Exposure Draft 111: The nature of temporary differences

Carolina Koornhof
University of Pretoria

In April 1997 the South African Institute of Chartered Accountants issued a new exposure draft on Income Taxes. Exposure Draft 111 closely follows the International Accounting Statement 12 (revised) and forms part of the Harmonisation and Improvements Project of the Institute. The exposure draft has far-reaching implications, especially for the calculation of deferred tax and is far too voluminous to discuss comprehensively in an article. This article briefly summarises the differences between AC 102 and ED 111. It then considers the nature and types of temporary differences, which now form the basis for the provision of deferred tax in terms of the exposure draft.

The main difference between AC 102 and ED 111 is that the former uses a liability method which focuses on the *timing differences* that arise between accounting profit and taxable income in the *income statement*. In other words, the statement uses an income statement driven approach. ED 111 uses a liability method which focuses on *temporary differences* which arise between the accounting carrying amount and the tax base of assets and liabilities in the *balance sheet*, in other words a balance sheet driven approach. This shift of focus from the income statement to the balance sheet now aligns the provision for deferred tax with the balance sheet focus adopted in AC 000.[1]

One of the major implications of ED 111 for practitioners and reporting entities is that the partial basis is no longer recognised as an acceptable method of providing for deferred tax. This means that companies still using the partial basis will have to change their accounting policy for deferred tax to the comprehensive basis once the exposure draft becomes an accounting statement. This change in accounting policy should be treated in accordance with the requirements of AC 103 (revised). Companies which provided for deferred tax on the comprehensive basis may find that their provision needs to be adjusted to accommodate the new approach. Such an adjustment is treated as a change in accounting estimate and is shown as part of the tax charge in the income statement in the year in which the new approach in calculating deferred tax is adopted.

Another important difference between AC 102 and ED 111 is that the latter requires deferred tax to be raised on the revaluation of all fixed assets, irrespective of whether the intention is to use or sell the asset. The intention of management may, however, influence the rate at which deferred tax is provided. Prior to the exposure draft deferred tax was only provided on the revaluation of an asset if management intended to sell the asset.

Other smaller differences between AC 102 and ED 111 include the discounting of deferred tax assets and liabilities, a matter not addressed in AC 102 and now prohibited in ED 111. The exposure draft also provides more guidelines than AC 102 on the recognition and measurement of current tax and deferred tax in the financial statements. In addition, ED 111 identifies the criteria for the offsetting of both current and deferred tax assets and liabilities. Finally, the exposure draft extends the disclosure requirements for current and deferred taxation. The disclosure requirements include amongst others, a reconciliation of the deferred tax assets and liabilities from the beginning to the end of the current reporting period, similar to the disclosure requirements for property, plant and equipment (AC 123).

In many cases where companies have adopted the comprehensive basis, the amount provided for deferred tax will remain the same while only the approach used in calculating the provision will change. There are, however, instances where differences will arise in the deferred tax provision. Such differences may for example arise with business combinations, the revaluation of fixed assets and the treatment of goodwill.

THE NATURE OF TEMPORARY DIFFERENCES

In terms of AC 102 deferred tax was provided on timing differences. Permanent differences do not result in future tax payments or receipts and require no provision. In contrast, ED 111 requires that deferred tax be provided on all temporary differences (paragraphs .19 and .28). The distinction made in the past between timing and permanent differences therefore falls away.

Temporary differences are defined as differences between the tax base of an asset or liability and its carrying amount in the balance sheet (ED 111.9). The tax base of an asset or liability is the amount attributed to that asset or liability for tax purposes. Deferred tax is provided when temporary differences arise. Various steps should be followed from recognising the temporary differences to finally providing for a deferred tax liability or raising a deferred tax asset. These are, however, not very clear in the exposure draft and are perhaps best explained in a diagram. (See diagram 1.)

It is not sufficient to conclude merely that a provision for deferred tax is required or not. Instead, it is necessary to refer to the diagram to establish where the provision or non-provision arises. In certain cases the position of the enterprise may change and temporary differences should therefore be reassessed annually. A brief discussion of the diagram will explain this statement.

