



Tax effect accounting – time to face it head on

From talking to our clients we know that tax isn't a topic many entities are comfortable with. Previously under AGAAP, tax didn't take up too much of your time because it was relatively straightforward – you determined your tax effect accounting entries from your income statement and anything more complex than that could be handballed to your tax colleagues. Now, under Australian International Financial Reporting Standards (AIFRS), most of you will need to dive into the world of tax and come to grips with the new requirements. This means understanding what the balance sheet approach means for your business and how the deferred tax balances under former AGAAP can change under the new standards.

This issue aims to cover some of the basics. We'll look specifically at how to record adjustments to deferred tax on amounts within equity accounts under the 'balance sheet' approach, highlight the recognition criteria for deferred tax assets and outline how tax interacts with the Business Combinations standard. So, strap yourselves in as Caroline Toovey from the firm's technical group shares with us the key conceptual changes in accounting for tax.

AIFRS demands a change to the way we consider tax

It's fair to say that we've all had a lot to contend with in the transition to AIFRS. The focus for many businesses has been coming to terms with the big ticket issues relating to financial instruments, business combinations and share-based payments. In my experience, tax is an area that many entities only focus on once a year, and usually at year end. However, now that we are in the AIFRS regime the first thing we need to do is change our way of thinking. Accounting for tax needs to be a regular consideration in business, which I'll explain as I move through two of the key changes under the new framework.

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AIFRS Update 05

Most of you will have heard about the new notion of calculating deferred tax under the “balance sheet” approach. In essence, this is where we determine the deferred tax by comparing the carrying amount of a balance sheet item with its tax base. One of the consequences of this is often missed by entities – adjustments to record deferred tax on amounts included within equity accounts, must be made in equity. So, take heed: AASB 112 *Income Taxes* requires us to reflect the current or deferred tax relating to a transaction consistent with its underlying transaction. Therefore, if a transaction is recognised in equity (i.e. as an asset revaluation reserve, hedging reserve or share related transaction) then the deferred tax must also be recognised through equity, rather than in income tax expense as was the case previously. It’s important to watch out for this one and ensure you get it right because now, under AIFRS, there are more transactions that are being recognised within equity in the balance sheet. Applying these new rules could impact a company’s tax expense and the net assets it would have reported under previous AGAAP accounting.

To highlight this point let’s work through two very different examples – the first scenario deals with an asset revaluation, which does not change the tax deductions available for an asset, and the second deals with tax deductions available for share capital raising costs.

Example 1: Land revaluation

Let’s say that an entity owns some land that it originally bought for \$1,000k, which it later revalues to \$1,500k. Let’s assume that the tax base of the land is \$1,000k (the same as its original cost). As land isn’t depreciated for accounting purposes, an entity operating under AGAAP wouldn’t have recognised any tax consequences on the revaluation of the land as the transaction wouldn’t have an impact on the income statement until the land was sold. However, under AASB 112, deferred tax is calculated under the balance sheet approach. Therefore:

	Accounting carrying value	Tax base	Temporary difference	Deferred tax liability calculated at 30%
Land	\$1500k	\$1000k	\$500k	(\$150k)

Now, under AIFRS, we must “tax effect” the difference between the carrying amount of \$1,500k and the tax base of \$1,000. This gives rise to a deferred tax liability, which is recognised through the asset revaluation reserve - just like the underlying transaction.

The accounting entries required at the time of the revaluation would be:

a) Reflect the land revaluation

DR Land	\$500k	
CR Asset Revaluation Reserve		\$500k

b) Reflect the deferred tax liability on the revaluation

DR Asset Revaluation Reserve	\$150k	
CR Deferred Tax liability		\$150k

Effect on financial statements:

	AGAAP	AIFRS
Land	Land 500+	Land 500+
Deferred tax liability	-	(\$150k)
Retained profits	No impact	No impact
Asset revaluation reserve	(\$500k)	(\$350k)

However, looking at the AIFRS guidance in AASB 112, there are similarities between it and the old guidance under AGAAP. Before recognising a deferred tax asset, AASB 112 guidance requires an entity to consider the following:

- Its taxable temporary differences, and if they will enable the tax losses to be utilised against them (given they are assessable amounts);
- Whether it will be making taxable profit before the losses expire;
- The cause of the losses in the first place, including whether it's likely they will recur; and
- (new under AIFRS) If there are any tax planning opportunities to make the recoupment of losses more attainable.

This guidance shows that the individual facts and circumstances of an entity's tax position will dictate the recognition of deferred tax under AIFRS. So, don't be fooled into thinking it is easier under AIFRS - in many cases it may not be.

