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SAICA recently issued Circular 1/2006, *Disclosures in relation to deferred tax*. The purpose of this Circular is to provide guidance on additional disclosures required for deferred tax where the expected manner of recovery of the carrying amount of an asset could materially influence the deferred tax balance, but the contents of the Circular is likely to raise a fresh debate amongst preparers and auditors of financial statements around some of the measurement issues resulting from paragraph 51.

PART 1

RRRRED TAX

0%, 14.5% OR 29%?

ASA

Over the last couple of years, the preparers of financial statements and their auditors have debated the meaning of paragraph 51 of IAS 12 (AC 102), *Income Taxes*. This paragraph requires the measurement of deferred tax liabilities and deferred tax assets to reflect the tax consequences of the manner in which, on the balance sheet date, an entity expects to recover or settle the carrying amount of its assets and liabilities. SAICA recently issued Circular 1/2006, *Disclosures in relation to deferred tax*. The purpose of this Circular is to provide guidance on additional disclosures required for deferred tax where the expected manner of recovery of the carrying amount of an asset could materially influence the deferred tax balance, but the contents of the Circular is likely to raise a fresh debate amongst preparers and auditors of financial statements around some of the measurement issues resulting from paragraph 51.

The purpose of this pair of articles is to consider the interpretation of paragraph 51, the application thereof to various types of assets, as well as the application of the Circular. In the first article, the authors will explore the meaning of the phrase "recovery of the carrying amount of an asset". This is done, firstly, by considering the meaning of the "carrying amount" of an asset and, secondly, by considering the potential manners in which the carrying amount of an asset can be "recovered". The application of these principles is then considered for revalued property, plant and equipment. Finally, the requirements of the Circular are highlighted. The second article investigates the deferred tax consequences of investment property.

What does the "carrying amount" of an asset imply?

As mentioned above, paragraph 51 of IAS 12 (AC 102) requires deferred tax to reflect the tax consequences of the expected manner in which the carrying amount of an asset is to be recovered. The first important issue to consider is therefore what the carrying amount of an asset implies.

The Framework states that an asset may only be recognised if, amongst other things, it is probable that future economic benefits associated with the item will flow to the entity. The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity (Framework paragraph 53). The recognition of an asset in the balance sheet therefore implies that a future stream of cash flows (or cash equivalents) is expected. One may thus conclude that, in essence, the carrying amount of an asset reflects the future cash flows and cash equivalents that the asset will generate. Although the carrying amount of an asset and, therefore, the value placed in the financial statements on the expected future stream of cash flows may be measured in various ways (for example: cost price, depreciated cost price, fair value, amortised cost, etc.), this does not change the general principle, namely that it is probable that the entity will receive a future stream of cash flows from the asset.

Taking into account the above conclusion, namely that the carrying amount of an asset reflects the future cash flows and cash equivalents that will be generated by an asset, the next issue that one has to consider is the manner in which this carrying amount will be recovered. This matter is discussed in more detail below.

Possible manners to recover the carrying amount of an asset

When IAS 12 (AC 102)§51 refers to the measurement of deferred tax based on the expected manner of recovery of the carrying amount of an asset, it requires one to consider the future streams of cash flows embodied in the asset and to measure deferred tax based on the tax consequences of those future cash flows.

IAS 12 (AC 102)§52 illustrates the application of paragraph 51 by

means of examples. The basic principle established by these examples is that the carrying amount of an asset can either be recovered by using the asset (for example, using an item of plant to produce goods are sold to generate a revenue cash flow stream) or by selling the asset (in other words, the asset generates cash flows through a sales transaction). Although IAS 12 (AC 102)§52 only illustrates the recovery of the carrying amount of an asset either through use or through sale, dual recovery is also possible. In other words an asset may be used for some time to generate cash flows, and then it is sold. In such a case, the measurement of deferred tax must reflect the tax consequences of the recovery of the carrying amount of the asset through dual recovery.

