

Revisiting deferred taxation

BY GOH KEAN HOE I

The recent accounting issue of whether certain tax incentives available to AirAsia Bhd can be recognised as a deferred tax asset has made many stakeholders of financial and corporate reporting rethink the subject matter. In a two-part series, I will revisit the topic of deferred taxation and the rules in the applicable accounting standards (Revised IAS12/FRS112). Part 2 will appear next week.

Income tax is treated as an expense instead of a form of profit distribution as far as accounting is concerned. The income measurement of any company is based on profit after tax as this is the net profit available to the shareholders. Most valuation techniques used in company valuation such as price-earnings multiple and discounted cash flow are also based on after-tax profit instead of before-tax profit. In fact, in many countries, tax expense is one of the highest, if not the highest, expense of businesses. In our country, all companies generally need to pay 28% of their profit to the government. It is obvious that the importance of income tax as an expense to a company cannot be overemphasised.

However, the nature of tax expense is very different from other

tions and is a key concept in dealing with accounting for income taxes.

Deferred taxation and the accounting standard

Deferred taxation has never been an easy subject although it has been around for easily more than 30 years. It is an accounting concept just like the concept of accrual accounting.

As a matter of fact, the applicable International Accounting Standard (IAS), the original IAS12 (Accounting for Taxes on Income), was effective in 1978. A major revision was, however, made in 1998 when the revised IAS 12 (called IAS12: Income Taxes) was issued. Malaysia's accounting standards have all the while followed IAS and the revised IAS12 was adopted by the Malaysian Accounting Standards Board (MASB) as MASB25 (now called FRS112) effective July 1, 2002.

The recent AirAsia case is a good example of the complication of deferred taxation. Due to different interpretations of the accounting standards on deferred taxation, the company provided two sets of earnings — one prepared in accordance with FRS112 giving a net profit of RM88 million, and the other under IAS12 giving a net profit of RM242 million. The huge

deferred taxation, the differences between tax profit and accounting profit are basically categorised into either timing differences (TD) or permanent differences (PD). The original IAS12 defined TD and PD as follows:

TD are the differences between the taxable income and the accounting income for a period that arise because the period in which some items of revenue and expense are included in taxable income does not coincide with the period in which they are included in accounting income. TD originate in one period and reverse in one or more subsequent periods.

PD are the differences between taxable income and accounting income for a period that originate in the current period and do not reverse in subsequent periods.

Under the original concept of deferred taxation, the tax effect of TD is to be accounted for as deferred taxation in order to match the tax expense to the profit reported. PD is not a deferred taxation and it will simply increase or reduce the current tax payable and hence the tax expense of the company. One common example of TD is the difference between accounting depreciation of fixed assets and the tax depreciation (called capital allow-

TABLE 1

Income statement 1 (without deferred tax)

	YEAR 1 RM'000	YEAR 2 RM'000	YEAR 3 RM'000	TOTAL RM'000
Profit before taxation (PBT)	1,000.00	1,000.00	1,000.00	3,000.00
Less: tax expenses (= tax payable)	-235.20	-268.80	-336.00	-840.00
Profit after taxation	764.80	731.20	664.00	2,160.00
Tax expense/PBT (Effective tax rate)	23.52%	26.88%	33.60%	28.00%

TABLE 2

Income statement 2 (with deferred tax)

	YEAR 1 RM'000	YEAR 2 RM'000	YEAR 3 RM'000	TOTAL RM'000
Profit before tax	1,000.00	1,000.00	1,000.00	3,000.00
Less: Tax expenses				
- Tax payable	(235.20)	(268.80)	(336.00)	(840.00)
- Deferred tax	(44.80)	(11.20)	56.00	0.00
	(280.00)	(280.00)	(280.00)	(840.00)
Profit after tax	720.00	720.00	720.00	2,160.00
Effective tax rate	28%	28%	28%	28%
Statutory tax rate	28%	28%	28%	28%

TABLE 3

Permanent differences & effective tax rate

	YEAR 1 RM'000
Profit before tax	1,000.00
Less: Tax expenses	
- Tax payable	-263.2

- Although profit is the same for each year, tax expense and hence profit after tax (PAT) is different in each year.
- The total tax expenses for all three years add up to 28% of profit before tax (PBT) but for each year, the tax expense is not 28% of PBT.
- On a year-to-year basis, the in-

types of business expenses. Firstly, it is payable to the government but there is no direct relationship to any specific goods and/or services received.

Secondly, it is technically payable only when the business generates profit. That's why tax expense is shown as a deduction from profit before tax in the income statement. However, when the business makes a loss, there is no direct compensation or refund from the government except that the losses can usually be available to offset future profits (or past profits as in certain countries) subject to certain conditions and hence reduce future tax liability.

Thirdly, tax liability is always determined based on the relevant tax laws and rules in the country which are usually different from the rules used in accounting. The tax rules are generally applicable to all companies but at the same time, there could be different rules for certain groups of companies or industries and there are exceptions and exemptions as well. Another point is that tax laws in different countries could be very different, whereas accounting standards in different countries are now getting closer with the world convergence towards International Financial Reporting Standards (IFRS). The result is tax profit is usually different from accounting profit.

Because of this special nature of tax expenses, specific accounting standards and rules have been developed on the accounting treatment for income taxes. Deferred taxation, in a way is a result of these situa-

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difference in net profit under two different treatments shows how important income tax expense is on income reporting.

