Taxation Ruling

Income tax: consolidation: recognising and measuring the liabilities of a joining entity under subsection 705-70(1) of the *Income Tax Assessment Act 1997*

Contents Para

Preamble

The number, subject heading, ***What this Ruling is about*** *(including* ***Class of person/arrangement*** *section),* ***Date of effect****, and* ***Ruling*** *parts of this document are a 'public ruling' for the purposes of* ***Part IVAAA of the Taxation Administration Act 1953*** *and are legally binding on the Commissioner of Taxation Rulings. TR 92/1 and TR 97/16 together explain when a Ruling is a 'public ruling' and how it is binding on the Commissioner.*

What this Ruling is about

1. This Ruling deals with the recognition and measurement of liabilities of a joining entity under subsection 705-70(1) of the *Income Tax Assessment Act 1997* (ITAA 1997). The value of a joining entity's liabilities is added at step 2 in the table to section 705-60 in working out the joined group's allocable cost amount.

Date of effect

2. This Ruling applies to years of income commencing both before and after its date of issue. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Ruling

3. Subsection 705-70(1) of the ITAA 1997 provides for the recognition and measurement of accounting liabilities of entities in respect of which an allocable cost amount (ACA) is to be calculated upon entry into a consolidated group. The term 'accounting liability' refers to a liability at the joining time that can or must be recognised in a statement of financial position in accordance with the accounting standards or statements of accounting concepts issued by the Australian Accounting Standards Board (AASB).

4. The purpose of subsection 705-70(1) is to recognise and measure accounting liabilities at step 2 of the ACA process in accordance with the established accounting framework that applies in Australia. Adoption of the accounting framework creates dynamic outcomes within the ACA and tax cost setting process. For instance, changes in the recognition or measurement of liabilities at step 2 may affect the measurement or aggregation of accounting profits at step 3. Recognition of these relationships is essential to correctly calculate the ACA and complete the tax cost setting process.

5. This Ruling does not provide interpretation on the application or impact of other sections and subsections which adjust or change the amount of the liability initially recognised and measured at subsection 705-70(1) in accordance with the interpretation provided below. The provisions that adjust the amount recognised at subsection 705-70(1) include subsection 705-70(1A), sections 705-75, 705-80, 705-85 and 705-59.

6. The following interpretations should be applied to subsection 705-70(1).

' … adding up the amounts of each thing (an accounting liability)…'

7. Liabilities are classified and measured in a statement of financial position in a consistent manner. They also have to be classified according to their nature, and by whether they are current or non-current. The process of classification, measurement and addition required to be undertaken under subsection 705-70(1) should be done in the same way as in the preparation of a statement of financial position.

'… in accordance with *accounting standards, or statements of accounting concepts …'

8. This phrase does not provide a choice about whether to apply an accounting standard or a statement of accounting concept in the recognition and measurement of an accounting liability. Accounting standards should be applied in preference to statements of accounting concepts by all joining entities (both reporting and non-reporting entities).

9. The reference to accounting standards and statements of accounting concepts does not exclude other parts of the accounting framework such as Urgent Issue Group Consensus Views (UIG Abstracts). These pronouncements should be specifically considered when recognising and measuring accounting liabilities at step 2 of the ACA process. UIG Abstracts and other authoritative pronouncements of the AASB are part of the accounting framework within which general purpose financial reports are prepared.

10. Joining entities may have previously produced statements of financial position in accordance with accounting standards, statements of accounting concepts and other authoritative pronouncements. The accounting policies adopted at the joining time would usually be expected to be consistent with those previous statements. However, the adoption of other accounting policies in the recognition and measurement of liabilities at the joining time may occur in three circumstances. First, when new accounting standards, statements of accounting concepts and other authoritative pronouncements are required to be, or can be, adopted on or before the joining time. Second, where existing accounting standards, statements of accounting concepts and other authoritative pronouncements in Australia allow the adoption of a different accounting policy. Third, under the circumstances noted in paragraph 11.

11. If an accounting transaction or event is not covered by an accounting standard, statement of accounting concept or other authoritative pronouncement of the AASB, joining entities may consider what guidance is available in comparable standards and authoritative pronouncements in other jurisdictions. Paragraph 4.1.2 of AASB 1001 (AAS 6) '*Accounting Policies*' provides guidance on other available sources of potential accounting policies. Some International Accounting Standards and the accounting standards of other nations cover matters not yet dealt with in Australia. Where a liability can be recognised in accordance with Statement of Accounting Concept 4 '*Definition and Recognition of the Elements of Financial Statements*' (SAC 4) other comparable standards and pronouncements can be applied to measure that liability.

12. Where a joining entity and a head company have previously been, and will continue to be, part of an economic group that produces a consolidated statement of financial position the accounting policies adopted at the joining time are expected to be consistently applied by the head company and the joining entity.

13. There are two circumstances where the requirements of the ACA calculation process would vary from what would appear in a statement of financial position. First, assets and liabilities would be recognised and measured on a gross basis even if they have to be set off against each other under the accounting framework. For example, the set off principle required by AASB 1020 (AAS 3) '*Income Taxes*' and AASB 1020 (AAS 3) '*Accounting for Income Tax (Tax-Effect Accounting)*' should not apply. Second, UIG Abstract 39 '*Effect of Proposed Tax Consolidation Legislation on Deferred Tax Balances*' can be chosen to apply by the joining entity to the joining time from 1 July 2002, and not from the substantive enactment date applied in UIG Abstract 39 of 21 October 2002. UIG Abstract 52 '*Income Tax Accounting Under the Tax Consolidation System*' can be chosen by the head company to apply to an implementation date for consolidation from 1 July 2002.

14. AASB 1031 (AAS 5) '*Materiality*' explains the role of materiality in the preparation of statements of financial position. However, materiality is defined by reference to the users of the reported data. In the context of ascertaining the amount of liabilities in determining the ACA, and ultimately therefore the calculation of a head company's taxable income, quantitative and qualitative standards of materiality will need to be considered. Materiality for these purposes may require an approach that is more rigorous than what might be acceptable or expected in the presentation of statement of financial position for other purposes.