Where the carrying value and tax base of an asset or liability are equal, no temporary difference arises and no provision for deferred tax is made. However, should the carrying value and tax base differ, however, a temporary difference arises (blocks 2 and 3).

Once a temporary difference is identified, it is necessary to consider whether the asset or liability is exempted in terms of paragraphs .19 or .28 (block 4). For example, where an asset was originally exempted from the provision of deferred tax and such an asset is subsequently revalued, this exemption may no longer apply and a provision for deferred tax will be raised. The other interpretation of this aspect of the exposure draft, to which the author subscribes, is that the exemption will continue to apply even if the asset is revalued. Where the exemption may no longer apply is, for example in a case where there has been a change of management intent.

Consider the situation where a company revalues an asset, such as plant, in excess of its original cost and the management's intention is to hold and use the asset. Deferred tax in this case is provided on the full temporary difference (being the difference between the revalued amount and the tax base) using the current tax rate (block 7). If the management's intention changes and the asset is to be sold, deferred tax is still raised on the full temporary difference but two different rates will be used in calculating the provision (blocks 6 and 7). The temporary difference arising between the tax base and the original cost of the asset, which will be taxed once the asset is sold, is provided for at the current income tax rate. The capital profit, being the difference between the original cost and the revalued amount, which is currently not taxed in South Africa, is provided for at a nil tax rate. If, in this example, the Income Tax Act subsequently changes and capital profits are taxed at a specified rate, say 15%, such a rate will be used to provide for deferred tax on the temporary difference between the original cost and the revalued amount if the asset is still unsold. The provision for deferred tax will then be adjusted accordingly.

It is apparent from the above discussion that where a temporary difference arises and the item has been exempted in terms of paragraphs .19 or .28, or where provision for deferred tax is made at various rates, the position should be reviewed at the end of each year.

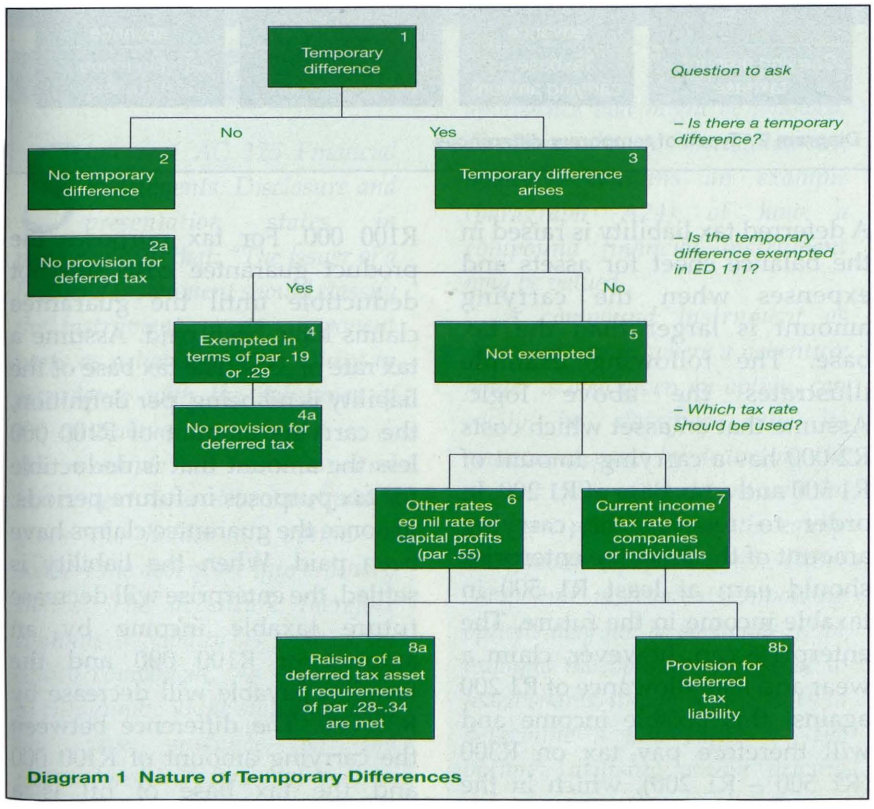

Diagram 1 Nature of Temporary Differences

TYPES OF TEMPORARY DIFFERENCES

ED 111.9 identifies two types of temporary differences – *taxable temporary differences* and *deductible temporary differences*. These two types of temporary differences apply to *assets and expenses* and *liabilities and revenue received in advance*. Both types of temporary differences will originate and reverse.