It is clear what is meant with the recovery of the carrying amount of an asset through sale, but it is not entirely clear what is meant with the recovery of the carrying amount of an asset through use. However, this should be considered on the basis of the principle that the carrying amount of an asset reflects its future stream of cash flows. The recovery of the carrying amount of an asset through use therefore refers to the reduction in the value of the asset as cash flows are generated, other than by selling the asset.

The reduction in the value of the asset through use is caused by the passing of time. As time passes and the entity receives the cash flows generated by the asset, the number of remaining years that an asset can generate cash flows normally decreases. This results in a reduction in the value of the asset. This reduction in the value is not necessarily immediately reflected in the financial statements. For example, in the case of a building classified as an investment property and accounted for in terms of the fair value model, the reduction in the value of the asset, as a result of the passing of time, might initially be offset by increases in the fair value of the remaining cash flows due to changes in market conditions. This results in a net positive fair value adjustment (income) which is recognised initially in profit or loss. However, this does not change the fact that a portion of the carrying amount of the asset has been recovered and that, at some point in future, the building will no longer be able to generate cash flows. For other assets, the reduction in the value as a result of the passing of time is reflected annually in profit or loss. In the case of property, plant and equipment, for example, this is reflected in the depreciation charge.

It should be noted that, even if the carrying amount of an asset is determined with reference to current market prices in an active market, this does not imply that the carrying amount of the asset is recovered through sale only. In fact, IAS 40 (AC 135), *Investment property*, states that the fair value of investment property reflects the rental income from current and future leases. In other words, the fair value of an investment property reflects the future cash generating capabilities of the asset. Where market prices are used to determine fair value, the fair value still reflects the future stream of cash flows embodied in the asset (i.e. the market places a value on the cash generating capabilities of the asset), which is not confined only to cash flows that will be obtained by selling the asset.

Applying the principles to depreciable revalued property, plant and equipment

IAS 16 (AC 123), *Property, Plant and Equipment*, states in paragraph 56 that the future economic benefits embodied in an item of property, plant and equipment are consumed by an entity principally through its use. The useful life of an item of property, plant and equipment is related to the expected cash inflows that are associated with that asset. To achieve a faithful representation, the depreciation period of an item of property, plant and equipment must reflect that useful life. By extension, it must also reflect the cash flow streams associated with the asset. The useful life of a depreciable tangible asset can never extend beyond the asset's expected physical utility to the entity.

Because the useful life of a depreciable tangible asset is finite, at the end of its useful life the asset ceases to generate further net cash inflows to the entity, and, therefore, the carrying amount of the asset is recovered while it is used by the entity.

Where the useful life of an asset is equal to its economic life, it implies that the future economic benefits embodied in the asset (stream of cash flows) can only be recovered through the use of the asset. The deferred tax should therefore be based on the tax consequences of the future stream of cash flows generated by using the asset, which is usually taxed at the normal company tax rate of 29%. As the useful life of an asset is defined in terms of the asset's expected utility to the entity, it may happen that the useful life of an asset is shorter than its economic life. Where the useful life of an asset is shorter than its economic life, the asset normally has a residual value, which implies that the asset will be sold at the end of its useful life. The carrying amount of the asset is therefore expected to be recovered through use to the extent of its depreciable amount and through sale at its residual value.

For example, if a plant has a revalued carrying amount of R120 000, an original cost price (and 1 October 2001 valuation date value for CGT purposes) of R80 000, a residual value of R95 000 and a tax base of R20 000, the deferred tax liability must reflect the consequences

price (and 1 October 2001 CGT valuation date value) of R80 000 and a tax base of R20 000, the deferred tax liability must reflect the consequences of the recovery of the carrying amount of the asset through sale. In other words, the deferred tax liability should be R23 200, calculated as follows:

(the revalued carrying amount – the original cost price) x the CGT inclusion rate of 50% x the company tax rate of 29% + (the original cost price – the tax base) x the company tax rate of 29% = the deferred tax liability

$$(120\,000 - 80\,000) \times 50\% \times 29\% + (80\,000 - 20\,000) \times 29\% = R23\,200$$

Non-depreciable revalued property, plant and equipment (land)

IAS 16 (AC 123)§58 determines that land normally has an unlimited useful life. If one therefore considers the carrying amount (value) of land to represent a stream of future cash flows, the present value of these cash flows does not decrease while the land is being used to generate cash, as the cash flow stream will continue into perpetuity (in other words, the passing of time does not cause a reduction in the future stream of cash flows). Although the future stream of cash flows, for example, rental income, has future tax consequences, the carrying amount of the asset cannot be "recovered" through use. The only manner in which the carrying amount of land can therefore be "recovered" is through sale. Hence, the deferred tax measurement should always reflect the tax consequences of sale, even if there is no intention of selling the asset.

