

**Can Taxable Income Be Estimated from Financial Reports of
Listed Companies in Australia?**

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Acknowledgements:

The financial support of the ANU College of Business and Economics Internal Grant Scheme is gratefully acknowledged.

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Abstract

Taxable income may provide some indication as to the credibility of pre-tax accounting profit reported in corporate financial statements, because the two income measures are based on the same set of economic transactions and events. This paper examines whether it is possible to estimate a firm's actual tax liability and taxable income from income tax disclosures under the current Australian Accounting Standard AASB 112 *Income Taxes* which applies to financial statements for reporting periods commencing on or after 1 January 2005. Specifically, this paper examines empirically the problems associated with estimating taxable income from current tax expense – a mandatory disclosure item under AASB 112. Recommendations are also made to improve the income tax disclosure requirements to enable estimation of a firm's taxable income.

Key words: Taxable income; current tax expense; income tax disclosures.

1. Introduction

In Australia, as well as in the United States (U.S.), two sets of rules are used to measure profit or net income of a business: one for financial reporting purposes and the other for income tax purposes. The two sets of measurement rules are different because the objectives of the two systems are different (Porcano and Tran 1998; Hanlon and Shevlin 2005). The primary objective of a tax system is to raise revenue for government programs, although the government may also use the tax system to exert control over the economy (fiscal policies), to accomplish social objectives (e.g. income redistribution), and for political purposes. The objective of general purpose financial reports is to provide information useful to users of financial reports for making and evaluating decisions about the allocation of scarce resources. Different objectives give rise to different principles and rules. For instance, employees' long service leave entitlements are accrued as an expense each year to improve the matching of expense and revenue in financial reporting, but for the sake of objectivity and certainty in the assessment of tax they are allowed as deductions from income only when they are paid. However, given that both reported before-tax accounting profit and taxable income are based on the same set of economic transactions and events, in most cases their differences should not be substantial.

Accounting profit or earnings before tax reported in the financial statements (book income) of a firm with equity traded on a stock exchange often differs from the taxable income in its tax return not only because financial reporting rules are different from tax rules, but also because the firm (or its managers) may have various incentives to "manage" book income and taxable income in different directions. Financial reporting rules require managers of firms to make judgements and estimates in financial reporting to various stakeholders. Information

asymmetry between managers and outside stakeholders enables managers to make use of private information they have when they choose accounting procedures and estimates from a feasible set of options under financial reporting rules with the intent of obtaining some private gains for themselves or for the equity-holders to whom they are accountable. A large body of earnings management literature investigates managers' motivations to over- or understate book income mostly in the U.S. setting (see, for example, reviews by Lev and Ohlson 1982; Watts and Zimmerman 1990; Fields *et al.* 2001). In general, managers have more incentives to aggressively report *high* book income than incentives to report low book income in the corporate financial statements. On the other hand, they also may have incentives to engage in tax planning strategies and to aggressively report *low* taxable income to the taxation authorities in corporate tax returns in order to avoid tax (see, for example, reviews by Shackelford and Shevlin 2001; Hanlon and Heitzman 2010).

In the U.S., researchers find that the difference between book income and taxable income has increased over time in the 1990s (Manzon and Plesko 2002; Mills *et al.* 2002; Desai 2003). A few high profile corporate collapses in early 2000's in the U.S. (*e.g.*, Enron) involved apparently profitable companies paying little or no tax. The financial scandals have undermined the creditability of financial statements, especially the credibility of reported earnings, and have drawn attention to the sources and magnitudes of book-tax income difference (Mills and Plesko 2003). Consequently, U.S. Senator Grassley (2002a; 2002b) asked the Internal Revenue Service (IRS) and the Securities and Exchange Commission (SEC) whether the tax returns of publicly traded firms could be made public to enable investors, analysts, and corporate regulators to cross-check the credibility of earnings reported in their financial statements. This suggestion has generated debates in the U.S. about whether public

firms should be required to disclose corporate tax return information (Hanlon 2003; Lenter *et al.* 2003; Mills and Plesko 2003; Hanlon and Shevlin 2005; Shackelford *et al.* 2007).

Hanlon (2003) finds that under the U.S. Financial Accounting Standard FAS 109 not much can be inferred about a firm's taxable income from its financial statements and provides three reasons why estimates of a firm's tax liabilities and/or taxable income may be incorrect. First, there are items that cause the current tax expense to be over- or understated relative to the actual tax liabilities of the firm, such as stock option deduction, tax-related contingent liabilities (usually known as tax cushion), and intraperiod tax allocation (e.g., the allocation of tax expense between continuing and discontinued operations that are reported separately). Second, there are problems with the estimation of taxable income calculated by grossing-up the current tax expense due to the presence of tax credits even when the current tax expense represents a reasonable proxy of the actual tax liabilities of the firm. The last issue is different consolidation rules for book and tax purposes that cause an inclusion of different corporations in financial statements from those in tax return.

More recently, Lisowsky (2009) examines the statistical association between the U.S. tax liability reported on corporate tax return and publicly available tax-related disclosures in corporate financial statements during the period 2000 to 2004. He finds a strong positive relationship between current U.S. tax expense in financial statements and Total Tax after Credits in corporate tax return in the subsample of firms with positive before-tax domestic earnings and no net operating loss carryforwards. On average in this subsample, for every dollar of current U.S. tax expense, about \$0.70 is reported to the IRS as Total Tax after Credits. He also finds that items such as the tax benefit of stock options, current year accrual of contingent tax liability reserve (tax cushion), and consolidation book-tax differences are

incrementally informative to current U.S. tax expense in explaining Total Tax after Credits in corporate tax return.

