



***TD 2014/12 - Income tax: which accounting principles must a financial report be prepared in accordance with in order to satisfy paragraphs 230-150(1)(a), 230-210(2)(a), 230-255(2)(a), 230-315(2)(a) and 230-395(2)(a) of the Income Tax Assessment Act 1997 ?***

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 There is a Compendium for this document: **TD 2014/12EC** .



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## Taxation Determination

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Income tax: which accounting principles must a financial report be prepared in accordance with in order to satisfy paragraphs 230-150(1)(a), 230-210(2)(a), 230-255(2)(a), 230-315(2)(a) and 230-395(2)(a) of the *Income Tax Assessment Act 1997*?

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This publication (excluding appendices) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

A public ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

If you rely on this ruling, the Commissioner must apply the law to you in the way set out in the ruling (unless the Commissioner is satisfied that the ruling is incorrect and disadvantages you, in which case the law may be applied to you in a way that is more favourable for you – provided the Commissioner is not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

### Ruling

1. A financial report must be prepared in accordance with those accounting standards and authoritative pronouncements of the Australian Accounting Standards Board (AASB) which are relevant to financial arrangements and which are capable of being applied in respect of the affairs of the entity whose financial position and performance is being reported. This is the case regardless of whether those accounting principles mandatorily apply to the entity or the financial report.
2. The financial report does not need to be prepared in accordance with accounting principles which are not relevant to financial arrangements or which are not capable of being applied in respect of the affairs of the entity whose financial position and performance is being reported.

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**Example: Consolidated financial report prepared by a tax consolidated group**

3. *Gemstone Pty Ltd is the head company of a tax consolidated group and although it is required to prepare a financial report under the Corporations Act 2001 (Corporations Act) because it is a large proprietary company,<sup>1</sup> it is not a reporting entity for the purposes of the Australian Accounting Standards. It has two wholly owned subsidiaries (Ruby Pty Ltd and Sapphire Pty Ltd).*

4. *Ruby Pty Ltd prepares a financial report containing special purpose financial statements (SPFS) in accordance with the recognition, measurement and disclosure requirements of the Australian Accounting Standards applicable to non-reporting entities. Specifically, Ruby Pty Ltd does not apply the disclosure requirements of AASB 7 Financial Instruments: Disclosures to any extent (including to the extent allowed by AASB 1053: Application of Tiers of Australian Accounting Standards).<sup>2</sup> The financial instruments held by Ruby Pty Ltd are material both individually and in aggregate.*

5. *Gemstone Pty Ltd is a non-reporting entity and prepares a financial report containing SPFS that encompass financial data of itself as the parent entity and its subsidiaries. Gemstone similarly does not apply AASB 7 to any extent in preparing its financial report.*

6. *The consolidated financial report, containing SPFS, prepared by Gemstone Pty Ltd is not prepared in accordance with all accounting principles relevant to financial arrangements and which are capable of being applied, specifically AASB 7. Therefore the financial report does not satisfy all of the requirements of paragraphs 230-150(1)(a), 230-210(2)(a), 230-255(2)(a), 230-315(2)(a) and 230-395(2)(a) of the Income Tax Assessment Act 1997.*

**Date of effect**

7. This Determination applies to years of income commencing both before and after its date of issue. However, it 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 Determination (see paragraphs 75 to 77 of Taxation Ruling TR 2006/10).

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**Commissioner of Taxation**28 May 2014

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<sup>1</sup> See subsection 292(1) of the Corporations Act.

<sup>2</sup> AASB 7 does not mandatorily apply to non-reporting entities which do not prepare general purpose financial statements

## Appendix 1 – Explanation

**①** *This Appendix is provided as information to help you understand how the Commissioner's preliminary view has been reached. It does not form part of the proposed binding public ruling.*

### Financial statements

8. The Australian financial reporting framework consists broadly of two regimes. Entities that are required to prepare a financial report for the purposes of the Corporations Act must prepare financial reports containing either general purpose financial statements (GPFS)<sup>3</sup> or SPFS.

