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DISCLOSURE OF DEFERRED TAX: A DESCRIPTIVE STUDY INTO THE APPROPRIATENESS OF DIFFERENT CLASSIFICATION METHODS

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Submitted in partial fulfillment of the requirements for the degree MAGISTER COMMERCII (TAXATION) in the Faculty of Economic and Management Sciences at the University of Pretoria

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ABSTRACT

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The distinction between current and non-current assets and liabilities used in the presentation of financial statements has been challenged for well over the past two decades. Despite this, the distiction is still used today and appears to still have relevance. The purpose of this study is to evaluate and determine the most appropriate method of classification of deferred tax between current and non-current in the context of the objective of financial statements. This is important as information that meets the objective of financial statements is useful to users of financial statements, and might influence their economic decisions. Furthermore, the most appropriate method of classification will have a direct impact on working capital ratios as well as other ratios in financial reporting analyses. A literature review of technical issues together with insights collected from accounting lecturers and technical partners and/or directors by way of a descriptive survey have shown that the destinction of deferred tax assets and liabilities between current and non-current assets and liabilities meets the objective of financial statements. This is in terms of both the current IASB Framework as well as the proposed revised Conceptual Framework. Standard setters in the accounting arena should therefore consider the value such a distinction would add to users of financial statements. This distinction will have the biggest impact on preparers of financial statements, as information of sufficient detail would have to be readily available to enable them to provide users with more relevant information.

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OPSOMMING

OPENBAARMAKING VAN UITGESTELDE BELASTING: 'N BESKRYWENDE STUDIE TEN OPSIGTE VAN DIE TOEPASLIKHEID VAN VERSKILLENDE KLASSIFIKASIE METODES

deur

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Die onderskeid tussen bedryfs- en nie-bedryfsbates en laste wat in die aanbieding van finansiële state gebruik word, word al vir meer as twee dekades bevraagteken. Ten spyte daarvan word hierdie onderskeid vandag steeds getref en blyk steeds relevant te wees. Die doel van hierdie studie is om die mees toepaslike metode vir die klassifikasie van uitgestelde belasting tussen bedrys- en nie-bedryfsbates en laste in die konteks van die doel van finansiële state te evalueer en te bepaal. Dit is belangrik omdat inligting wat aan die doel van finansiële state voldoen, bruikbaar is vir gebruikers van finansiële state en sodoende hulle ekonomiese besluite mag beïnvloed. Voorts sal die mees toepaslike metode van klassifikasie 'n direkte impak op bedryfskapitaalverhoudings asook ander verhoudings in die ontleding van finansiële verslagdoening hê. Uit 'n literatuur ontleding van die tegniese punte, tesame met insigte verkry van rekeningkunde dosente en tegniese vennote en/ of direkteure deur middel van 'n beskrywende ondersoek, blyk dit dat die onderskeid van uitgestelde belasting bates en laste tussen bedryfs- en nie-bedryfsbates en laste wel aan die doel van finansiële state voldoen. Dit is in terme van beide die huidige IASB Raamwerk asook die voorgestelde hersiene Konseptuele Raamwerk. Standaardaanwysers in die rekeningkunde arena moet daarom die waarde wat hierdie onderskeid aan gebruikers van finansiële state toevoeg, oorweeg. Diegene wat finansiële state voorberei sal die meeste deur hierdie onderskeid geraak word, aangesien meer gedetailleerde inligting beskikbaar moet wees om hulle in staat te stel om meer relevante inligting aan gebruikers te voorsien.

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LIST OF ABBREVIATIONS

APB	Accounting Principles Board
ARB	Accounting Research Bulletin
FASB	(United States) Financial Accounting Standards Board
IAS	International Accounting Standard
IAS 1	IAS 1 – *Presentation of Financial Statements*
IAS 12	IAS 12 – *Income taxes*
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standard
Opinion 11	APB Opinion No 11, *Accounting for Income Taxes*
SFAS	(United States) Statement of Financial Accounting Standards
SFAS 37	FASB Statement No. 37 – *Balance Sheet Classification of Deferred Income Taxes*
SFAS 109	FASB Statement No. 109 – *Accounting for Income Taxes*
The Current Framework	*Framework for the Preparation and Presentation of Financial Statements as issued by the IASB*
The Discussion Paper	Discussion Paper – *Preliminary Views on an Improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information*
US	United States of America
US GAAP	United States Generally Accepted Accounting Principles

DISCLOSURE OF DEFERRED TAX: A DESCRIPTIVE STUDY INTO THE APPROPRIATENESS OF DIFFERENT CLASSIFICATION METHODS

CHAPTER 1
INTRODUCTION AND BACKGROUND

1.1 BACKGROUND

As far back as 1980, the distinction between current and non-current assets and liabilities used in the presentation of annual financial statements has been challenged. In an article published in 1980, Heath proposed the abolishment of the practice of distinguishing assets and liabilities between current and non-current. He also suggested that the current/non-current distinction be substituted with additional disclosure about the attributes of certain assets and liabilities. To the contrary, Bernstein opposes the abandonment of this working capital concept. He suggests that the accounting profession is obliged to improve the concept and tighten the definitions of current versus non-current. Another author, Most argues that Heath is incorrect in saying that the only characteristic current assets and liabilities have is their classification. However, Most agrees that improving balance-sheet classification is desirable. Block refutes Heath's assertion that the working capital ratio is only "a vestige of a bygone era." Rather, it is still used today and still has relevance. Heath replies that many of the arguments proposed by his three critics (Bernstein, Most & Block) are not relevant to his recommendations. He gives two reasons for ceasing to classify assets and liabilities as current or non-current. Firstly, the classifications give the user no useful information and secondly, the distinction between current and non-current can be misleading (Bernstein, Leopold., Most, Kenneth S., Block, Max., Heath, Loyd., 1981:82).

It is clear that the accounting profession disagrees with Heath, as most annual financial statements still, today, distinguish between current and non-current assets and liabilities. Paragraphs 51 and 52 of IAS 1, state the following:

"51. *An entity shall present current and non-current assets, and current and non-current liabilities, as separate classifications on the face of its balance sheet in accordance with paragraphs 57-67 except when a presentation based on liquidity provides information that is reliable and is more relevant.*

52. When an entity supplies goods or services within a clearly identifiable operating cycle, separate classification of current and non-current assets and liabilities on the face of the balance sheet provides useful information by distinguishing the net assets that are continuously circulating as working capital from those used in the entity's long-term operations. It also highlights assets that are expected to be realised within the current operating cycle, and liabilities that are due for settlement within the same period."

It is clear from the extract above, that entities are currently required to distinguish between current and non-current assets and liabilties in the preparation of their annual financial statements, except if the financial statements are presented in the order of liquidity, as certain entities in the financial sector do.

In the preparation of financial statements, the preparer should always consider the objective of financial statements. The classification of assets and liabilities in the financial statements should be consistent with this objective. The objective of financial statements is set out in paragraph 12 of the current Framework:

"*12. The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.*"

As part of their joint project to develop a common Conceptual Framework for Financial Reporting, the FASB and the IASB issued a Discussion Paper – *Preliminary Views on an Improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information* ("the Discussion Paper"). This Discussion Paper sets out the proposed revised objective of financial reporting as follows:

"*The objective of general purpose external financial reporting is to provide information that is useful to present and potential investors and creditors and others in making investment, credit, and similar resource allocation decisions.*

To help achieve its objective, financial reporting should provide information to help present and potential investors and creditors and others ***to assess the amounts, timing, and uncertainty of the entity's future cash inflows and outflows*** *(the entity's future cash flows). That information is essential in assessing an entity's ability to generate net cash inflows and thus to provide returns to investors and creditors.*" **[Emphasis added]**

It appears as though there might be inconsistencies between the disclosure requirements of IAS 1.