Lenter, Slemrod and Shackelford (2003) point out that public disclosure of corporate tax return information may have some undesirable consequences. The disclosure of the entire corporate tax return could reveal proprietary information that provides a competitive advantage to firms that are not required to make such disclosures. Furthermore, full disclosure will cause companies to dilute the information content of tax returns, hampering tax enforcement. Therefore, Lenter *et al.* (2003) only support disclosure of bottom-line items such as taxable income either directly or indirectly through disclosures in financial statements.

While complete disclosure of corporate tax return information may not be desirable, substantial benefits can be gained by various stakeholders if publicly-traded corporations are required to disclose their taxable income either directly, or indirectly through financial statement disclosures about their income tax expense or income, current and deferred tax liabilities and assets (income tax disclosures). For the investors, analysts and corporate regulators, disclosure of taxable income may provide some indication as to the credibility of reported accounting profit. Also, given that financial reports are released by large corporate taxpayers a few months before they lodge their corporate tax returns, taxation authorities can make use of such disclosure to estimate revenue collections, and to direct their tax audit effort when corporate tax return is lodged.

Taxable income is arguably more reliable than book income in Australia. First, accounting rules in general allow more leeway for manipulation than tax rules. Second, unlike other stakeholders, taxation authorities have access to both tax returns and financial statements. The

larger the book-tax income differences, the more likely a tax audit will be conducted and post-audit adjustments made (Mills, 1998). Therefore, publicly-traded firms, especially the large ones under close scrutiny by the taxation authorities, may exercise caution to ensure that the taxable income reported in corporate tax return is correct. Furthermore, unlike the U.S. where the classical system of company taxation is adopted, Australia adopts a dividend imputation system. Under the imputation system, tax paid by companies can be passed on to equity-holders as tax credits when profits are distributed as dividends. Consequently, corporate tax is not necessarily a real cost, and publicly-traded Australian firms with predominantly domestic ownership may have less incentives to manipulate taxable income to avoid tax. Therefore, disclosure of taxable income, either directly or indirectly through income tax disclosures in financial statements, will enable the public and corporate regulators to cross-check the credibility of reported book income, discourage earnings management, and contribute to better functioning of the capital markets.

Although there are some empirical studies about the book-tax income gap in Australia (*e.g.*, Tran 1997; Tran 1998; Tran and Yu 2008), there has been no empirical study about the extent to which taxable income can be estimated from financial statements in Australia. This study investigates whether it is possible to estimate a firm's tax liability and taxable income from income tax disclosures under the current Australian Accounting Standard AASB 112 *Income Taxes* which applies to financial reports for accounting periods commencing on or after 1 January 2005. If the current income tax disclosures are found to be insufficient to allow estimation of taxable income, additional disclosures will be recommended.

One method of estimating taxable income from financial statements is to gross-up the current portion of the tax expense (current tax expense) by the statutory tax rate (or a weighted

average of Australian and foreign tax rates if the company has significant foreign source income) under the assumption that current tax expense represents Australian and foreign (if relevant) tax liabilities estimated by the firm to be reported in corporate tax return(s) a few months after the release of financial statements. This study examines empirically the issues of using current tax expense to estimate taxable income under the current disclosure regime based on a sample of 604 listed Australian companies that reported positive pre-tax book income in 2006.

The rest of the paper is organised as follows. The next section describes the income tax disclosures in Australia under Australian accounting standards. Section 3 discusses the problems associated with estimating taxable income from current tax expense under the current disclosure regime and recommends improvement to the income tax disclosure requirements. Section 4 summarises the findings and recommendations, acknowledges the limitations of the study, and draws conclusion.

2. Income Tax Disclosure Regime

This section describes the disclosure of tax related information under the current Australian accounting standards and discusses their implications on the estimation of taxable income.

Australian Accounting Standard AASB 112 *Income Taxes* applies to reporting periods beginning on or after 1 January 2005. Income taxes include both Australian income tax and foreign income taxes. Due to differences in accounting rules and tax rules, transactions and events recognised in the financial statements can have tax consequences in current year (current tax expense or income) and future years (deferred tax expense or income). AASB

112 requires recognition of both current and deferred tax liabilities and assets arising from transactions and events recognised in current year financial statements. Current tax expense (income) is the amount of income tax payable (refundable) in respect of taxable income (tax loss) for an accounting period. Current tax liability is the amount of current tax payable at the reporting date (normally current tax expense less tax instalments already paid, e.g. under the Pay-As-You-Go system in Australia). Current tax asset is the amount of current tax recoverable at the reporting date (e.g. when tax instalments paid exceed current tax expense).

AASB 112 adopts the balance sheet approach to deferred tax. The balance sheet approach focuses on the temporary differences between the carrying amounts and the tax bases of assets and liabilities in the balance sheet. The tax effect of temporary differences gives rise to deferred tax asset and liability. Change of deferred tax asset and liability from one reporting date to the next is deferred tax expense or income.

Paragraph 77 of AASB 112 requires that the tax expense (income) related to profit or loss from ordinary activities be presented in the statement of comprehensive income.¹ Paragraph 79 further requires separate disclosure of major components of tax expense (usually in a note to the financial statements), including (paragraph 80):

- current tax expense (or income);
- any adjustments recognised in the period for current tax of prior periods;
- deferred tax expense (or income);
- deferred tax expense (or income) relating to changes in tax rates or imposition of new taxes;

¹ Accounting Standard AASB 101 *Presentation of Financial Statements* requires firms to report in the statement of comprehensive income (or an income statement and a statement of comprehensive income separately) (a) profit or loss, and (b) other comprehensive income credited or charged directly to equity such as changes in revaluation surplus, gains or losses from translating the financial statements of a foreign operation.

- the amount of the benefit arising from a previously unrecognised tax loss, tax credit or temporary difference of a prior period that is used to reduce *current* tax expense;
- the amount of the benefit arising from a previously unrecognised tax loss, tax credit or temporary difference of a prior period that is used to reduce *deferred* tax expense;
- deferred tax expense arising from the write-down, or reversal of a previous write-down, of a deferred tax asset (due to reviews of the probability that the firm can generate future assessable income to utilise the benefit of deferred tax asset);
- the amount of tax expense (income) relating to those changes in accounting policies and errors that are included in profit or loss in accordance with AASB 108, because they cannot be accounted for retrospectively.

