction of an accounting expense that was previously recognized for tax purposes as non-deductible in the tax reconciliation.

Then, in order to recover this tax deduction, the taxpayer must reverse (recover) the deferred tax asset in fiscal year 2019, as follows:

Accounts	Debit	Credit
Income tax	6.600	
Deferred tax asset		6.600

In parallel, the taxpayer must register the respective tax deduction within the "tax reconciliation", as well:

Accounting profit or loss	**XXXX**
Tax reconciliation	
(-) Impairment loss of inventories	(30,000)

It is important to note that now the effect on the tax reconciliation is negative (deduction), and therefore, it will decrease the taxable base in an amount of $30,000 in fiscal year 2019, generating an effective tax savings of $6,600 (once applied the 22 % tax rate.)

This way, the temporary difference would be reversed and the deferred tax asset would be recovered (through the tax reconciliation deduction of the 2019 income tax return).

6.2 Main cause of the generation of deferred tax assets

We have noted that deferred taxes arise from the differences in the financial and tax treatment of the same economic transaction.

In the particular case of deferred tax assets, these may be generated mainly by the fact that in the application of IFRS there are certain accounting expenses (or losses) that are the product of estimates based on principles (use of professional judgement and the best information available), as was the recent example of the impairment loss of the inventory. Because it is an estimate (although it should be very accurate), a tax regulation could consider such expenditure or loss as non-deductible from the income tax so far-and to the extent that- such estimates are end up becoming the reality (that is to say, when the facts become accomplished).

Another situation that may generate a deferred tax asset (i.e., a right to future tax deduction) is the fact that under IFRS there may be an accounting record of an expense (or a loss) without necessarily having a related accounting income. For example, when an entity is in its pre-operative stage, the disbursements corresponding to this stage should be generally accounted for as expenses in the income statement.

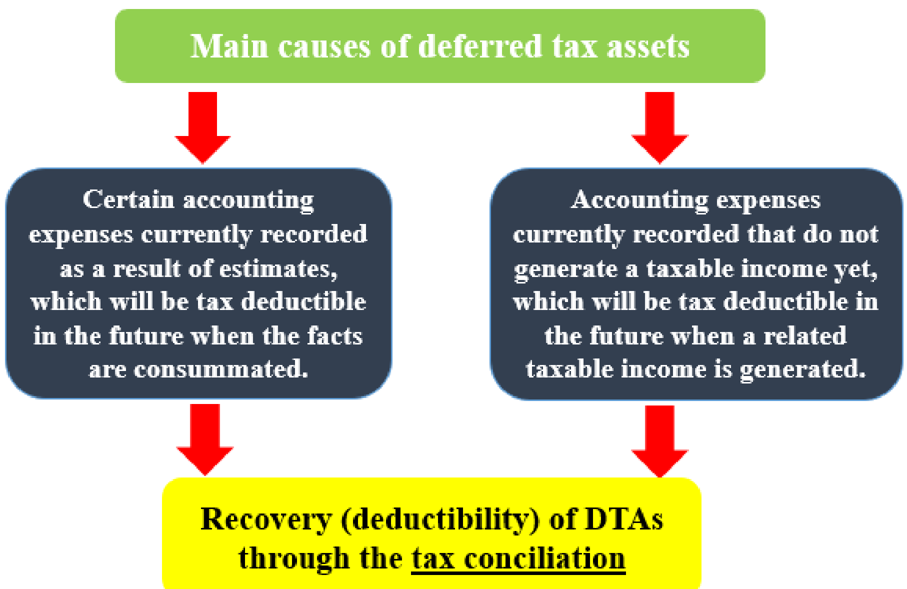
Consequently, during this pre-operative stage, the entity may present losses in the income statement at the end of the year. Therefore, IFRS standards do not necessarily work with a principle of associating income and expenditure.

However, from the experience gained by the author working with tax administrations, national tax regulations include usually a basic rule that provides that *an expense is deductible for income tax purposes whenever it is associated with a taxed income.* That is to say, the tax doctrine generally contemplates a principle of association income-expense for the determination of the taxable base of the income tax.

