

Treating unutilised investment allowances

| BY GOH KEAN HOE |

The accounting issue on unutilised investment allowances (IA) faced by AirAsia in 2006 was regarded by some as a high-profile issue and was quite extensively reported. The issue has taken some twists and turns since then. The latest development is the adoption of a new accounting treatment by AirAsia and Tanjong plc in their 2007 financial reports. Both companies have recognised unutilised IA as deferred tax assets (DTA) and have booked in a prior year adjustment to effect the change.

As a result, AirAsia recorded a huge DTA of RM284 million as of March 31, 2007 (when it first made the change) and RM329 million as of June 30, 2007 (its year-end). Tanjong also booked in an equally huge DTA of RM295 million as of Jan 31, 2007 (its year-end) on the unutilised IA of one of its subsidiaries in Malaysia.

In explaining the change to the new accounting treatment, both companies have directly or indirectly cited the letter from the Ministry of Finance (MoF) to the Malaysian Accounting Standards Board (MASB) dated Feb 16, 2007, as the triggering point for the change. More specifically, they now took the view that the investment allowance is equivalent to the "tax credits" provided in IAS12/FRS112 and hence can be recognised as DTA under the standard itself.

It is not a temporary difference arising from an initial recognition; thus it cannot be recognised as a DTA under FRS112/IAS12, a view taken by MASB. In addition, they also regarded FRS112(2004) as different from IAS12 due to the presence of Para 36 in FRS112(2004). In its Q42007 announcement, AirAsia further stated that it has early-adopted the "new" FRS112 issued by MASB on June 15, 2007, which is effective from July 1,

2007. The "new" FRS112 is identical to IAS12.

As there is no official interpretation, guidance, consensus or stand issued by either the accounting standard boards (locally and internationally) or the accounting professional bodies in Malaysia on this issue, these events have given rise to one big question — what is the right accounting treatment on unutilised investment allowances? Did those events suggest that the unutilised IA can now be recognised as DTA? Is there anything wrong with the existing method? Can one continue to follow the existing practice which is more conservative? Is the new method more appropriate? Is there any other alternative method? Does this signify the end of this issue, finally?

The issue in perspective

To answer these question, let's first look at the issue in perspective. Investment allowance (or re-investment allowance) is a type of tax incentive in the form of tax exemption or partial tax exemption made available by the government of Malaysia to companies investing in a specific sector, especially the service sector including privatisation projects. The rationale for the incentive must be that these are risky projects and hopefully the potentially improved return, through full or partial tax exemption, will encourage more companies to venture into it.

The amount of IA is calculated based on certain percentage (usually 60% to 100%) of the amount of approved capital expenditures incurred during a specific period (usually five years). The IA can be used to reduce the taxable income (usually between 70% and 100% of the statutory income each year) and hence reducing the tax payable on the profits made. However, the IA is deducted from the

taxable income only after capital allowances have been deducted.

Any amount of IA not absorbed in a particular year due to insufficient income can be carried forward to future years to reduce future taxable income. This creates the unutilised investment allowances that we are talking about.

The question is, how should unutilised IA be treated in accounting and financial reporting? If the company that enjoys such incentive generates sufficient profits to fully utilise the IA, there will be no issue as the tax reduction will be shown in the financial statements in the form of lower tax payable and lower tax expenses accordingly. A complication arises when the profits generated are not sufficient to allow the investment allowances that arose or claimed to be fully utilised. This scenario is very common as capital-intensive projects usually take a number of years to generate substantial profit to allow, firstly, all the capital allowances to be absorbed and then the IA. The issue is whether the potential tax benefits of the unutilised IA should be recognised in the financial statements in the years the IA arises or in the years when it is realised or in any other ways.

The existing method — anything wrong?

The existing and the new methods interpret the rules in IAS12/FRS112 (2004) differently, resulting in different accounting treatment on the unutilised IA. Under the existing practice which has been adopted or accepted in Malaysia all this while, the unutilised IA is viewed as a deductible temporary difference arising from initial recognition of the assets and as such, cannot be recognised as a DTA under IAS12 (Para 22 & 33) and more

Table 1

Q42007 FINANCIAL ANNOUNCEMENT OF AIRASIA

AirAsia's deferred tax income and assets for 2007 & 2006

	YEAR ENDED JUNE 30, 2007 (UNAUDITED) RM MIL	YEAR ENDED JUNE 30, 2006 (RESTATED) RM MIL
Revenue	1,603	1,058
Profit before taxation (PBT)	278	86
Tax income	220	116
Profit after taxation (PAT)	498	202
Deferred tax assets (on balance sheet)	329	104

specifically in accordance with Para 36 of FRS112 (2004). Alternatively, the IA is considered a permanent difference, under the old rules of deferred taxation and hence is not a deferred taxation item. This interpretation views the investment allowances as an additional allowance over and above the normal capital allowances claimed on the assets purchased. The unutilised IA is hence recognised only when it is utilised, that is, on realisation basis. The amount of unutilised IA, if significant, is usually disclosed in the financial statements. This method "delays" the recognition of the potential tax benefits from the unutilised IA and is certainly a very conservative accounting policy.

This method appears to be reasonable and acceptable except that when applied strictly, it can create a situation where a company that enjoys this tax incentive and which has an unutilised IA may still have to record a tax expense on the profits reported. This was exactly how AirAsia was caught in its 2006 financial results. AirAsia had to book in a tax expense of RM27 million against its pre-tax profit of RM116 million and a deferred tax liability of RM39 million on the balance sheet despite the fact that it had a huge unutilised IA of RM549 million. Does it make sense to report a tax expense amounting to about 26% of the pre-tax profit when

the company enjoys tax exemption or partial exemption? Technically, this situation arises largely because the claiming of substantial capital allowances in the initial years of investment will usually lead to a deferred tax liability which must be recognised in full under the "full provision" approach of IAS12/FRS112. Since the unutilised IA cannot be recognised as DTA to off-set or reduce the deferred tax liabilities, a tax expense situation will arise.

