COLLEGE OF ACCOUNTING

FINANCIAL REPORTING | INTERMEDIATE

Video Transcription: Deferred Tax – Introduction

What impact does the accrual basis have on the recognition of tax? The amount of tax paid is dependent on how the relevant revenue authority calculates tax.

Now in South Africa, this revenue authority is known as SARS and the way in which SARS calculate tax might very well be different to the amount of tax that is attributable to the amounts that are recognized on the financial statements. When there is a difference like this Deferred Tax is the mechanism we use to ensure that the tax effects of a transaction are recognised when the transaction takes place as opposed to when SARS levies the tax. Now, let's assume that a transaction is taxed at the same amount as it is included in revenue. But it is included in taxable income in a different period to when it is included in accounting profit. If a company receives R100 000 from a customer in Year 1 but only performs the service in Year 2, the revenue will only be recognised in Year 2.

However, SARS will tax the amount when it is received, which is going to be in Year 1. Therefore using the current tax rate of 28%, R28 000 is going to be payable. As you can see this results in an after tax loss of R28 000 in Year 1 and a profit of R100 000 in Year 2. Now you might be thinking that SARS should not tax the company on the R100 000 until Year 2 when the company has actually performed the service, but when we think SARS should tax a company is completely irrelevant.

SARS makes up their own rules for calculating tax and those rules may very well differ from the principles that are applied to recognising revenue in the income statement. As an example, in order to sort of encourage investment in production capacity, SARS often allows a deduction of 50% of the cost of an asset in the year in which is has been acquired. The result of this is that your tax payable in that first year is going to be less. I mean, sometimes SARS could even allow deduction of 150% of the cost of the asset. These deductions are separate to our consideration of how we calculate depreciation in terms of IFRS. And companies are not going to change the way they apply IFRS just because SARS changes their deductions. What we need to do is to provide decision-useful information to our users even though the accounting principles may well be different to the tax rules that SARS applies.

Let's go back to the example where the R100 000 was taxed in Year 1 and recognised in revenue in Year 2. Assuming that there are no other transactions, what profit should we be recognising at the end of these years? From an economic perspective, the company earned revenue of R100 000 in Year 2 and is taxed at 28% on its revenue. The tax relates directly to the revenue and should be taxed in the same financial year in which it is recognised. But the way the example currently looks, there is a reported loss of R28 000 in Year 1 and a profit of R100 000 in Year 2. Do you think this is giving the correct information to users?

The economic reality is that no profit was generated in Year 1 and R72 000 was generated in Year 2. So we have some adjusting to do. In Year 1 we need to move from a loss of R28 000 to a zero profit, and in Year 2 we need to reduce our profit from R100 000 to R72 000. How we do this, is reverse the tax expense of R28 000 in Year 1 and rather go and recognise it in Year 2. What this does is, give no profit in Year 1 and R72 000 in Year 2, which is just what it needs to be. To express this slightly differently, the tax that was paid in Year 1 should be deferred to Year 2 as that is the year in which the revenue is recognised.

Deferred tax is an accounting entry that is made to adjust for the difference in the way in which amounts are recognised in financial statements and for calculating tax payable to SARS. The principle behind deferred tax is that all the tax consequences have to be recognized in the same financial period in which the transaction is recognised.

Where this is different to the manner in which we calculate tax payable, a deferred tax adjustment needs to be made to correct that difference. If the basis used to calculate tax payable to SARS is different, then we need to make a deferred tax adjustment to correct that difference. Now, deferred tax does not change the amount of tax payable to SARS and has no cash flow implications. It is merely an account entry that originates in one year and reverses in subsequent years.

Going back to the income statement, we want no tax expense in Year 1 and a tax expense of R28 000 in Year 2 in order to ensure that we are picking up the tax consequences of the revenue, which we are recognising in Year 2. This does not change the tax payable to SARS, which is still going to be an expense of R28 000 in Year 1 and nil in Year 2. To compensate for this, we need a credit to the tax expense in Year 1 and a debit to the tax expense in Year 2. This will make our total tax in Year 1 nil and R28 000 in Year 2. Deferred tax is the mechanism we use to adjust the tax expense, to ensure that all the tax consequences are recognised of amounts that are shown in the financial statements.

Tax consists of two components: there is current tax, which is payable to SARS, and then deferred tax which is this accounting entry, which we raise in one year and reverse in another to compensate for those differences between tax and IFRS.

Before we are looking at the journal entries, let's think about that liability of R100 000 we have in Year 1. Remember the company received cash in Year 1 but had not performed whatever service they were meant to perform. So, the company has an obligation to deliver goods or services as a result of the cash that they have received in that first year.

Companies are taxed at 28% on revenue but this company has paid tax on the R100 000 that it has not even recognised as revenue yet. As a result of the tax paid in Year 1 the company has a benefit of being able to receive the full R100 000 in income in Year 2, without having to pay over another R28 000 to SARS. The past event of having paid that tax in Year 1 results in a future benefit of receiving that full amount in income without having to pay tax on it.

Now, it does not make sense to recognise a deferred revenue obligation as a liability of R100 000 in Year 1 without also recognising an asset for the fact that you are going to pay less tax in the future as result of the tax you already paid, in that first year. Remember that users expect tax to equal 28% of profit and by recognising an asset of R28 000 you are correctly reflecting the benefit of having already paid that tax in the first year.

In Year 1 this is the journal entry that would be processed. The debit gives rise to the asset reflecting the benefit of having paid the tax in Year 1 for future revenue still to be earned. The credit gives rise to the amount recognised in profit and loss in Year 1 that offsets the current tax expense to reflect no tax when no revenue was recognised. In Year 2 the journal entry that will be processed is the following: can you see how this journal entry is the reversal of the journal entry of Year 1?

After this entry has been processed there is no deferred tax balance remaining for this transaction. This is correct as there are no future tax consequences, and at the end of Year 2 the revenue and taxable income have both been fully recognised. By recognising and then reversing the deferred tax entry, the total tax now correctly reflects the tax consequences of the transaction in the same financial year it is recognised. Deferred tax can only compensate for differences between tax and accounting that come about because they are recognised in different financial periods. What I mean by this is that these differences are temporary. They originate in one year and then reverse in following years.

This may look fairly simple when you are just looking at one transaction, but in practice it is not always so easy to isolate one transaction but hopefully this video has at least helped you to better understand the way that IFRS explains deferred tax. The liability for income received in advance represents the total amount of cash that has been received for which no service has actually been rendered. And at any reporting date this also shows you the cumulative amount of tax that you have paid for which you have not actually recognised anything in income yet. This implies that a deferred tax asset should be recognised for the total amount of deferred revenue x the applicable tax rate, which is currently 28%.

Deferred tax is calculated by looking at the assets and liabilities on the financial statements, and considering the future tax implications of those assets and liabilities. Where you find that those tax implications are different to accounting you are going to need to recognise deferred tax.

We have now seen an example of deferred revenue where we have had a deferred tax asset because we are now going to pay less tax in the future than what we actually expected. In most cases, tax deductions on capital assets are given earlier than when we recognise their equivalent depreciation. In those cases, you are going to have deferred tax liability because you are going to be paying more taxes in the future than what you originally expected. Deferred tax transfers the benefit of those deductions to the year in which depreciation is recognised or the asset is sold.

I hope this video has helped you in your understanding of how to apply the accrual basis to tax.