15. In the usual case, where audited accounts are the basis for a notional statement of financial position it will not warrant further inquiry as to the value of reported liabilities. However, it is possible that evidence may exist which suggests the position taken will cause the Commissioner to question the appropriateness of the entity's approach to materiality issues. Such evidence may include the consistent adoption of positions on the recognition and measurement of liabilities that are on the edge of materiality. In these circumstances liabilities may be required to be recast.

'…is a liability of the joining entity at the joining time …'

16. In order to correctly recognise and measure accounting liabilities at the joining time the phrase 'at the joining time' in subsection 705-70(1) has to be interpreted as if the single entity rule did not apply for this purpose.

17. In order to recognise and measure the accounting liabilities for a statement of financial position at the joining time in accordance with subsection 705-70(1), the joining time has to be treated, effectively, as a reporting date. For the purposes of AASB 1002 (AAS 8) '*Events Occurring After Reporting Date*' only, the lodgement of the next consolidated income tax return after the joining time is treated as a report date.

18. The treatment of the joining time as a reporting date means that the joining time is the date that has to be considered in applying the accounting standards, authoritative pronouncements and statements of accounting concepts that are relevant in the recognition and measurement of accounting liabilities.

'…that can or must be recognised in the entity's statement of financial position...'

19. The words 'can or must be recognised' refers to the relevant choice of accounting policies applied to accounting standards, statements of accounting concepts and other authoritative pronouncements of the AASB in preparing an entity's notional statement of financial position. Application of the accounting framework to the recognition and measurement of accounting liabilities will, in certain circumstances, allow joining entities a choice

of recognising and measuring some liabilities. In those circumstances certain liabilities ‘can’ be recognised and measured at the joining time, but need not be recognised and measured at that time. However, all other liabilities ‘must’ be recognised and measured in accordance with applicable accounting standards, statements of accounting concepts and other authoritative pronouncements.

20. The application of the accounting framework to the recognition and measurement of liabilities at step 2 of the ACA process is undertaken within the context of developing a notional statement of financial position at the joining time. This notional statement is otherwise part of a general purpose financial report. The application of the accounting framework should consistently apply to all joining entities, whatever their structure or legal status. The consistent application also applies whether the joining entities are reporting or non-reporting entities.

Explanation

The accounting framework

21. The ACA and tax cost setting process uses a combination of economic, accounting and tax concepts in its calculation. An eight step process for working out the ACA is outlined at section 705-60. Step 2 of the ACA process is about adding accounting liabilities of the joining entity at the joining time, step 3 is about adding undistributed taxed (accounting) profits accruing to the joined group before the joining time, and step 4 is about subtracting pre-joining time distributions out of certain (accounting) profits.

22. The accounting framework includes double entry accounting conventions, Australian accounting standards, statements of accounting concepts and authoritative pronouncements of the AASB together with other relevant pronouncements of professional bodies and other national accounting standard setting bodies that apply to the preparation of financial reports.

23. The accounting framework should be applied to the ACA and tax cost setting process in a consistent manner in preparing a notional statement of financial position which is used to recognise and measure liabilities at step 2 and retained earnings at step 3. For example, the adoption of different accounting policies within the notional statement of financial position that changes the value of liabilities should be fully documented with consequential changes to assets and equity accounted for and, where necessary, used in the ACA and tax cost setting process.

'...adding up the amount of each thing (an accounting liability)...'

24. The 'amount of each thing' is referred to as an accounting liability in subsection 705-70(1). The meaning of the word 'liability' is defined in paragraph 48 of SAC 4 as 'the future sacrifices of economic benefits that the entity is presently obliged to make to other entities as a result of past transactions or other past events.' Paragraph 65 of SAC 4 states that a liability should be recognised in a statement of financial position when and only when:

(a) it is probable that the future sacrifice of economic benefits will be required; and

(b) the amount of the liability can be measured reliably.

25. Guidance is provided within SAC 4 about the essential characteristics of a liability and matters associated with the recognition criteria noted above. Where a liability or obligation does not meet the definition and recognition criteria outlined in SAC 4, joining entities should not include those liabilities or obligations at step 2 of the ACA process.

26. Statement of Accounting Concept 3 '*Qualitative Characteristics of Financial Information*' (SAC 3) places emphasis on the relevance and reliability of financial information together with comparability and understandability. These characteristics should underpin the aggregation of liabilities at step 2 of the ACA process.

27. Joining entities, when recognising each accounting liability for step 2 of the ACA process, should classify and measure like items in the same consistent way as if preparing a statement of financial position.

Alternative views

28. It has been suggested that 'adding up the amounts of each thing' disaggregates liabilities (an accounting liability) to a singular thing that meets the definition of a liability. It is to this singular liability that accounting standards and statements of accounting concepts are applied. There is a choice of what accounting standard or statement of accounting concept can be applied to each individual liability, even within the same class or type.

29. This view is not consistent with the authoritative guidance in SAC 3 and SAC 4. The preferred view is noted at paragraphs 24 to 27.

'…in accordance with *accounting standards, or statements of accounting concepts…'

Role of accounting standards

30. The term 'accounting standards' is defined in subsection 995-1(1) of the ITAA 1997 as having 'the same meaning as in the *Corporations Act 2001*'. Section 9 of the *Corporations Act 2001* provides that the term 'accounting standards' means:

> (a) an instrument in force under section 334; or
>
> (b) a provision of such an instrument as it so has effect.

31. Subsections 334(1) and 334(2) of the *Corporations Act 2001* provide:

> (1) The AASB may make accounting standards for the purpose of this Act. The standards must be in writing and must not be inconsistent with this Act or the regulations.
>
> (2) A standard made under subsection (1) is a disallowable instrument for the purposes of section 46A of the *Acts Interpretation Act 1901*.

32. AASB Accounting standards contain both the standard and a commentary. Standards state at the end of the Contents material, 'Standards are printed in bold type and commentary in light type'.