But shouldn't accounting be based on the substance rather than the mechanism and the form of the transaction? Obviously, this method also totally ignores the effect the unutilised IA may have in determining and computing the deferred taxation on other temporary differences, including the temporary differences on the assets purchased. As can be seen in its 2006 financial statements, AirAsia understandably could not accept this and felt strongly that this method did not reflect truly and fairly the tax and financial position of the company. The search for an alternative treatment hence began.

The new method — more appropriate?

As said, AirAsia and Tanjong have now recognised the unutilised IA fully as DTA based on their interpretation that the unutilised IA is essentially equivalent to the tax credit in IAS12 and hence can be recognised as a DTA so long as it

is probable that there will be sufficient profits for the unutilised IA to be utilised. But is it crystal-clear that unutilised IA is unutilised tax credits and hence a DTA? Although IAS 12 states that unutilised tax losses and unutilised tax credits are deferred tax assets (Para 5 & 34), surprisingly no definition of tax credits can be found in IAS12. IAS12 also did not explain why unutilised tax credits are deferred tax assets. It is not sure whether IAS12 intended the tax credits to cover tax incentive, such as the investment allowance in Malaysia. The MoF letter and the tax legislations in Malaysia also did not mention that IA is tax credits. It is not known if AirAsia and/or Tanjong have sought any confirmation or clarification from IASB and/or MASB on this question in arriving at their conclusion.

But more importantly, is this new method more appropriate? This method may solve the problem of the existing method but it seems to have gone overboard and has hence created other problems as it may create a potentially huge tax income in the income statement and a huge deferred tax asset on the balance sheet. This can be clearly seen from the 2007 results of AirAsia under the new method as shown in Table 1.

It is probably unprecedented to see a company showing a huge tax income against the profits reported on year -to-year basis boosting its post tax profit to an even higher figure than the pre-tax profit.

What really is this huge tax income of RM220 million in 2007 and RM116 million in 2006? What is this huge asset of RM329 million in 2007 and RM104million in 2006? How could a company create an instant income simply by buying assets? How could a company create one accounting asset immediately after buying another asset? If the IA is a form of government grant, it should be accounted for as such and not as deferred tax. What may happen if this post-tax profit is used in valuing the company? Does it make accounting sense as well as common sense? Numerous questions could be asked on this method.

This method argues that the unutilised allowances are similar to unutilised tax losses as both can be used to reduce future tax liability and hence should be treated the same way, that is, both are DTA. But this argument is only partly true as there is a clear distinction between the unutilised tax losses and the unutilised investment allowances in term of their causes. There is no doubt that tax losses are always a deferred tax item under both the old rules and the current rules of deferred taxation. Tax losses arise from the excess of expenses over the income, which are already reported in the income statement. Since the tax losses can only be deducted in future tax period, there is essentially a timing difference and hence a deferred tax arises. The deferred tax asset and income recognised will reduce the losses reported, which is in line with the matching principle as well. It will not turn the loss into a profit.

Investment allowance is basically a tax incentive where the income generated from the investments are exempted or partially exempted from income tax. Unlike tax losses, it is not due to any item reported in the income statement and is hence not a timing difference. As can be seen from AirAsia's case, recognising the unutilised IA

as DTA can result in a huge credit in the income statement and a huge DTA on the balance sheet, which cannot be easily supported with substance. Also, if it is acceptable to recognise such tax reduction on potential future profits on the projects/investments, will it be also acceptable to recognise the profits to be made in the future at the same time? Isn't it that accounting is about recording and reporting past transactions and events, instead of future transactions and events? In short, this new method recognises the potential tax benefits on the IA in advance and is certainly a very aggressive accounting policy. Unless we can explain, rationalise and support the potentially huge income and assets created by the new method with substance, its appropriateness is also questionable.

Conclusion

While the existing method may create a problem in certain circumstances, the new method seems to have gone overboard and have created other problems. In my personal view, this high-profile issue has not ended. There could also be other alternative ways to deal with this issue. One possible approach is to look at the substance and objective of the IA incentive and ignore its mechanism and technicality. If we take the view that the objective of the IA incentive is to exempt or reduce the income taxes on the profits from the investments made, then the tax effect on the IA should be reflected in the years the profits are made in order to match with the profits.

To give effect to this, the IA can be allocated using a reasonable and meaningful basis to match with the profits reported so that it will result in an effective tax rate which reflects the tax position of the company.

Alternatively, the effect of the unutilised IA can be considered in determining the expected future tax rate of the company for

the purposes of measuring the deferred taxation. This approach will avoid or mitigate the problems created by both the existing and the new methods and has the effect of smoothening the profit reporting, the very reason why deferred tax concept was created in the first place. The concept of systematic allocation is not new in accounting and depreciation accounting is one good example.

Though this issue may look simple on its surface, the complicated nature of deferred taxation and the unclear provisions in IAS12/FRS112 have made it complex. The recent introduction of some new concepts of accounting, such as fair value accounting and share-based payment, have only further complicated and confused the issue. Obviously, IAS12 requires further improvement and fine-tuning. So until a clear rule is established with acceptable basis of conclusion, the argument of what is the right accounting treatment on the unutilised IA will go on. Meanwhile, whichever method is chosen, one must be prepared to answer the questions that may be put forward to support the choice made, especially if an aggressive policy is chosen. ■

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