

Deferred Tax

Each year in our Annual Report we explain an aspect of our accounts which is of particular importance or relevance to our shareholders. In this year's "Accounting Mini-series", we have chosen to explain the concept of "deferred tax" and to provide some examples of its application throughout the Group.

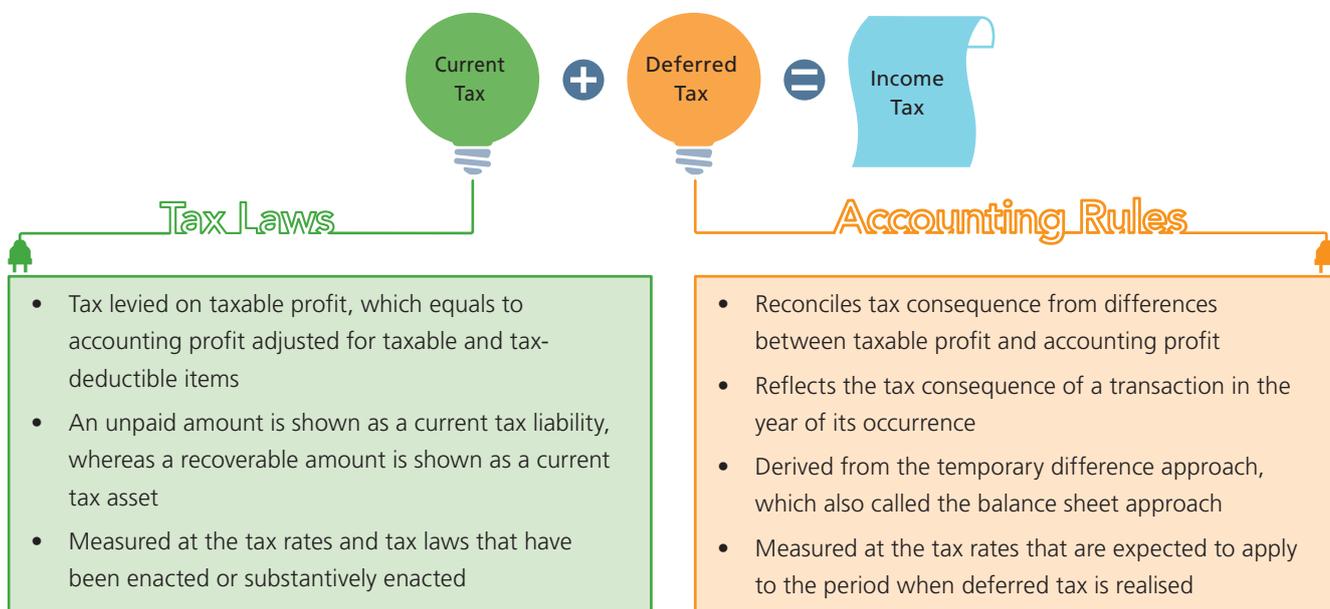
Why Can Tax be Deferred?

Tax laws and accounting rules seldom match with each other. Profits tax is payable or recoverable based on the taxable and deductible amounts assessed by a tax authority according to the prevailing tax laws of respective jurisdictions. However, the recognition of tax expense or credit in our financial statements is governed by accounting standards.

The accounting standard – HKAS 12 "Income Taxes" introduces the concept of "deferred tax" to reconcile this matching of transactions and events with their tax effects. Through the application of this accounting standard, CLP has recognised deferred tax assets of HK\$1,025 million and deferred tax liabilities of HK\$8,370 million at 2012 year end.

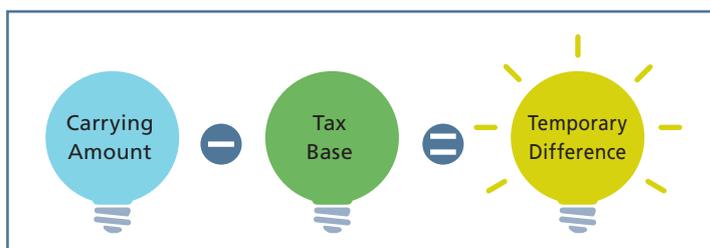
Income Tax

Income tax in the accounting regime comprises both the actual tax levied by a tax authority (i.e. current tax) and future tax consequences (i.e. deferred tax).



The "Temporary Difference" Approach

Every asset and liability has a "shadow value" under tax laws for tax computation, which the accounting standard calls its "tax base". For example, the tax base of an asset means the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset. The difference between the carrying amount of an asset or a liability in the financial statements and its tax base is referred to as a "temporary difference". A temporary difference can either be a taxable temporary difference or a deductible temporary difference.

