

Possible differences in interpretation

BY GOH KEAN HOE

There was a major change in the rules of deferred taxation when the revised International Accounting Standard (IAS) 12 (Income Taxes) was issued in 1998 to replace the original IAS12 (Accounting for Taxes on Income). Locally, the revised IAS 12 was adopted as Financial Reporting Standard (FRS) 112, formerly called Malaysian Accounting Standard Board (MASB) 25 in 2002. Unlike the original IAS12 which was a principles-based standard, the revised IAS12 is relatively a rules-based standard and it is quite similar to the US standard.

Unfortunately, the revised IAS12 is not an easier standard; rather, it is more complicated and can be confusing as well.

To me, it is about new focus; new terminologies and methods; being more comprehensive and specific, and providing more disclosures. But the real big change is in the new recognition rules and criteria on both deferred tax liabilities and assets. One way to understand, in this second part of our discussion on deferred taxation, is to compare it to the original IAS12.

Changes in rules

The changes in the deferred tax rules under the revised IAS12/FRS112 can basically be discussed under the following six areas:

ences are not deferred tax items. In the revised IAS12/FRS112, the term “permanent difference” is not used. To take care of this, the revised IAS12/FRS112 introduces exception clauses on recognition of deferred tax liability/asset. Under the exception clauses, no deferred tax (both liability and asset) shall be recognised on temporary differences that arose from the initial recognition of that asset or liability which:

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

This exception clause would have covered all permanent differences.

It is clear that tax base is the key item in determining the temporary differences and hence the deferred tax liabilities/assets. Unfortunately, the definition of tax base in the revised IAS12/FRS112 (as mentioned above) is very general. Also, a good knowledge of the taxation laws will be required to determine the tax base of each of the assets and liabilities in the balance sheet.

3. More comprehensive

The revised IAS12/FRS112 attempts to be a more comprehensive standard that addresses the tax effects of accounting for income taxes. As stated before, all timing differences are temporary differences. As such, all items considered as deferred tax items under the origi-

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 the revised IAS12/FRS112.

Recognising 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 the revised IAS12/FRS112, there is no such permission, that is, deferred tax liability arising from all timing differences must be recognised 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 shift in focus to the 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.

Recognising 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 recognised in the accounts. In practice, many companies in Malaysia consider it sufficient to dispose of this issue by stating that the company has no

tax asset should be recognised 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 recognised 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.

The real difference is that it is easier to recognise deferred tax assets under the revised IAS12/FRS112 as the test of the “probable”, which is less stringent. Under the original IAS12, accountants generally apply the prudence principle and very rarely recognise deferred tax assets on unused tax losses. Since the implementation of the revised IAS12/FRS112 in 2002, what has happened in practice is that certain companies decided to recognise the deferred tax asset on unused tax losses either fully or partially.

There were also companies which did not recognise any amount of the unused tax losses as deferred tax asset either because there was no reasonable expectation of profits in the near future or purely on prudence basis.

In AirAsia’s case, the issue was if deferred

1. Shift in focus to balance sheet

There is a major shift in focus on accounting for deferred taxation in the revised IAS12/FRS112. The original IAS12 focuses on income statement and the difference in the accounting and taxable profits. It allows the use of either the deferral or liability method.

The revised IAS12/FRS112 focuses on balance sheet and it allows the use of the liability method only. It is often regarded as the balance sheet liability method. Accordingly, the deferred taxation under the revised IAS12/FRS112 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. In the end, the revised IAS12/FRS112 is concerned with ensuring that 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.

2. Introducing new terminologies and methods

The change in the fundamental concept and focus to balance sheet inevitably introduces new terminologies. The biggest change is the new terminology “temporary differences”; it is defined in the revised IAS12/FRS112 as the differences between the carrying amount of an asset or liability in the balance sheet and its tax base. Temporary differences may 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.

The tax base of an asset or liability is defined as the amount attributed to that asset or liability for tax purposes.