Consequently, a tax regulation could establish that pre-operational expenses will be deductible for income tax purposes at the time the entity begins to generate taxable income (taxed income), which may happen in fiscal period later than the one in which the pre-operative expenses were recorded for accounting purposes.

In this sense, the entity must consider as non-deductibles for fiscal purposes (in the tax reconciliation) those pre-operative expenses in the fiscal year when no taxable income was generated (simultaneously registering a deferred tax asset); and Then, to recover the deduction (via the tax reconciliation) in the following fiscal year in which the taxable income is generated (by reversing at that time the deferred tax asset).

Figure 7: Main cause of deferred tax assets (DTAs)



To conclude this section corresponding to the deferred tax assets, it is important to indicate that the purpose of the section has been to highlight the *main reasons* for the existence of deferred tax assets in practice. We note the differences between accounting and tax treatments and see how these differences can be reconciled. This is a framework or guideline for the tax administrations. However, other causes that generate the accounting record of deferred tax assets may exist.[17]

[17] For example, deferred tax assets may also be generated for tax losses and tax credits from previous periods, among others.

6.3 Deferred tax liabilities

In general, a deferred tax liability, on the contrary, represents a tax obligation for future fiscal years (through the tax reconciliation), as a result of the recovery of an asset or the settlement of a liability.

To explain the functionality of a deferred tax liability and how it allows full compliance with IFRS standards and the tax regulations of a country, let us consider also a practical example.

Example: Measuring biological assets

During the fiscal year 2018, an entity (taxpayer) initially records a biological asset[18] worth $1,000. As of December 31, 2018, the taxpayer has incurred production costs directly related to the biological transformation of the asset, with a total value of $5,000. At the same date, the "fair value les costs to sell" of the biological asset is $10,000.[19] The taxpayer sells the biological asset at the beginning of the year 2019 for a price of $10,000. During 2019, the taxpayer did not incur any production cost for the biological transformation of the asset.

In 2018:

In the purchase of the biological asset, the taxpayer of the example should record the following accounting item:

Accounts	Debit	Credit
Biological assets	1,000	
Cash		1,000

For the accounting of production costs incurred in fiscal year 2018, the taxpayer may recognize them as expenditure in the income statement, as follows:[20]

Accounts	Debit	Credit
Production costs	5,000	
Cash/Payable accounts/other accounts		5,000

[18] A biological asset corresponds to a live animal or living plant that is used in an 'agricultural activity'. For example, livestock constitutes a biological asset for a farming company. Teak is also a biological asset for a forestry-focused company.

[19] In general, it can be assimilated as having to update the accounting balance of the biological asset to its market value (i.e. at a current value) at the end of the fiscal year.

[20] IFRS does not include specifications on the accounting treatment of subsequent agricultural expenditures (e.g., feeding costs, veterinary services, seeding, weeding, irrigation, fertilization, harvesting and slaughter). Therefore, the entities may choose to capitalize (activate) such costs. In practice, many entities recognize these "production costs" as expense (in the income statement) in the period in which they occur. For the example that we develop, we will apply this last approach.

By updating the accounting balance of the biological asset from $1,000 to $10,000 on December 31, 2018, the taxpayer may record a gain in the income statement by measuring the 'fair value less cost to sell', at a value of $9,000, as shown below:

Accounts	Debit	Credit
Biological assets	9,000	
Gain from 'fair value less cost to sell' measurement		9,000

Therefore, a net operating income of $4,000 ($9,000 – $5,000) will be generated in the income statement. What tax treatment should be given to the recorded accounting gain and its associated production costs?

If the country's tax regulations establish, for example, that this accounting gain (corresponding to measuring the biological asset at its 'fair value less costs to sell') will not be taxed for the income tax until the moment that said assets are sold, then that accounting gain must be adjusted (subtracted) in the tax reconciliation of the fiscal year 2018.[21] By consistency, if this type of accounting income are not subject to the income tax (while the asset has not been sold), the associated production costs will neither be deductible from income tax until the time the biological asset is sold.

