DISCLOSURES IN RELATION TO DEFERRED TAX

Introduction

Recently there has been some debate among preparers of financial statements and their auditors as to the measurement of deferred tax. While this debate has focused specifically on measuring deferred tax in relation to investment properties, similar measurement issues arise in relation to deferred tax on other temporary differences. .01

The purpose of this circular is to discuss those areas where entities should consider providing additional information in relation to deferred tax in order to achieve fair presentation in relation to the various tax amounts and balances. .02

Requirements of accounting standards and legislation

Paragraph 15 of IAS 1(AC 101) – *Presentation of Financial Statements*, which is part of the section of the standard that deals with the overall consideration of fair presentation, states that *"In virtually all circumstances, a fair presentation is achieved by compliance with applicable IFRSs"*. .03

Paragraph 113 of IAS 1(AC 101) states *"An entity shall disclose, in the summary of significant accounting policies or other notes, the judgements, apart from those involving estimations (see paragraph 116), that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements"*. .04

Paragraph 66(2) of the Fourth Schedule to the Companies Act states *"Any matter not prescribed by this Schedule but which is material for the appreciation of the state of the affairs of the company and its subsidiaries, if any, shall be dealt with in the directors' report under appropriate headings"*. Paragraph 67(1) also requires the directors' report to *"deal with every fact or circumstance material to the appreciation of the state of affairs and financial position of the company by its members"*. .05

.06 Paragraph 47 of IAS 12(AC 102) – *Income Taxes*, deals with the tax rates to be used to measure deferred tax and states *"Deferred tax assets and liabilities shall 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 substantively enacted by the balance sheet date"*.

.07 Paragraph 51 of IAS 12(AC 102) states *"The measurement of deferred tax liabilities and deferred tax assets shall reflect the tax consequences that would follow from the manner in which the entity expects, at the balance sheet date, to recover or settle the carrying amount of its assets and liabilities"*.

.08 Paragraph 52 of IAS 12(AC 102) states that *"the manner in which an entity recovers (settles) the carrying amount of an asset (liability) may affect either or both of (a) the tax rate applicable when the entity recovers (settles) the carrying amount of the asset (liability); and (b) the tax base of the asset (liability)"*.

.09 Paragraphs 79 to 88 of IAS 12(AC 102) deal with disclosures in relation to income taxes. Paragraph 79 requires that *"The major components of tax expense (income) shall be disclosed separately"*.

.10 Among the disclosures required in IAS 12(AC 102) are the following that are included in paragraph 81:

"The following shall also be disclosed separately:
(a) …
(c) an explanation of the relationship between tax expense (income) and accounting profit in either or both of the following forms:
(i) a numerical reconciliation between tax expense (income) and the product of accounting profit multiplied by the applicable tax rate(s), disclosing also the basis on which the applicable tax rate(s) is (are) computed; or
(ii) a numerical reconciliation between the average effective tax rate and the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed;
(d)…

(g) in respect of each type of temporary difference, and in respect of each type of unused tax losses and unused tax credits:

(i) the amount of the deferred tax assets and liabilities recognised in the balance sheet for each period presented;

(ii) the amount of the deferred tax income or expense recognised in the income statement, if this is not apparent from the changes in the amounts recognised in the balance sheet."

Discussion of requirements of accounting standards and legislation

Whilst IAS 12(AC 102) sets out specific disclosures in relation to income taxes, this does not necessarily mean that fair presentation in relation to income taxes is achieved by compliance with IAS 12 (AC 102) alone. Entities need to consider whether other disclosures are needed for fair presentation to be achieved. .11

In applying the above requirements, entities need to consider how they will realise an asset or settle a liability in order to determine the impact of the related tax consequences on the calculation of the deferred tax. In the examples given in paragraph 52 of IAS 12(AC 102) the ways in which assets may be recovered are through use, sale or a combination of use and sale. .12

In some cases, whether the carrying amount is recovered through use or sale might not affect the calculation of deferred tax, but in other cases this could cause material differences in the deferred tax balance. .13

For example, in the case of an item of plant carried using the cost model and which can be claimed over a period as a tax deduction, the amount of deferred tax might not differ if the carrying amount is recovered through use or sale. This is because any excess of the carrying amount over the tax base of the asset would be expected to be regarded as a recoupment for tax purposes and to be taxed at the normal tax rate for taxable income. .14

However, if the same item of plant were revalued, the deferred tax might be different. If the carrying amount exceeded the tax base of the asset, this temporary difference would give rise to deferred tax, but .15

more than one tax rate could apply. For example, if it is expected that the carrying amount would be recovered entirely through use, the deferred tax would be calculated at the use rate. However, if it is expected that the carrying amount would be recovered entirely through sale, the deferred tax that related to the difference between the tax base and original cost would be calculated at the use rate (recoupment of prior tax allowances), with the deferred tax that related to the difference between the carrying amount and original cost being calculated at the sale rate, namely the rate applicable to capital gains tax. Furthermore, some of this difference might bear a nil capital gains tax rate, for example if the value of the item at 1 October 2001 (the date when capital gains tax became applicable) were higher than the cost of the asset.

.16 This example might become more complex if the item of plant is likely to be used for a period before it is sold. In this case, the future economic benefits embodied in the carrying amount of the asset will be recovered through both use and sale. The likely disposal value would need to be estimated to determine the extent to which the use and sale rates need to be applied to the temporary difference. Because part of the carrying amount of the asset that is in excess of its cost will be recovered through use and the remainder by sale, different tax rates will apply to these differences.