Paragraph 70 of IAS 1 states the following:

"70. *When an entity presents current and non-current assets, and current and non-current liabilities, as separate classifications on the face of its balance sheet, it shall* ***not*** *classify deferred tax assets (liabilities) as current assets (liabilities).*" **[Emphasis added]**

It is thus clear from IAS 1 that all assets and liabilities should be distinguished between current and/or non-current assets and liabilities, except for deferred tax assets and liabilities.

During September 2002, the IASB and the FASB commenced a convergence project between IAS 12 and SFAS 109 (the corresponding US Standard). The objective of the project is to reduce the differences that exist between IAS 12 and SFAS 109 and related US GAAP and also to remove the need for the reconciliation requirement for non-US companies that use IFRSs but that are registered in the United States.

One of the differences identified between the IFRS and the US GAAP accounting standard (SFAS) on Income Taxes was with respect to the balance sheet classification of deferred tax assets and liabilities (IASB and FASB 2006:1).

As mentioned earlier, IAS 1 prohibits the distinction of deferred tax assets and liabilities between current and non-current assets and liabilities. Paragraph 41 of SFAS 109, however, requires the following:

"41. *In a classified statement of financial position, an enterprise shall separate deferred tax liabilities and assets into a current amount and a non-current amount.*

Deferred tax liabilities and assets shall be classified as current or non-current based on the classification of the related asset or liability for financial reporting. A deferred tax liability or asset that is not related to an asset or liability for financial reporting (paragraph 15), including deferred tax assets related to carryforwards, shall be classified according to the expected reversal of the temporary difference pursuant to FASB Statement No. 37, Balance Sheet Classification of Deferred Income Taxes ("SFAS 37"). *The valuation allowance for a particular tax jurisdiction shall be allocated between current and non-current deferred tax assets for that tax jurisdiction on a pro rata basis.*"

The Exposure Draft prior to the issue of SFAS 37 (an amendment of APB Opinion No. 11), was issued for public comment on March 14, 1980. Some respondents suggested classifying all deferred income taxes based on when the timing differences reverse or classifying as current only those deferred income taxes that will actually be paid.

In summary, 3 methods exist as to the most appropriate classification of deferred tax, namely:

- Deferred tax should be classified as non-current;
- Deferred tax should be classified according to the underlying asset or liability to which the temporary differences relate; or
- Deferred tax should be classified based on when the timing differences reverse ("scheduling").

From the above it can be argued that uncertainty prevails regarding the most appropriate method of classification of deferred tax.

1.2 RESEARCH AND OBJECTIVES

The purpose of this study is to evaluate and determine the most appropriate method of classification of deferred tax between current and non-current in the context of the objective of financial statements.

1.2.1 Objectives

The objectives that will be specifically addressed are the following:

- To determine the appropriateness of the classification of deferred tax assets and liabilities in terms of the current Framework, based on the following three methods of classification:

    - Deferred tax assets and liabilities should be classified as non-current assets and liabilities. This is in terms of the current requirement of IAS 1, paragraph 70;

    - The balance sheet classification of deferred tax assets and liabilities should follow the classification of the balance sheet item in respect of which the asset or liability is raised. This is in terms of the current requirement of SFAS 109, paragraph 41; and

    - The deferred tax asset and liability should be classified according to the expected reversal of the temporary differences to which they relate (i.e. the temporary difference should be scheduled, with those temporary differences reversing within 12 months after the balance sheet date being classified as current, and the balance classified as non-current). This is in terms of the comments received on the exposure draft issued prior to the issue of SFAS 37.

- To determine the appropriateness of the classification of deferred tax assets and liabilities in terms of the proposed revised Framework based on the following three methods of classification:

    - Deferred tax assets and liabilities should be classified as non-current assets and liabilities. This is in terms of the current requirement of IAS 1, paragraph 70;

    - The balance sheet classification of deferred tax assets and liabilities should follow the classification of the balance sheet item in respect of which the asset or liability is raised. This is in terms of the current requirement of SFAS 109, paragraph 41; and

    - The deferred tax asset and liability should be classified according to the expected reversal of the temporary differences to which they relate (i.e. the temporary difference should be scheduled, with those temporary differences reversing within 12 months after the balance sheet date being classified as current, and the balance classified as non-current). This is in terms of the comments received on the exposure draft issued prior to the issue of SFAS 37.

1.3 ASSUMPTIONS

IAS 12 requires that deferred tax assets should be recognised when it is probable that taxable profits will be available against which the deferred tax asset can be utilised. Where an entity has a history of tax losses, the entity recognises a deferred tax asset only to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available.

For the purposes of this dissertation it is assumed that the company will have sufficient future taxable profit in order to recognise the deferred tax asset.

Furthermore, the research conducted will focus on financial statements being prepared on the current non-current basis in terms of IAS 1, and not on the liquidity basis.

1.4 RESEARCH DESIGN

1.4.1 Classification

A literature review will be performed which will focus on the relevance of the three methods identified in respect of the classification of deferred tax assets as current and non-current assets and liabilities, against the objective of the preparation of financial statements.

The literature review will be supplemented by comments received from the accounting lecturers (lecturing students on the honours level at universities in South Africa) as well as accounting technical partners and/ or directors of the top 4 auditing firms in South Africa (“defined population”) on the classification of deferred tax assets and liabilities as current and non-current assets and liabilities.

1.4.2 Method

The literature review will be conducted in the way of research of technical issues relating to the classification of assets and liabilities as current or non-current.

Insights from accounting lecturers and technical partners and/or directors will be collated in the form of a descriptive survey. The data from the questionnaires will be evaluated and concluded upon.

1.4.3 Control of Researcher

Minimum manipulation exists for the researcher due to the fact that all the objectives of the research will be measured against definitions in existing literature. Data obtained from questionnaires will be statistically interpreted and concluded upon. The researcher therefore has a medium level of control over the data.

1.5 RESEARCH METHODS

1.5.1 Description of research methods

1.5.1.1 Literature review

A literature review will be conducted in order to measure the objectives of the study against principles already established in existing literature. The literature review will incorporate the in-depth research of current IFRSs and related US GAAP standards applicable to this dissertation as well as the review of published journals and articles highlighting strong principles that will meet the objectives of this dissertation.

1.5.1.2 Survey research

Survey research will be conducted in order to collect data from a sample of respondents. The sample will consist of the opinions of accounting lecturers (lecturing students on the honours level at universities in South Africa) and accounting technical partners and/or directors practising at the top 4 auditing firms in South Africa. The survey research will be conducted by way of a descriptive survey, consisting of a predetermined list of questions that will lead the respondent to the objectives of the dissertation.

1.6 IMPORTANCE OF STUDY

1.6.1 Users of financial statements

The appropriate distinction between current and non-current deferred tax assets and liabilities, and the method used to make this distinction, must be consistent with the objective of financial statements in terms of the Conceptual Framework. This is so, because information that meets the objective of financial statements is useful to the users of financial statements, and might influence their economic decisions. It is also important to determine the most appropriate method of classification, as this will have a direct impact on working capital ratios as well as other ratios in financial reporting analyses.