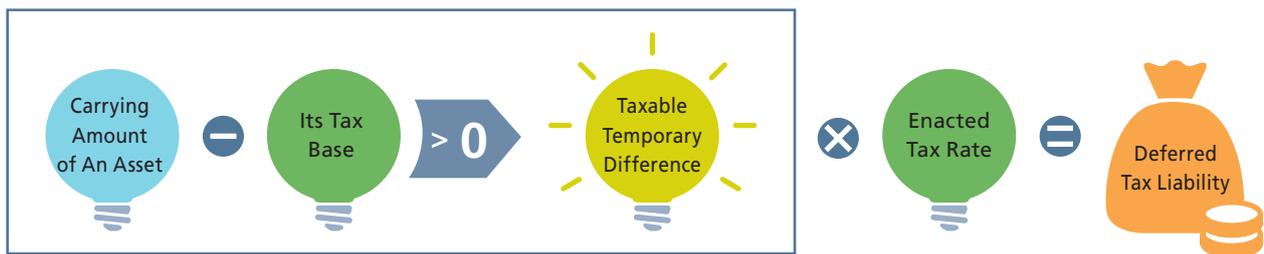


Deferred Tax Liability

A temporary difference that will result in taxable amounts in determining taxable profit of future periods when the carrying amount of an asset or a liability is recovered or settled is regarded as a "taxable temporary difference". It commonly arises from the differences between accounting depreciation and tax depreciation (i.e. capital allowances).

The accounting rules require an asset with a limited useful life to be subject to accounting depreciation. Concurrently, the asset may be eligible for capital allowances under the tax laws. Because governments often use tax policy to encourage capital investment, capital allowances usually depreciate an asset at a faster rate than accounting depreciation. This leads to a higher asset carrying amount (cost less accumulated accounting depreciation) compared to its tax base (cost less accumulated tax depreciation).

The accounting standard requires us to recognise all taxable temporary differences. They are recorded as deferred tax liabilities in the financial statements.



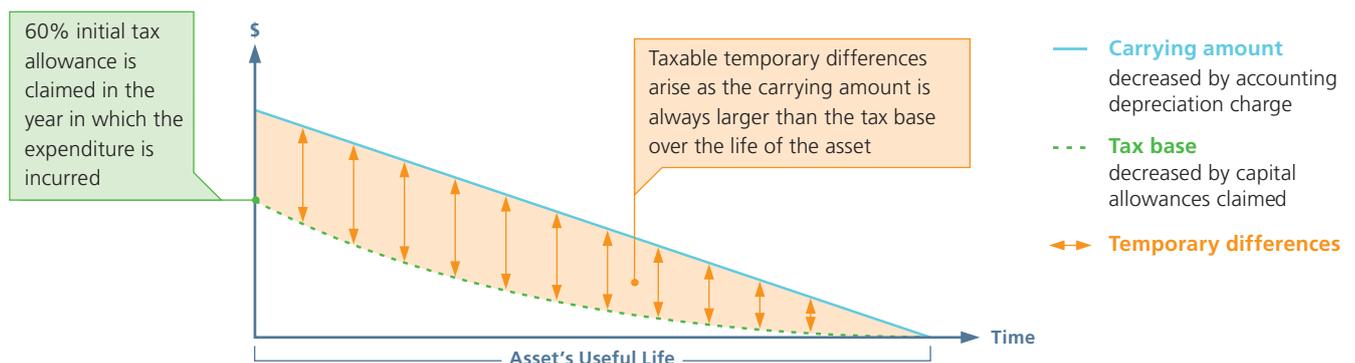
Example: Electricity Business in Hong Kong

Deferred tax liabilities of CLP arise mainly from our Hong Kong electricity business. One example where a deferred tax liability arises is the treatment of equipment such as switchgear and transformer installed in our substations. This equipment is subject to both accounting depreciation and capital allowances under the accounting and Hong Kong Profits Tax regime.