Paragraph 81 of AASB 112 also requires separate disclosure of:

- the aggregate current and deferred tax relating to items that are charged or credited to equity;
- a reconciliation of *prima facie* or theoretical tax expense (i.e. accounting profit multiplied by the applicable tax rate(s)) and actual tax expense, which can take the form of either an amount reconciliation showing the tax effects of permanent differences, or a rate reconciliation between the applicable statutory tax rate(s) and the average effective tax rate, or both;
- in respect of discontinued operations, the tax expense relating to (a) the gain or loss on discontinuance, and (b) the profit or loss from the ordinary activities of the discontinued operation for the period, together with the corresponding amounts for each prior period presented.

Paragraph 88 of AASB 112 requires disclosure of tax-related contingent liabilities and contingent assets in accordance with AASB 137 *Provisions, Contingent Liabilities and Contingent Assets*.² An example given is contingent liabilities and contingent assets arising from unresolved disputes with the taxation authorities.

Paragraph 35 of Australian Accounting Standards AASB 107 *Cash Flow Statements* requires disclosure of cash flows arising from income taxes which are usually classified as cash flows from operating activities in a cash flow statement. For a firm that only pays Australian income tax, cash outflows related to income tax in an accounting period usually include the fourth quarterly instalment and the final balance (upon lodgement of corporate tax return) for the previous year, and the first three quarterly instalments for the current year.

A common method of estimating taxable income from financial statements is to gross-up the current tax expense by the applicable statutory tax rate(s). Current disclosure requirements in AASB112 are not sufficient to allow taxable income to be estimated. First, AASB 112 does not require separate disclosure of Australian income tax and foreign income taxes and the applicable statutory tax rates.

Second, although AASB 112 requires firms to disclose separately the current and the deferred portions of their income tax expense related to profit or loss from ordinary activities, it does not require separate disclosure of current tax and deferred tax in respect of discontinued operations. In practice, some firms show the major components of tax expense related to both

² AASB 137 defines a contingent liability as “(a) a *possible* obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or (b) a *present* obligation that arises from past events but is not recognised because: (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or (ii) the amount of the obligation cannot be measured with sufficient reliability.” AASB 137 defines a *contingent asset* as “a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.”

continuing and discontinued operations, while others only show the major components of tax expense related to continuing operations. Therefore, the total current tax expense related to both continuing and discontinued operations may not always be disclosed.

Third, financial statements are released to the public within four months after the end of the accounting period, but corporate tax return is not due until about seven months after the end of the accounting period. The current tax expense in financial statements may therefore differ from the tax liability eventually reported in corporate tax return due to adjustments using later information (“true-ups”). For instance, firms with a 30 June reporting date must release financial reports by 31 October, but they are not required to lodge tax returns until 15 January of the following year (or later with extension) which is about three months after the financial reports were approved by the Board of Directors. Between October and January, corporate tax manager may make corrections to the current and deferred tax expenses worked out by financial accountant, and make decisions about utilisation of prior year tax losses, etc. These adjustments may be reported separately, if material, in the following year as adjustments to tax expense of prior periods – a component of the tax expense of the following year. Although paragraph 80 of AASB 112 includes “any adjustments recognised in the period for *current* tax of prior periods” as a major component of tax expense, it does not include “any adjustments recognised in the period for *deferred* tax of prior periods”. Therefore, in practice, some firms disclose separately adjustments made to prior year current tax and deferred tax, others only disclose adjustments made to prior year tax expense without distinguishing adjustments to prior year current tax from adjustments to prior year deferred tax.

The deficiency of the current income tax disclosure regime and other problems that may arise in estimating taxable income from current tax expense will be discussed in the following section.

3. Problems Encountered in Estimating Taxable Income from Current Tax Expense

This section focuses on the specific problems associated with inferring a firm's actual tax liabilities and taxable income from current tax expense. Where applicable, this study uses the data from the financial reports of listed Australian companies for the accounting period ended in 2007 in Connect4 to quantify the extent of the problems. Improvement to the income tax disclosure requirements is also recommended to enable users of financial statements to estimate a firm's taxable income.

3.1 Data Source and Sample Selection

The sample for this study includes firms with equity listed on the Australian Securities Exchange (ASX). The Connect4 Annual Reports Database (Connect4) is chosen as the main data source because it provides the full annual reports of most, if not all, listed firms.³ Full annual reports are required because data such as current tax expense used to estimate taxable income can only be found in the income tax notes to the financial statements, and are not available in other databases such as Aspect Financial Analysis. A total of 1,646 annual reports for the financial year ended in 2007 were downloaded from Connect4.

The initial sample consists of 1,646 firms in the Connect4 2007 Annual Reports Database. A total of 91 firms are property trusts and are excluded from the sample because trust income is

³ Unlike the U.S. where the Internal Revenue Service allows some researchers access to confidential corporate tax return data for research purposes, Australian researchers in general have no access to corporate tax return data.

not subject to income tax if it is distributed to beneficiaries. Twenty six foreign firms are also excluded because only a minor portion of their profits are subject to Australian income tax. Firms that have their registered head office located overseas are treated as foreign firms.

As this study uses the tax information for both 2006 and 2007 disclosed in 2007 financial reports, 33 new firms with only 2007 data are excluded. Since a current tax expense for 2006 is reported only if a firm report a profit before tax for 2006, firms that report a loss before tax for 2006 (836 firms), or a zero profit before tax for 2006 (11 firms), and firms with zero tax expense for 2006 and 2007 (45 firms) are also excluded, leaving a final sample of 604 firms.⁴ Table 1 summarises the derivation of the final sample.