9. In broad terms, the accounting standards each state that they apply, amongst other things, to GPFS<sup>4</sup> or financial statements that are held out to be GPFS. This means that such financial statements comply with the International Financial Reporting Standards as adopted in Australia and any other reporting regime devised by the AASB for the preparation of GPFS.

10. Financial statements that do not follow all accounting standards capable of applying are referred to as SPFS. These financial statements can apply a subset of the accounting standards as the accounting standards themselves prescribe limited mandatory application (though entities preparing SPFS can nonetheless choose to apply the remaining standards).<sup>5</sup>

### Tax timing elective methods

11. Division 230 of the *Income Tax Assessment Act 1997* (ITAA 1997) is about the taxation of financial arrangements (TOFA). Division 230 provides a range of elective methods for determining the gains and losses from a financial arrangement for an income year, namely the elective portfolio treatment of fees,<sup>6</sup> the elective fair value method,<sup>7</sup> the elective foreign exchange retranslation method,<sup>8</sup> the elective hedging method<sup>9</sup> and the elective financial reports method.<sup>10</sup> Absent an elective method applying, relevant gains and losses will be dealt with under the default accruals and realisation methods.

<sup>3</sup> General purpose financial statements consist of two tiers of reporting requirements: Tier 1 (full International Financial Reporting Standards as adopted in Australia) and Tier 2 (Reduced Disclosure Requirements). See AASB 1053.

<sup>4</sup> There are some standards which contain other application criteria. For example, AASB 8 *Operating Segments* limits its application to for-profit entities and AASB 1004 *Contributions* limits its application to not-for-profit entities.

<sup>5</sup> Non-reporting entities that are required to prepare financial statements under the Corporations Act are only required to apply a limited set of accounting standards (see AASB 101 *Presentation of Financial Statements*, AASB 107 *Statement of Cash Flows*, AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*, AASB 1031 *Materiality*, AASB 1048 *Interpretation of Standards*, and AASB 1054 *Australian Additional Disclosures*).

<sup>6</sup> See sections 230-150, 230-155, 230-160 and 230-165 of the ITAA 1997.

<sup>7</sup> Contained in Subdivision 230-C of the ITAA 1997.

<sup>8</sup> Contained in Subdivision 230-D of the ITAA 1997.

<sup>9</sup> Contained in Subdivision 230-E of the ITAA 1997.

<sup>10</sup> Contained in Subdivision 230-F of the ITAA 1997.

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12. The elective methods are broadly designed to allow entities to better align tax treatment of gains and losses from a financial arrangement with the accounting treatment that applies to that arrangement, in a way that does not allow for inappropriate tax benefits.<sup>11</sup> Each of these methods refers, to varying degrees, to the particular accounting treatment of relevant financial arrangements.

13. An entity can only elect to use one or more of the elective methods if, among other things, it prepares a financial report which meets certain requirements.<sup>12</sup> One of those requirements ('the accounting requirement') is that the financial report is prepared by the entity:

- (a) ... in accordance with:
  - (i) the \*accounting principles; or
  - (ii) if the accounting principles do not apply to the preparation of the financial report – comparable standards for accounting made under a \*foreign law that apply to the preparation of the financial report under a foreign law ...

14. In addition to the accounting requirement, it is necessary that the financial report be audited in accordance with the 'auditing principles' ('the auditing requirement'). Nothing in this Determination should be taken as addressing the substantive requirements of the auditing requirement.

## In accordance with the accounting principles

15. The accounting requirement for accessing to the elective methods focuses on the financial report, and whether or not it has been prepared 'in accordance with the accounting principles'. The accounting requirement enquires whether the report was prepared in accordance with 'the' accounting principles (as opposed to the particular entity's accounting principles,<sup>13</sup> or only those principles that must otherwise be complied with).<sup>14</sup> In doing so, it provides integrity in ensuring that the quality of a particular financial report is measured against an objective standard or benchmark.

16. On the face of the provision the most natural reading of the accounting requirement (together with the relevant defined terms) is that the financial report must be in accordance with all accounting principles capable of applying to the affairs of the particular entity, reflected in the financial report.