Timing differences and permanent differences, the terminologies used in the original IAS12, shift the focus to income statement. Both differences — timing and permanent — may give rise to temporary differences. Under the original IAS12, permanent differ-

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nal IAS12 would also be covered by the revised IAS12/FRS112. As in the original IAS12, tax effect on revaluation of assets is also dealt with in the revised IAS12/FRS112.

However, as temporary differences also arise in other circumstances that may not constitute timing differences, the revised IAS12/FRS112 also 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.

It basically attempts to ensure that all assets and liabilities included in the balance sheet are stated net of their tax effect, now and in the future, consistent with the new focus on the balance sheet.

4. New recognition rules for deferred taxation

Deferred tax can be a liability or an asset, depending on what give rise to it. Should a deferred tax liability or asset be recognised in the accounts depends on whether it meets the

intention to sell the assets in the foreseeable future and hence no provision for deferred tax liability is required.

Under the revised IAS12/FRS12, 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 recognised. It is irrelevant whether there is any intention to dispose of the assets in the foreseeable future except that the tax rate to be used in the calculation of deferred tax may be different.

This new requirement has resulted in certain companies having to recognise additional deferred tax liability on the revaluation surplus of fixed assets when the revised IAS12 came into effect in 2002 and caused the net tangible assets of these companies to be reduced significantly.

Recognising deferred tax asset (DTA):

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 realisation. Also, the potential tax saving relating to a tax loss carried forward may only be recognised if there is assurance beyond any reasonable doubt that future taxable income will be sufficient to allow the benefit of the loss to be realised.

Under the revised IAS12/FRS112, deferred

tax assets can be recognised on the tax incentive in the form of unused investment allowances. There is no specific provision in the revised IAS 12 on this although the new recognition exception clause relating to initial recognition of asset/liability as discussed above should be applicable. FRS112, however, does provide some guidance on this in which it basically disallows the tax incentive similar to unused investment allowances to be recognised as a deferred tax asset. Obviously, AirAsia and MASB have different interpretations of the standard.

5. Only one measurement rule

The original IAS12 allows either deferral or liability methods to be used. Under the revised IAS12/FRS112, deferred tax assets and liabilities should be measured at the tax rates that are expected to apply to the period when the asset is realised 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 the balance sheet.

6. More disclosure requirement and more transparency

There are more requirements on disclosures under the revised IAS12/FRS112 compared with the original IAS12 in terms of items and details. The three major additional disclosures are:

- A reconciliation between the tax expenses and the profit in the form of amount or rate. This detailed reconciliation will indirectly reveal the tax efficiency of the company/group and the accuracy of the tax estimation;
- Composition of deferred tax liabilities/assets; and
- If a company that has suffered losses in either the current or preceding period recognises deferred tax assets beyond the existing taxable temporary differences, it is required to disclose the evidence supporting its recognition.

With the more detailed disclosures, the financial statements should be more transparent.

More specific but with new challenges

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Conclusion

In short, the original concept of deferred taxation, though clearer in terms of its principle and objective, was lacking in terms of specific rules and it also allows alternative treatment or different accounting policies. This resulted in different version and inconsistency in application. Although the revised IAS12/FRS 12 provided many rules which are more specific, the introduction of new terminologies and methods made the understanding of deferred taxation even more challenging to many people.

While some old issues have been solved by the revised IAS12/FRS112, new issues were created at the same time. There are also flaws in the revised IAS12 which needs to be further improved and fine-tuned.

The AirAsia case is a good example of the possible difference in the interpretation of the standard due to confusion over the new methodology of temporary differences and the lack of specific guidance on the treatment of tax incentive. It is perhaps high time the International Accounting Standards Board carried out significant improvements to the IAS12.

In the meantime, in case of uncertainty, it will be important to fall back on the relevant principles of accounting, such as substance over form and possibly the original concept of deferred taxation to ensure that the accounting treatment chosen will present a true and fair view of the financial performance and conditions of the company. **E**

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