Finally, when preparing your future earnings models to support the recoupment of tax losses, it's important to ensure that the key factors and assumptions used in these models are consistent with the factors and assumptions used in your budgets or impairment test models.

The interaction of business combinations and tax consolidations

Another area you should be mindful of when it comes to considering tax under AIFRS are two of the key principles in AASB 3 *Business Combinations* associated with recording deferred tax. Firstly, in relation to any tax losses, it's important to consider whether they originated from the acquirer or the acquiree. Secondly, it's also important to ascertain whether the entry into a tax consolidated group of the acquirer impacts the measurement of the deferred tax assets and liabilities of an acquired entity. Let's look at this a little closer.

Firstly, following a business combination, different accounting consequences apply depending on whether tax losses relating to an acquiree were considered recoverable in the acquisition accounting. If they were, the deferred tax asset is simply recognised as part of the purchase price allocation. If they weren't - but subsequently become eligible to be recognised - then they should be recognised with a corresponding adjustment made to the income tax expense. However, any goodwill recognised in the acquisition should be decreased and recognised as an expense. In contrast, if the losses relate to the acquirer and they now meet the "probable" recognition criteria outlined above, they will be recognised directly through income tax expense, even though probability of recovery was triggered by the business combination.

Secondly, an overriding principle in AASB 3 states that current and deferred taxes should be measured and assessed from the perspective of the combined entity. Therefore, any changes in the tax base of the acquiree's assets and liabilities - as a result of entering tax consolidation with the acquirer's tax group - should be considered, and any impact may need to be factored into the measurement of deferred tax assets and liabilities at acquisition. This needs to be carefully considered as different accounting consequences apply depending on the timing of the decision to enter the acquirer's tax group.

In closing...

So, that covers a couple of the basics when accounting for tax for the first time under AIFRS. Some key changes have taken place here, and it's important that all Australian companies are aware of how they will be effected.

AIFRS update: July 2006

AIFRS update provides you with a series of quick tips to keep you abreast of some of the key issues occurring within the financial reporting space. Designed as a short and sharp update, we trust you will find this a convenient way to keep in touch with issues relevant to your business.

Tips for applying the new set of standards

- AASB 139 *Financial Instruments: Recognition and Measurement* requires an entity, when it first becomes a party to a contract, to assess whether any embedded derivative contained in the contract needs to be separated from the host contract and accounted for as a separate derivative. However, the standard is silent on whether an entity should subsequently reassess this position. Consequently, the UIG has issued Interpretation 9 **Reassessment of Embedded Derivatives** to clarify that subsequent reassessment is required only if there has been a change in the terms of the contract that significantly modifies the cash flows that originally arose under the contract. The interpretation applies to annual reporting periods beginning on or after 1 June 2006, with early adoption encouraged for annual reporting periods beginning on or after 1 January 2005.
- Entities should disclose in the financial statements the financial impact of **pronouncements that have been issued or amended** but not yet applied by the entity. Some disclosure needs to be made even if the impact on the entity isn't expected to be material. However, there's no requirement to mention a standard or interpretation if it's clearly not applicable to the entity. UIG 6, for example, deals with liabilities arising under the European Union's Directive on Waste Electrical and Electronic Equipment, and wouldn't typically rate a mention in an Australian entity's accounts.

News from the Australian Accounting Standards Board

- From 1 July 2006, the AASB is replacing the Urgent Issues Group with a **new interpretations model**. Under this model, the AASB is taking direct responsibility for developing interpretations, both Australian equivalents of IFRIC interpretations and domestic interpretations. A feature of the new model will be the formation of advisory panels, which will prepare alternative views and, where necessary, recommendations for consideration by the Board. The Board is now inviting applications from interested parties who wish to be included on a public register of potential advisory panel members. Visit the AASB website (www.aasb.com.au) for more information.
- Following the International Accounting Standards Board, the AASB has released **Exposure Draft 149 Proposed Amendments to AASB 123 Borrowing Costs** for public comment. The exposure draft proposes the removal of the option in AASB 123 of recognising borrowing costs immediately as an expense, to the extent that they are directly attributable to the acquisition, construction or production of a qualifying asset. The removal of the option to expense borrowing costs attributable to qualifying assets is aimed at moving IFRS towards convergence with US GAAP. The AASB seeks comments by 21 August 2006.
- Following the international board, the AASB has just published Exposure Draft '**Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation**'. The ED proposes amendments to AASB 132 *Financial Instruments: Presentation* so that some financial instruments with characteristics similar to ordinary shares (e.g. units issued by limited life trusts) which are classified as liabilities under the current version of AASB 132 could be reclassified as equity if specified criteria are met. Entities should be aware that these proposals cannot be applied to 30 June 2006 AIFRS financial statements.