Accounting for deferred taxes under NZ IAS 12

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The introduction of international financial reporting standards brings dramatic changes to the way deferred tax must be accounted for. NZ IAS 12 provides the new guidelines.

The adoption of International Financial Reporting Standards (IFRS) in New Zealand will introduce varying levels of change in the way that entities account for their transactions. One area of accounting that will be affected dramatically is deferred taxes, which historically has been a complex and controversial issue. Under IFRS entities will have to account for deferred taxes using the requirements embodied in the New Zealand Equivalent to International Accounting Standard 12 (NZ IAS 12), “Income Taxes.” This replaces Statement of Standard Accounting Practice No.12 (SSAP-12), “Accounting for Income Tax.”

NZ IAS 12 provides a significant and fundamental shift in thinking on how to account for deferred taxes in New Zealand. At the heart of this shift is a reorientation towards a “balance sheet” approach to determining deferred taxes, as opposed to an “income statement” approach, which forms the basis of SSAP-12. Accordingly, the requirements of NZ IAS 12 could lead to deferred tax figures reported in the financial statements that are somewhat different to those that would be determined under SSAP-12.¹

In this article I examine four important areas of change that will affect an entity’s accounting for deferred taxes as a result of adopting NZ IAS 12. Specifically, these are: (1) the orientation to a “balance sheet” approach; (2) the discontinuation of allowing partial recognition of deferred taxes; (3) the relaxing of the recognition rules related to deferred
A primer on accounting for deferred taxes

The income figure before tax that is calculated on an entity's income tax return (referred to in NZ IAS 12 as taxable profit) is often different from that reported in its annual financial statements (referred to in NZ IAS 12 as accounting profit). This is because these two income numbers are often calculated using different rules. Taxable profit is based on taxation legislation to derive the amount of tax that is currently payable (referred to in NZ IAS 12 as current tax) to the taxation authorities. On the other hand, accounting profit is based on generally accepted accounting principles (GAAP) embodied usually in accounting standards to provide information for a variety of decision making contexts, such as investment decisions.

From an accounting perspective, the issue of concern is how to calculate the income tax expense to be recognised in the financial statements? One approach is to base the income tax expense calculation on the taxable profit figure by letting the income tax expense equal the current tax (commonly known as the "taxes payable" method). However, this approach has not been widely accepted in the major accounting jurisdictions. This is because of the view that income taxes are the outcome of transactions or events that bring about the accounting profit figure. As such, the income tax expense should be related to accounting profit and be subject to the same recognition and measurement rules that apply to other expenses reported in the financial statements. This view has lead to the development of "tax effect" accounting, which is required under NZ IAS 12.

Tax effect accounting attempts to reconcile the difference that may arise between taxable profit and accounting profit. It does this by recognizing an income tax expense figure that aligns with accounting profit, rather than taxable profit. In particular, income tax expense (from hereon, I will refer to this simply as tax expense, as this is the term used in NZ IAS 12) is calculated as the sum of the amount of current tax and an item known as deferred tax. Deferred tax can be defined as the future tax effect of items recognised on the balance sheet (or on a balance sheet prepared for tax purposes). Tax effect accounting acknowledges that it is important to recognise the tax effects of transactions or events that produce accounting profit. This is even if the tax effects have not taken place yet and will actually occur in the future.

Two approaches can be broadly used to implement tax effect accounting. These are: (1) the "income statement" approach, and (2) the "balance sheet" approach.

A “balance sheet” approach

The most significant change in NZ IAS 12 from SSAP-12 is that the basis used to account for deferred taxes follows a balance sheet approach as opposed to an income statement approach. To calculate deferred taxes under the balance sheet approach, we must determine an entity’s temporary differences. Temporary differences are the differences between the carrying amount of an asset or liability in the balance sheet and its tax base (i.e., the amount attributed to the same asset or liability for tax purposes). In contrast, to calculate deferred taxes under the income statement approach, we must determine an entity’s timing differences. Timing differences arise when revenue and expense items are recognised in the calculation of accounting profit before or after they are included in the calculation of taxable profit.