33. Although in recent years the format or layout of the accounting standards have changed, this differentiation between the accounting standard and the commentary to the standard has always been maintained. The commentary or explanatory material is considered to be an integral part of the standard and is recognised as an aid to the interpretation of the accounting standard. This was acknowledged by McLelland CJ in *Solomon Pacific Resources NL v. Acacia Resources Ltd* (No. 2) (1996) 19 ACSR 677. In that case, the court considered whether commentary to the accounting standards formed part of the standards themselves. McLelland CJ commented (at page 681) that:

> In the case of AASB 1010, I think it is clear that the commentary (although not the Preface) was intended to, and does, form part of the accounting standard made by the Board. But the effect to be given to the 'commentary' must by implication be limited to that stipulated in cl 3, namely as an aid to interpreting the remainder.

34. Therefore, the commentary to the accounting standards, such as paragraph 4.1.2 of AASB 1001 (AAS 6) '*Accounting policies*', is relevant for entities preparing a notional statement of financial position for the purpose of recognising and measuring liabilities at the joining time.

Role of statements of accounting concepts

35. PS 5 '*The Nature and Purpose of Statements of Accounting Concepts*' issued by the AASB, at paragraphs 8 and 9, states:

> 8. Statements of Accounting Concepts do not override or amend Accounting Standards and other authoritative pronouncements including UIG Consensus Views.
>
> 9. Statements of Accounting Concepts do not have legal force for entities reporting under the Corporations Act.

36. Statements of accounting concepts provide a framework within which accounting standards and other authoritative pronouncements are made by the AASB when establishing a view on particular accounting issues. The statement of accounting concepts is

also used as guidance in preparing financial reports when there are no accounting standards or UIG Abstracts that deal with the specific accounting policy on a particular topic. This matter is further dealt with at paragraphs 42 to 46.

The use of the word 'or'

37. In the context of subsection 705-70(1), it is considered that in the compound phrase 'accounting standards, or statements of accounting concepts', the words accounting standards and statements of accounting concepts are used collectively rather than as alternatives. Therefore, in recognising and measuring liabilities for step 2 purposes, statements of accounting concepts are to be applied after consideration of accounting standards and other authoritative pronouncements of the AASB in accordance with the established accounting framework in the order of preference as set out at paragraph 4.1.2 of AASB 1001 (see paragraph 39).

Inclusion of UIG Abstracts and other authoritative pronouncements

38. Within the accounting framework entities make decisions about the recognition and measurement of elements included in the financial reports. In recognising and measuring the elements, entities apply accounting policies or principles which are set out in accounting standards, UIG Abstracts, statements of accounting concepts and other authoritative pronouncements as recognised by the AASB.

39. The hierarchical framework for dealing with accounting policies to be applied to transactions associated with the general purpose financial reports is provided in AASB 1001 (AAS 6) '*Accounting Policies*'. Paragraph 4.1.2 of that standard provides that in the absence of a specific accounting standard, other authoritative pronouncements of the AASB and/or the Public Sector Accounting Standards Board (PSASB) or UIG Abstracts, an accounting policy set out in other authoritative pronouncements can be applied. These pronouncements, in order of preference, are:

(a) the requirements and guidance in other Accounting Standards or other authoritative pronouncements of the AASB and/or the PSASB dealing with similar or related issues;

(b) the requirements and guidance in UIG Consensus Views dealing with similar or related issues;

(c) the definitions and recognition criteria of assets, liabilities, equity, revenues and expenses set out in Statement of Accounting Concepts SAC 4 'Definition and Recognition of the Elements of Financial Statements';

(d) International Accounting Standards and Interpretations of the Standing Interpretations Committee of the International Accounting Standards Committee (only to the extent that these are consistent with (a), (b) and (c) of this paragraph); and

(e) the pronouncements of other national accounting standard setting bodies and accepted industry practices (only to the extent that these are consistent with (a), (b) and (c) of this paragraph).

40. Entities preparing general purpose financial reports are, therefore, required to follow accounting policies and principles set out in the accounting standards along with the requirements and guidance contained in the UIG Abstracts. The UIG Abstracts are published to provide timely guidance on urgent financial reporting issues and to prevent the development of divergent or unsatisfactory practices in areas not dealt with by the accounting standards. AASB 1001 (AAS 6) '*Accounting Policies*' gives preference to UIG Abstracts and other authoritative pronouncements over statements of accounting concepts.

41. Although UIG Abstracts are not accounting standards, it is mandatory for members of the Institute of Chartered Accountants in Australia and the Australian Society of Certified Practising Accountants to follow the UIG Abstracts. APS 1 '*Conformity with Accounting Standards and UIG Consensus Views*', issued by the professional accounting bodies, provides that accounting standards and UIG Abstracts must be consistently applied in the preparation and presentation of financial reports.

Applying a different choice of accounting policies at the joining time

42. Within the accounting framework the choice of accounting policies for recognising and measuring liabilities at the joining time may be different to those policies that were used previously for financial statement or other reporting purposes. This may occur where either:

- new accounting standards, statements of accounting concepts or other authoritative pronouncements are required to be, or can be, adopted on or before the joining time;
- existing accounting standards, statements of accounting concepts or other authoritative pronouncements in Australia allow the adoption of a different accounting policy that is relevant; or
- where the circumstances noted in paragraph 43 occur.

43. A change in accounting policies may be applicable to the joining time where a transaction or event has not been previously recognised and:

- there is no existing standard or other authoritative pronouncement from the AASB that deals with recognition and measurement of the transaction or event;
- the transaction or event meets the recognition criteria in SAC 4 for a liability to be included;
- the choice of accounting policy selected to recognise and measure the transaction or event satisfies the concepts of relevance and reliability in SAC 3; and
- the accounting policy is applied to the notional statement of financial position at the joining time to recognise and measure not only liabilities, but assets and equity.

44. Different accounting policies may be relevant when the definition of an asset for tax cost setting purposes includes certain assets to which ACA will be allocated that were not previously recognised and measured in the entity's statement of financial position. If another accounting policy that satisfied the above criteria allowed appropriate recognition of these assets, or some of these assets, in the notional statement of financial position, then related changes to liabilities and equity would also be recognised and measured at the joining time. The resultant change in liabilities would be included at step 2 of the ACA process. The changes may also impact elsewhere in the ACA and tax cost setting process, for example at step 3 of the ACA process.