For the fiscal year 2018, although it is true that the company has recorded gains and costs associated with the measurement of the biological asset in accordance with IFRS standards (accounting technique), it has not sold the asset (or disposed of it). For this reason, the taxpayer shall consider these accounting gains as non-taxable income for the time being, and their associated production costs as attributable to non-taxable income (i.e., non-deductible), both in the tax reconciliation, with the expectation that they can be taxed and deducted respectively later, when the conditions established in the fiscal regulations are fulfilled.

[21] This is appropriate when the tax legislation of the country specifically clarifies the tax treatment of gains resulting from the measurement of biological assets at their 'fair value less costs to sell'. However, when in a country the tax regulations have not been reformed (or clarified) considering the tax treatment of these concepts, then there is tax uncertainty. In the absence of clarity, some taxpayers, by 'conservatism' have declared the gains by measuring at 'fair value minus less cost to sell' as taxable income for the income tax, breaking the principle of 'tax capacity' and damaging the liquidity of the company. Because the taxpayer has not yet sold its biological assets, such accounting income has simply been generated by the updating to the 'market value' of the biological asset, i.e. it is an accounting income by financial valuation, more not by a real sale. Because of the experience, this has resulted in the practice that in some countries some agricultural sectors are significantly harmed, affecting their working capital and preferring to measure the biological asset to the historical cost model (instead of fair values). Let us remember that tax systems and their regulations have the main objectives of achieving economic stability and promoting the economic growth of a country. Additionally, by the principle of 'neutrality' these new types of accounting records must not generate a minor -nor a higher- payment of income tax in relation to the tax amounts that were normally considered before the application of IFRS standards in each country, otherwise it would alter the economic behavior of the taxpayers and the functioning of the market. By causing distortions and not providing fiscal certainty for the application of IFRS standards, as shown by recent experiences of the author working as a consultant in the private sector, this has affected investors' decisions when they evaluate in which country of the region to invest their capital (the investors consider as more attractive those countries where the tax regulations provide all the clarity necessary to the new types of accounting records product of the application of the IFRS standards, generating legal stability).

Consequently, within the tax reconciliation of the fiscal period 2018, the gain by measuring the biological asset at “fair value less cost to sell” of $9,000 should be considered as a decrease of the taxable base (as a non-taxable income). In turn, the production costs associated with a total of $5,000 will represent an increase in the taxable base (as a non-deductible expenditure for fiscal purposes), as shown below:

Accounting profit or loss	**XXXX**
Tax reconciliation	
(-) Gain from ‘fair value less cost to sell’ measurement	(9,000)
(+) Production costs	5,000

We note that the net effect on the items reconciliation of the biological asset measurement is a non-taxable profit for $4,000. This represents, in essence, the net operating income about for which the taxpayer is not taxed now, but will be taxed in the future when the conditions established in the tax regulations are fulfilled (i.e. when the biological asset is sold).

Note that a temporary difference is generated between the accounting and the tax treatments, due to the $4,000 profit that is presented in the 2018 accounts but that will be taxed in a future fiscal period.[22] For this reason, the taxpayer must account for the respective deferred tax liability (the tax rate that is considered in force for the tax year in which the temporary difference is reversed is 22%). The deferred tax liability is $880 (i.e. $4,000 * 22%).

Accounting accounts	**Debit**	**Credit**
Income tax	880	
Deferred tax liability		880

While we have already calculated the deferred tax liability in an intuitive way, we can also do so using the ‘balance sheet liability method’:

Book value	**Tax Base**[23]	**Temporary difference**	**Deferred tax**
10.000	6.000	4.000	880

[22] This difference is called ‘taxable temporary difference’.

