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Video Transcription: Deferred Tax – Where to Recognise Deferred Tax Adjustments

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Recognising Deferred Tax

Once you have calculated a deferred tax balance, do you know how to deal with any movements in the balance? Are they recognised in profit, other comprehensive income, goodwill or directly in equity?

The principle behind recognising tax, both current and deferred tax, is that the tax is always recognised, in the same component of the financial statements, as the underlying transaction that gave rise to the tax adjustment.

Carrying amount (1)	R50 000 (1)	Accounting adjustment (2)	Recognition of Tax (3)
Revaluation	**R30 000**	OCI	OCI - deferred
Revalued carrying amount	R80 000		
Depreciation	**(R10 000)**	Profit	Profit – current & deferred
Carrying amount	R70 000		
Profit on sale	**R30 000**	Profit	Profit – current & deferred
Proceeds	R100 000		

Think about revaluing an asset – this must give rise to deferred tax as the carrying value changes without a change in the tax base of that asset. Revaluing the asset increases the carrying amount and therefore the temporary difference. The increase in value is recognised in OCI and therefore the related deferred tax is recognised in OCI. As the asset is subsequently depreciated, the carrying value is reduced by the depreciation that is recognised in profit or loss and therefore the related deferred tax is in profit or loss, and similarly the deferred tax relating to a profit on sale.

This is the key principle that you need to refer to when deciding where to recognise tax adjustments – and that relates to both current and deferred tax. Identify where the accounting entry is recognised and then recognise the tax in the same component of the financial statements.

Think about the sale of shares when a parent company reduces its shareholding in a subsidiary from 80% to 60%, that is referred to as an equity transaction when producing group accounts, as it is a transaction between shareholders – the parent and the non-controlling. SARS will levy capital gains tax on the difference between the original cost and the proceeds – any adjustment in the group accounts will go directly to equity, and therefore the related tax, current in this case, also goes directly to equity.

Think about another example, revaluing equity instruments to fair value will give rise to a temporary difference as the tax base remains as the cost of the asset. If the fair value gain is recognised in profit, the deferred tax adjustment will be recognised in profit. If the fair value gain is recognised in other comprehensive income – the deferred tax will be recognised in other comprehensive income. Remember that the selection of tax rate will depend on whether the sale of the investment is taxed at the full or the CGT rate, and does not depend on where the item is recognised.

Let's focus on the mechanics of doing the calculations. Once you have correctly identified all your temporary differences and selected the correct tax rate, you can work out a deferred tax balance.

Deferred tax – Statement of financial position

		Bal B/F (1)	calc
?????		?????	
Bal C/F (1)	Calc		

Remember that a temporary difference is the cumulative difference between the carrying amounts on the statement of financial position and tax base at a point in time, and therefore the deferred tax amount that you calculate is the balance at that point. There will usually be a prior year balance – and therefore the only entries that will need to be processed during the year are the current year movements.

The bulk of deferred tax adjustments arise from differences in profit or loss – this will include all differences relating to depreciation, profit on sale of assets, bad debts, provisions, employee benefits etc. Generally it is difficult to calculate the amount in profit directly as it is made up of so many different components, so it is usually more efficient to derive that amount as the balancing figure once you have identified all the other movements i.e. those that are not recognised in profit or loss.

Let's look at some typical deferred tax adjustments that are not recognised in profit or loss, and then pull it all together using a ledger account at the end.

We have already recognised that revaluation gains on "property, plant and equipment" are recognised in other comprehensive income and therefore the deferred tax adjustment arising from increasing the carrying value are also recognised in other comprehensive income, while the deferred tax relating to the depreciation is in profit. We also saw that if the fair value adjustments on equity instruments were recognised in OCI, so too was the related deferred tax.

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If you are dealing with group accounts, there are a number of other additional issues to think about.

Analysis of Equity of Subsidiary

Share capital	R5 000
Retained income	R395000
Machinery – fair value adjustment	R100 000
Less: deferred tax @ 28%	(R28 000)
Net asset value at acquisition	**R472 000**
Goodwill	R48 000
Consideration given	**R520 000**

Recognising a fair value adjustment at acquisition will give rise to a temporary difference – the group carrying amount changes, whereas the tax base in the subsidiary is unchanged, and as that temporary difference arises in a business combination, the deferred tax exemption criteria in paragraph 15 of IAS 12 can never apply (go and read that section again very carefully – no temporary difference that arises from a business combination can ever be exempt from deferred tax. Recognising a fair value adjustment on acquisition, changes the net asset value of the acquired business and therefore the related goodwill. As the fair value adjustments affect goodwill, so too must the related deferred tax. This is done automatically when calculating the after tax effect of the fair value adjustment at acquisition.

The fair value adjustment on machinery will give rise to subsequent depreciation adjustments, which will be recognised in group profit or loss, together with the related deferred tax.