45. Accounting standards and authoritative pronouncements of the AASB do not cover all possible transactions and events that may be relevant to the recognition and measurement of assets, liabilities and equity in a statement of financial position. Where an accounting standard or other authoritative pronouncement of the AASB does deal with transactions and events then those standards and pronouncements are mandatory for reporting entities. Transactions and events not dealt with, or differently dealt with, in those standards and pronouncements may be recognised as assets, liabilities and equity in the statement of financial position where they meet the relevant definitions used in SAC 4.

46. AASB 1001 (AAS 6) '*Accounting Policies*' at paragraph 4.1 states that '…accounting policies must be selected and applied in a manner which ensures that the resulting financial information satisfies the concepts of relevance and reliability'. SAC 3 provides guidance on relevance and reliability. The choice of what measurement policy should be adopted once a transaction or event meets the recognition criteria is provided by paragraph 4.1.2 of AASB 1001 which outlines the order of preference for using other authoritative pronouncements to measure the transaction or event. This is noted at paragraph 39.

47. Where different accounting policies are applied at the joining time for the purposes of ACA and the tax cost setting process, those policies should be applied to recognise and measure changes in assets, liabilities and equity in a notional statement of financial position at the joining time. As a result of changes in accounting policies that recognise and measure liabilities at step 2, there may be changes to the aggregated values at other steps of the ACA and tax cost setting process. For instance, in many cases a change in recognition of liabilities at step 2 will impact on the value of accounting profits at step 3 of the ACA process. These related impacts must be considered in the ACA and tax cost setting process when adopting different accounting policies.

48. Changes to accounting policies in the circumstances noted in the previous paragraph should be fully documented and the accounting impact of the change measured in the notional statement of financial position at the joining time. Where the change impacts on the values applied at other steps in the ACA and tax cost setting process, these changes should be recognised and fully applied to that process in a consistent manner.

Use of consistent accounting policies within an economic entity

49. Joining entities that have previously been controlled by the head company or another entity that is an existing economic entity producing consolidated financial statements, would normally be expected to have applied congruent accounting policies in producing general purpose financial reports in each of those entities. These congruent accounting policies should continue to be applied in each joining entity and the head company at the joining time for the purposes of the ACA and tax cost setting process.

50. AASB 1024 '*Consolidated Accounts*' (AAS 24 '*Consolidated Financial Reports*') at paragraph 9.1 defines an economic entity as '…a group of entities comprising a parent entity and each of its subsidiary entities'. An entity is broadly defined in paragraph 9.1 and would include all entities that could become members of an income tax consolidated group where those entities meet the requirements for being a member of the group as set out at section 703-15 of the ITAA 1997. Paragraph 9.1 of AASB 1024 takes 'control' to mean the capacity to dominate decision making both directly and indirectly. The entities that fall within an economic entity would be expected to adopt similar congruent policies unless not required by another standard or authoritative pronouncement.

Circumstances that diverge from application of the accounting framework

Reversal of set off

51. Subject to an exception in respect of the treatment of linked assets and liabilities, Part 3-90 of the ITAA 1997 applies separately to each asset and liability even though under the accounting framework they would be set off against each other when presented in a statement of financial position (section 705-58 of the ITAA 1997). There are three principal Australian accounting standards where set off is required on presentation: AASB 1014, AASB 1033 and AASB 1020. The concept of set off is defined at paragraph 9.1 of AASB 1014 (AAS 23) '*Set-off and Extinguishment of Debt*'; paragraphs 9.1.1 to 9.1.10 provide further commentary on set off. The concept is again used at paragraph 4.5 of AASB 1033 (AAS 33) '*Presentation and Disclosure of Financial Instruments*'; paragraphs 4.5.1 to 4.5.9 provide commentary on set off of financial assets and liabilities. A different application of set off is applied to deferred tax assets and liabilities in AASB 1020 (AAS 3) '*Income Taxes*' (both the 1989 and 1999 standard). Deferred tax assets and liabilities are dealt with separately below.

52. Set off is primarily a presentation issue in the statement of financial position. In the absence of set off, assets and liabilities should be recognised and measured in accordance with the accounting framework. When set off is reversed entities may still have a choice of how to recognise and measure linked or related assets and liabilities. The choice of recognition and measurement of certain linked assets and liabilities occurs because at this time the current Australian accounting standards, such as AASB 1033 on financial instruments, do not specifically deal with the recognition and measurement of some linked or related assets and liabilities. However, if recognition of the asset and liability is applicable within the definition applied at SAC 4, other standard setters may have provided some relevant guidance on measurement of these particular assets and liabilities.

53. The choice of recognition and measurement of liabilities at subsection 705-70(1) that have not been set off should be made within the context of the objectives of ACA and tax cost setting process. The relevant choice of recognition and measurement of the assets and liabilities in the notional statement of financial position, by applying the relevant accounting policies within the established accounting framework, should encompass consideration of the following issues:

- what accounting policy has previously been consistently applied by the entity and the economic group for the recognition and measurement of the linked assets and liabilities prior to set off in the notional statement of financial position;

- the accounting policy adopted at the joining time should similarly apply to all linked or related assets, liabilities and in consequence retained earnings within the notional statement of financial position;
- the choice in the recognition and measurement of the unbundled liabilities for step 2 must be aligned to, and have the same characteristics as, the recognition of the linked or related assets for which cost or market value is measured in the tax cost setting process; and
- the operation and application of section 705-59 in dealing with the linked assets and liabilities and the potential application of CGT Event L7 in dealing with linked liabilities.

54. The reference to each and every liability in section 705-58 and to each liability in subsection 705-70(1) is not taken to imply that within the recognition and measurement choices available for linked or related assets and liabilities there is a requirement to unbundle to the lowest individual amount. Linked or related liabilities (and assets) can be treated as a singular amount for the purposes of subsection 705-70(1), and also for section 705-59, in certain circumstances. These circumstances include, but are not limited to, situations where the transactions underlying the linked assets and liabilities have some or all of the following characteristics:

- the underlying contracts operate with standard conditions and clauses;
- they are settled with the same counterparty or through the same exchange or clearing house mechanism; and
- they are expected to be settled at the same time and, therefore, settled in the same financial period.