[23] According to the IFRS, the tax base of an asset is the amount that will be deductible for tax purposes from the taxable economic benefits that the entity obtains in the future, when it recovers the book amount of that asset. If such economic benefits are not taxable, the tax base of the asset shall be equal to the amount in the books. In our example, for tax purposes, the value that will be deductible from income tax in relation to the biological asset, will be the costs incurred (in this case: the value paid to acquire the biological asset of $1,000 plus production costs incurred during fiscal year 2018, $5,000).

This “deferred tax liability" registered as of December 31, 2018, represents a taxable effect (through the tax reconciliation) that the taxpayer has in future tax years for his calculation of the income tax. The accounting record of this liability is made against the "income tax"' in the income statement, reflecting not only the current tax consequences, but also the future tax consequences (i.e. the effects of deferred taxes).

In 2019:

In the following fiscal period, in 2019, when the taxpayer sells the biological asset, the following accounting records (according to the previous background, the biological asset was effectively sold at $10,000) should be made:

Accounts	Debit	Credit
Cash	10,000	
Biological assets		10,000

In such a way that the biological asset has been completely derecognized (coincidentally, it was sold to an amount equal to its last accounting valuation), and the respective receipt of the cash is recognized.[24] According to the background, the taxpayer did not incur in production costs associated with this biological asset in 2019, so no accounting record is made.

Note that in 2019, there has not been a net affectation from this transaction in the income statement, since the $4,000 that are generated as net operating income ($10,000 less the costs incurred by the biological asset of $6,000 – including the purchase price), were recognized (but not taxed) in fiscal year 2018. So how can the taxpayer submit this (taxable) concept now in 2019?

Let us remind that in the tax year 2018, the taxpayer has registered a deferred tax liability, which represents the future taxation of the net operational income that was previously recognized for accounting purposes but not taxed for fiscal purposes. Then, in order to comply with this tax obligation, the taxpayer must reverse the liability for the deferred tax in the tax year 2019, as follows:

Accounts	Debit	Credit
Deferred tax liability	880	
Income tax		880

In parallel, the respective effect of taxation should be recognized within the 2019 tax reconciliation, as follows:

[24] IFRS standards does not include specifications on the accounting record of sales of biological assets. In the IFRS training material for SMEs developed by the staff of the IFRS Foundation (the entity that oversees the activities of the International Accounting Standards Board – IASB), it can be seen that in the sales of the biological asset, the asset account is credited and the consideration received is directly recorded (in our example: Cash). If there is any difference between the amount of the consideration received and the balance of the biological asset that is credited, that difference is recognized directly in profit or loss.

Accounting profit or loss	XXXX
Tax reconciliation	
(+) Gain from 'fair value less cost to sell' measurement	9,000
(-) Production costs	(5,000)

Note that in the tax reconciliation, the effect of the gain from the biological asset measurement is now positive (taxation). The associated production cost is now negative (deduction), and therefore, in net terms, the taxable base will increase by an amount of $4,000 in fiscal year 2019, generating an effective tax payment (applying the rate of 22%) of $880 in that year, which relates to the net operating income that was not taxable in the previous fiscal year.

In this way, the temporary difference would be reversed and the deferred tax liability would be canceled (through taxation in the tax reconciliation).