The same conclusions are reached in SIC 21 (AC 421), *Income Taxes – Recovery of Revalued Non-Depreciable Assets*, although a slightly different argument is used. This Interpretation argues that "because the asset (land) is not depreciated, no part of its carrying amount is expected to be recovered (that is, consumed) through use". Unfortunately, to a certain extent, the emphasis in SIC 21 (AC 421) on the non-depreciable nature of the asset is one reason for the confusion surrounding the interpretation of IAS 12 (AC 102)§51. Although the authors agree with the consensus in SIC 21 (AC 421), it might be conceptually more justifiable to argue the consensus in terms of the fact that the stream of future cash flows embodied in land cannot be "recovered" through its use, as these cash flows continue into perpetuity. The measurement of deferred tax should therefore reflect the consequences of sale. This principle can then also be applied to other assets such as investment property carried at fair value, whereas the depreciable or non-depreciable principle might be difficult to apply (this argument is discussed in more detail in the second of this pair of articles).

(It should be noted that, as a result of the application of paragraph 15(b) of IAS 12 (AC 102), no deferred tax is provided on the portion of the carrying amount of land below its cost price.)

Disclosures required by Circular 1/2006

The Circular requires a number of disclosures to be made where a change in the manner in which the carrying amount of an asset is recovered could result in a materially different deferred tax balance. The following flowchart details when disclosure is required to be made in terms of the Circular. ➤

It is clear what is meant with the recovery of the carrying amount of an asset through sale, but it is not entirely clear what is meant with the recovery of the carrying amount of an asset through use.

of the recovery of the carrying amount of the asset through use from a value of R120 000 to R95 000 and recovery through sale from R95 000 onwards. In other words, the deferred tax liability should be R26 825, which is calculated as follows:

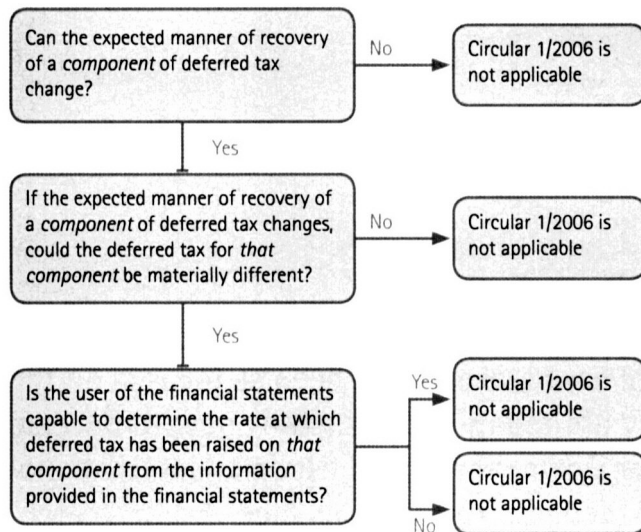
(the revalued carrying amount – the residual value) x the company tax rate of 29% + (the residual value – the original cost price) x the CGT inclusion rate of 50% x the company tax rate of 29% + (the original cost price – the tax base) x the company tax rate of 29% = the deferred tax liability

$$(120\,000 - 95\,000) \times 29\% + (95\,000 - 80\,000) \times 50\% \times 29\% + (80\,000 - 20\,000) \times 29\% = R26\,825$$

Once an item of property, plant and equipment has been classified as a non-current asset held for sale in terms of IFRS 5 (AC 142), *Non-current Assets Held for Sale and Discontinued Operations*, it can no longer be said that a portion of the carrying amount of the asset will be recovered through use. This is due to the fact that IFRS 5 (AC 142)§6 states that the carrying amount of a non-current asset held for sale is recovered principally through a sale transaction rather than through continuing use. Therefore, once an asset has been classified as held for sale (and only in those circumstances), the deferred tax measurement should reflect the tax consequences of recovery only through sale, as the future cash flow stream now originates from a sale transaction.