55. Within the accounting framework, unbundling of certain types of rights and obligations is limited by the treatment of agreements equally proportionately unperformed. This matter is dealt with, for example, at paragraphs 77 and 78 of SAC 4.

Deferred tax assets and liabilities not set off

56. During the period 1 July 2002 to 30 June 2005 entities have a choice of applying AASB 1020 (AAS 3) '*Accounting for Income Tax (Tax-Effect Accounting)*' – the 1989 standard, or AASB 1020 (AAS 3) '*Income Taxes*' – the 1999 standard. Both applicable standards require deferred tax assets to be set off against deferred tax liabilities and recognise the net amount in the statement of financial position. This net amount is calculated differently in the two standards. However, for the purpose of calculating the ACA, including step 2 of the process, deferred tax assets and liabilities should not be set off as required by the two accounting standards.

57. The reversal of set off of deferred tax assets and liabilities does not mean the recognition and measurement criteria for deferred tax assets and liabilities have changed. For instance, deferred tax assets associated with tax losses that do not meet the recognition criteria in AASB 1020 (both 1989 and 1999 standard) would not be included in the measurement of the deferred tax asset amount after set off is reversed.

58. Once an accounting liability has been recognised and measured as required by subsection 705-70(1), certain other calculation processes may apply to those liabilities at step 2. Subsection 705-70(1A) applies to deferred tax liabilities. Section 705-75 applies to certain deferred tax assets and section 705-80 applies to certain deferred tax assets and liabilities. Again, through the application of step 5 and 6 of the ACA process, deferred tax assets associated with losses become excluded assets for the purpose of tax cost setting. Further, the deferred tax assets associated with certain inherited deductions of the head company also become excluded assets through the application of step 7 of the ACA process. Correct outcomes are achieved in the ACA process when the measurement of the deferred tax assets and liabilities in the notional statement of financial position at the joining time is not on a set off basis.

Early application of UIG Abstracts 39 and 52

59. UIG Abstracts 39 and 52 were developed by the Urgent Issues Group of the AASB to deal with accounting matters that arose as a result of the introduction of the income tax consolidation regime. The accounting outcomes of adopting UIG 39 and UIG 52 may vary according to when tax consolidation was implemented by an entity, which version of AASB 1020 is relevant to the joining time and which version of UIG 39 and 52 was applicable. UIG Abstract 39 '*Effect of Proposed Tax Consolidation Legislation on Deferred Tax Balances*' (UIG 39) is relevant for joining entities and the head company until the implementation of the income tax consolidation system. UIG Abstract 52 '*Income Tax Accounting under the Tax Consolidation System*' (UIG 52) is generally relevant after implementation of the income tax consolidation system, but may impact on joining time balances where the 1999 version of AASB 1020 has been adopted.

60. UIG 39 introduced the principle of 'substantive enactment' to the application of UIG 39 and 52. That is, UIG 39 and 52 were only to be considered as applicable by reporting entities after substantive enactment of the income tax consolidation legislation by Parliament. It was subsequently decided by the Urgent Issues Group that substantive enactment of the legislation took place on 21 October 2002. For reporting purposes, UIG 39 and 52 could have no effect where the reporting date was before 21 October 2002. This date conflicts with the start date for the income tax consolidation legislation of 1 July 2002.

61. For the purposes of the development of a notional statement of financial position at the joining time, entities that join in the period 1 July 2002 to 20 October 2002 can elect to apply UIG 39 from 1 July 2002. The head company can elect to apply UIG 52 after the joining time event from 1 July 2002. Not applying UIG 39 and UIG 52 to implementation dates in the period 1 July 2002 to 20 October 2002 could result in different recognition and measurement of outcomes for deferred tax assets and liabilities used in the ACA process for entities joining or forming a tax consolidated group. This would be contrary to the intent of the legislation to treat all joining entities in the same manner.

Application of materiality to subsection 705-70(1)

62. AASB 1031 (AAS 5) '*Materiality*' explains the role of materiality in making judgments in the preparation and presentation of financial reports. Paragraph 4.1 states:

> Information is material if its omission, misstatement or non-disclosure has the potential to adversely affect:
>
> (a) decisions about application of scarce resources made by users of financial reports; or
>
> (b) the discharge of accountability by the management or governing body of the entity.

63. Paragraph 4.1.6 of AASB 1031 provides some quantitative thresholds for the purposes of financial statement reporting in the context of accounting standards applied to general purpose financial reports. Paragraph 4.1.3 of that standard also provides some qualitative factors of materiality.

64. Application of materiality to subsection 705-70(1) should be approached in a different context to that applied for financial reporting. In the context of subsection 705-70(1) liabilities are recognised and measured at step 2 of the ACA and tax cost setting process, which is ultimately part of the lodgement of the consolidated tax return. The public officer of the head company discharges accountability by attesting that 'the information in this return is true and correct'. The appropriate quantitative and qualitative level of materiality for determining the 'true and correct' view is more precise than what might be acceptable or expected in the presentation of a statement of financial position for other purposes.

65. When considering the application of materiality to determining the amount of a liability for step 2 of the ACA process the operation of CGT Event L7 should be considered. CGT Event L7 is applicable where certain liabilities are taken into account in working out the ACA, but those liabilities are then later discharged for a different realised amount. Capital gains and losses may result in these circumstances.

Alternative views

66. It has been suggested that the phrase 'in accordance with accounting standards, or statements of accounting concepts' provides a choice between applicable accounting standards and statements of accounting concepts to the extent a choice is available. The choice arises because the word 'or' can be read in its ordinary disjunctive manner. The choice between accounting standards and statements of accounting concepts could allow the adoption of different recognition and measurement policies to that which the joining entity had previously adopted for a statement of financial position or other general purpose financial reports.