Table 1 about here

A firm is a group of entities under a common control. Relevant data are extracted from the consolidated financial statements.

3.2 Why Estimates of a Firm's Tax Liability and Taxable Income May Be Incorrect?

Although conceptually, taxable income equals current tax expense divided by applicable statutory tax rate(s), Hanlon (2003) finds that in the U.S. context, estimating taxable income from current tax expense is prone to errors for a number of reasons. The items identified by Hanlon (2003) to cause estimation errors in the U.S. are examined here to determine whether they also present problems in the Australian context.

3.2.1 Employee Stock Options

⁴ Another reason for not collecting data for the full sample of 1,646 firms is research budget constraint.

Hanlon (2003) describes the divergent accounting and tax treatments of employee stock options (ESO) in the U.S. as follows:

“The accounting for the tax benefit of nonqualified employee stock options (NQOs) often results in the current tax expense being overstated relative to the firm’s actual tax liabilities. For financial accounting purpose, an expense for stock option compensation is not currently required. *FAS123 Accounting for Stock-Based Compensation...* allows firms to continue accounting for ESOs under *APB No. 25 Accounting for Stock Issued to Employees...* Because almost all firms apply APB No. 25 accounting with note disclosure, the recognised ESO compensation expense is, in most cases, zero for most firms. In contrast, for tax purpose, NQOs entitle the granting firm to a deduction equal to the amount of ordinary income recognised by the employee on the exercise date. Thus, the ESO tax deduction equals the intrinsic value (market price less the strike price) at exercise. As a result, for NQOs the firm obtains a tax deduction in the exercise year but under APB No. 25 treatment, never recognizes compensation expense for financial reporting purposes.... The normal treatment for items that create a difference between book and taxable incomes that will never reverse is to treat them as permanent differences... However, APB No. 25 requires that the tax benefits related to NQOs be accounted for as a credit to additional paid-in capital (APIC)... with an offsetting debit to income taxes payable (thus, no reduction to tax expense). As a result of this accounting treatment, the current tax expense overstates the actual taxes due on the firms’ current period income by the amount of the ESO tax benefit.”⁵

In Australia, one of the significant changes to the financial accounting rules following the adoption of Australian equivalent to International Financial Reporting Standards (IFRS) from

⁵ From 2005, Statement of Financial Accounting Standards No. 123R changed the financial accounting treatment for employee stock options. Since then, employee stock options generate temporary, not permanent, differences and affect deferred tax expense (Frank 2009).

1 January 2005 is the requirement to recognise an expense associated with share-based payment (Chalmers and Hanlon, 2005). Australian Accounting Standard AASB 2 *Share-based Payment* requires that where an entity grants equity instruments (shares or share options) to an employee, the entity shall measure the fair value of the services rendered by the employee by reference to the fair value measured at the grant date of the equity instruments granted. If the equity instruments vest immediately, the entity shall recognise the expense on the grant date with a corresponding increase in equity. If the equity instruments do not vest until the employee completes a specified period of service or achieves a performance target, the expense is recognised over the vesting period or the expected vesting period.

Division 13A of the *Income Tax Assessment Act 1936* (ITAA 1936) applied before 1 July 2009. The grant of employee shares and share options gives rise to a deduction under s.139DC only if the shares/options are qualifying ones under s.139CD and the three exemption conditions under s.139CE are satisfied. The deduction per employee per year is the smaller of \$1,000 and the discount (i.e., the market value of the shares/options less the consideration paid by the employee). From 1 July 2009, Division 83A of ITAA 1997 replaced Division 13A of ITAA 1936. An employer is entitled to a deduction of shares or share options they provide to employees under an employee share scheme (ESS) if the scheme meets the conditions under s.83A-35 for an employee to receive the upfront concession up to \$1,000 (s.83A-205). The amount of deduction is the smaller of \$1,000 and the discount received by the employee (s.83A-205).

If the fair value of the shares or share options measured at the grant date (accounting expense) is different from the tax deduction, there will be a permanent difference that affects the firm's

tax expense. If the accounting expense is recognised over the vesting period or the expected vesting period, there will also be a temporary difference. Thus, there can be permanent and/or temporary differences arising from employee share schemes but they should be accounted for as such and disclosed in income tax note to the financial statements, if material. There is no special credit entry to equity that results in inflated current tax expense as in the United States, and the issue raised by Hanlon (2003) does not apply to Australia.

3.2.2 Tax Cushions

Hanlon (2003) describes tax cushion as follows:

“When a firm takes an aggressive position for tax reporting that it thinks may not stand up to future IRS scrutiny, the firm can accrue an additional amount of tax expense on its income statement in order to reflect this liability. This accrual is... similar to many other types of accruals for expenses incurred currently but where the cash payment will not occur until a future period. Under FAS 109, this additional reserve, or “tax cushion” is generally booked to current tax expense because there is no deferred tax liability or asset to which it is related and thus it cannot go through the deferred tax expense or benefit. As a result, the current tax expense as shown on the financial statement will overstate the underlying current tax liability by the amount of this tax cushion. ...estimating the overstatement due to the tax cushion is nearly impossible.”⁶

In Australia, AASB 112 paragraph 80(b) requires, if material, separate disclosure of any adjustments recognised in the current period for current tax of prior periods. While adjustments to current tax of prior periods may include some tax cushions for prior periods, in no way tax cushion related to current period included in current tax expense can be estimated.

⁶ From 2007, Financial Interpretation No. 48 *Accounting for Uncertainty in Income Taxes* issued by the U.S. Financial Accounting Standards Board requires firms to disclose tax cushions or tax reserves (Blouin et al, 2010).

Thus, tax cushions, if exists, will mean that the current tax expense is higher than the tax liability reported in the tax return.

3.2.3 Intraproduct Tax Allocation

In the U.S., FAS 109 (paragraphs 35 and 36) indicate that income tax expense or benefit should be allocated to four categories:

- continuing operations;
- discontinued operations;
- extraordinary items;
- items charged or credited directly to shareholders' equity.