17. Subsection 995-1(1) of the ITAA 1997 provides that:

a matter is in accordance with **accounting principles** if it is in accordance with:

- (a) \*accounting standards; or
- (b) if there are no accounting standards applicable to the matter – authoritative pronouncements of the Australian Accounting Standards Board that apply to the preparation of financial statements.

<sup>11</sup> See in particular sections 230-205, 230-250, 230-390 of the ITAA 1997.

<sup>12</sup> Subsections 230-150(1), 230-210(2), 230-255(2), 230-315(2), 230-395(2) of the ITAA 1997.

<sup>13</sup> For example the requirement in subsection 705-70(1) of the ITAA 1997 that certain liabilities be determined in accordance with 'the joining entity's' accounting principles.

<sup>14</sup> Compare TD 2013/21.

18. The term ‘accounting standards’ has the same meaning as in the Corporations Act.<sup>15</sup> The term ‘accounting standard’ as defined in the singular under the Corporations Act is a standard made by the AASB by legislative instrument and in force under section 334 of the Corporations Act.<sup>16</sup> ‘Accounting standards’ is a reference to more than one ‘accounting standard’.

19. Accordingly, a natural reading of the term ‘*the accounting principles*’ is that it means all such accounting standards – that is, the collection of all instruments in force under section 334 of the Corporations Act (or, if there are no such accounting standards applicable to the relevant ‘matter’, all authoritative pronouncements of the AASB that apply to the preparation of financial statements).

20. In the context of the accounting requirement set out under paragraphs 230-150(1)(a), 230-210(2)(a), 230-255(2)(a), 230-315(2)(a) and 230-395(2)(a) of the ITAA 1997, the relevant ‘matter’ for the purposes of the definition of ‘accounting principles’ is the financial report itself.

21. But in determining the scope of the accounting requirement, an interpretation which best gives effect to the purposes or objects of the Act is to be preferred to another interpretation.<sup>17</sup> The principle that the context in which a provision appears is a key consideration in determining the purpose or intent of that provision has been consistently applied by the courts.<sup>18</sup> Furthermore it is accepted that context should be considered from the outset, not only once ambiguity as to the interpretation of a provision has been identified.<sup>19</sup> Where a literal interpretation results in a provision operating in a way which is perceived as unintended, an alternative to the literal interpretation may be preferred.<sup>20</sup>

22. It is clear from the statutory context and relevant explanatory material that there are two general policy concerns which have resulted in the enactment of the accounting requirement and other links to the accounting principles and financial reports in Division 230. These are:

- the desire to reduce compliance costs for taxpayers which are subject to Division 230 of the ITAA 1997, and
- to do so in a way which nevertheless ensures integrity by ensuring that the quality of a particular financial report is measured against objective benchmarks, including the accounting requirement.

23. The desire to reduce compliance costs is reflected in paragraphs 1.13, 1.16 and 5.11 of the Explanatory Memorandum (EM) accompanying the introduction of Division 230 of the ITAA 1997.<sup>21</sup>

<sup>15</sup> See section 995-1 of the ITAA 1997.

<sup>16</sup> See sections 9 and 334 of the Corporations Act.

<sup>17</sup> See section 15AA of the *Acts Interpretation Act 1901*.

<sup>18</sup> See the judgment of McHugh, Gummow, Kirby and Hayne JJ in *Project Blue Sky Inc & Others v. Australian Broadcasting Authority* (1998) 194 CLR 355.

<sup>19</sup> See the judgment of Brennan CJ, Dawson, Toohey and Gummow JJ in *CIC Insurance Ltd v. Bankstown Football Club Ltd* (1997) 187 CLR 384.

<sup>20</sup> *Cooper Brookes (Wollongong) Pty Ltd v. Federal Commissioner of Taxation* (1981) 147 CLR 297.

<sup>21</sup> Explanatory Memorandum (EM) accompanying the Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008.

24. The need for integrity is also addressed in the EM (referring to accounting standards rather than accounting principles, as originally enacted) which explained the role of this requirement as follows:

The requirement in the elective Subdivisions for the preparation of financial reports in accordance with accounting standards is a fundamental requirement which ensures that the timing and measurement of the gains and losses made from relevant financial arrangements are reliable and suitable for tax purposes.