67. It has further been suggested that subsection 705-70(1) can be interpreted to exclude consideration of other authoritative pronouncements on recognition and measurement of a liability that have been issued by the AASB as the legislation does not specifically mention those pronouncements. For instance, UIG Abstracts are not accounting standards or statements of accounting concepts and do not have legal force until such times as they are incorporated into an accounting standard. As a result UIG Abstracts and other authoritative pronouncements are not to be considered in the recognition and measurement of a liability for the purpose of subsection 705-70(1) of the ITAA 1997.

68. Adoption of these views would be contrary to the established accounting framework that has developed in Australia. The preferred view is noted at paragraph 30 to 41.

'…is a liability of the joining entity at the joining time…'

Meaning of 'at the joining time'

69. Section 705-10 of the ITAA 1997 deals with the application and object of Subdivision 705-A, the basic case. Subsection 705-10(1) introduces the concept of the joining time and states:

> This subdivision has effect, subject to section 701-15, for the head company core purposes set out in subsection 701-1(2) if an entity (the **joining entity**) becomes a subsidiary member of a consolidated group (the **joined group**) at a particular time (the **joining time**).

70. The phrase 'at the joining time' is not defined in the income tax consolidation legislation or elsewhere in the income tax law. The concept of the joining time is referred to in a number of places in the consolidation legislation. For the purposes of subsection 705-70(1) the phrase 'at the joining time' should be interpreted as if the single entity rule did not apply to cause the accounting liabilities to be that of the head company at that time.

71. The joining time is an event that takes place 'at a particular time' and acts as a trigger for certain processes to occur within income tax consolidation. Once the act of joining has occurred at the joining time the single entity rule is in operation. This means subsidiary members of a consolidated group are taken to be parts of

the head company for the purposes of working out the head company's income tax liability and amount of loss. However for step 2 purposes, it is the accounting liabilities of the joining entity at the joining time that are relevant. Treating the particular time referred to in the legislation as if the single entity rule did not apply for this purpose enables the pre-joining time accounting liabilities of a joining entity to be determined for the purpose of subsection 705-70(1).

The joining time as a reporting date

72. For the purposes of subsection 705-70(1) and the associated ACA process the joining time is considered to be a reporting date. The lodgement of the first relevant consolidated income tax return which includes the joining entity is considered to be a report date for the purposes of AASB 1002 (AAS 8) '*Events Occurring After Reporting Date*'.

73. Where a joining entity does not prepare, on a regular basis, or had not previously prepared, a statement of financial position or other general purpose financial report then the reporting period for that entity is taken to be the same as that used for its income year. Entities that use the financial year or tax income year as a substitute for the reporting period are then enabled to determine which accounting standards, UIG Abstracts and other authoritative pronouncements of the AASB are applicable at the joining time, and apply those in recognising and measuring the liabilities presented on an entity's notional statement of financial position.

74. Recognition of a reporting date and report date results in two outcomes:

- it defines which standards, authoritative pronouncements and statements of accounting concepts are applicable to the recognition and measurement of liabilities at the joining time; and
- it applies the established accounting framework to events occurring after the joining time, but before the lodgement of the relevant consolidated income tax return, which may impact on the recognition and measurement of liabilities.

75. The established accounting framework of accounting standards, other authoritative pronouncements including UIG Abstracts and statements of accounting concepts are applicable from a particular operative date. For accounting standards, these dates are normally expressed either in respect of annual reporting periods beginning on or after a certain date or ending on or after a certain date. UIG Abstracts may similarly apply to reporting periods, or from a specific date, or from the date of a specific event. (For example, UIG Abstract 39 and 52, where the reference point is the implementation of the tax consolidation regime.) Statements of accounting concepts have an operative date, as do other authoritative pronouncements, as outlined in those pronouncements.

76. Recognition of the joining time as a reporting date means that all accounting standards, authoritative pronouncement or statement of accounting concept of the AASB, which are applicable as at that date are applied to the recognition and measurement of liabilities at that time. Accounting standards, authoritative pronouncements and statements of accounting concepts are applicable to the joining time where they apply:

- for financial reporting periods beginning at a date before the joining time, or on the same date as the joining time;
- for financial reporting periods ending on a date later than the joining time where the financial reporting period either begins on, or includes, the joining time;
- from a specific date or event that has occurred before the joining time takes place; or
- in accordance with subsection 334(5) of the *Corporations Act 2001*, the directors of the entity have elected for early adoption of the accounting standard for financial statement purposes and that election is dated on or before the lodgement date of the relevant consolidated income tax return. (This early adoption is not available to joining entities that do not fall within the scope of subsection 334(5).)

77. Accounting standards (except in respect of the early adoption of a standard noted above), other authoritative pronouncements and statements of accounting concepts are not relevant to the joining time where they apply:

- to financial reporting periods beginning after the joining time date;
- to financial reporting periods ending after the joining time where the first day of that period is also after the joining time date; or
- from a specific date or event that has occurred after the joining time date.

78. Adoption of different accounting standards, other authoritative pronouncements and statements of accounting concepts at a later time that are considered to be not relevant to the joining time do not retrospectively impact on the recognition and measurement of liabilities at step 2 of the ACA process.

Application of AASB 1002 (AAS 8) 'Events Occurring After Balance Date'

79. For the purposes of subsection 705-70(1) the lodgement of the first relevant consolidated income tax return after the joining time is considered to be a report for the purposes of AASB 1002 (AAS 8) '*Events Occurring After Reporting Date*'. Paragraph 4.2 of AASB 1002 states that:

> The financial report must reflect the financial effect of an event occurring after reporting date that:
>
> (a) provides additional evidence of conditions that existed at reporting date; or
>
> (b) reveals for the first time a condition that existed at reporting date.

80. Paragraph 4.2.2 of AASB 1002 provides examples of events occurring after reporting date, the financial effect of which is reflected in the report. Paragraph 5.1.2 of AASB 1002 provides examples of events occurring after reporting date that do not provide evidence of conditions existing at the reporting date. The events noted in paragraph 5.1.2 should not be recognised and measured in the financial report.