This allocation means that current tax expense is not the current tax expense on all type of earnings of the firm. Rather, it is only the current tax on the continuing operations of the firm. Items reported separately below continuing operations are reported net of their respective tax effects. To obtain the total tax liability of the firm, the current tax expense related to these items would also have to be added to current tax expense of continuing operations. However, sometimes, the related tax amounts are not disclosed and, if they are, often the current and deferred portions, as well as the U.S. and foreign portions, are not disclosed separately (Hanlon 2003).

In Australia, the "extraordinary items" classification has been abolished. AASB 112 requires separate disclosure of tax expense related to "discontinued operations" and "items charged or credited directly to shareholders' equity". AASB 112, paragraph 81(a), requires separate disclosure of the aggregate current and deferred tax relating to items that are charged or credited to equity. However, paragraph 81(h) does not specifically require a breakdown of

tax expense related to discontinued operations into current tax and deferred tax. Thus, the problem of intraperiod tax allocation in the U.S. also applies to Australia.

Table 2 about here

Table 2 shows the descriptive statistics about discontinued operations based on the data from the sample of 604 firms. Panel A of Table 2 shows that 13.4% and 16.9% of firms reported a profit or loss after tax from discontinued operations for 2007 and 2006 respectively in their income statements. Panel B of Table 2 shows that across the whole sample of 604 firms, on average, profit or loss after tax from discontinued operations is -49.7% and 10.5% of net profit after tax from continuing operations for 2007 and 2006 respectively due to presence of extreme values.⁷ When the top 5% and bottom 5% of the ratio “profit or loss after tax from discontinued operations” to “net profit after tax from continuing operations” are excluded, the 5% trimmed mean becomes 0.17% and 0.77% respectively for 2007 and 2006. Panel C shows that, of the 103 firms that reported a profit or loss from discontinued operations in 2006 and/or 2007, 60 firms (58%) disclosed the major components (i.e., current tax expense, deferred tax expense, etc) of income tax expense on profit or loss from both continuing and discontinued operations together. Thus, intraperiod tax allocation present a problem in estimating tax liability only for the 42% of firms that did not include the current tax expense related to discontinued operations in the breakdown of tax expense.

3.3 Problems with Grossing-up Current Tax Expense to Estimate Taxable Income

As mentioned above, a common method of estimating taxable income from firm’s financial statements is to gross-up the current tax expense by the statutory tax rate. However, there are

⁷ Extreme values can arise if net profit after tax from continuing operations (the denominator) happens to be a small amount.

problems with this method of estimating taxable income even when the current tax expense is a reasonable proxy of the actual tax liabilities of a firm because of the presence of tax credits.

In Australia, tax credits include imputation credits related to franked dividends received, and foreign tax credits (or foreign income tax offsets) for foreign income taxes paid on income from foreign operations. If tax credits are material and separately disclosed in the *prime facie* and actual tax expense reconciliation or tax rate reconciliation, users aware of this issue can adjust their taxable income estimates accordingly.

If a company received a franked dividend, the imputation credit (or ‘franking credit’ as it is called in tax law) will offset the tax on the dividend, so accounting will treat a franked dividend as if it is an exempt income and, if material, the tax effect of exempt income will appear as a permanent difference in the tax expense reconciliation (or tax rate reconciliation). Tax law treats both the dividend amount and the imputation credit as assessable income and hence taxable income. Users of financial statements can estimate taxable income by:

Grossing up the current tax expense by statutory tax rate (i.e., $\text{CTE} \div 30\%$)
 + Imputation credit $\div 30\%$ (i.e., the amount of the franked dividend + imputation credit)
 = Grossing up the sum of current tax expense and imputation credit by 30%.

Note that the taxable income is inflated by the amount of imputation credit which should be excluded when compared with book income to work out any book-tax income difference.

For firms with foreign operations, income is subject to tax at different tax rates in foreign jurisdictions, using Australian tax rate to gross up current tax expense will not yield a correct estimate of taxable income. Information required for a correct estimate of taxable income includes the proportion of taxable income taxed in each jurisdiction and the applicable tax

rates. Consider the following example. If an Australian firm operates in both Australia (with a tax rate of 30%) and a foreign country (with a tax rate of 40%), and the pre-tax profits from Australia and from the foreign country are both \$100 (in Australian dollars). The foreign tax paid will be \$40 ($\$100 \times 40\%$). When the foreign profits are included in Australian taxable income⁸ and taxed at the Australian tax rate of 30% (*i.e.* \$30 Australian tax), a foreign tax credit/offset, which is the lower of the foreign tax and the Australian tax, is available. In this case, the foreign tax credit is \$30. In total, the company paid ($\$60 - \30) Australian tax, and \$40 foreign tax, *i.e.* a total of \$70 current tax expense. When the current tax expense is grossed up by 30%, the result is \$233, which is more than the actual taxable income of \$200.

There is no requirement in AASB 112 to break down the current tax expense into Australian tax and foreign taxes, so in most cases, the current tax payable to foreign tax authorities as well as the foreign tax rate(s) used to gross up the foreign current tax expense are unknown. Limited information may be available in the reconciliation of *prima facie* tax expense and actual tax expense. Paragraph 85 of AASB 112 provides that:

In explaining the relationship between tax expense (income) and accounting profit, an entity uses an applicable tax rate that provides the most meaningful information to the users of its financial report. Often, the most meaningful rate is the domestic rate of tax in the country in which the entity is domiciled, aggregating the tax rate applied for national taxes with the rates applied for any local taxes which are computed on a substantially similar level of taxable profit (tax loss). However, for an entity operating in several jurisdictions, it may be more meaningful to aggregate separate reconciliations prepared using the domestic rate in each individual jurisdiction.