1.6.2 International Accounting Standards Board (IASB)

The classification of deferred tax assets and liabilities between current and non-current assets and liabilities will align the requirements of paragraphs 51, 52 and 70 in IAS 1. The alignment of the requirements of these paragraphs will lead to fairer presentation of financial statements.

1.7 CHAPTER OUTLAY

Chapter 1	Introduction and Background
Chapter 2	The Objective of the Preparation of Financial Statements
Chapter 3	The Three Methods Considered in order to Classify Deferred Tax Assets and Liabilities as Current and Non-Current Assets and Liabilities
Chapter 4	Results of the Empirical Study
Chapter 5	Conclusion on the Study

CHAPTER 2
THE OBJECTIVE OF THE PREPARATION OF FINANCIAL STATEMENTS

2.1 INTRODUCTION

This chapter will explore the objective of the preparation of financial statements, which forms the basis for the research in considering the most appropriate method of classification of deferred tax assets and liabilities between current and non-current assets and liabilitiies. The objective of the preparation of financial statements is contained in the IASB's *Framework for the Preparation and Presentation of Financial Statements* ("the Current Conceptual Framework"). The IASB and the FASB also issued a document as part of their joint project to develop a conceptual framework to be used by both boards, namely Discussion Paper – *Preliminary Views on an Improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information* ("the proposed revised Conceptual Framework").

This chapter will focus on the background behind the IASB and FASB's convergence project and the need for one conceptual framework, the reasons for the reconsideration of their different frameworks as well as the actual change in the objective of the preparation of financial statements.

2.2 BACKGROUND

At their joint meeting in September 2002, the FASB and the IASB affirmed their commitment to the goal of achieving convergence of accounting standards used for international financial reporting. Both boards agree that *convergence* means the "*development of a single set of high-quality accounting standards that could be used for both domestic and cross-border financial reporting*" (Attachment F: Short-term International Convergence, Financial Accounting Standards Advisory Council, March 2004). According to Tweedie (2006: 6), IASB Chairman, the objective of the convergence project is to develop a single set of global standards. He explained that the best standard of the two Boards would be selected, if available, otherwise a new standard would be written.

The FASB believes that convergence is consistent with its mission and obligation to its domestic constituents. US constituents are expected to benefit from convergence in many ways, such as:

- Efficient functioning of the global capital markets – decisions about the allocation of resources rely heavily on credible, transparent, and understandable financial information that is comparable across national borders. The results of similar companies reporting under different bases of accounting, are not easily comparable for members of the user community;

- Reducing the administrative burden on multinational entities that are currently required to prepare financial statements under several different bases of accounting and reconcile them for cross-border reporting; and

- Enabling US companies to access capital markets outside the United States without having to "reconcile" their US GAAP-based financial results to those that would have been reported under IFRS.

The convergence goal of the Board is supported by many. The Trustees of the Financial Accounting Foundation and regulators such as the Securities and Exchange Commission have strongly encouraged the FASB to include convergence with the IASB among the organisation's highest priorities.

The short-term international convergence project is just one of the several tactics the Boards are using to achieve their convergence goal. Others include coordinated development of specific accounting standards (through joint projects such as business combinations and projects undertaken cooperatively such as share-based payment) and broader coordination of their standard-setting activities.

The purpose of the short-term international convergence project is to address certain narrow differences between US GAAP and IFRS that are not significant individually, but collectively reduce the comparability of financial information and contribute to the administrative cost of preparing financial statements in multiple jurisdictions. Candidates for inclusion in this project include:

- Narrow differences in the provisions of similar existing US GAAP and IFRSs that represent high-quality accounting standards (for example, differences in the accounting for income taxes). The short-term convergence project is an opportunity in the near term to reduce or eliminate the non-comparability that results from those differences; and

- Narrow differences in areas for which, between existing IFRSs and US GAAP, one of the existing standards is viewed as a high-quality accounting standard. Convergence would be achieved by both Boards adopting the similar high-quality standard.

While convergence is the catalyst for including a particular difference in the scope of the project, both Boards are committed to making a change to their standards only when they conclude that a change represents a high-quality solution to the issue being addressed (Attachment F: Short-term International Convergence, Financial Accounting Standards Advisory Council, March 2004).

Currently, the IASB uses the current Framework and the FASB uses the *Statements of Financial Accounting Concepts,* each of which forms the foundation for the Boards to set consistent standards. The reason behind the reconsideration of the Boards' existing frameworks is because they believe that a common Conceptual Framework, that is both complete and internally consistent, is essential for the development of accounting standards that are principle-based, internally consistent, internationally converged, and lead to financial reporting that provides the necessary information to the users of financial statements (Deloitte IAS Plus newsletter – August 2006).

In July 2006, the IASB and FASB published for comment an IASB Discussion Paper and FASB Preliminary Views document *Conceptual Framework for Financial Reporting: Objective of Financial Reporting and Qualitative Characteristics of Decision-Useful Financial Reporting Information* ("the Discussion Paper"). (Deloitte IAS Plus newsletter – August 2006).

This chapter sets out the objective of financial statements as currently contained in the IASB's *Framework for the Preparation and Presentation of Financial Statements* as well as the objective of financial reporting discussed in the document issued by the IASB and the FASB as part of their joint project to develop a conceptual framework to be used by both boards.

2.3 REASON FOR RECONSIDERATION OF DIFFERENT FRAMEWORKS

A potential answer to the reason behind the reconsideration of the two existing frameworks is the fact that:

> "*A common goal of the boards – a goal shared by their constituents – is for their standards to be clearly based on consistent principles*" (July 2006 Discussion Paper – Conceptual Framework for Financial Reporting. Par P3.)

In order to have consistency between principles in all standards issued by either the IASB or the FASB, it is necessary that those principles be rooted in fundamental concepts rather than being a collection of conventions. In order to achieve coherent financial reporting in standards taken as a whole, the need arises for a financial reporting framework supporting all concepts in the underlying standards. This will lead to a framework that is sound, comprehensive and internally consistent.

Another common goal of the Boards is to bring their standards into convergence and therefore align their agendas more closely. In order to successfully converge standards, decisions need to be based on one framework setting out the underlying principles.

To provide the best foundation for developing principles-based and converged standards, the Boards undertook a joint project to develop a common and improved conceptual framework. The goals for the project include updating and refining the existing concepts to reflect changes in markets, business practices and the economic environment that have taken place in the two or more decades since the concepts were developed. The Boards also intend to improve certain aspects of the existing frameworks, such as recognition and measurement, as well as to fill gaps in the frameworks.

2.4 THE CHANGE IN OBJECTIVE

As stated earlier, the current Framework of the IASB states that the objective of the presentation of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions. In order to meet these objectives, an entity that prepares financial statements in terms of IFRS prepares a balance sheet (providing information about the financial position), an income statement (providing information about performance) and a statement of changes in equity (providing information about changes in financial position).

As part of the development of a conceptual framework for the preparation of financial statements in terms of both IFRS and US GAAP, the IASB and the FASB issued the Discussion Paper which proposes changes to the objective of financial statements from that mentioned above. This Discussion Paper sets out the objective of general purpose external financial reporting (previously financial statements) as providing information that is useful to present and potential investors and creditors and others in making investment, credit and similar resource allocation decisions. To achieve its objective, financial reporting should provide information to help present and potential investors and creditors and others to assess the amounts, timing and uncertainty of the entity's future cash inflows and outflows (the entity's future cash flows). This information is essential in assessing an entity's ability to generate net cash inflows and thus to provide returns to investors and creditors.