The focus of the deferred tax calculation in the balance sheet approach is on items that appear in the balance sheet, while for the income statement approach it is on items that appear in the income statement. However, since the income statement is a by-product of the balance sheet, all timing differences by definition must be a component of temporary differences (see paragraph 17 of NZ IAS 12 which hints at this point).

In some situations, the amount of temporary differences will equal the amount of timing differences in a period. However, the amount of timing differences cannot be greater than the amount of temporary differences. This is because not all asset and liability items in the balance sheet necessarily have an effect that passes through the income statement and which would impact on deferred taxes. For example, a temporary difference, but not a timing difference, can arise when an asset is revalued upwards (with the increment in value recognised in equity and not in the income statement), but there is no equivalent adjustment made for tax purposes (see later for a more detailed discussion of how this is accounted...
for under NZ IAS 12).

Therefore, the main consequence of the balance sheet approach for entities when they adopt NZ IAS 12 is that it can capture a much wider range of items that will give rise to the recognition of deferred taxes in the financial statements. Further, the change to a balance sheet approach is consistent with the asset-liability orientation to financial reporting that is advocated for by the International Accounting Standards Board in its "Framework for the Preparation and Presentation of Financial Statements" and the New Zealand Institute of Chartered Accountants (formerly the Institute of Chartered Accountants of New Zealand) in its "Statement of Concepts for General Purpose Financial Reporting."

Recognition of all temporary differences – no “partial” recognition

NZ IAS 12 requires a deferred tax liability to be recognised for all taxable temporary differences. Taxable temporary differences result in taxable amounts that impact the taxable profit of future periods when the carrying amount of an asset or liability is recovered or settled. Further, NZ IAS 12 requires a deferred tax asset to be recognised for all deductible temporary differences, although this is subject to certain criteria. Deductible temporary differences result in amounts that are deductible in determining the taxable profit of future periods when the carrying amount of an asset or liability is recovered or settled. Therefore, while some very limited exceptions apply, the requirement in NZ IAS 12 is that all temporary differences (taxable and deductible) are to be recognised as deferred taxes (liability and asset, respectively) in the financial statements.4

In general, when all temporary differences are recognised as deferred tax, this is often referred to as tax effect accounting under a "comprehensive" basis. When only some, but not all, temporary differences are recognised as deferred tax, this is often referred to as tax effect accounting under a "partial" basis. Using this terminology and distinction, NZ IAS 12 can be viewed as following a comprehensive basis.5 On the other hand, SSAP-12 allows entities the choice to recognise deferred taxes either under a comprehensive basis or under a partial basis, although the preferred option is comprehensive. As such, this provides a significant variation between the two accounting standards because the partial basis is not allowed in NZ IAS 12.

By and large the partial basis arose out of concerns regarding the recognition of deferred tax liabilities when tax effect accounting under the comprehensive basis was used. These concerns centre on the issue of whether taxable temporary differences "reverse". There are situations where the temporary differences created under the comprehensive basis may cause an entity to report on its balance sheet a deferred tax liability that appears never to be settled and which may be ever growing in nature. This can occur if an entity has high investments and/or a policy of continually investing in depreciable assets. In such a case, the taxable temporary differences may not reverse because new temporary differences are created and recognised that more than offset any reversing temporary differences from a prior period. Hence, this gives the impression that settlement of the deferred tax liability can be postponed indefinitely. The partial basis would overcome this concern by recognizing as deferred taxes in the financial statements only those temporary differences that are expected to have a future cash flow effect (i.e., those that are expected to reverse).