In the case of financial reports not prepared in accordance with the accounting standards, there may not be sufficient integrity associated with the preparation of such reports to allow them to be relied upon for tax purposes.<sup>22</sup>

25. The role of the accounting requirement and auditing requirement in ensuring integrity for tax purposes is also addressed at paragraph 5.15 of the EM:

...the financial reports of a taxpayer may, in effect, be relied upon to determine the amount of the gains or losses made from a financial arrangement that are to be brought to account for income tax purposes. Accordingly, the integrity of those reports is important. The accounting and auditing requirements, which the taxpayer must meet to be able to make an election under any of the elective Subdivisions, provide a level of integrity and certainty in relation to processes and methodologies used to calculate the amount of the gains or losses from financial arrangements that are to be brought to account for tax purposes. That integrity will work to ensure that opportunities for tax avoidance or tax deferral are minimised.

26. Both policy considerations are clearly reflected in the objects of Division 230 of the ITAA 1997 generally,<sup>23</sup> as well as the specific objects of the tax timing methods.<sup>24</sup>

27. Furthermore, the focus of Division 230 of the ITAA 1997 is obviously on financial arrangements. To the extent that the taxation of financial arrangements are linked to the accounting principles and financial reports, the legislative context clearly indicates that this link is intended to be confined to accounting principles relevant to financial arrangements and how financial arrangements are reported on in a financial report. This is the case whether or not the entity must mandatorily apply these accounting principles for purposes other than tax. For example, in the context of the fair value elective method in Subdivision 230-C of the ITAA 1997, the law clearly contemplates the gain or loss from the financial arrangement as being the movement in the fair value of the arrangement as required under the accounting principle. There is therefore an expectation that the accounting principle which provides for fair value treatment will be applied.<sup>25</sup>

28. In order to give effect to the purpose of the accounting requirement, it is appropriate to depart from a more natural reading of the provisions which would require a financial report to be in accordance with all accounting principles, as such an interpretation would not be consistent with the focus on financial arrangements, increase compliance costs in many cases, and arguably have little effect on the integrity of information in the financial report for tax purposes where that report applies the accounting principles relevant to financial arrangements and satisfies the auditing requirement.

<sup>22</sup> See paragraphs 5.18 and 5.19 of the EM.

<sup>23</sup> See section 230-10 of the ITAA 1997.

<sup>24</sup> See for example section 230-390 of the ITAA 1997.

<sup>25</sup> See also paragraphs 5.18 to 5.21 of the EM.

29. Accordingly, the accounting requirement should be read in a way which is consistent with a requirement that the relevant entity prepare a financial report for an income year in accordance with the accounting principles *relevant to financial arrangements*.

30. Although neither the legislation nor the EM explicitly set out the full suite of accounting principles which must be complied with, the EM does note that the most relevant accounting principles include AASB 139 *Financial Instruments: Recognition and Measurement*, AASB 121 *The Effects of Changes in Foreign Exchange Rates*, and AASB 127 *Consolidated and Separate Financial Statements* but states that other accounting principles may also be relevant.<sup>26</sup> It is the Commissioner's view that the accounting requirement encompasses accounting principles which are relevant to the disclosure of financial arrangements such as AASB 7, not merely those relevant to recognition and measurement.<sup>27</sup>

31. An entity which does not apply all accounting principles relevant to financial arrangements and capable of applying in the preparation of a financial report, irrespective of whether the entity must mandatorily apply those principles for accounting purposes, will not be reporting in accordance with the accounting principles as required under the accounting requirement. For this reason, a financial report containing such financial statements (for example, those which have not applied AASB 7), will not be in accordance with the accounting principles for the purposes of paragraphs 230-150(1)(a), 230-210(2)(a), 230-255(2)(a), 230-315(2)(a) and 230-395(2)(a) of the ITAA 1997. That is, such a financial report will not satisfy the accounting requirement for the elective methods.