We are making good progress unravelling our deferred tax ledger account:

Deferred tax – Statement of financial position

		Bal B/F (1)	calc
Sale of subsidiary (5)		OCI – Fair value adjust on equity (2)	
		OCI – reval PPE (2)	calc
		Goodwill – acquisition Sub (3)	calc
		Acquisition of subsidiary (4)	
Def tax – P & L (6 *)	????	Def Tax – P &L (6)	????
Bal C/F (1)	Calc		

(1) The opening and closing balances are calculated using temporary differences and appropriate tax rates at the beginning and end of the financial year. Remember that you can watch the video on selecting rates if you feel unsure of how to do that.

(2) The deferred tax on amounts recognised in OCI are included in the ledger account – assuming that the carrying amount of the asset increased, this gives rise to an increase in the deferred tax credit balance arising from recognising a debit to deferred tax in other comprehensive income. We have discussed fair value adjustments on equity instruments and revaluing "property, plant and equipment".

(3) Assuming this is in a group and there has been a business combination during the year, deferred tax on fair value adjustments recognised at the date of acquisition and therefore recognised from goodwill, are identified.

(4) Don't forget that in the year in which control is gained you will recognise all the deferred tax in the subsidiary in the closing group balance but not the opening – and therefore that is one of the causes of movements during the year.

(5) Remember also you may have lost control of a subsidiary – in which case all the related deferred tax of the subsidiary needs to be removed as it is in the opening but not the closing balance

(6) Assuming no change in tax rates – the balancing figure in your ledger account is the amount in profit or loss – and it could be a debit to profit or loss if the balancing figure is a credit (6) or a credit to profit and loss (6*).

Deferred tax – Statement of financial position

		Bal B/F	@ 14%
		Incr 18.6% - 14% - rate change	
		Bal @18.6%	
		OCI – reval land 18.6%	calc
Bal C/F 18.6%	Calc		

What happens if the opening balance is calculated at a different tax rate from the closing balance? That would imply that some of the movement in the current year arises from restating the opening balance to the new tax rate and not from current year movements. The opening balance is last year's closing balance and is calculated at the rates that applied last year. The current year balance is calculated at the rates that apply this year. The portion of the movement that relates to the impact of changing the tax rates needs to be calculated and presented separately. For example, in 2012 the CGT rate went from a 50% to a 66.6% inclusion rate –increasing the effective tax rate from 14% to 18.6%. Deferred tax balances that were calculated at 14% need to be restated to 18.6%, and current year movements recognised at 18.6% to ensure that the closing balance is calculated at 18.6%.

When the tax rate changes, the change to the deferred tax balance arose as a result of recognising deferred tax previously and not because something changed this year i.e. the temporary differences are the same. The impact of the change should be recognised in other comprehensive income if the original temporary difference was recognised in other comprehensive income, for example, as a result of a fair value adjustment on an equity instrument or revaluing "property, plant and equipment". This is entirely consistent with the general principle that where an estimated amount changes, the impact of the change in estimate is recognised on the same basis as the original amount.

A similar principle applies where a change in intention from using to selling an asset causes a change in the deferred tax balance, which requires a trace back to where the original temporary difference arose. In the video on selecting the correct rate to use we looked at an example where the anticipated recovery of a revalued depreciable asset was changed from use to sale. The amounts we calculated were deferred tax on a usage basis of R224 000 and on a sale basis of R205 200.

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1. Carrying value = R1.2m

1. Original cost = R1m

1. Tax base = R0.4m

2. Usage basis – D/T bal = (R1,2m – R0.4m) x 28% = R224 000

3. Sale basis - D/T bal = (R1,2m – R1,0m) x 18.6% + (R1.0m – R0.4m) x 28% = R205,2

Change of intention = R224 000 – R205 200 = R18 800

In this example, the deferred tax balance changed as a result of a change in intention with respect to the asset. The impact of the change in intention is recognised in other comprehensive income as the temporary difference arose when the asset was revalued, giving rise to a revaluation gain in other comprehensive income as well as the related deferred tax. The change in the estimate of the deferred tax relating to that asset is also recognised in other comprehensive income. In other words it is traced back to where the original deferred tax was recognised when the related temporary difference arose.

The usual principle is to recognise deferred tax where the temporary difference arose – where the tax rate changes or the deferred tax balance differs because of a change in intention, the change in deferred tax balance results in a change of measurement of existing deferred tax as opposed to the result of temporary differences, and is therefore traced back to where that deferred tax arose.

The key to identifying where to recognise deferred tax is to understand what transaction caused the deferred tax balance to change, and then recognise the deferred tax in the same place. Remember that the deferred tax will often arise in a different component than where it will reverse, for example revaluing a depreciable asset and the subsequent depreciation or the fair value adjustment at acquisition of a subsidiary and the subsequent impact on group profits.

Another useful tip is to check that the relationship between the pre- and post-tax amounts, make sense. A tax-rate reconciliation helps you do that for items that are in profit; and remember for items that are not in profit, there needs to be individual disclosure of the tax related to each item – as you have seen with items recognised in other comprehensive income. You may like to refer to the video on tax rate reconciliations (see "Tax Rate Reconciliation"), as well as back to the example on selling the revalued asset in the video on selecting tax rates to help reinforce these concepts.