Taxable temporary differences are temporary differences that will result in taxable amounts in determining taxable profit or tax loss of future periods when the carrying amount of the asset or liability is recovered or settled (ED 111.9). A *deferred tax liability* is recognised in respect of all taxable temporary differences unless the exemptions in paragraph 19 apply. A deferred tax liability is not raised in terms of paragraph 19 if it arises from:

- goodwill for which amortisation is not deductible for tax purposes; or
- the initial recognition of an asset or liability in a transaction which:
  - is not a business combination; and
  - at the time of the transaction affects neither accounting profit nor taxable profit/tax loss.

Deductible temporary differences are temporary differences that will result in amounts that are deductible in the determination of the taxable profit or tax loss in future periods when the carrying amount of the asset or liability is recovered or settled (paragraph 9). A *deferred tax asset* is recognised for all deductible temporary differences to the extent that it is probable that future taxable profits will be available against which the deductible temporary difference can be utilised, unless the exemptions in paragraph .28 apply. A deferred tax asset is not recognised in terms of paragraph .28 if it arises from the initial recognition of an asset or liability in a transaction which:

- is not a business combination; and
- at the time of the transaction, affects neither accounting profit nor taxable profit/tax loss.

The types of temporary differences and their impact on assets and liabilities are illustrated in Diagram 2

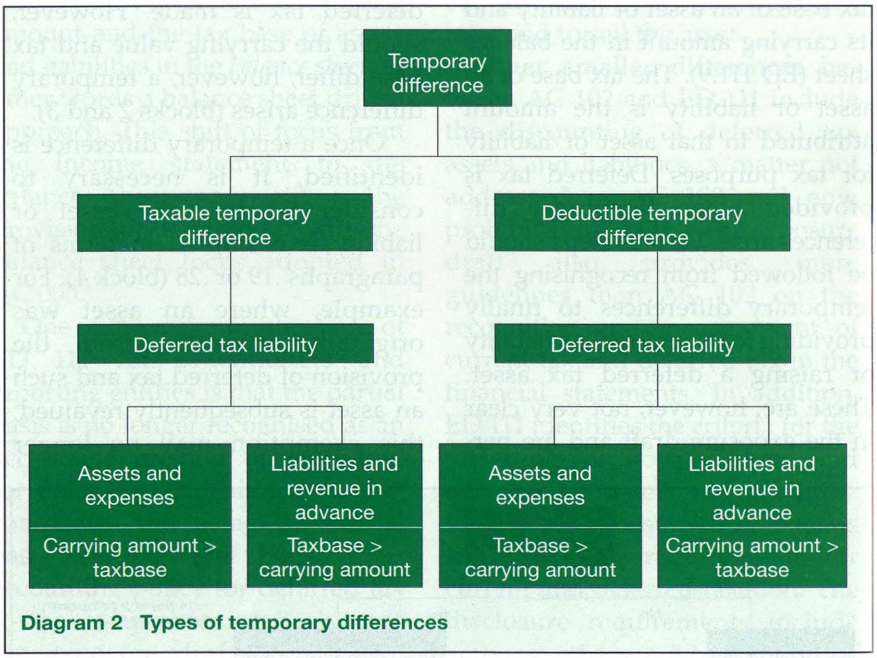

Diagram 2 Types of temporary differences

A deferred tax liability is raised in the balance sheet for assets and expenses when the carrying amount is larger than the tax base. The following example illustrates the above logic. Assume that an asset which costs R2 000 has a carrying amount of R1 500 and a tax base of R1 200. In order to recover the carrying amount of the asset the enterprise should earn at least R1 500 in taxable income in the future. The enterprise can, however, claim a wear and tear allowance of R1 200 against this taxable income and will therefore pay tax on R300 (R1 500 – R1 200), which in the current period is the taxable temporary difference (carrying amount > tax base or R1 500 > R1 200). If a tax rate of 35% applies, the enterprise will have to create a deferred tax liability of R105 (R300 x 35%).[2]