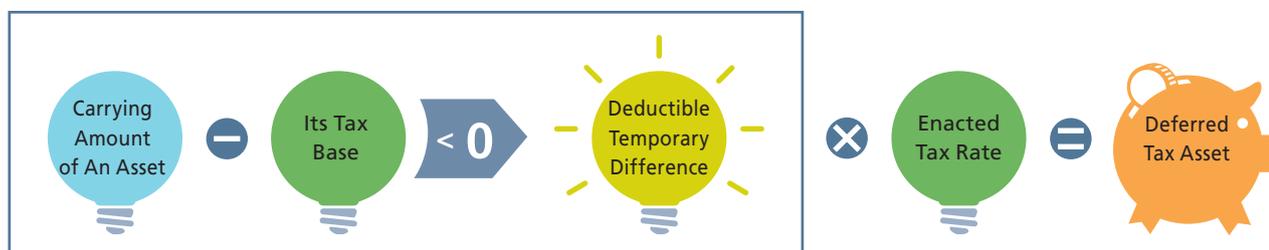
In this example, the Hong Kong tax regime allows for a 60% capital allowance in the year in which the expenditure is incurred, whereas for accounting purposes the equipment is depreciated on a straight-line basis over an estimated useful life of 50 years. This initial capital allowance reduces our current tax liability for that year and results in the tax bases of switchgear and transformer being lower than their carrying amounts throughout their useful lives.

These temporary differences will be reduced gradually to zero over time as accounting depreciation exceeds annual capital allowance. This means higher tax levies in future years, thereby reducing our deferred tax liability over time.



Deferred Tax Asset

A temporary difference which gives rise to deductions in calculating the taxable profit in future years is regarded as a “deductible temporary difference”. One example of a deductible temporary difference is asset impairment, which reduces the carrying amount of an asset on the balance sheet, although its tax base under the tax computation is not affected. In other words, the impaired amount is still available for tax deductions in future years.



Deferred tax asset is also applied to unused tax losses and tax credits that are carried forward for tax purposes. This is another kind of deductible temporary difference.

The accounting standard sets out stringent rules on the recognition of a deferred tax asset. It can only be recognised if it is probable that future taxable profits will be available to utilise the deductible temporary differences. Every year, the carrying amount of a deferred tax asset will be reviewed and reduced, if appropriate, to the extent that sufficient taxable profits will be available to allow the benefit of part or all of that deferred tax asset to be utilised.

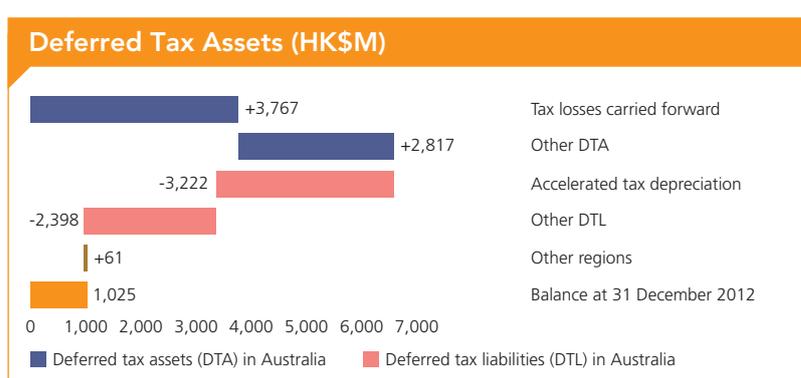
Example: Energy Business in Australia

Deferred tax assets recognised in our books mainly relate to tax losses carried forward in our Australia energy business of HK\$3,767 million. The majority of these tax losses are operating losses of Yallourn Power Station accumulated in the years prior to its acquisition by the Group in 2003.

As mentioned above, deferred tax assets can only be recognised if it is probable that future taxable profits will be available. This recognition criterion must be satisfied on an ongoing basis. Through our annual Business Planning process, we forecast the taxable profits of EnergyAustralia and our ability to utilise the unused tax losses. In undertaking this assessment, consideration must be given to past performance and the accuracy of previous forecasts as indicators of the likelihood of the current forecasts being realised.

Netting-off Deferred Tax Assets and Liabilities

Deferred tax assets and liabilities are required to be disclosed separately in the financial statements. They are allowed to be presented on a net basis only if we have a legally enforceable right to set off current tax assets against current tax liabilities and they are levied by the same tax authority. The chart opposite illustrates the netting-off effect between deferred tax assets and liabilities of our Australia tax consolidation group.



Merits of Deferred Tax Accounting

Most transactions and events recorded in the financial statements have a tax consequence which may be immediate or may be deferred. By applying deferred tax accounting, the tax effects of all income and expenditure, gains and losses, assets and liabilities are recognised in the same period in which these items are recognised and not in the period in which they form part of taxable profit. This matching of transactions and events with their tax effects brings investors one step closer to understanding our underlying performance every year.