An entity's investors and creditors (both present and potential) are directly interested in the amount, timing and uncertainty of their cash flows from dividends, interest, sale, redemption, or maturity of securities or loans.

Whereas the current framework refers to information being useful in making "economic decisions", the Discussion Paper refers to information being useful in making "investment, credit and similar resource allocation decisions." Ernst & Young is of the view that one consequence of these changes is that the result of managements stewardship are now regarded as relevant only insofar as they relate to 'resource allocation decisions' and not as an objective of financial statements in their own right. In their view, a basic purpose of financial statements would be compromised in many jurisdictions if IFRS financial statements are prepared on this basis. They view this basic purpose as enabling shareholders to exercise accountability over management as part of the system of corporate governance. (Global EYe on IFRS: Insights on International GAAP. 2007. Ernst & Young. *The Quest for a Revised Conceptual Framework*. UK. January.).

In order to meet this proposed objective, it flows logically that the classification of assets and liabilities between current and non-current assets and liabilities becomes critical in assessing the amount, timing and uncertainty of future cash flows.

2.5 CONCLUSION

It is clear from the facts contained in both the current and proposed financial reporting framework that the objective of general purpose financial reporting (previously financial statements) has moved from merely presenting financial statements containing a balance sheet, income statement and statement of changes in equity to providing information that enable users to assess the future cash flows of an entity. The amount, timing and uncertainty of cash flows will play an integral role in the assessment of the entities future cash flows.

2.6 SUMMARY

In this chapter the objective of the preparation of financial statements was researched, both in terms of the current Conceptual Framework as well as the proposed revised Conceptual Framework. This chapter focused on the background behind the IASB and FASB's convergence project and the need for one conceptual framework, the reasons for the reconsideration of their different frameworks as well as the actual change in the objective of the preparation of financial statements.

Chapter 3 will focus on the classification of deferred tax assets and liabilities between current and non-current assets and liabilities in order to meet the objective of the preparation of financial statements either in terms of the current Conceptual Framework or the proposed revised Conceptual Framework.

CHAPTER 3
THE THREE METHODS CONSIDERED IN ORDER TO CLASSIFY DEFERRED TAX ASSETS AND LIABILITIES AS CURRENT AND NON-CURRENT ASSETS AND LIABILIITES

3.1 INTRODUCTION

This chapter will explore on the three methods of classification of deferred tax assets and liabilities as current and non-current assets and liabilities, identified during the literature review. More specifically, this chapter will focus on each of the different alternative classification methods in order to identify the most appropriate one in terms of the conceptual framework. This chapter will investigate the appropriateness of the three methods against both the current conceptual framework in issue by the IASB as well as against the newly proposed conceptual framework jointly published by the IASB and the US FASB during July 2006 (“the Discussion Paper”).

3.2 BACKGROUND

During the execution of the literature review it was established that three potential methods exist for the classification of deferred tax assets and liabilities between current and non-current assets and liabilities. The three methods are as follows:

- Deferred tax assets and liabilities should be classified as non-current assets and liabilities. This is in terms of the current requirement of paragraph 70 of IAS 1;

- The balance sheet classification of deferred tax assets and liabilities should follow the classification of the balance sheet item in respect of which the asset or liability is raised. This is in terms of the current requirement of paragraph 41 of SFAS 109 (the related US GAAP standard); and

- The deferred tax asset and liability should be classified according to the expected reversal of the temporary differences to which they relate (i.e. the temporary difference should be scheduled, with those temporary differences reversing within 12 months after the balance sheet date being classified as current, and the balance classified as non-current). This is in terms of the comments received on the exposure draft issued prior to the issue of SFAS 37.

3.3 DEFERRED TAX ASSETS AND LIABILITIES CLASSIFIED AS NON-CURRENT ASSETS AND LIABILITIES

Paragraph 70 of IAS 1 states:

"70. *When an entity presents current and non-current assets, and current and non-current liabilities, as separate classifications on the face of its balance sheet, it shall not classify deferred tax assets (liabilities) as current assets (liabilities).*"

In order to meet the objective of financial statements in terms of the current Framework, an entity shall present information about its financial position (i.e. the balance sheet). The presentation of the balance sheet is further supported by the requirements of IAS 1, paragraph 51 and 52, which requires an entity to distinguish between current and non-current assets and liabilities. The separate classification of current and non-current assets and liabilities provides useful information (about the financial position) by distinguishing assets and liabilities that are continuously circulating as working capital from those used in the entity's long-term operations. It also provides information about assets and liabilities that are expected to be realised within the current operating cycle, and liabilities that are due for settlement within the same period.

Paragraphs 57-59 of IAS 1 define a current asset as follows:

"57. *An asset shall be classified as current when it satisfies any of the following criteria:*

(a) It is expected to be realised in, or is intended for sale or consumption in, the entity's normal operating cycle;

(b) It is held primarily for the purpose of being traded;

(c) It is expected to be realised within twelve months after the balance sheet date; or

(d) *It is cash or a cash equivalent (as defined in IAS 7, Cash Flow Statements) unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the balance sheet date.*

All other assets shall be classified as non-current.

58. This Standard uses the term "non-current" to include tangible, intangible and financial assets of a long-term nature. It does not prohibit the use of alternative descriptions as long as the meaning is clear.

59. The operating cycle of an entity is the time between the acquisition of assets for processing and their realisation in cash or cash equivalents. When the entity's normal operating cycle is not clearly identifiable, its duration is assumed to be twelve months. Current assets include assets (such as inventories and trade receivables) that are sold, consumed or realised as part of the normal operating cycle even when they are not expected to be realised within twelve months after the balance sheet date. Current assets also include assets held primarily for the purpose of being traded (financial assets within this category are classified as held for trading in accordance with IAS 39, Financial Instruments: Recognition and Measurement) and the current portion of non-current financial assets."

Paragraphs 60-67 of IAS 1, define a current liability as follows:

"*60. A liability shall be classified as current when it satisfies any of the following criteria:*

(a) it is expected to be settled in the entity's normal operating cycle;

(b) it is held primarily for the purpose of being traded;

(c) it is due to be settled within twelve months after the balance sheet date; or

(d) the entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the balance sheet date.

All other liabilities shall be classified as non-current.

61. Some current liabilities, such as trade payables and some accruals for employee and other operating costs, are part of the working capital used in the entity's normal operating cycle. Such operating items are classified as current liabilities even if they are due to be settled more than twelve months after the balance sheet date. The same normal operating cycle applies to the classification of an entity's assets and liabilities. When the entity's normal operating cycle is not clearly identifiable, its duration is assumed to be twelve months.

62. Other current liabilities are not settled as part of the normal operating cycle, but are due for settlement within twelve months after the balance sheet date or held primarily for the purpose of being traded. Examples are financial liabilities classified as held for trading in accordance with IAS 39, bank overdrafts, and the current portion of non-current financial liabilities, dividends payable, income taxes and other non-trade payables. Financial liabilities that provide financing on a long-term basis (i.e., are not part of the working capital used in the entity's normal operating cycle) and are not due for settlement within twelve months after the balance sheet date are non-current liabilities, subject to paragraphs 65 and 66.