The difference in interpretation is mainly attributable to the complication and confusion created by the new rules provided in the revised IAS12/FRS112. These new rules are rather complicated and even many accountants find it difficult to understand. There are flaws in the standard as well which make it more challenging to understand and apply the standard. One way to make it perhaps easier to understand the new rules of deferred taxation under the revised IAS12 is to look back at the original concept of deferred taxation and then review the changes made in the revised IAS12. This is exactly what this article is trying to explain.

Timing differences – The original concept

What I mean by the original concept of deferred taxation is basically the one in line with the principles contained in the original IAS12: Accounting for taxes on income.

Under the original concept of

ances in Malaysia). We will use an illustration to show compare how the income statement will look like if tax expense is based on tax payable only and if tax expenses consist of both tax payable and deferred taxation on TD.

Assuming that Company A makes a profit before taxation of RM1 million each for Years 1, 2 and 3. In Year 1, it purchased computers costing RM600,000. For accounting purposes, the computers depreciate over three years on a straight-line basis, giving a yearly depreciation charge of RM200,000. For tax purposes, the company is entitled to capital allowances at 60% for Year 1 and 40% for Year 2. Based on this information, the income tax payable by Company A for Years 1, 2 and 3 has been determined to be RM235,200, RM268,800 and RM336,000 respectively.

For income-reporting purposes, if the tax expense for the profit of RM1 million is based on the tax payable by the company only, the income statement of Company A for Years 1, 2 and 3 will look like Table 1.

The problems with this income statement are:

come appears to be distorted as it shows a lower PAT for Years 1 and 2 and a higher PAT for Year 3 when they should be the same.

These problems can be rectified if the timing differences between the depreciation and capital allowances are accounted for as a deferred taxation (see Table 2).

As can be seen, the net profit for all the three years are now the same, that is, RM720,000 for each year. Also, with deferred taxation, the effective tax rate is now equal to the statutory tax rate of 28% for each year. The tax expense is RM280,000 in each year by providing for the deferred tax in Years 1 and 2 and its reversal in Year 3. This should be the case as the company makes the same profit for each of the years and the tax rate remains the same. The only difference is the treatment of the computers costing RM600,000 purchased in Year 1. The amount charged as expenses for accounting purposes and the amount deducted for tax purposes are different for each year but ultimately, the total deduction in accounting and tax is the same, that is, the whole amount of RM600,000 will be deducted after three years. The difference is only in the timing.

However, it should be noted that deferred taxation is only an accounting tax and therefore does not affect cash flow. The cash flow will be affected by the tax payable which is determined by the tax rules. Deferred tax liabilities represent potential or future tax liabilities which will only crystallise in the future if and when the

-Deferred tax	-44.8
	-308
Profit after tax	692
Reconciliation	
Effective tax rate	-30.80%
Tax effect on donation	-2.80%
Statutory tax rate	28.00%

company makes profit.

Other common examples of TD include:

- Those relating to different basis in revenue and income recognition. (For example, for property developers, estimated project loss must be provided for in full for accounting purposes whereas for tax purposes, it is only deductible when the project is completed and the loss is realised or incurred in later years);
- Expenses such as provision for warranty and retirement benefits which are deductible for tax purposes in the different period than the accounting; and
- General provision for doubtful debt (trade debt) and impairment loss of operating assets which are deducted for tax purposes only in the subsequent periods.

Accounting for the tax effect on the TD by way of deferred taxation will inevitably give rise to either a debit balance or credit balance on the balance sheet. They can be called deferred tax liabilities or credits and deferred tax assets or debits. This will be discussed further in the article.

Taking care of profit

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Permanent differences and effective tax rate

As stated, PD is not deferred taxation and it will simply increase or reduce the tax expense. This means the effective tax rate will be higher or lower than the statutory tax rate. Some common examples of PD are:

- Non-deductible expenses such as unapproved donation (non-deductible donation) and entertainment expenses;
- Loss on disposal of long-term investment;
- Non-taxable income such as gain on disposal of long term investment and non-taxable government grant or contribution; and
- Expenses that qualify for double deduction.

To illustrate this, let's say included in the Year 1 profit of RM1 million in the above example is a donation of RM100,000 which is not tax deductible. The tax payable and hence tax expense will increase by RM28,000, that is, 28% multiplied by RM100,000. The effective tax rate will increase 2.8% to 30.8% (see Table 3 on Page 64).

What it means is the company suffered a higher tax rate by 2.8% when compared to the statutory tax rate of 28% because the company has incurred an expense which is not tax deductible now and will not be deductible in the future. From a management point of view, this is not considered a good result (not tax efficient) as the income is taxable whereas the expense is not deductible.

It should be noted that the revised IAS12/FRS112 requires a disclosure on the reconciliation between the effective tax rate and the statutory tax rate. The bottom part of Table 3 shows an example of such reconciliation. By disclosing this in the financial statements every year, users of financial statements will be able to form a basis as to what is the average effective tax rate of the company and the tax efficiency of the company or the group. It will also provide a basis in predicting the future net earnings of the company.

Conclusion

In short, deferred taxation is a concept that is created to take care of the differences between the accounting profit and tax profit caused by TD so that income reporting for each period will not be distorted. With deferred taxation, the effective tax rate will be equal to the statutory tax rate. However, in reality, the effective tax rate is usually different from the statutory tax rate as there are always some amounts of PD such as non-deductible expenses or no group relief for losses of subsidiaries. With this basic understanding, I will next discuss the new rules of deferred taxation under the revised IAS12/FRS112 which are essentially the current rules of deferred taxation. **E**

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