81. For the purposes of recognising and measuring liabilities at step 2 of the ACA process, events occurring after the joining time, but prior to the lodgement of the related consolidated income tax return, should be considered where they meet the criteria outlined in paragraph 4.2 of AASB 1002. This approach is in accordance with the accounting framework and will in some circumstances assist groups consolidating for income tax purposes to identify the correct value of liabilities at step 2.

82. If an adjustment to certain liabilities for events occurring after implementation date as described above would not be material, either collectively or individually, entities may choose not to adjust those liabilities at step 2. In these instances, CGT Event L6 or L7 will be applicable to the events to recognise the difference as a capital gain or capital loss.

Alternative views

83. It has been suggested that in the absence of legislative guidance as to the interpretation of 'joining time', entities may choose to apply a different view of each circumstance where the phrase 'joining time' is used in the legislation. Thus where the joining time and first time application of a new accounting standard or UIG Abstract occurs on the same day, they may be considered to have happened either simultaneously, or in a sequence nominated by the entity. For instance, where accounting standards apply from the same day as the joining time the entity can choose whether or not to recognise the particular standard. Also, UIG Abstract 52 is applicable to entities that have joined a tax consolidated group. UIG Abstract 52,

and not UIG 39, may therefore be applied to recognise and measure deferred tax assets and liabilities in the notional statement of financial position at the joining time.

84. The Commissioner's view is that 'joining time' takes its meaning from its context. The context for subsection 705-70(1) is the preparation of a notional statement of financial position for the joining entity by applying accounting standards and UIG Abstracts to the joining time in a like manner to all joining entities.

85. There is a view that 'adding up the amounts of each thing (an accounting liability) … at the joining time' does not represent a report. Subsection 705-70(1), together with other relevant subsections, describes the process and rules of aggregation for step 2 in the calculation of the ACA at the joining time. The joining time is not a reporting date. It is just an event, or a snapshot, at which time liabilities for the purpose of step 2 are aggregated. Events occurring after the joining time are not relevant.

86. The Commissioner's view is that application of AASB 1002 within the established accounting framework and the adoption of a reporting date/report date are required to achieve the intent of subsection 705-70(1).

'...that can or must be recognised in the entity's statement of financial position…'

Consistent rules to be applied by all joining entities

87. For the purposes of subsection 705-70(1) all entities entering income tax consolidation, whatever their structure or legal status, whether a reporting entity or non-reporting entity, are obliged to recognise and measure liabilities at the joining time in accordance with the applicable accounting standards, authoritative pronouncements and statements of accounting concepts. Paragraph 5.68 of the Explanatory Memorandum to the *New Business Tax System (Consolidation) Bill (No. 1) 2002* supports this position. The paragraph states:

> The accounting standards and statements of accounting concepts may not apply to all entities. However, if an entity joins a consolidated group then it is necessary to identify the relevant liabilities by reference to those liabilities that can or must be identified under the accounting standards or statements of accounting concepts. This requirement enables consistent rules to be applied in determining the allocable cost amount for all entities that join a consolidated group.

88. The accounting framework in Australia applies to reporting entities. Reporting entities are defined in SAC 1 '*Definition of the Reporting Entity*' (SAC 1) at paragraph 40, and in various AASB Standards, as:

> entities (including an economic entity) in respect of which it is reasonable to expect the existence of users of general purpose financial reports for information which will be useful to them for

> making and evaluating decisions about the allocation of scarce resources.

89. Paragraph 41 of SAC 1 requires that:

> Reporting entities shall prepare general purpose financial reports. Such reports shall be prepared in accordance with Statements of Accounting Concepts and Accounting Standards.

90. In preparing general purpose financial reports for reporting entities APS 1 requires all members of the professional accounting bodies in Australia to follow UIG Abstracts and other authoritative pronouncements of the AASB as well as accounting standards and statements of accounting concepts.

91. All entities that are not reporting entities are considered to be non-reporting entities. Non-reporting entities are not required to prepare general purpose financial reports in accordance with the established accounting framework. However, if general purpose financial reports are prepared, it is common practice for the reports to be prepared in accordance with accounting standards and UIG Abstracts.

92. A statement of financial position is part of a general purpose financial report. For the purposes of recognising and measuring liabilities at step 2, the same established accounting framework should be applied by all entities in a consistent manner, whether reporting or non-reporting, as if they were part of a notional statement of financial position.

The use of 'can or must'

93. The phrase 'can or must' is not defined in the income tax law. In the context of subsection 705-70(1), the word 'can' is taken as meaning 'to be able to'. That is, 'can' refers to a joining entity's ability to recognise and measure certain liabilities at the joining time. If a joining entity at the joining time is able to recognise and measure liabilities in accordance with the established accounting framework, then those liabilities may be recognised and measured even if that entity is not required to do so. Exercising choice is discussed at paragraph 42 to 48.

94. The word 'must' in the context of subsection 705-70(1) is taken to mean an obligation or a necessity. That is, any liability that 'must' be recognised and measured under the accounting framework is required to be recognised and measured according to the accounting policy set out within the framework.

95. The choices joining entities have as to the accounting policies that are applicable in the recognition and measurement of relevant liabilities are embodied in the accounting framework. This choice of whether an amount can be recognised does not, however, override the recognition and measurement of those liabilities as required by a relevant accounting policy within the accounting framework. That is, where the accounting framework requires that joining entities must

recognise and measure a liability in a particular way under the accounting standard, 'can' does not override this requirement. 'Can' does not mean that a different recognition and measurement policy may be adopted by applying a statement of accounting concept or another authoritative pronouncement which is in conflict with the requirements set out in the relevant accounting standards.

Recognised in the entity's statement of financial position

96. The term 'statement of financial position' is not defined in the income tax law. However, AASB 1040 (AAS 36) '*Statement of Financial Position*' at paragraph 9.1 defines the statement to mean '…the balance sheet as required by the Corporations Law'. Subsection 292(1) of the *Corporations Act 2001* requires certain entities to prepare annual financial reports. Subsection 295(1) requires the financial statements for the year to be part of the financial report, and subsection 295(2) requires that the financial report includes a balance sheet as at the end of the year. Subsection 292(1) requires disclosing entities, public companies, large proprietary companies and registered schemes to prepare annual financial statements. Subsection 296(1) then states '…the financial report for a financial year must comply with the accounting standards'.