A deferred tax asset is raised in the balance sheet, subject to the requirements of ED 111 paragraphs .28-.34, for liabilities and revenue received in advance when the carrying amount is larger than the tax base. The following example illustrates the above logic. Assume that a newly formed company creates a provision for product guarantee costs amounting to R100 000. For tax purposes the product guarantee costs are not deductible until the guarantee claims have been paid. Assume a tax rate of 35%. The tax base of the liability is nil being, per definition, the carrying amount of R100 000 less the amount that is deductible for tax purposes in future periods, viz once the guarantee claims have been paid. When the liability is settled, the enterprise will decrease future taxable income by an amount of R100 000 and the taxation payable will decrease by R35 000. The difference between the carrying amount of R100 000 and the tax base of nil is a

deductible temporary difference of R100 000. The enterprise should therefore create a deferred tax asset of R35 000.[2] However, the requirement in respect of the creation of the asset, namely that in future sufficient taxable income will be earned to utilise the benefit emanating from the reduced tax payments, should still be met.

Logic similar to the above can be applied to the few instances where a liability or revenue received in advance gives rise to a deferred tax liability and to the instances where assets and expenses result in a deferred tax asset. Whether the deferred tax liability or deferred tax asset is raised and the rate at which it is raised depend on the requirements illustrated in diagram 1. In fact, diagram 2 can be fitted into diagram 1 between block 3 and blocks 4 and 5.

The deferred tax liability is raised on *originating* taxable timing differences which *reverse* in future periods. Similarly, the deferred tax asset is based on *originating* deductible temporary differences which also *reverse* in future periods.

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CONCLUSION

In terms of Exposure Draft 111 on Income Taxes, deferred tax is now provided on all temporary differences. The purpose of this article is to discuss the nature of temporary differences and to consider the different types of temporary differences that result in either deferred tax assets or deferred tax liabilities being raised in the balance sheet.

References

1 Koornhof C "A balance sheet approach v the income statement approach to financial reporting" October 1995 *Podium* Vol 4 No 5 p 6-7.

2 Vorster Q, Joubert WA, Koen M and Koornhof C *Descriptive Accounting* 2 edition Kenwyn Juta & Company 1997 pp 61-62 and 64-65.

Valuation of options: Do we have to know how?

Pierre Lucouw, Potchefstroom University – Vaal Triangle Campus

INTRODUCTION

Statement AC 125 Financial Instruments: Disclosure and presentation states in paragraph .20 that: "The issuer of a financial instrument should classify the instrument, or its component parts as a liability or as equity in accordance with the substance of the contractual arrangement . . ." An example of a compound instrument is a debenture which gives the holder an option to convert the debenture into ordinary shares. The debenture therefore contains a liability as well as an equity component. As emphasised in paragraph .30 the statement does not give guidance on the measurement of financial instruments, but only suggests approaches that might be followed. The appendix to the statement, however, contains an example (paragraph A24) of how a compound financial instrument may be valued.

A compound instrument as described above, where a debenture holder is also given an option, can easily be classified into its component parts by deducting the present value of the debenture from the issue price to obtain the equity component (option value). Other compound instruments involving options may not be so simple if, for example the options are linked to listed shares, it may be necessary to determine a fair value for the options, utilising option pricing models. In the appendix to the statement a brief description of the Black-Scholes option pricing model, developed in 1973, is given. It is doubtful, however, whether many accountants are familiar with sophisticated option pricing models.

OPTION VALUATION

In simple terms, the value of an option is the difference between the present value of the underlying instrument at expiration and the exercise price of the option. In other words, the value of an option is the present value of the expected value at maturity. However, this requires an estimate of the expected rate of return on the underlying instrument as well as the expected rate of return on the