32. In the case of a tax consolidated group, the effect of the single entity rule in section 701-1 is that a head company and its subsidiary members are taken for relevant purposes to be a single taxpayer. The subsidiary members of a group are taken to be part of one entity, being the head company, and the transactions of the subsidiary members are taken to have been undertaken by the head company. Where that head company prepares a consolidated financial report containing SPFS having regard to the transactions of its subsidiaries and does not separately disclose their material financial instruments, the SPFS will not be in accordance with AASB 7. For this reason, such a report cannot be said to be in accordance with the accounting principles, for the purposes of paragraphs 230-150(1)(a), 230-210(2)(a), 230-255(2)(a), 230-315(2)(a) and 230-395(2)(a) of the ITAA 1997.

33. For completeness, in assessing whether the accounting requirement has been satisfied, the following should be noted:

- If a particular accounting principle (or part of such a principle) cannot be applied by an entity, for example because it is irrelevant to the affairs of the particular entity, or it is inconsistent with another applicable accounting principle which the entity has applied, failing to apply that accounting principle will not result in the financial report failing the accounting requirement.

<sup>26</sup> See paragraphs 5.20 and 5.21 of the EM.

<sup>27</sup> This can be contrasted with the recently introduced section 230-527 of the ITAA 1997 which explicitly states that only the recognition and measurement requirements are necessary for Australian branch reports of foreign Authorised Deposit-taking Institutions.



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- If an accounting principle provides an entity with a choice as to how one or more accounting principles apply in particular circumstances, choosing one approach in favour of another (though either approach could potentially apply) will not result in the financial report failing the accounting requirement. For example, the accounting principles include AASB 1053. Where an entity meets the preconditions for preparing a reduced disclosure report as set out under the Tier 2 framework in AASB 1053, it may choose to apply the accounting principles (including those relevant to financial arrangements) in a modified way. This type of financial report can be said to apply all of the accounting principles relevant to financial arrangements, albeit in a modified way.
- Where an entity has prepared a financial report containing financial statements which do not satisfy the accounting requirement, it may nevertheless restate its financial statements to be in accordance with the accounting principles for the purposes of Division 230 of the ITAA 1997.

## References

### *Previous draft:*

Draft TD 2013/D8

### *Related Rulings/Determinations:*

TR 2006/10; TD 2013/21

### *Subject references:*

- accounting standards
- consolidation
- elective methods
- financial statements
- general purpose financial statements
- special purpose financial statements
- taxation of financial arrangements

### *Legislative references:*

- ITAA 1997 Div 230
- ITAA 1997 230-10
- ITAA 1997 230-150
- ITAA 1997 230-150(1)
- ITAA 1997 230-150(1)(a)
- ITAA 1997 230-155
- ITAA 1997 230-160
- ITAA 1997 230-165
- ITAA 1997 Subdiv 230-C
- ITAA 1997 230-205
- ITAA 1997 230-210(2)
- ITAA 1997 230-210(2)(a)
- ITAA 1997 Subdiv 230-D
- ITAA 1997 230-250
- ITAA 1997 230-255(2)
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- ITAA 1997 230-395(2)
- ITAA 1997 230-395(2)(a)
- ITAA 1997 230-527
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- ITAA 1997 705-70(1)
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### *Case references*

- *Cooper Brookes (Wollongong) Pty Ltd v. Federal Commissioner of Taxation* (1981) 147 CLR 297
- *CIC Insurance Ltd v. Bankstown Football Club Ltd* (1997) 187 CLR 384
- *Project Blue Sky Inc & Others v. Australian Broadcasting Authority* (1998) 194 CLR 355

### *Other references*

- AASB 7 Financial Instruments: Disclosures
- AASB 8 – Operating Segments
- AASB 101 Presentation of Financial Statements
- AASB 107 Statement of Cash Flows
- AASB 108 Accounting Policies, Changes in Accounting Estimates and Errors
- AASB 121 The Effects of Changes in Foreign Exchange Rates
- AASB 127 Consolidated and Separate Financial Statements
- AASB 139 Financial instruments: Recognition and Measurement
- AASB 1004 Contributions
- AASB 1031 Materiality
- AASB 1048 Interpretation of Standards
- AASB 1053 Application of Tiers of Australian Accounting Standards
- AASB 1054 Australian Additional Disclosures
- Explanatory Memorandum accompanying the Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008

### ATO references

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