⁸ For an Australian company, both Australian source income and foreign source income are subject to Australian tax.

AASB 112 (paragraph 85) provides an example to illustrate two possible ways of presentation: (a) compute the *prima facie* tax expense with the domestic tax rate, and show the effect of higher or lower foreign tax rates as a permanent difference in the reconciliation; (b) compute the *prima facie* tax expense with the applicable domestic and foreign tax rates, and show no permanent difference due to higher or lower foreign tax rates in the reconciliation. Disclosure of the effect of foreign tax rates as a permanent difference or a weighted average applicable tax rate will help to work out the applicable tax rate used to gross up current tax expense. However, AASB 112 does not require separate disclosure of Australian tax and foreign taxes so users of financial statements have no idea what proportion of current tax expense is paid/payable to domestic taxation authorities and hence available to frank the firm's dividends.

3.4 Different Consolidation Rules for Financial Reporting and Tax Purposes

In both Australia and the U.S., for accounting consolidation purpose, control normally exists when an entity (parent) owns more than 50% of the voting interest of another entity (subsidiary). Thus, if the ownership percentage is greater than 50%, consolidation is required: group book income includes 100% of book income of the subsidiary, less the portion attributable to minority interest.

If the ownership percentage is between 20% and 50%, the investor is presumed to have a significant influence over the investee (associated company) and, in most cases, the equity method of accounting for investment is required: group book income includes a share of the associated company's book income.

If the ownership percentage is less than 20%, no significant influence is presumed, so in most cases the cost method of accounting for investment is adopted: group book income only includes dividends received from the investee company.

For tax purpose, in the U.S., tax consolidation can be elected when ownership, direct or indirect, of a domestic subsidiary is at least 80% in terms of voting power and value. Foreign subsidiaries are not included in tax consolidation because the U.S. tax system does not generally tax foreign-sourced income until repatriated as dividends to the U.S. parent company.

In Australia, for tax purpose, from 1 July 2002, ITAA 1997, Part 3-90, allows wholly-owned groups of Australian resident companies (together with eligible trusts and partnerships) to elect consolidation for income tax purposes. The election is irrevocable. If consolidation is elected, a wholly-owned group is treated as a single entity for tax purposes. The former grouping provisions such as transfers of tax losses, excess foreign tax credits, and CGT group rollover provisions were removed following introduction of tax consolidation.

If tax consolidation is elected, due to book-tax consolidation differences and the equity method of accounting for investment in associated companies, book income may exceed taxable income by:

- The book income of *domestic* subsidiaries with more than 50% but less than 100% ownership;
- The book income of *foreign* subsidiaries with more than 50% ownership unless attributed under s 456 of ITAA 1936 (the controlled foreign company accrual regime);

- The share of net income of associated companies owned between 20% and 50% due to the equity method of accounting.

On the other hand, taxable income may exceed book income by:

- Dividends received from the above entities, with imputation credit for franked dividends.

Table 3 shows that based on a sample of 604 firms for 2007, over 91% of firms elected tax consolidation, 3% did not elect. Four percent of firms did not have wholly-owned subsidiaries resident in Australia hence tax consolidation was not relevant. The remaining 1.5% had wholly-owned Australian subsidiaries but did not indicate whether or not they elected tax consolidation. Thus, more than 90% of firms that had wholly-owned Australian subsidiaries elected tax consolidation.

Table 3 about here

Minority interests in shareholders' equity and in net profit after tax reported in financial statements can provide an indication of the extent of book-tax difference due to "majority ownership" consolidation rule for accounting and "full ownership" consolidation rule for taxation. In Table 4, Panel A shows that about 31% of the 604 firms in the sample reported minority interests. Panel B shows that across the sample, on average, minority interests amount to 1.5% and 1.6% of shareholders' equity for 2007 and 2006 respectively. Panel C shows that on average, the net profit (loss) after tax attributable to minority interests is -0.6% and -2.4% of a firm's net profit (loss) after tax for 2007 and 2006 respectively. Examination of the lists of subsidiaries of a small sample of firms also confirmed that most subsidiaries were wholly-owned subsidiaries. Thus, with the exception of a few extreme cases, domestic subsidiaries included in accounting consolidation but not in tax consolidation do not appear to

be a significant source of book-tax difference that affects estimation of taxable income. However, current disclosure regime does not allow users of financial statements to estimate the book-tax difference caused by inclusion of foreign subsidiaries in accounting consolidation but not in tax consolidation.

Table 4 about here

The share of net profits (losses) of associated companies reported in income statement can provide an indication of the extent book-tax difference caused by equity accounting for investment in associated companies. In Table 5, Panel A shows that about 31% and 29% of the 604 firms in the sample reported a share of net profits (losses) of associated companies for 2007 and 2006 respectively. Panel B shows that on average, the share of net profits (losses) of associated companies amounts to 4.3% and 5.2% of a firm's net profit after tax for 2007 and 2006 respectively. However, as the share of net profits (losses) after tax of associated companies is separately disclosed in the income statement, users of financial statements can exclude this item from book income when compare with the estimate of taxable income.

Table 5 about here

3.5 Adjustments to Current Tax Expense after Release of Financial Statements

Financial statements are released to the public within four months after the year end, but corporate tax return is not due until about seven months after the year end. The current tax expense in financial statements may therefore differ from the tax liability eventually reported in corporate tax return due to adjustments using later information (“true-ups”).

Table 6 shows the descriptive statistics of the major components of tax expense expressed as a fraction of tax expense across the sample of 604 firms based on the descriptions in paragraph

80 of AASB 112. On average, current tax expense is 95.3% and 105% of tax expense for 2007 and 2006 respectively. Although based on the mean and median, current tax expense appears to be the predominant component of tax expense, the minimum and maximum statistics suggest that in extreme cases, current tax expense can be up to 140 times (2007) or -46.7 times (2006) of tax expense and is offset by other components of tax expense. The second largest component of tax expense is deferred tax expense which, on average, is 5.7% and 12.6% of tax expense for 2007 and 2006 respectively. Again, the minimum and maximum statistics suggest that in extreme cases, deferred tax expense can vary between 35.5 times and -139 times of tax expense in 2007. The next two components of tax expense, in the order of size, are benefit arising from a previously unrecognised tax loss, tax credit or temporary difference of a prior period that is used to reduce current and deferred tax expense respectively.