63. An entity classifies its financial liabilities as current when they are due to be settled within twelve months after the balance sheet date, even if:

(a) the original term was for a period longer than twelve months; and

(b) an agreement to refinance, or to reschedule payments, on a long-term basis is completed after the balance sheet date and before the financial statements are authorised for issue.

64. If an entity expects, and has the discretion, to refinance or roll over an obligation for at least twelve months after the balance sheet date under an existing loan facility, it classifies the obligation as non-current, even if it would otherwise be due within a shorter period. However, when refinancing or rolling over the obligation is not at the discretion of the entity (for example, there is no agreement to refinance), the potential to refinance is not considered and the obligation is classified as current.

65. When an entity breaches an undertaking under a long-term loan agreement on or before the balance sheet date with the effect that the liability becomes payable on demand, the liability is classified as current, even if the lender has agreed, after the balance sheet date and before the authorisation of the financial statements for issue, not to demand payment as a consequence of the breach. The liability is classified as current because, at the balance sheet date, the entity does not have an unconditional right to defer its settlement for at least twelve months after that date.

66. However, the liability is classified as non-current if the lender agreed by the balance sheet date to provide a period of grace ending at least twelve months after the balance sheet date, within which the entity can rectify the breach and during which the lender cannot demand immediate repayment.

67. In respect of loans classified as current liabilities, if the following events occur between the balance sheet date and the date the financial statements are authorised for issue, those events qualify for disclosure as non-adjusting events in accordance with IAS 10, Events After the Balance Sheet Date:

(a) refinancing on a long-term basis;

(b) rectification of a breach of a long-term loan agreement; and

(c) the receipt from the lender of a period of grace to rectify a breach of a long-term loan agreement ending at least twelve months after the balance sheet date."

From the above it can be argued that a deferred tax asset and/or liability (or a portion thereof) can be classified as a current asset and/or liability. This being that it can be expected that a deferred tax asset (or a portion thereof) will realise within an entity's normal operating cycle or within twelve months after the balance sheet date, where the operating cycle is assumed to be twelve months. The same applies for the situation where an entity accounts for a deferred tax liability, as it can be expected that the temporary differences that resulted in the deferred tax liability, will reverse within its normal operating cycle.

It is therefore concluded upon that the classification of deferred tax assets and liabilities as non-current assets and liabilities in terms of paragraph 70 of IAS 1 appears not to meet the objective of financial statements in terms of the current Framework.

It is furthermore concluded that the current classification of deferred tax assets and liabilities as non-current assets and liabilities in terms of paragraph 70 of IAS 1 will not meet the proposed objective of financial reporting as contained the Discussion Paper issued by the IASB and FASB. In the discussion paper, it now becomes critical for financial reporting to enable users to assess the future cash flows of an entity. In order to assess future cash flows, amounts and timing becomes essential, which will only be attainable through the appropriate classification of assets and liabilities (including deferred tax assets and liabilities) between current and non-current assets and liabilities.

3.4 DEFERRED TAX ASSETS AND LIABILITIES CLASSIFIED AS CURRENT AND NON-CURRENT ASSETS AND LIABILITIES BASED ON THE BALANCE SHEET CLASSIFICATION OF THE UNDERLYING ITEM

Paragraph 57 of APB Opinion No 11, *Accounting for Income Taxes* ("Opinion 11") (the US related standard of IAS 12 – *Income Taxes*) states:

"57. *Deferred charges and deferred credits relating to timing differences represent the cumulative recognition given to their tax effects and as such do not represent receivables or payables in the usual sense. They should be classified in two categories – one for the net current amount and the other for the net non-current amount. This presentation is consistent with the customary distinction between current and non-current categories and also recognises the close relationship among the various deferred tax accounts, all of which bear on the determination of income tax expense. The current portion of such deferred charges and credits should be those amounts which relate to assets and liabilities classified as current. Thus, if instalment receivables are a current asset, the deferred credits representing the tax effects of uncollected instalment sales should be a current item; if an estimated provision for warranties is a current liability, the deferred charge representing the tax effect of such provision should be a current item.*"

A proposed Interpretation, *Balance Sheet Classification of Deferred Income Taxes*, was released for comment on June 22, 1979. The proposed Interpretation of Opinion 11 addressed the classification of deferred income taxes related to timing differences associated with long-term construction contracts, undistributed earnings of subsidiaries, and a change in method of accounting for income tax reporting purposes. Fifty-one comment letters were received. The Interpretation proposed to clarify that deferred income taxes classified as current should be reclassified to non-current only if the related asset or liability is reclassified to non-current. Many respondents to the proposed Interpretation questioned the appropriate balance sheet classification when the timing difference is not related to an asset or liability because realisation of the asset or liquidation of the liability does not result in reversal of the timing difference. Others commented that there is no asset or liability related to the deferred income taxes for certain timing differences. The Board concluded that it should amend paragraph 57 of Opinion 11 to address the balance sheet classification of deferred income taxes in those circumstances.

An Exposure Draft of a proposed Statement, on *Balance Sheet Classification of Deferred Income Taxes*, an amendment of APB Opinion No. 11, was issued for public comment on March 14, 1980. The Board received 67 letters of comment in response to the Exposure Draft. Some respondents suggested classifying deferred income taxes based on the net effect of (a) reversals of existing timing differences and (b) any additional timing differences that may arise. The Board concluded that balance sheet classification of deferred income taxes is based on the deferred income taxes that exist at the balance sheet date. Other respondents suggested classifying all deferred income taxes based on when the timing differences reverse or classifying as current only those deferred income taxes that will actually be paid. The Board concluded, however, that such criteria would involve a more fundamental change in paragraph 57 of Opinion 11 that should not be considered at this time.

Several respondents to the Exposure Draft commented about the operating cycle in the illustration of construction contracts. It was not the intention of the Board to address or change how an operating cycle is determined. Accordingly, that illustration has been revised to be consistent with the operating cycle concepts expressed in Chapter 3A, "Current Assets and Current Liabilities," of ARB 43.

Several comments were received on the capital lease illustration. The comments suggested classifying the deferred income taxes according to the underlying asset or liability. The Board concluded that, based on the facts set forth in the capital lease illustration, the nature of lease timing differences and the classification of the associated deferred income taxes described in paragraph 27 are appropriate.

The last two sentences of paragraph 57 of Opinion 11 were deleted and replaced with:

A deferred charge or credit is related to an asset or liability of reduction (the term "reduction" includes amortisation, sale, or other realisation of an asset and amortisation, payment or other satisfaction of a liability) if the asset or liability causes the timing difference to reverse. A deferred charge or credit that is related to an asset or liability shall be classified as current or non-current based on the classification of the related asset or liability. A deferred charge or credit that is not related to an asset or liability because (a) there is no associated asset or liability or (b) reduction of an associated asset or liability will not cause the timing difference to reverse shall be classified based on the expected reversal date of the specific timing difference. Such classification disregards any additional timing differences that may arise and is based on the criteria used for classifying other assets and liabilities.

FAS 37: Balance Sheet Classification of Deferred Income Taxes an amendment of APB Opinion No. 11 ("SFAS 37"), now specifies the basis for classification of deferred income taxes in a classified balance sheet. Deferred income taxes related to an asset or liability are classified to match the related asset or liability. Deferred income taxes that are not related to an asset or liability are classified according to the expected reversal date of the timing difference.