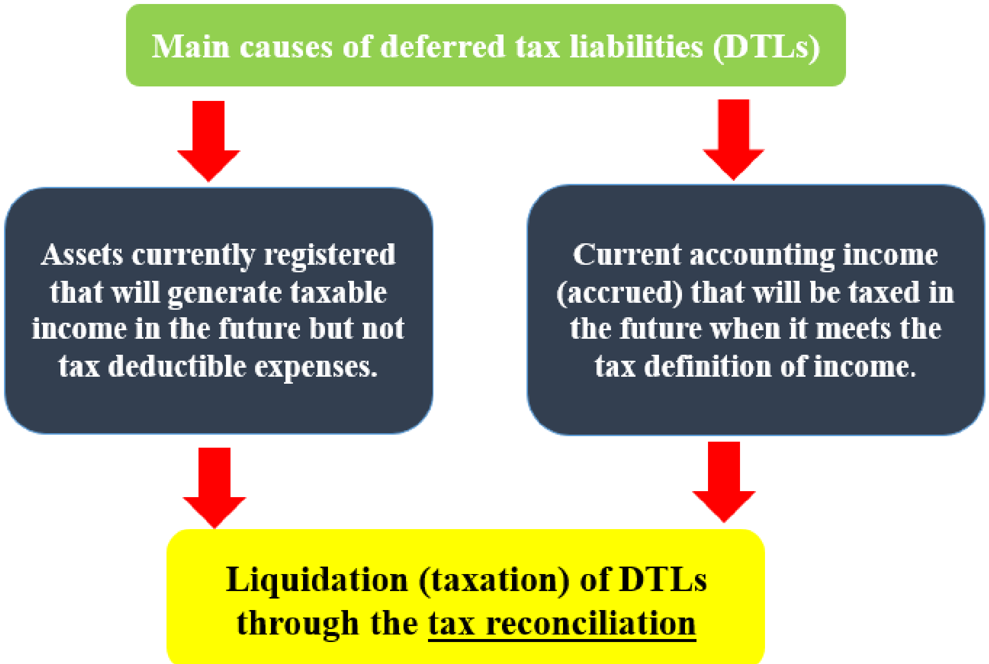
6.4 Main causes of the generation of deferred tax liabilities

We have indicated that deferred taxes arise from the differences between the financial and the tax treatment of the same economic transaction.

In the particular case of deferred tax liabilities, these may be generated mainly by the fact that in the application of IFRS standards there are certain accounting income that do not constitute an income for tax purposes, as was the case from the recent example of measuring the biological assets at their "fair value less costs to sell". This type of accounting income could be taxed for tax purposes in another fiscal period; for example, when the related biological asset is sold. This will generate a taxable temporary difference (i.e., a value to be added later in the tax reconciliation), and consequently, a deferred tax liability.

Another situation can generate a taxable temporary difference (i.e., values to be added later in the tax reconciliation), and consequently, deferred tax liabilities. This happen when certain assets have been revalued for accounting purposes (increasing their balance in books above the historical cost) but that, for fiscal purposes, the tax regulations could consider that the increased value of the asset (product of the revaluation) will not be deductible for calculating the taxable base of the income tax (although such asset generates taxable income). In such assets, the accounting base shall be higher than its tax base (i.e. the accounting value shall be greater than the future deductible values for fiscal purposes), and therefore a temporary difference shall be generated, which corresponds to the non-deductible values in the future when the asset will be recovered (for example, when depreciating). Because the future tax effect corresponds to values that will be added later in the tax reconciliation, the type of difference that occurs is taxable, therefore, deferred tax liabilities are generated.

Figure 8: Main causes of deferred tax liabilities



To conclude this section corresponding to the deferred tax liabilities, it is important to indicate that the purpose of this has been to highlight the *main reasons* for the existence of deferred tax liabilities in practice. We have denoted the differences between the accounting approach and the tax treatment. We have seen how these differences are reconciled, as a guide for the tax administrations. However, other causes may also generate the accounting record of deferred tax liabilities.