While many New Zealand entities currently use the comprehensive basis and recognise all timing differences as deferred tax, NZ IAS 12 will cast that net wider by requiring all temporary differences to be recognised. The effect of this on entities will be small if the total amount of temporary differences is similar to the total amount of timing differences. But the effect could be substantial for entities that currently use the partial basis under SSAP-12 and have a history of not recognizing deferred taxes from all timing differences. These unrecognised amounts will now have to be recognised, and for some entities, this will not be a trivial exercise. To illustrate, consider what happened to Air New Zealand when it reported a change in its accounting policy for income taxes from the partial basis to the comprehensive basis for its financial year ending 2000, albeit under the requirements of SSAP-12. The financial effect of doing so increased Air New Zealand’s deferred tax liability by $786 million, an amount that had previously been unrecognised. It also significantly contributed to Air New Zealand’s bottom line net loss of $600 million and substantially increased its debt to total assets ratio from 34 to 66 percent for its 2000 financial year. Interestingly, Air New Zealand cited that its main reason for changing to the comprehensive basis was to bring its books in line with international accounting standard trends. More recently, Wong and Wong6 provide descriptive evidence that deferred taxes from unrecognised timing differences from a sample of New Zealand’s largest companies in 2002 and 2003 are not small.

NZ IAS 12’s requirement to recognise all temporary differences as deferred tax will fuel further debate on the merits of tax effect accounting under the comprehensive and partial bases. The resolution of this debate is far from certain, especially given recent research findings that entities choose partial over the comprehensive basis because it provides more accurate and relevant information about the deferred tax figures presented in the financial statements when there are temporary differences that are not expected to reverse.7

Deferred tax assets

NZ IAS 12 and SSAP-12 both allow the recognition of deferred tax assets. However, the recognition conditions in NZ IAS 12 differ from those in SSAP-12. In NZ IAS 12, the recognition of a deferred tax asset depends on “the extent that it is probable that taxable profit will be available against
Revalued assets

An interesting issue that arises in NZ IAS 12 concerns the revaluation of assets. In this situation, when an asset is revalued upwards in the financial statements, but there is no similar adjustment to the tax base of the asset, this creates a taxable temporary difference that requires the recognition of a deferred tax liability. In comparison, no deferred tax liability would be recognised in the balance sheet for an asset that is revalued under the income statement approach in SSAP-12. Generally, this is because of the way in which the depreciation charge from the revalued asset is handled in the income statement for accounting and tax purposes. While the depreciation expense for accounting purposes is based on the revalued amount, depreciation expense that is deducted for tax purposes must still be based on the asset's original cost. This means that the depreciation expense that arises from the revaluation increment never has a tax effect (i.e., a timing difference does not arise from that part of the depreciation expense related to the revalued asset) under SSAP-12. Hence, the change in requirement in NZ IAS 12 could increase significantly the amount of the deferred tax liability that is recognised on the balance sheet because entities revalue their assets regularly.

The measurement of the deferred tax liability from the revaluation in NZ IAS 12 depends on the manner in which the carrying amount of the asset is expected to be recovered at balance date (see paragraph 52 of NZ IAS 12, in particular example B) - that is, whether the asset is expected to be recovered through its further use or if the asset is expected to be recovered through its subsequent disposal. If the carrying amount of the asset is expected to be recovered through its further use, a deferred tax liability would be recognised by calculating the difference between the carrying amount (i.e., the revalued amount) and the tax base of the asset. If the carrying amount of the asset is expected to be recovered through its subsequent disposal, a deferred tax liability would be recognised by determining the difference between the carrying amount and the tax base of the asset, but adjusted for any amount considered to be a capital gain (i.e., the expected proceeds from the disposal in excess of the original cost of the asset). This adjustment is necessary because capital gains are not taxable under current New Zealand tax legislation. Also, the deferred tax liability that is recognised from the revaluation of the asset must be charged directly to equity (paragraph 61 of NZ IAS 12). This is because the accounting for the revaluation itself involves the increment in value being recognised in equity and not in the income statement.

To illustrate these two situations, consider this example. Assume an entity owns an asset that cost $100,000 to acquire. The carrying amount before the asset is revalued is $60,000, while the tax base is $50,000. The asset is revalued to $120,000, but no similar adjustment is made for tax purposes. The tax rate is 33 percent and capital gains from the sale of assets are not taxed.

