

Slug: MASB25b

Title: Deferred Taxation Redefined – Part II

Stf: The MASB25 has become more specific in its implementation.

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Text:

Deferred Tax can either be a liability or an asset depending on what give rise to it. Should a deferred tax liability or asset be recognized in the accounts depends on whether or not it meets the recognition criteria laid down in the applicable accounting standard. There is a significant (in fact, the biggest) difference in the recognition rules and criteria on both the deferred tax liability and deferred tax asset between the original IAS12 and MASB25.

Deferred Tax Liability

The original IAS12 permits non-provision for deferred tax liability on certain timing differences when there is reasonable evidence that these timing differences will not reverse for some considerable period (at least three years) ahead. This is sometime referred to as 'partial application'.

Under MASB25, there is no such permission, that is, deferred tax liability arising from all timing differences must be recognized in the accounts whether or not they may reverse in the future. This big change is in line with the change in the fundamental concept and the shift in focus to balance sheet. It is not important if the reversal may not happen in the near future but the net assets in balance sheet must be stated after taking into consideration the future tax effect.

Companies that had deferred tax liabilities but did not recognize or only recognized partially because of adopting partial application will be hit with a potentially big adjustment when MASB25 becomes operative. There will be a negative impact on the net tangible assets of these companies.

Deferred Tax Liability on Revaluation Surplus of Assets

The original IAS12 does not make it compulsory for deferred tax liability on the revaluation surplus of assets to be recognized in the accounts. Generally, Malaysian accountants consider it sufficient to dispose off this issue by stating that the company has no intention to sell the assets in the foreseeable future.

Under MASB25, taxable temporary differences arising from the revaluation upward of assets is treated the same way as other taxable temporary differences and accordingly the resulting deferred tax liability will need to be recognized. It is irrelevant whether there is any intention to dispose off the assets in the foreseeable future except that the tax rate to be used in the calculation of deferred tax may be different.

Many companies in Malaysia opted for no recognition of deferred tax liability on revaluation surplus of assets as permitted by the original IAS12. As such, these companies will have to book in an adjustment to recognize the deferred tax liability on the revaluation surplus of assets in the first year of operations of MASB25. The deferred tax liability is to be debited from the revaluation reserve account and as such it will not have any effect on the income for the year. However the NTA will be reduced.

Deferred Tax Asset

The original IAS12 stated that the tax effect of timing differences that result in a debit balance or a debit to the deferred tax balance should not be carried forward unless there is a reasonable expectation of realization. Also, the potential tax saving relating to a tax loss carried forward may only be recognized if there is assurance beyond any reasonable doubt that future taxable income will be sufficient to allow the benefit of the loss to be realized.

Under MASB25, deferred tax asset should be recognized for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary differences can be used.

The same criteria apply to unused tax losses and unused tax credits. However, when the deferred tax assets is recognized beyond the existing taxable temporary differences and the enterprise has suffered a loss either in the current or preceding period, the amount of the deferred tax asset and the nature of the evidence supporting its recognition must be disclosed.

What are the differences, really?

With respect to deferred tax asset on timing or temporary differences, any difference would lie in the difference between 'reasonable expectation' and 'probable'. It would appear that 'reasonable expectation' requires a higher level of possibility of the realization compared with 'Probable'. 'Probable' would ordinarily mean a chance of more than 50 percent. With respect to deferred tax assets on unused tax losses, it is obvious that the requirement of 'assurance beyond any reasonable doubts' under the original IAS12 is almost equivalent to no recognition is allowed. Accordingly, under the original IAS12, the accountants generally apply the prudence principle and very rarely recognize deferred tax assets.

Under MASB 25, it would appear that it tends to allow recognition of deferred tax assets. The requirement to disclose the evidence supporting the recognition of deferred tax assets when (only when) an enterprise suffered losses either in the current or preceding period indirectly suggests that the deferred tax assets can certainly be recognized if the enterprise is and has been in profitable situation. The discussion notes in MASB 25 also mentioned about the possible use of tax planning opportunity to create future taxable profits as one way to show support for recognizing deferred tax assets.

It is expected that companies will begin to recognize deferred tax assets either partially or fully when MASB25 is effective.

Review of Carrying Amount of Deferred Tax Asset

The original IAS12 does not specifically mention the need to review the carrying amount of the deferred tax assets although it is understood that all assets should be stated not more than their recoverable amount. MASB25 specifically requires a review on each balance sheet date of the carrying amount of deferred tax asset. A reversal should be done to the extent it is no longer probable that sufficient taxable profits will be available to allow the benefit of part or all of that deferred tax assets to be realized.

Specific Measurements

The original IAS12 allows either Deferral or Liability Methods to be used. Under the Deferral Method, the tax rate applicable when the timing differences originates will be used. Upon reversal of those timing differences, the same tax rate will be used. Under the Liability Method, the tax rate applicable at the balance sheet date is used. Adjustment on the deferred tax balance will be made when the tax rate changes.

Under MASB 25, deferred tax assets and liabilities should be measured at the tax rates that are expected to apply to the period when the asset is realized or the liability is settled based on tax rates (and tax laws) that have been enacted or substantially enacted by the balance sheet date. Adjustment on the deferred tax balance will be made when the tax rate changes. This is equivalent to the Liability Method of the original IAS12. This is also in line with the changes of focus to balance sheet.

More Disclosures

Both the original IAS12 and MASB25 require the deferred tax liability/asset to be presented as a separate item on balance sheet and as non-current liability/asset. The original IAS12 allows off-set between deferred tax assets and liabilities but does not set up criteria for off-set. This suggests that they can be off-set in any circumstances. MASB25 has expanded this but setting up conditions for the off-set.