97. The AASB standards therefore must be observed by companies and other disclosing entities required to lodge annual financial statements which include a statement of financial position. It is this statement of financial position that all entities joining an income tax consolidated group should notionally create at the joining time to demonstrate that liabilities have been recognised and measured in accordance with the established accounting framework. The development of a notional statement of financial position at the joining time that includes all recognised and measured liabilities for the purposes of subsection 705-70(1) is integral to the validation of those liabilities and correctly capturing the amounts that would otherwise impact on the correct calculation of ACA and its application in the tax cost setting process.

98. Where previously applied accounting policies change for the reasons outlined in paragraphs 42 to 44 it is expected that the change will be consistently applied to the head company and all joining entities that were members of the existing economic entity at the joining time. To demonstrate that congruent policies have been applied at the joining time the head company should develop a notional statement of financial position at the joining time using accounting policies that are congruent with those applicable to the joining entities it has previously controlled.

Alternative views

99. It has been suggested that 'can or must be recognised' provides entities with a choice of what recognition and measurement criteria to adopt for determining the amount of liabilities. The effect of the choice is that entities may recognise and measure certain

liabilities that 'can be recognised' and include those on the statement of financial position instead of, or as well as, those liabilities that 'must be recognised' in the statement of financial position. Therefore, accounting standards do not have to be followed if an alternative recognition policy is available. These different recognition approaches will allow the adoption of accounting policies based upon statements of accounting concepts and other authoritative pronouncements (for example, international accounting standards).

100. The Commissioner's view is that this interpretation of 'can or must' is not the intent of subsection 705-70(1). Application of the accounting framework to subsection 705-70(1) would not support such an interpretation to be applied to recognising and measuring liabilities at step 2 of the ACA process. The appropriate application of accounting standards, statements of accounting concepts and other authoritative pronouncements is provided at paragraphs 30 to 36 and 38 to 41. The application of choice of accounting policies at the joining time, where appropriate, is considered at paragraphs 42 to 48.

101. The phrase 'can or must' is also not intended to be interpreted as if a joining entity can choose to apply and adopt different accounting policies in determining the accounting liability in the notional statement of financial position, except from the choices that exist within the established accounting framework.

102. It has been further suggested that the statement of financial position refers to the form of general purpose financial reports mandated for reporting entities by AASB 1040 (AAS 36) '*Statement of Financial Position*'. Joining entities may or may not be reporting entities. While reporting entities must produce a statement of financial position, non-reporting entities do not have to produce such a statement. For the purposes of calculating the ACA at step 2, non-reporting entities can choose what recognition and measurement criteria to apply to liabilities from either accounting standards or statements of accounting concepts and not place those liabilities within a statement of financial position.

103. The Commissioner's view is that all entities (reporting and non-reporting entities) are required to apply the same accounting framework to the recognition and measurement of liabilities at step 2 of the ACA process.

Detailed contents list

104. Below is a detailed contents list for this Taxation Ruling:

Commissioner of Taxation
29 September 2004

Previous draft:

TR 2004/D11

Related Rulings/Determinations:

TR 92/1; TR 92/20; TR 97/16

Subject references:

- AASB
- accounting framework
- accounting standards
- allocable cost amount
- authoritative pronouncements
- can or must
- consolidation
- joining time
- notional statement of financial position
- recognising and measuring liabilities
- statement of financial position
- statements of accounting concepts
- subsection 705-70(1)
- tax cost setting
- UIG

Legislative references:

- TAA 1953 Pt IVAAA
- ITAA 1997 Pt 3-90
- ITAA 1997 701-1(2)
- ITAA 1997 701-15
- ITAA 1997 703-15
- ITAA 1997 Subdiv 705-A
- ITAA 1997 705-10
- ITAA 1997 705-10(1)
- ITAA 1997 705-58
- ITAA 1997 705-59
- ITAA 1997 705-60
- ITAA 1997 705-70(1)
- ITAA 1997 705-70(1A)
- ITAA 1997 705-75
- ITAA 1997 705-80
- ITAA 1997 995-1(1)
- Corporations Act 2001
- Corporations Act 2001 9
- Corporations Act 2001 292(1)
- Corporations Act 2001 295(1)
- Corporations Act 2001 295(2)
- Corporations Act 2001 296(1)
- Corporations Act 2001 334
- Corporations Act 2001 334(1)
- Corporations Act 2001 334(2)
- Corporations Act 2001 334(5)
- Acts Interpretation Act 1901 46A

Case references:

- Solomon Pacific Resources NL v. Acacia Resources Ltd (No. 2) (1996) 19 ACSR 677; (1996) 131 FLR 179

Other references:

- Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002
- AASB 1001 (AAS 6) ‘Accounting Policies’
- AASB 1002 (AAS 8) ‘Events Occurring After Reporting Date’
- AASB 1014 (AAS 23) ‘Set-off and Extinguishment of Debt’
- AASB 1020 (AAS 3) ‘Income Taxes’
- AASB 1020 (AAS 3) ‘Accounting for Income Tax (Tax-Effect Accounting)’
- AASB 1024 ‘Consolidated Accounts’ (AAS 24 ‘Consolidated Financial Reports’)
- AASB 1031 (AAS 5) ‘Materiality’
- AASB 1033 (AAS 33) ‘Presentation and Disclosure of Financial Instruments’
- AASB 1040 (AAS 36) ‘Statement of Financial Position’
- APS 1 ‘Conformity with Accounting Standards and UIG Consensus Views’
- PS 5 ‘The Nature and Purpose of Statements of Accounting Concepts’
- SAC 1 ‘Definition of the Reporting Entity’

- SAC 3 'Qualitative Characteristics of Financial Information'
- SAC 4 'Definition and Recognition of the Elements of Financial Statements'
- UIG Abstract 39 'Effect of Proposed Tax Consolidation Legislation on Deferred Tax Balances'
- UIG Abstract 52 'Income Tax Accounting Under the Tax Consolidation System'

ATO references
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