Slug: MASB25

Title: Deferred Taxation Redefined – Part I

Stf: Big adjustment on deferred tax that reduces or increases the net tangible assets of companies maybe expected when MASB25 becomes operative.

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Text:

The new MASB25 Income Taxes becomes operative for annual financial statements covering periods beginning on or after 1 July 2002. Companies with financial year-end of June will be the first group of companies to be subject to this new standard. MASB 25 supercedes MASB Approved Accounting Standard IAS12 Accounting For Taxes on Income (the original IAS12) that has been effective since 1981.

The International Accounting Standards Committee (IASC) has issued a revised IAS12 in 1998 to replace it. MASB 25 is in all respect; similar with the revised IAS12 and the Malaysian Institute of Accountants has actually issued the revised IAS12 as an Exposure Draft in 1998. It was, however, not subsequently implemented. What is included in MASB25 should, therefore, be nothing new to the Malaysian accounting fraternity except that its implementation has been delayed until today, almost five years later.

Like the original IAS12, MASB25 deals with accounting for income taxes that include both current tax payable and deferred taxation. The accounting for current tax is a straightforward one and there is no significant change between MASB25 and the original IAS12. The interest is on deferred taxation as MASB25 introduces some major changes which application may have significant effect on the financial statements of companies. This article discusses the deferred taxation part of the MASB25 only.

What then are the big changes in MASB25 when compared with the old standards on the subject of deferred taxation?

The following provides a glimpse of the differences between MASB25 and the original IAS12, “New focus, new terminology and method, more comprehensive, more specific, and more disclosures. But the real big change is in the new recognition rules and criteria on both deferred tax liabilities and assets.”

It can be said that MASB25 has actually introduced a new concept of deferred taxation. A number of new terminology and definition have been inevitably introduced along with the new concept. It attempts to be more comprehensive and more specific on the application, recognition and disclosures. In the following discussion, we attempt to take a critical look at these and other areas and highlight the major changes compared with the original IAS12.

Shift in Focus

Accounting for deferred taxation is a result of tax effect accounting that treats income tax as an expense incurred in earning the income and must therefore be accrued in the same period as the income under the accounting principle of accrual. This is and has to be the same between the original IAS12 and MASB25. There is, however, a major shift in the focus on accounting for deferred taxation in MASB25.

The original IAS12 focuses on income statement and the timing differences which cause the difference in the accounting and taxable profits. It allows the use of either a deferral or liability method.

MASB25 focuses on balance sheet and it allows the use of the liability method only. It is often regarded as Balance Sheet Liability Method.

Accordingly, the deferred taxation under MASB 25 is primarily based on the Temporary Differences between the carrying amount of assets and liabilities in the balance sheet and their respective Tax Base. It should be noted that all timing differences are temporary differences. In the end, MASB 25 is concerned about ensuring the net assets of an entity are stated after accounting for their possible tax effect. The amount transferred to or from the tax expense account in income statement is essentially the residue of the changes in the deferred tax liability/asset between current and previous balance sheet date.

Although there is a change in focus, theoretically the result should be the same as the cumulative effect of the deferred taxation on the timing differences in each year should add up to the deferred taxation calculated based on balance sheet method. In practice, even under the original IAS12 regime, balance sheet amount was used in the calculation of deferred tax as it serves as a shortcut to the cumulative timing differences.

In essence, however, the change in focus is paramount as it represents a shift to a new fundamental concept of deferred taxation. It is in fact based on this new fundamental concept that new terminology and method of determining deferred tax are introduced, a new scope is derived and new recognition rules as well as criteria are set.

New Terminology & Method

The change in the fundamental concept and focus inevitably introduces new terminologies. The key terminologies used in the original IAS12 are Accounting Income, Taxable Income, Timing Differences and Permanent Differences.

In MASB25, Accounting Profit and Taxable Profit are used to replace Accounting Income and Taxable Income but they basically refer to the same thing. The biggest change is the new terminology called Temporary Differences.

Temporary Differences is defined in MASB25 as the differences between the carrying amount of an asset or liability in the balance sheet and its Tax Base. Temporary Differences may either be Taxable Temporary Differences or Deductible Temporary Differences. Taxable Temporary Differences will lead to deferred tax liability whereas Deductible Temporary Differences will lead to deferred tax asset. Tax Base of an asset or liability is defined as the amount attributed to that asset or liability for tax purposes.