Table 6 about here

On average, adjustments for current tax of prior periods amount to -0.8% and -5.2% of tax expense for 2007 and 2006 respectively. However, the minimum and maximum statistics suggest that in extreme cases, the adjustments can vary between 7.5 times (2007) and -28.1 times (2006) of tax expense. Some firms described this item as “adjustments for tax expense of prior periods”, so for these firms this item might actually include adjustments to both current tax and deferred tax of prior periods. The presence of these adjustments using later information or “true-ups” after the financial statements are released to the public means that in general, income tax disclosures in financial statements are not sufficient to estimate taxable income eventually reported in corporate tax returns.

3.6 Suggestion for Additional Income Tax Disclosures

Based on the above discussion, the following additional income tax disclosures are required to enable users of financial statements to estimate taxable income:

- tax cushions;
- intraperiod tax allocation: separate disclosure of current tax expense related to continuing operations, discontinued operations, and gains and losses credited or charged directly to equity;
- Australian and foreign components of current tax expense and the applicable tax rates;
- differences due to different accounting and tax consolidation rules;
- adjustments to current tax expense subsequent to the release of financial statements.

Users of financial statements will be able to estimate the taxable income to cross-check the pre-tax book income of a publicly traded firm if Australian accounting standards require additional disclosure in a note to financial statements of a reconciliation between its current tax expense and the estimated tax liabilities to be reported in its Australian and foreign tax returns as depicted in Figure 1.

Figure 1 about here

The requirement to disclose tax cushions will discourage firms to take aggressive tax position that may not stand up to the future scrutiny of the taxation authorities. This will encourage sound tax risk management and corporate governance.

A second reconciliation described in Figure 2 is recommended to be required by the *Australian Securities Exchange Listing Rules* (as part of the continuous disclosure) to be announced by firms at the time when their Australian tax return is lodged to reveal the effect of the adjustments made to current tax expense subsequent to the release of financial report,

so that users of financial report can have early access to these adjustments without the need to wait for the financial report of the following period. Of course, the most straight-forward solution is to require firms to announce their taxable income reported to Australian and foreign taxation authorities after lodgement of corporate tax returns, but such disclosure requirement may be difficult to achieve.

Figure 2 about here

4. Summary and Conclusion

The primary research question of this study is: can we estimate taxable income from income tax disclosures in financial reports of listed companies in Australia? To answer this question, this paper has assessed whether income tax disclosures under the current Australian accounting standards provide sufficient information to allow users to estimate the taxable income of publicly traded companies. This paper has also examined empirically the problems associated with estimating taxable income from current tax expense using a sample of 604 firms that report net profit after tax for 2006 in their 2007 financial reports, and has recommended additional income tax disclosures to be required by Australian accounting standards and ASX Listing Rules to facilitate such estimation.

By providing additional reconciliations in two stages of current tax expense and the tax liabilities eventually reported in corporate tax returns, separate into Australian tax and foreign taxes (with weighted average foreign tax rate also disclosed), investors, analysts, corporate regulators are able to estimate taxable income to cross check the credibility of reported book income. Taxation authorities also can gain additional information about book-tax income

difference and are in a better position to target their tax audit effort. The recommended additional income tax disclosures not only will help discourage earnings management and improve the functioning of the capital markets, it also will help promote sound tax risk management and improve corporate governance.

One major limitation of this study is that the empirical component is only based on descriptive statistics of financial statement data. The Internal Revenue Service in the U.S. has allowed some tax researchers access to corporate tax return data for research purposes subject to certain confidentiality undertakings. Perhaps the Australian Taxation Office should consider allowing tax researchers in Australia similar access to enable more in-depth studies of book-tax income differences to be conducted, and models to estimate taxable income from disclosures in financial statements to be developed.

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Table 1 – Number of Firms in the Final Sample

Sample selection criteria	Number of firms
Initial sample from Connect4 2007 Annual Report Database	1,646
Less: Trusts	91
Less: Foreign firms	26
Less: Firms with only 2007 data	33
Less: Firms that reported a loss before tax for 2006	836
Less: Firms that reported a zero profit before tax for 2006	11
Less: Firms that reported a zero tax expense for 2006 and 2007	45
Final Sample Size	604

Table 2 – Discontinued Operations

Panel A				
Number of firms reporting a profit or loss from discontinued operations in the sample of 604 firms				
	2007		2006	
	No.	%	No.	%
Firms reporting a profit or loss from discontinued operations	81	13.4	102	16.9

Panel B		
“Profit or loss after tax from discontinued operations” expressed as a percentage of “Net profit after tax from continuing operations” across the sample of 604 firms		
	2007	2006
Mean	-49.7%	10.5%
5% trimmed mean	0.17%	0.77%
Median	0%	0%
Standard deviation	1,292%	162%
Minimum	-31,716%	-1,851%
Maximum	581%	2,734%

Panel C		
Firms disclosing the major components of tax expense on profit or loss from both continuing and discontinued operations		
	Number of firms	Percentage
Firms reporting a profit or loss from discontinued operations in 2007 and/or 2006	103	100
Firms disclosing major components of tax expense on profit or loss from both continuing and discontinued operations	60	58

Table 3 – Election of Tax Consolidation (Reporting Period Ended in 2007)

Tax consolidation	Number of firms	Percentage
Tax consolidation elected	553	91.5
Tax consolidation not elected	18	3
Did not have wholly-owned Australian subsidiaries	24	4
Had wholly-owned Australian subsidiaries but did not indicate whether tax consolidation was elected	9	1.5
Total	604	100