It is therefore concluded that, based on the above discussion, the classification of deferred tax assets and liabilities between current and non-current assets and liabilities in terms of US GAAP, meet the objective of financial statements contained in the current Conceptual Framework. This is based on the premise that the proposed method of classification between current and non-current assets and liabilities contained in SFAS 37 is mature and therefore leads to a fair presentation of the financial position of an entity. The conclusion on whether the method of classification between current and non-current deferred tax assets and liabilities contained in SFAS 37 is mature, is not within the scope of this dissertation.

It is furthermore concluded that the current classification of deferred tax assets and liabilities between current and non-current assets and liabilities in terms of US GAAP, will, to a limited extent, meet the objective of financial statements contained in the proposed revised Conceptual Framework, to the extent that these classifications will give a fair presentation of the amount, timing and uncertainty of the entity's future cash flows. The current classification method in terms of US GAAP, however, does not only take temporary differences that will result in future cash inflows or outflows into account, but also includes those temporary differences that will not have a cash flow impact.

3.5 DEFERRED TAX ASSETS AND LIABILITIES CLASSIFIED AS CURRENT AND NON-CURRENT ASSETS AND LIABILITIES ACCORDING TO THE EXPECTED REVERSAL OF THE UNDERLYING TEMPORARY DIFFERENCE ("SCHEDULING")

As mentioned earlier, an Exposure Draft of a proposed Statement, on *Balance Sheet Classification of Deferred Income Taxes*, an amendment of APB Opinion No. 11, was issued for public comment on March 14, 1980. The Board received 67 letters of comment in response to the Exposure Draft. Some respondents suggested classifying all deferred income taxes based on when the timing differences reverse ("scheduling") or classifying as current only those deferred income taxes that will actually be paid. The Board concluded, however, that such criteria would involve a more fundamental change in paragraph 57 of Opinion 11 that should not be considered at this time.

Furthermore, as stated earlier, the presentation of the balance sheet is supported by the requirements of IAS 1, paragraph 51 and 52, which requires an entity to distinguish between current and non-current assets and liabilities. The separate classification of current and non-current assets and liabilities provides useful information (about the financial position) by distinguishing assets and liabilities that are continuously circulating as working capital from those used in the entity's long-term operations. It also provides information about assets and liabilities that are expected to be realised within the current operating cycle, and liabilities that are due for settlement within the same period. This results from the definitions of *current assets* and *current liabilities* contained in paragraphs 57-59 and 60-67 of IAS 1 respectively.

It is therefore concluded that the scheduling method of classification of deferred tax assets and liabilities between current and non-current assets and liabilities meet the objective of financial statements contained in the current Conceptual Framework. This is based on the premise that the method of scheduling to classify deferred tax assets and liabilities between current and non-current assets and liabilities will be more closely aligned with the definitions of *current asset* and *current liability* contained in IAS 1.

It is furthermore concluded that the scheduling method of classification of deferred tax assets and liabilities between current and non-current assets and liabilites will, to a limited extent, meet the objective of financial statements contained in the proposed revised Conceptual Framework, to the extent that these classifications will give a fair presentation of the amount, timing and uncertainty of the entity's future cash flows. This objective will only be met if the method of scheduling takes temporary differences that will result in future cash inflows or outflows into account, and not those temporary differences that will not have a cash flow impact.

3.6 SUMMARY OVERVIEW – BALANCE SHEET CLASSIFICATION

US GAAP requires that deferred tax assets and liabilities be classified to match the balance sheet classification of the underlying asset or liability, while IFRS requires classification to be non-current (Attachment F: Short-term International Convergence, Financial Accounting Standards Advisory Council, March 2004).

As stated in Chapter 1, paragraph 70 of IAS 1 prohibits the classification of deferred tax assets and liabilities between current and non-current assets and liabilities, while paragraphs 51 and 52 specifically states that an entity shall classify assets and liabilities between current and non-current assets and liabilities.

3.7 CONCLUSION

The IASB decided to amend IAS 12, to converge with the requirements of SFAS 109 in respect of the balance sheet classification of deferred tax assets and liabilities (www.iasb.org.uk: Short-term convergence: income taxes, Project Update dated 1 March 2006).

IAS 12 will, therefore, require deferred tax assets and liabilities to be classified between current and non-current assets and liabilities, based on the balance sheet classification of the underlying asset or liability to which the temporary difference relates. For temporary differences which can not be directly attributed to a asset or liability, the expected reversal of the temporary difference should be scheduled, and the deferred tax asset or liability classified accordingly.

3.8 SUMMARY

This chapter explored the different alternative classification methods in order to identify the appropriateness of the three methods against both the current conceptual framework in issue by the IASB as well as against the newly proposed conceptual framework jointly published by the IASB and the FASB during July 2006 ("the Discussion Paper").

Although the IASB decided to amend IAS 12 in order to align the requirements regarding the classification of deferred tax assets and liabilities with that of the US GAAP standard equivalent, the research conducted revealed that the scheduling method of classification of deferred tax assets and liabilities between current and non-current assets and liabilites will, to a greater extent, meet the objective of financial statements contained in the proposed revised Conceptual Framework, to the extent that these classifications will give a fair presentation of the amount, timing and uncertainty of the entity's future cash flows. This objective will only be met if the method of scheduling takes temporary differences that will result in future cash inflows or outflows into account, and not those temporary differences that will not have a cash flow impact.

Chapter 4 will explore the appropriateness of the classification method of deferred tax assets and liabilities between current and non-current assets and liabilities by way of an emperical study.

CHAPTER 4
RESULTS OF THE EMPIRICAL STUDY

4.1 INTRODUCTION

This chapter will explore the appropriateness of the classification of deferred tax assets and liabilities between current and non-current assets by way of an emperical study. The emperical study was done by way of a questionnaire, sent to a defined population, of which more detail is discussed in the background to the questionnaire. Furthermore, this chapter discusses the response rate as well as the statistical results and conclusions reached from the questionnaires returned by subjects of the population.

4.2 BACKGROUND TO THE QUESTIONNAIRE

The purpose of the questionnaire was to test the conclusions reached in the literature review against the opinions of accounting specialists in South Africa.

The empirical questionnaire was distributed to the Accounting lecturers at South African universitities teaching students at the post-graduate level (“the lecturers”) and accounting technical partners and/ or directors (“technical partners”) at the four largest auditing firms in South Africa (“defined population”). These two groups form the defined population for this study. The questionnaires were sent to this population in an attempt to increase the quality of the answers. Accounting lecturers and the technical partners were selected as they are currently actively involved with the accounting standards on a day-to-day basis and should, therefore have an in-depth knowledge of the provisions and requirements of accounting standards. The limitation associated with qualitative questionnaires should, however, be kept in mind, namely that they are primarily based on the opinions and perceptions of the respondents and that the opinions and perceptions of the respondents might be influenced by literature or opinions that are currently available in respect of a certain issue.

The lecturers in South Africa were identified either from information contained on the websites of the respective universities or from a telephone call made directly to the university concerned to obtain the information and the lecturers’ contact details.

The four largest auditing firms in South Africa were selected based on fee income, as contained in a survey done by the International Accounting Bulletin (Dayasena 2003:12). A questionnaire was sent to all the technical accounting partners of each firm. These individuals were identified by means of a telephone call to each of the firms to obtain the name(s) and e-mail address(es) of the relevant parties. The questionnaires were distributed to the parties via e-mail.