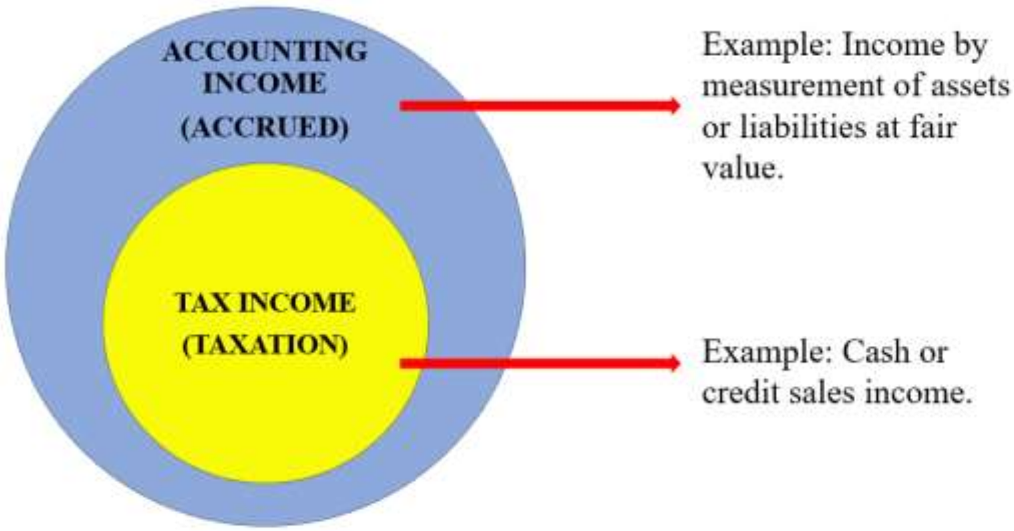
6.5 A reflection

At this point, the reader may ask why previously in Latin America the deferred tax assets or liabilities had not been recorded and presented in the financial statements. As the readar may notice, the accounting record of deferred taxes is subject to the simultaneous compliance with the financial standards and the tax regulations. However, before the application of IFRS standards in each country of the region, accounting recordings had traditionally been *following tax rules* (*"tributarizar la contabilidad"*), so there were virtually no temporary differences between the accounting treatment and the fiscal treatment.

7. DIFFERENCES BETWEEN ACCOUNTING INCOME AND TAX INCOME.

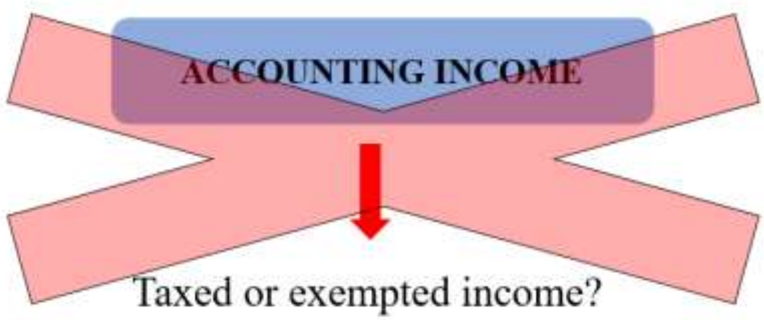
As the reader has already noticed, not all the accounting income registered for the application of IFRS standard constitutes automatically income from a tax viewpoint, as shown in Figure 9:

Figure 9: Accounting income (accruals) and revenue (taxation)



Therefore, it is important that the tax administrations bear in mind that at the time of analyzing and regulating the tax treatment of an accounting income, the traditional analysis that evaluates directly whether the income is "taxed" or "exempt" income for fiscal purposes is no longer valid in the context of financial statements prepared under IFRS standards.