There are more requirement on disclosures under MASB25 compared with the original IAS12 in terms of items and details. The main highlights are as follows:

- Component of tax expenses - MASB requires the major components of tax expense/income to be disclosed separately. The components will primarily comprise current tax, deferred tax and adjustments on current and deferred tax.
- Relationship between tax expense/income and accounting profit/loss - The original IAS12 requires an explanation of the relationship between tax expense and accounting income if not explained by the applicable tax rate. In practice, usually a descriptive explanation is provided by quoting the major factor for the difference such as the presence of significant non-deductible expenses or the availability of tax incentive such as reinvestment allowances. However under MASB25, the explanation must be in the form of reconciliation in terms of amount or rate. In addition, the basis of computing the rate and the reason for change in the applicable tax compared with the previous period must be disclosed, if available. This detailed reconciliation will indirectly reveal the tax efficiency of the company and the accuracy of the tax estimation. Users of financial statements will find it useful to understand quite thoroughly why the tax expense of the company is lower or higher than the applicable tax rate. It will also alert and remind the management to take steps to find a more efficient tax structure if the company always shows a high effective tax rate due to non-deductibility of certain expenses or absence of group relief on losses incurred by certain companies in the group. The management may take more interest in the subject of tax planning to ensure that there is efficiency in the taxation management for the group.
- Composition of deferred tax liabilities/assets - MASB25 requires each type of temporary differences, unused tax losses and unused tax credits in respect of the deferred tax liabilities/assets recognized on each balance sheet date presented to be disclosed. The amount of deferred tax expenses/income recognized in the income statement should also be disclosed if it is not apparent from the changes of the balance sheet dates.
- Deferred tax assets for companies that suffer losses - If a company that has suffered losses in either the current or preceding period recognize deferred tax assets beyond the existing taxable temporary differences, it is required to disclose the evidence supporting its recognition. This disclosure will enable the users of financial statement to judge for themselves if the deferred tax assets recognized may be recoverable.
- Tax credit to frank distribution of retained profits - Although the original IAS12 does not have requirement to disclose if there is sufficient tax credits to frank the distribution of retained profits, such requirement is provided in the Ninth Schedule of the Companies' Act, 1965. Such disclosure is usually found in the audited financial statements of Malaysian companies although omission of such disclosure is also surprisingly quite common. MASB25 has specifically required such disclosure and if it is not sufficient, the extent of the retained profits not covered.

With so much and so detailed disclosure on taxation item being required by MASB25, users of financial statements will now have adequate information to form his/her own evaluation of the tax position of the companies concerned.

Conclusion

The adoption of MASB25 gives rise to a new regime of accounting and reporting for tax expenses that has been delayed. The changes can be briefly described as follows:

1. Shift in focus to balance sheet;
2. Introduction of new terminology and new method of determining deferred tax using temporary differences and tax base;
3. No more partial application of recognition of deferred tax liabilities is allowed and deferred tax liabilities on revaluation surplus on assets must be recognized;
4. Criteria for recognition of deferred tax assets is less stringent;
5. Deferred tax effect on temporary differences arising from fair value adjustments in business combination and translation of foreign operations must be accounted for;
6. More disclosures are required to provide more information to users to understand the tax position of the company and to assess the effect of taxation on the company's financial position.

Nevertheless, the real big change in MASB25 compared with the original IAS12 that may carry a significant effect on the financial statements is the new recognition rules and criteria on both deferred tax liabilities as well as assets. Companies that had significant deferred tax liabilities but did not recognize them fully because of adopting partial application will face a significant negative impact on its financial statement under MASB25 regime. On the other hand, companies that had significant deferred tax assets and did not recognize them because of prudence principles expected by the industry can now have the opportunity to recognize them without risking the critics. In short, any 'hidden' deferred liability/asset will now be unfolded. Businessmen, directors and those responsible for the bottom line of their enterprises may now need to take more interest in understanding the concept of deferred tax as it has direct impact on the enterprise's financial statements although there is no cash flow implication. More interest on tax planning is also expected to ensure the taxation accounts and the information provided in the published financial statements do not indicate that the company's or the group's tax matters have not been efficiently managed. To the users of financial statements, the adoption of MASB25 will enable them to easily understand the tax position of the company and will allow a more consistent comparison of performance to be made on different companies. This is made possible by the more standardized (no option given) and clear-cut rules on recognition of deferred tax liabilities/assets and the more disclosures requirement imposed. Every company will be on the same level of fair play now in terms of showing out their tax position, structure and efficiency. This is probably the biggest benefit of MASB25 to the financial reporting. To the accountants, the adoption of MASB25 represents a new challenge to them as a new internal system and policy will have to be developed to ensure the deferred tax is determined accurately and the required disclosures are complied with. Those who ignored deferred tax all these while will have to play catch up to master the concept and 'beauty' of deferred tax. There is no room for ignorance under the MASB25. Its effect on the NTA and EPS will be a great area of concern. In addition to understanding the new MASB25, a good knowledge of taxation will certainly be helpful to accountants to ensure compliance with MASB25.

From the experiences in applying MASB25, the author finds that following the four steps listed here will help to ensure compliance:

- Step 1: Identify all possible deferred tax items.
- Step 2: Determine tax base, temporary differences and thus deferred tax liabilities/assets.
- Step 3: Analyze and reconcile movement of deferred tax liability/asset balance between balance sheet dates and the corresponding items in income statement and tax computation.
- Step 4: Perform overall review to ensure compliance with the recognition rules and criteria, and the disclosures requirement set out in MASB25 as well as that of the financial statements is 'true & fair'.

In addition, in the first year when MASB25 becomes operative, that is, the first financial year commencing on or after 1 July 2002, there will be a need to determine if the adoption of MASB25 represents a change in accounting policy and if so, retrospective application will be relevant.

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