The questionnaire was divided into two parts, with each part containing the exact 3 questions. In part 1 of the questionnaire, respondents had to evaluate the questions against the current objective of financial statements as contained in the conceptual framework on a sliding scale between 1 and 5, with 1 being "least consistent with the objective of financial statements" and 5 being "most consistent with the objective of financial statements". In part 2 of the questionnaire respondents had to evaluate the questions on the same sliding scale against the objective of financial statements as contained in the revised conceptual framework as proposed by the IASB. The questionnaire contained an extract of all the relevant paragraphs in the conceptual framework, proposed revised conceptual framework, IAS 1, IAS 12 and SFAS 109 that are relevant to the study and the questions that were posed. No question in respect of the respondent's level of knowledge on the conceptual framework, proposed revised conceptual framework, IAS 1, IAS 12 or SFAS 109 were posed as the research performed focuses on an underlying principle in the preparation of financial statements, and not on a technical issue contained in one of the mentioned standards.

4.3 RESPONSE RATE

In total, 56 questionnaires were distributed, of which 17 were distributed to the accounting technical partners at the four largest auditing firms in South Africa, and 39 were distributed to the Accounting lecturers. The total response rate for the total population was 32,1% (18 respondents). The response rate in respect of the accounting technical partners were 52,9% (9 respondents), whereas the response rate in respect of the lecturers were 23,1% (9 respondents).

Questionnaires that had not been returned by the deadline date were followed up on with additional e-mails and/or telephone calls.

The percentage of questionnaires returned is below the average of expected returns that Babbie and Mouton (2005:261) propose, as they suggest that a response rate of 50% is adequate. The results of this study can therefore not be used to make generalised assumptions about the whole study population. The data gathered from the returned questionnaires do, however, provide some insight about a small part of the whole study population.

4.4 STATISTICAL SUMMARY OF RESULTS

The following tables set out the results of the responses received to the empirical questionnaire:

4.4.1 Part 1

Question 1: Deferred tax assets and liabilities should be classified as non-current assets and liabilities.

Respondent	Least consistent with the objective of financial statements				Most consistent with the objective of financial statements	Total
	1	2	3	4	5	
	%	%	%	%	%	%
Lecturers	33,4	11,1	22,2	11,1	22,2	100,0
Partners	33,4	33,3	33,3	-	-	100,0
Total	33,4	22,2	27,7	5,6	11,1	100,0

The results of the questionnaire confirmed the conclusion drawn from the literature study, namely that the classification of deferred tax assets and liabilities as non-current assets and liabilities in terms of paragraph 70 of IAS 1 appears not to meet the objective of financial statements in terms of the current Framework. A low percentage (16,7% - scales 4 and 5) of the respondents are of the opinion that this method of classification of deferred tax assets and liabilities is consistent with the objective of financial statements contained in the IASB Framework.

Question 2: The balance sheet classification of deferred tax assets and liabilities should follow the classification of the balance sheet item in respect of which the asset or liability was raised.

Respondent	Least consistent with the objective of financial statements				Most consistent with the objective of financial statements	Total
	1	2	3	4	5	
	%	%	%	%	%	%
Lecturers	22,2	22,2	33,4	11,1	11,1	100,0
Partners	22,2	22,2	44,5	11,1	-	100,0
Total	22,2	22,2	38,9	11,1	5,6	100,0

A high percentage (38,9%) of the respondents are almost neutral in their opinion that the classification of deferred tax assets and liabilities in terms of US GAAP is neither least consistent nor most consistent with the objective of financial statements contained in the IASB Framework.

Question 3: The deferred tax asset and liability should be classified according to the expected reversal of the temporary differences to which they relate.

Respondent	Least consistent with the objective of financial statements				Most consistent with the objective of financial statements	Total
	1	2	3	4	5	
	%	%	%	%	%	%
Lecturers	-	22,3	11,1	33,3	33,3	100,0
Partners	-	-	11,1	11,1	77,8	100,0
Total	-	11,1	11,1	22,2	55,6	100,0

The results of the questionnaire confirmed the conclusion drawn from the literature study, namely that the classification of deferred tax assets and liabilities according to the expected reversal of the temporary differences to which they relate, meets the objective of financial statements in terms of the current Framework. A very high percentage (77,8% - scales 4 and 5) of the respondents are of the opinion that the classification of deferred tax assets and liabilities according to the expected reversal of the temporary differences to which they relate is most consistent with the objective of financial statements contained in the IASB Framework.

4.4.2 Part 2

Question 1: Deferred tax assets and liabilities should be classified as non-current assets and liabilities.

Respondent	Least consistent with the objective of financial statements				Most consistent with the objective of financial statements	Total
	1	2	3	4	5	
	%	%	%	%	%	%
Lecturers	33,3	33,3	11,1	22,3	-	100,0
Partners	44,5	22,2	22,2	11,1	-	100,0
Total	38,8	27,8	16,7	16,7	-	100,0

The results of the questionnaire confirmed the conclusion drawn from the literature study, namely that the classification of deferred tax assets and liabilities as non-current assets and liabilities in terms of paragraph 70 of IAS 1 will not meet the proposed objective of financial reporting as contained in the Discussion Paper issued by the IASB and FASB on a proposed revised Conceptual Framework. A high percentage (66,6% - scales 1 and 2) of the respondents are of the opinion that the classification of deferred tax assets and liabilities as non-current assets and liabilities in terms of paragraph 70 of IAS 1 will not meet the objective of financial statements contained in the proposed revised Conceptual Framework.

Question 2: The balance sheet classification of deferred tax assets and liabilities should follow the classification of the balance sheet item in respect of which the asset or liability was raised.

Respondent	Least consistent with the objective of financial statements				Most consistent with the objective of financial statements	Total
	1	2	3	4	5	
	%	%	%	%	%	%
Lecturers	22,2	11,1	33,4	22,2	11,1	100,0
Partners	33,3	11,1	33,4	22,2	-	100,0
Total	27,8	11,1	33,3	22,2	5,6	100,0

The results of the questionnaire confirmed, to a certain extent, the conclusion drawn from the literature study, namely that the classification of deferred tax assets and liabilities between current and non-current assets and liabilities in terms of US GAAP, will, to a limited extent, meet the objective of financial statements contained in the proposed revised Conceptual Framework. Some respondents (33,3% - scale 3) are almost neutral in their opinion that the classification of deferred tax assets and liabilities in terms of US GAAP is neither least consistent nor most consistent with the objective of financial statements contained in the Discussion Paper issued by the IASB and FASB on a proposed revised Conceptual Framework. Other respondents (38,9% - scales 1 and 2) are of the opinion that this classification is least consistent with the proposed revised Conceptual Framework.

Question 3: The deferred tax asset and liability should be classified according to the expected reversal of the temporary differences to which they relate.

Respondent	Least consistent with the objective of financial statements				Most consistent with the objective of financial statements	Total
	1	2	3	4	5	
	%	%	%	%	%	%
Lecturers	-	-	11,2	44,4	44,4	100,0
Partners	-	-	11,1	11,1	77,8	100,0
Total	-	-	11,1	27,8	61,1	100,0

The results of the questionnaire confirmed, to a certain extent, the conclusion drawn from the literature study, namely that the classification of deferred tax assets and liabilities according to the expected reversal of the temporary differences to which they relate, meets the objective of financial statements in terms of the proposed revised Conceptual Framework. A very high percentage (88,9% - scales 4 and 5) of the respondents are of the opinion that the classification of deferred tax assets and liabilities according to the expected reversal of the temporary differences to which they relate is most consistent with the objective of financial statements contained in the proposed revised Conceptual Framework.