Figure 10: Traditional fiscal analysis of accounting income



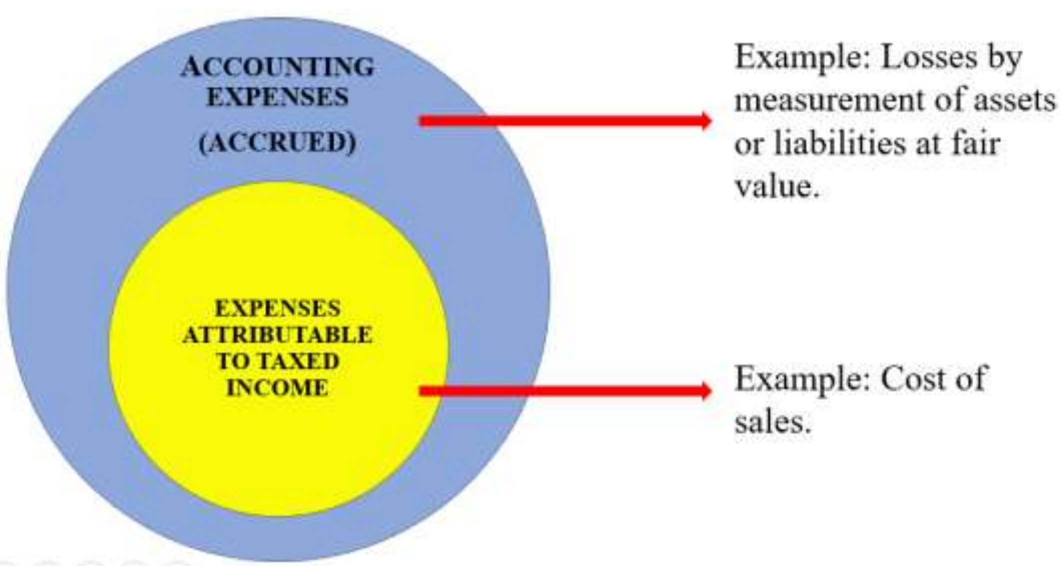
Therefore, tax administrations are encouraged to regulate the fiscal treatment of the accounting income by evaluating in the first instance if that income complies with the tax definition of "income" as it is established in each fiscal regulation.

If it does not comply, then the accounting income is not under the scope of the tax (and therefore, it is an "income non subject to income tax"); and if it complies, then we have to proceed to analyze whether it is taxed or exempted income according to the fiscal regulation of each country, as shown in Figure 11 below:

Figure 11: A New approach to fiscal analysis of accounting income

Likewise, it is necessary to regulate the tax treatment of the *accounting expenses* arising after the implementation of the IFRS standards, especially the tax treatment of those expenses associated with accounting income "not subject to income tax".

Figure 12: Accounting expenses (accrued) and expenses attributable to income



8. CONCLUSIONS

From this work, we can arrive at the following conclusions:

- Even if the financial standards and the tax regulations pursue different objectives, they can coexist, through the tax reconciliation and the accounting for deferred taxes.
- The roles of both do not overlap; rather, they complement each other: the action of the tax rules begins once the action of the financial standards has ended.
- With the correct application of IFRS standards and tax regulations, a dual objective is achieved:
    - When entities prepare and present high-quality financial information, they can **take better economic decisions and they gain better access to capital.**
    - The calculation of the income tax takes as a starting point the accounting figures, and to the extent that the IFRS standards have been applied correctly and that the tax regulations of the country provide the clarity necessary to adjust this accounting figures, **the tax results generated will be appropriate**.

The financial, accounting and tax professions, the companies, regulators and the academia, currently face opportunities and challenges from the application of IFRS standards. We are fortunate to live in this time of important changes in our countries. Thanks to this paradigm shift that take place in Latin America, the present and new generations of taxpayers will be able to understand clearly the differences between the financial standards and tax regulations, what their objectives are, and how their differences should be reconciled.

While the preparation of financial statements using tax rules has been rooted for more than 30 years in the region, we fully trust that the process of *emancipating* financial accounting from taxation can be achieved fully over the years. A long journey starts with a first step, and together we can be agents of change in our exciting profession.

"Start by doing what is necessary, then what is possible, and suddenly you will find yourself doing the impossible."

Saint Francis of Assisi (1182 – 1226), Italian deacon.

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***Note:** The present work has been lectured at the CReCER event, organized by the World Bank, IFAC and the Certified Accountants Association of Pichincha and Ecuador, in May 2015 in Quito-Ecuador; and it has also been lectured at the Inter-American Accounting Conference (CIC), an event organized by the Inter-American Accounting Association (AIC) in October 2017 in Lima-Peru. During 2018, the present work has been published by the Inter-American Center of Tax Administrations (CIAT), the Institute of Fiscal Studies of the Ministry of Economy and Finance of Spain (IEF), the Thomson Reuters agency of Argentina, and the International Journal LEGIS of Colombia, all publications in Spanish.*