Example

Item of plant purchased on 1 January 2002 at a cost of R10 000.
At its most recent year end it was revalued to R15 000.
It is expected to be used for another three years before it is sold.
Its current residual value is R12 000 and its tax base is R4 000.
The current tax rate is 30% and the capital gains tax rate is 15%.
The temporary difference is R11 000 (15 000 – 4 000).
The value from R4 000 to R10 000 will be recovered through sale but will be taxed at the normal tax rate as a recoupment of previous tax allowances.
The value from R10 000 to R12 000 will be recovered through sale and will be taxed at the capital gains tax rate.
The value from R12 000 to R15 000 will be recovered though use, and deferred tax should be calculated with the use rate.
Deferred tax should therefore be R3 000 ((6 000 + 3 000)*.3 + 2 000 *.15).

If the same asset had a disposal value of R10 000 or less, then deferred tax would be R3 300 (11 000*.3).

The same principles need to be applied to other assets and liabilities. For example: .17

- Investments in associates could be recovered through sale, which could give rise to capital gains tax, or through the receipt of tax-free dividends.
- Investment properties could be recovered through sale, by use (rental income) if the property is expected to be held throughout its economic life, or through a combination of use and sale by holding the property for a period and then selling it.
- Deferred tax on temporary differences relating to a financial asset that is measured at fair value through profit or loss might be calculated at the normal tax rate if the financial asset is held for trading or at the sale rate if the financial asset is designated upon initial recognition as being carried at fair value through profit or loss.

In some cases, whether assets will be recovered through use or sale, or the extent to which they will be recovered through use or sale, could have a material impact on the deferred tax balance. The same could apply to liabilities. In some cases, as in the case of plant that is revalued, the deferred tax movement would be included in the revaluation reserve in equity, but in other cases, such as in the case of investment properties, the deferred tax movement would be included in the income statement. .18

Entities do not have a free choice in selecting which tax rates should be applied to the various temporary differences, nor can they merely specify their selected rates in an accounting policy. These rates should be determined by applying paragraphs 47 and 51 of IAS 12(AC 102). Accordingly, the accounting policy should be based on the wording of these paragraphs, with the tax rate to be used arising from the application of the accounting policy as opposed to the rates being a mere accounting policy choice. .19

.20 Preparers of financial statements should consider whether sufficient details have been provided in the financial statements on how the deferred tax balance was determined, particularly where the balance could be materially different depending on how the entity expects to realise assets or settle liabilities.

.21 In some cases the disclosures required in terms of paragraph 81 of IAS 12(AC 102) might have to be supplemented by additional information regarding judgements that concern the manner of recovery or settlement of assets and liabilities for users to be provided with information that is material to an appreciation of the state of affairs and financial position of the entity.

.22 The discussion above requires consideration in relation to deferred tax amounts given that the expected manner of recovery or settlement can have a significant effect on the deferred tax balance.

Conclusion

.23 An entity should consider whether it has provided sufficient information to enable a user to understand how the entity expects to recover an asset or settle a liability, particularly where the manner of recovery or settlement of the asset or liability would give rise to materially different deferred tax balances if the manner of recovery or settlement were to change.

.24 It is expected that the disclosures in terms of paragraph 81(c) of IAS 12(AC 102) would include the effect of including tax at the capital gains tax rate as opposed to the normal income tax rate. This disclosure might only relate to one specific category of asset or liability (for example investment properties), but where it relates to a number of assets and liabilities then consideration should be given to providing additional information in terms of paragraph 23 above.

.25 Again the disclosures in terms of paragraph 81(g) of IAS 12(AC 102) need to be considered in terms of whether they provide a user with sufficient information to achieve fair presentation and the judgements made by management in the process of applying the entity’s accounting policy.

The application of this circular means that the following disclosures should be provided, or be capable of being determined, for those components of the deferred tax amounts that could be materially different if the manner of recovery or settlement were to change: .26

- The expected manner of recovery and the tax rate used to calculate the deferred tax balance.
- Where more than one tax rate is used for each category of temporary difference, the components of the deferred tax at the various rates, including those components on which no tax is expected to be paid.

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Example of application of the circular

Assumption – normal tax rate 30%, capital gains tax rate 15%

		Entity A	Entity B
Income statement			
Revenue – rent received		10 000	10 000
Dividends received			2 000
Increase in the value of investment properties		50 000	50 000
Profit on sale of investments			8 000
Operating expenses		(7 000)	(7 000)
Profit before tax		53 000	63 000
Tax		8 400	12 600
Normal tax	– current	700	700
	– deferred	200	200
Capital gains tax	– current	-	450
	– deferred	7 500	11 250
Profit after tax		44 600	50 400

	Entity A	Entity B
Tax rate reconciliation (in notes)		
Statutory tax rate	30.00	30.00
Adjustments:		
Exempt income		(3.33)
Effect of income at capital gains tax rate	(14.15)	(6.67)
Effective tax rate	15.85	20.00

In Entity A, the deferred tax expense is 15% of the increase in the value of investment properties and it can be presumed that the entity is expecting to recover the investment properties by way of sale. In this case, additional disclosures would not be necessary.

The same does not apply in the case of Entity B. It is not clear why the exempt income of 7 000 (63000*0.0333/0.3) differs from the non-taxable dividend of 2 000, nor whether the deferred capital gains tax is indicating that the investment properties will be recovered through use and sale or whether some properties will be recovered through use and others by sale. In this case, additional disclosures such as the following would be expected:

Investment properties include two properties, which have the same value. One of these is expected to be sold shortly, whereas the other property is being held indefinitely. The income tax charge was also affected by a non-taxable profit of 5 000, arising from the increase in the value of investments classified as available-for-sale, that arose prior to the introduction of capital gains tax and which is included in equity until the investments are disposed of.