The discussion notes in MASB25 further explain the tax base of an asset and liability as follows:

- The tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an enterprise when it recovers the carrying amount of the asset. If those economic benefits will not be taxable, the tax base of the asset is equal to its carrying amount.
- The tax base of a liability is its carrying amount, less any amount that will be deductible for tax purposes in respect of that liability in future periods.

It is thought that with the shift in the focus, there is a need to introduce new terminologies that will ensure adherence to the new focus. Timing Differences and Permanent Differences, the terminologies used in the original IAS12, signify the focus on income statement. Both timing differences and permanent differences may give rise to Temporary Differences. In addition, there are additional items that also form part of Temporary Differences. Temporary Differences, therefore, is more comprehensive.

Under the original IAS12, Permanent Differences are not deferred tax item. In MASB25, the term Permanent Difference is not mentioned at all. To take care of this, MASB25 introduces exception clauses on recognition of deferred tax liability/asset. Under the exception clauses, no deferred tax (both liability and asset) shall be recognized on Temporary Differences that arose from the initial recognition of that asset or liability which:

a) is not a business combination; and
b) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

This exception clause would have covered all Permanent Differences.

The introduction of new terminology and the shift of focus to balance sheet at the end give birth to a new way or method of determining deferred tax liability/asset. The new method would logically start from balance sheet. The next step is to determine the tax base of the balance sheet items. Temporary Differences are simply the difference between the carrying amount in balance sheet and the corresponding tax base. Deferred tax liabilities/assets are derived from the temporary differences subject to fulfilling the recognition criteria.

It is clear that Tax Base is the key item in determining the Temporary Differences and hence the deferred tax liabilities/assets. However, the definition of Tax Base in MASB25 (as mentioned above) is very general. Knowledge of the taxation laws will be required to determine the tax base of each of the assets and liabilities in the balance sheet. The explanation and examples given in MASB25 do offer helps though.

More Comprehensive

MASB25 attempts to be a comprehensive standard that addresses the tax effect of accounting for income taxes. As stated before, all timing differences are Temporary Differences. As such, all items considered being a deferred tax item under the original IAS12 would also be covered by MASB25. As in the original IAS12, tax effect on revaluation of assets is also dealt with in MASB25. However, as Temporary Differences also arise in other circumstances that may not constitute timing differences, MASB25 thus has a wider scope. It includes the Temporary Differences that arise when:

- The cost of acquisition is allocated to the identifiable assets and liabilities based on their fair value in business combination;

- The non-monetary assets and liabilities of a foreign operation that is integral to the operations of the reporting entity are translated at historical exchange rate; and
- Non-monetary assets and liabilities are restated under the international best practice on financial reporting in hyperinflationary economies.

Although the original IAS12 provided a definition on Timing Differences, it only gave two examples of timing differences in the discussion notes (different treatment on revenue recognition and difference in accounting depreciation and tax depreciation rates). What constituted a timing difference was therefore not clear at times and was thus subject to interpretation by the accountants of the definition of timing differences. As a result of this, there were times where deferred tax liabilities were not accounted for on certain items on the argument that they did not constitute a timing difference. When this argument failed to stand up, the policy of partial application would conveniently come to the rescue. This has partly caused accounting for deferred taxation to be inconsistent between years and among companies.

Although MASB25 does not provide definition on Timing Differences, it states that all timing differences are temporary differences. In addition, the discussion notes and illustrations provide many examples of temporary differences where deferred tax liabilities/assets are to be recognized if the criteria are met.

The examples given in MASB25 include:

- Interest revenue that is recognized on time proportion basis but subject to tax on receipt basis;
- Accounting depreciation that is different from tax depreciation/capital allowances;
- Development cost that is capitalized and amortized over future period but deductible for tax purposes when incurred;
- Assets are revalued and no equivalent adjustment is made for tax purposes;
- Cost of a business combination that is an acquisition is allocated to the identifiable assets and liabilities acquired by reference to their fair values;
- Retirement benefit costs that are provided as services provided by employees but deductible for tax purposes only when paid;
- Research costs that are recognized as expenses when incurred but only deductible for tax purposes at later period when conditions are met.

These specific examples, together with the disallowance of partial application have made the scope of deferred tax liabilities/assets under MASB25 more comprehensive and more specific. It basically attempts to ensure all assets and liabilities included in balance sheet are stated net of their tax effect, now and in the future. In addition, all off balance sheet items (such as tax losses) that have tax effect are also accounted for, one way or another.

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