4.5 OVERALL CONCLUSION ON EMPIRICAL STUDY

The following results emerged from the empirical study:

Most of the respondents believed that the classification of deferred tax assets and liabilities according to the expected reversal of the temporary differences to which they relate, meets the objective of financial statements, both in terms of the current IASB Framework as well as in terms of the proposed revised Conceptual Framework.

There was some uncertainty amongst respondents as to whether the classification of deferred tax assets and liabilities between current and non-current assets and liabilities in terms of US GAAP, where the classification of deferred tax assets and liabilities should follow the classification of the balance sheet item in respect of which the asset or liability was raised, is consistent with the current IASB Framework or with the proposed revised Conceptual Framework.

Furthermore, respondents were uncertain whether the classification of deferred tax assets and liabilities as non-current assets and liabilities in terms of paragraph 70 of IAS 1 meets the objective of financial statements as contained in the IASB Framework. Respondents were reasonably clear that, in their opinion, the classification of deferred tax assets and liabilities as non-current assets and liabilities in terms of paragraph 70 of IAS 1 is not consistent with the objective of financial statement as contained in the proposed revised Conceptual Framework.

4.6 SUMMARY

This chapter explored the appropriateness of the classification of deferred tax assets and liabilities between current and non-current assets by way of an emperical study. The emperical study was done by way of a questionnaire, sent to a defined population. Furthermore, this chapter discussed the response rate as well as the statistical results and conclusions reached from the questionnaires returned by subjects of the population.

Chapter 5 will conclude on the overall outcome of the study, which includes conclusions from the literature review as well as the findings as a result of the emperical study.

CHAPTER 5

CONCLUSION ON THE STUDY

5.1 INTRODUCTION

This chapter will discuss the overall conclusion on the study, which includes the findings of the literature review as well as the outcome as a result of the emperical study. Furthermore, this chapter will again mention the objectives of the study, the importance thereof and how the results of the study will contribute towards meeting the objective of the preparation of financial statements. This chapter will also discuss areas for future research.

5.2 OBJECTIVES OF THE STUDY

The objectives that were specifically addressed are the following:

- To determine the appropriateness of the classification of deferred tax assets and liabilities in terms of the current Framework, based on the following three methods of classification:

  - Deferred tax assets and liabilities should be classified as non-current assets and liabilities. This is in terms of the current requirement of IAS 1, paragraph 70;

  - The balance sheet classification of deferred tax assets and liabilities should follow the classification of the balance sheet item in respect of which the asset or liability is raised. This is in terms of the current requirement of SFAS 109, paragraph 41; and

  - The deferred tax asset and liability should be classified according to the expected reversal of the temporary differences to which they relate (i.e. the temporary difference should be scheduled, with those temporary differences reversing within 12 months after the balance sheet date being classified as current, and the balance classified as non-current). This is in terms of the comments received on the exposure draft issued prior to the issue of SFAS 37.

- To determine the appropriateness of the classification of deferred tax assets and liabilities in terms of the proposed revised Framework based on the following three methods of classification:

  - Deferred tax assets and liabilities should be classified as non-current assets and liabilities. This is in terms of the current requirement of IAS 1, paragraph 70;

  - The balance sheet classification of deferred tax assets and liabilities should follow the classification of the balance sheet item in respect of which the asset or liability is raised. This is in terms of the current requirement of SFAS 109, paragraph 41; and

  - The deferred tax asset and liability should be classified according to the expected reversal of the temporary differences to which they relate (i.e. the temporary difference should be scheduled, with those temporary differences reversing within 12 months after the balance sheet date being classified as current, and the balance classified as non-current). This is in terms of the comments received on the exposure draft issued prior to the issue of SFAS 37.

5.3 IMPORTANCE OF THE STUDY

5.3.1 Users of financial statements

The appropriate distinction between current and non-current deferred tax assets and liabilities, and the method used to make this distinction, must be consistent with the objective of financial statements in terms of the Conceptual Framework. This is so, because information that meets the objective of financial statements is useful to the users of financial statements, and might influence their economic decisions. It is also important to determine the most appropriate method of classification, as this will have a direct impact on working capital ratios as well as other ratios in financial reporting analyses.

5.3.2 International Accounting Standards Board (IASB)

The classification of deferred tax assets and liabilities between current and non-current assets and liabilities will align the requirements of paragraphs 51, 52 and 70 in IAS 1. The alignment of the requirements of these paragraphs will lead to fairer presentation of financial statements.

5.4 PURPOSE OF THE STUDY

The purpose of this study was to evaluate and determine the most appropriate method of classification of deferred tax between current and non-current in the context of the objective of financial statements. This was evaluated against the objective of financial statements as set out in paragraph 12 of the current *Framework for the Preparation and Presentation of Financial Statements* ("the current Framework"), as well as in the Discussion Paper – *Preliminary Views on an Improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information* ("the Discussion Paper"), issued by the US Financial Accounting Standards Board ("FASB") and the International Accounting Standards Board ("IASB").

5.5 CONCLUSION

The answers of the majority of the respondents to the questionnaire supported the conclusions reached in the literature study, that the classification of deferred tax assets and liabilities according to the expected reversal of the temporary differences to which they relate ("scheduling"), meets the objective of financial statements, both in terms of the current IASB Framework as well as in terms of the proposed revised Conceptual Framework. This method is contained in comments received on the exposure draft issued prior to the issue of FASB Statement No. 37 – *Balance Sheet Classification of Deferred Income Taxes*.

The literature study supports the notion that the scheduling method of classification of deferred tax assets and liabilities between current and non-current assets and liabilities meets the objective of financial statements contained in the current Conceptual Framework. This is based on the premise that the method of scheduling to classify deferred tax assets and liabilities between current and non-current assets and liabilities will be more closely aligned with the definitions of *current asset* and *current liability* contained in IAS 1 – *Presentation of Financial Statements* ("IAS 1").

Furthermore, the scheduling method of classification of deferred tax assets and liabilities between current and non-current assets and liabilites will, to a limited extent, meet the objective of financial statements contained in the proposed revised Conceptual Framework. This will be to the extent that these classifications will give a fair presentation of the amount, timing and uncertainty of the entity's future cash flows. This objective will only be met if the method of scheduling takes temporary differences that will result in future cash inflows or outflows into account, and not those temporary differences that will not have a cash flow impact.

The conclusion can therefore be reached that the classification of deferred tax assets and liabilities between current and non-current assets and liabilities should be based on the expected reversal of the temporary differences to which they relate, as this is most consistent with the objective of financial statements in terms of both the current Conceptual Framework and the proposed revised Conceptual Framework.

5.6 MANAGEMENT IMPLICATIONS

The implementation of the results from the study will have the biggest impact on the preparers of financial statements. Preparers would have to be able to schedule their temporary differences in order to reach an appropriate split between current and non-current deferred tax assets and liabilities. This will require the set-up of an entities chart of accounts at a level detailled enough to enable the preparer of financial statement to have the information readily available. Although this might be very costly to implement and monitor, preparers of financial statements should also consider the benefit of providing the users of their financial statements with more relevant financial information.

5.7 FURTHER RESEARCH

Further research could focus on the dual nature of deferred tax as a cash flow and a reversal to and from the income statement, as a deferred tax balance could be separated between the two types. In this case it might be helpful to classify the cash reversals using one method and the income statement reversals using another. This might lead to a high-quality solution to the issue being addressed.

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