For example, if a plant (classified as a non-current asset held for sale) has a revalued carrying amount of R120 000, an original cost

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For example, an item of machinery has a revalued carrying amount of R120 000, a CGT valuation date value of R110 000, a cost price of R95 000 and a tax base of R60 000. The machinery has no residual value; in other words, the entity recovers the carrying amount of the asset entirely through use. A deferred tax liability of R17 400 is reflected in the financial statements. This is calculated as follows:

(the revalued carrying amount – the tax base) x the company tax rate of 29% = the deferred tax liability

$$(120\,000 - 60\,000) \times 29\% = R17\,400$$

This deferred tax liability consists of three components. The first component is the difference between the revalued carrying amount and the CGT valuation date value. This component amounts to R2 900 [(120 000 – 110 000) x 29%]. The second component is the difference between the CGT valuation date value and the cost price of the asset, at R4 350 [(110 000 – 95 000) x 29%]. The third component is calculated as the difference between the cost price and the tax base of the asset, at R10 150 [(95 000 – 60 000) x 29%].

The Circular 1/2006 decision tree is applied to these three components as follows:

- First component: it is possible that the expected manner of recovery of this component could change from recovery through use to recovery through sale. If that happens, it could have a material effect on the measurement of that component, as the rate used to calculate the deferred tax would change from 29% to 14.5%.
- Second component: it is possible that the expected manner of recovery of this component could change from recovery through use to recovery through sale. If that happens, it could have a material effect on the measurement of that component, as the rate used to calculate the deferred tax would change from 29% to 0%.
- Third component: it is possible that the expected manner of recovery of this component could change from recovery through use to recovery through sale. If that happens, it will not have a material effect on the measurement of that component, as the rate used to calculate the deferred tax would still be 29% (the rate at which recoupments are taxed).

Circular 1/2006, therefore, requires additional disclosure for the first and second component. The authors are of the opinion that the required disclosure should be provided as part of the deferred tax note to the balance sheet as follows:

Recovery through use is reflected in the passing of time, because as time passes, the number of remaining years that an asset can generate cash flows decreases.

Analysis of temporary differences	
Machinery	R17 400
Included in the analysis of temporary differences on machinery there is a component of deferred tax of R2 900, which relates to the difference between the asset's carrying amount and its CGT valuation date value. Deferred tax has been provided for on this component at a rate of 29%, based on the assumption that the carrying amount of the asset is recovered through use. If the carrying amount of the asset is to be recovered through sale, rather than through continuing use, deferred tax should be measured at 14.5%.	
Included in the analysis of temporary differences on machinery there is a component of deferred tax of R4 350. This relates to the difference between the CGT valuation date value and original cost price of the asset. Deferred tax is provided for on this component at a rate of 29%, based on the assumption that the carrying amount of the asset will be recovered through use. If the carrying amount of the asset is to be recovered through sale, rather than through continuing use, deferred tax should be measured at 0%.	

Concluding remarks

In this article the interpretation of paragraph 51 of IAS 12 (AC 102) has been considered. The following important principles have been established:

- The carrying amount of an asset reflects, in substance, the future cash flows and cash equivalents to be generated by the asset.
- The carrying amount of an asset can potentially be recovered through use, sale or a combination of use and sale.
- Recovery through use is reflected in the passing of time, because as time passes, the number of remaining years that an asset can generate cash flows decreases. This implies that for certain assets, for example, land, "use" cannot be a valid manner of "recovery", because the passing of time does not reduce the number of years that an asset such as land can generate cash flows (the cash flow stream will continue in perpetuity). The carrying amount of land can therefore only be recovered through sale.

In the second article of this pair of articles, the principles established in this article are extended to explore the deferred tax measurement of investment property at fair value. **ASA**

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