Table 4 – Minority Interests

Panel A				
Number of firms reporting minority interests in shareholders' equity in the sample of 604 firms				
	2007		2006	
	No.	%	No.	%
Firms reporting minority interests in shareholders' equity	190	31.5	184	30.5

Panel B		
“Minority interests” expressed as a percentage of “Shareholders equity” across the sample of 604 firms		
	2007	2006
Mean	1.51%	1.63%
5% trimmed mean	0.51%	0.50%
Median	0%	0%
Standard deviation	9.09%	6.22%
Minimum	-147%	-20%
Maximum	78%	63%

Panel C		
“Net profit (loss) attributable to minority interests” expressed as a percentage of “Net profit after tax” across the sample of 604 firms		
	2007	2006
Mean	-0.63%	-2.42%
5% trimmed mean	0.15%	0.06%
Median	0%	0%
Standard deviation	27.6%	45.7%
Minimum	-586%	-1,056%
Maximum	241%	95%

Table 5 – Associate Companies

Panel A
**Number of firms reporting “Share of net profits (losses) of associated companies”
in the sample of 604 firms**

	2007		2006	
	No.	%	No.	%
Firms reporting share of net profits (losses) of associated companies	186	30.8	173	28.6

Panel B
**“Share of net profits (losses) of associated companies” expressed as a percentage of
“Net profit after tax” across the sample of 604 firms**

	2007	2006
Mean	4.28%	5.23%
5% trimmed mean	1.65%	1.61%
Median	0%	0%
Standard deviation	23.6%	46.9%
Minimum	-268%	-459%
Maximum	265%	803%

Table 6 – Major Components of Tax Expense Expressed as a Fraction of Tax Expense

Major Component of Tax Expense	2007		2006	
Current tax expense (income)	Mean	0.953	Mean	1.05
	5% trimmed mean	0.834	5% trimmed mean	0.878
	Median	0.977	Median	0.975
	Standard deviation	6.48	Standard deviation	6.38
	Minimum	-42	Minimum	-46.7
	Maximum	140	Maximum	134
Adjustments for current tax (or tax expense) of prior periods	Mean	-0.008	Mean	-0.052
	5% trimmed mean	-0.007	5% trimmed mean	-0.014
	Median	0	Median	0
	Standard deviation	0.825	Standard deviation	1.32
	Minimum	-16.3	Minimum	-28.1
	Maximum	7.5	Maximum	6.26
Deferred tax expense (income)	Mean	0.057	Mean	0.126
	5% trimmed mean	0.172	5% trimmed mean	0.15
	Median	0.025	Median	0.037
	Standard deviation	6.22	Standard deviation	2.41
	Minimum	-139	Minimum	-45.9
	Maximum	35.5	Maximum	21.5
Deferred tax expense (income) relating to changes in tax rates or the imposition of new taxes	Mean	0.002	Mean	0.007
	5% trimmed mean	0	5% trimmed mean	0
	Median	0	Median	0
	Standard deviation	0.048	Standard deviation	0.191
	Minimum	-0.19	Minimum	-0.92
	Maximum	1.02	Maximum	4.36
Benefit arising from a previously unrecognised tax loss, tax credit or temporary difference of a prior period that is used to reduce <i>current</i> tax expense	Mean	0.057	Mean	-0.05
	5% trimmed mean	0	5% trimmed mean	0
	Median	0	Median	0
	Standard deviation	1.11	Standard deviation	1.38
	Minimum	-1.51	Minimum	-23.1
	Maximum	26.1	Maximum	9.57
Benefit arising from a previously unrecognised tax loss, tax credit or temporary difference of a prior period that is used to reduce <i>deferred</i> tax expense	Mean	-0.042	Mean	-0.087
	5% trimmed mean	0	5% trimmed mean	0
	Median	0	Median	0
	Standard deviation	1.03	Standard deviation	6.59
	Minimum	-24.2	Minimum	-134
	Maximum	1.41	Maximum	83
Deferred tax expense arising from the write-down, or reversal of a previous write-down, of a deferred tax asset	Mean	0.001	Mean	0.001
	5% trimmed mean	0	5% trimmed mean	0
	Median	0	Median	0
	Standard deviation	0.014	Standard deviation	0.015
	Minimum	0	Minimum	-0.03
	Maximum	0.35	Maximum	0.36
Tax expense (income) relating to those changes in accounting policies and errors that are included in profit or loss in accordance with AASB 108	Mean	0	Mean	0
	5% trimmed mean	0	5% trimmed mean	0
	Median	0	Median	0
	Standard deviation	0	Standard deviation	0
	Minimum	0	Minimum	0
	Maximum	0	Maximum	0

Figure 1**Reconciliation between Current Tax Expense and Estimated Tax Liabilities****Disclosed in Financial Statements**

	Australian Tax (30%)	Foreign Taxes (Weighted average tax rate = x%)	Total
Current tax expense on continuing operations	xxx	xxx	xxx
Add/Less: Current tax expense (income) related to discontinued operations	xxx	xxx	xxx
Add/Less: Current tax expense (income) related to items charged or credited directly to equity	xxx	xxx	xxx
Add/Less: Differences due to accounting and tax consolidation rules	xxx	xxx	xxx
Less: Current year tax cushions	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>
Tax liabilities estimated at the time when financial report is approved	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>

Figure 2

Reconciliation between Estimated and Actual Tax Liabilities
Released through ASX When Australian Tax Return Is Lodged

	Australian Tax (30%)	Foreign Taxes (Weighted average tax rate = x%)	Total
Tax liabilities estimated at the time when financial report was approved	xxx	xxx	xxx
Add/Less: Adjustments subsequent to release of financial report	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>
Tax liabilities reported in tax returns	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>