If the carrying amount of the revalued asset is expected to be recovered through its further use, the amount of the temporary difference would be $70,000 (i.e., $120,000-$50,000). This figure is a taxable temporary difference because the entity expects to recover benefits from the asset's further use to the carrying amount of $120,000. Hence, the deferred tax liability that is recognised from the revalued asset would be $23,100 (i.e., $70,000 x 33 percent).

If the carrying amount of the revalued asset is expected to be recovered through its subsequent disposal, the taxable temporary difference would again amount to $70,000 (i.e., $120,000-$50,000). However, $20,000 of this amount is a capital gain (found by deducting the original cost of $100,000 from the revalued amount of $120,000). This means that only $50,000 of the $70,000 temporary difference is actually taxable. Hence, the deferred tax liability that is recognised from the revalued asset would be $16,500 (i.e., $50,000 x 33 percent).

We can see from the above example that not only will NZ IAS 12 require entities to recognise a deferred tax liability from an asset that is revalued upwards, but it will also require entities to make a decision about how their assets are expected to be recovered, as this will have a bearing on how entities measure the deferred tax liability.

Concluding remarks

In this article I examine some of the changes that will result from adopting NZ IAS 12 as opposed to SSAP-12. Four important areas of change are discussed. These are:
(1) the orientation to a balance sheet approach of income tax determination; (2) the discontinuation of allowing partial recognition of deferred taxes; (3) the relaxing of the recognition rules related to deferred tax assets; and (4) the recognition of deferred tax on revalued assets. Each of these areas of change in NZ IAS 12 may have a potentially significant effect on the financial statements of New Zealand entities compared to the requirements under SSAP-12.

This article was only able to highlight some of the main areas of change in NZ IAS 12. However, there are also other issues that entities will have to pay close attention to when they adopt NZ IAS 12. One of these is matters regarding disclosure. NZ IAS 12’s disclosure requirements are much more burdensome than those required under SSAP-12. Specifically, entities will have to provide more disclosure about income tax items, and at a greater level of detail, than previously. This will probably generate higher information production costs for entities and will contribute, along with other more onerous disclosure requirements of IFRS in general, to a bigger size set of financial statements in terms of the number of pages. Hopefully, it will provide users of the financial statements with information that is more useful and transparent.

In conclusion, it will be interesting to see whether NZ IAS 12 will resolve some of the controversial and complex issues that have surrounded the area of accounting for deferred taxes. These issues have been debated now for over 40 years and there is little sign that the debate is lessening in its intensity. However, only time will tell us what influence NZ IAS 12 will have on entities and users of financial statements in New Zealand.

Further reading
Previous research studies are referred to in the article and references are given below. The following references, which examine the importance of tax effect accounting and whether temporary differences reverse, are suggested as further reading:

References
2. Note, technical terms used in NZ IAS 12 or SSAP-12 are identified in their first instance of use in italics. This is done to provide clarity in the discussion that follows.
3. This is the case in SSAP-12 and NZ IAS 12. However, entities may be able to use the taxes payable method if differential reporting requirements are applicable.
4. These exceptions relate to: (i) the initial recognition of goodwill for taxable temporary differences; and (ii) the initial recognition of an asset or liability in a transaction that is not a business combination and at the time of the transaction it does not affect either accounting profit or taxable profit, for both taxable and deductible temporary differences.
5. Note NZ IAS 12 does not use the terms “comprehensive” or “partial” in describing how temporary differences are recognised, although this terminology is used in SSAP-12. I only use these terms for convenience to describe this issue.
8. For simplicity, I only discuss the tax effects that arise from an upward revaluation. However, we should note that when there is a downward revaluation of an asset, but no similar adjustment is made to the tax base of the asset, a deductible temporary difference will arise that requires the recognition of a deferred tax asset (see paragraph 26(d) of NZ IAS 12).
9. Note that SSAP-12 does contemplate that a timing difference may arise when an asset is revalued and that the timing difference would have to be recognised as deferred tax if it is *expected* to reverse through the realisation by sale of the asset in the foreseeable future (paragraph 4.29 of SSAP-12).

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