

IASB Research Forum 2017

Making Deferred Taxes Relevant

Arjan Brouwer and Ewout Naarding

Brussels, 28 November 2017



Introduction

- The IASB decided in May 2016 to keep IAS 12 unchanged and to halt any further research efforts into whether this standard should be fundamentally changed.
- The decision was taken after completing a research project that was part of the 2011 Agenda Consultation, at a time when there was increased attention on IAS 12's shortcomings (see for example the Discussion Paper of EFRAG/ASB from 2011).
- In our view this decision was taken without sufficiently considering the (empirical) academic results and insights from value relevance studies on deferred taxes.
- Criticism of deferred taxes is not new and has created a large body of literature that provides insights into the model's shortcomings. These results should in our view find their way into the accounting standard-setting process.
- Our paper systematically analyses **the key shortcomings of IAS 12** by looking at its **exemptions** and **conceptual problems** and uses the results from **academic research** to derive **possible solutions** to address these issues.

Exceptions in IAS 12 lack theoretical basis

1. IAS 12 does not allow recognising a DTL on the **initial recognition of goodwill** as this would trigger additional DTLs and the standard indicates that recognizing DTLs through an iterative calculation does not result in useful information:
 - > DTAs should however be recognized for the initial recognition of goodwill;
 - > DTLs should be recognized in case of temporary differences after initial recognition.
2. IAS 12 does not allow recognising a DTA/DTL on the **initial recognition of an asset or liability** that is not part of a business combination and at the time of recognition does not affect accounting or tax profit as this is expected to reduce transparency:
 - > However, DTA/DTLs are recognized on temporary differences created in BC;
 - > Distinction between acquiring assets or a business can depend on details, the accounting treatment of income taxes is however significantly different.
3. IAS 12 requires that **DTLs on subsidiaries** are not recognised if the investor is able to control the timing of the reversal of the taxable temporary difference and it is probable that this temporary difference will not reverse in the foreseeable future:
 - > While understandable from an economic and tax perspective it is not consistent with the principles and not clear why this logic should not be applied to other DTLs.

Initial goodwill recognition exception

Example 1: The case of the DTL exception on the initial recognition of goodwill

Entity A acquires all shares of entity X and recognises a goodwill amount of 1,000 that is not tax-deductible. Entity B acquires all shares of entity Y and recognises a goodwill amount of 1,000 that is tax-deductible and amortised over 10 years. The tax accounting impact for the years 1-10 is as follows:

Entity A				Entity B		
Year	Goodwill	DTL	Net result	Goodwill	DTL	Net result
0	1,000	-	-	1,000	-	-
1	1,000	-	750	1,000	(25)	750
2	1,000	-	750	1,000	(50)	750
3	1,000	-	750	1,000	(75)	750
4	1,000	-	750	1,000	(100)	750
5	1,000	-	750	1,000	(125)	750
6	1,000	-	750	1,000	(150)	750
7	1,000	-	750	1,000	(175)	750
8	1,000	-	750	1,000	(200)	750
9	1,000	-	750	1,000	(225)	750
10	1,000	-	750	1,000	(250)	750

Other information

- Both entities have earnings before income tax and the abovementioned transaction of 1,000 in each of the years presented.
- A tax rate of 25% applies in each of the years.

- At the beginning of year 1, the balance sheet of entity A and entity B are similar, even though their economic position is not similar (entity B has goodwill tax amortisation benefits; entity A does not).
- At the end of year 10, both entities have IFRS goodwill of 1,000 that is not deductible (anymore) for tax purposes and thus have the same economic position, but only entity B has recognised a DTL.

Conceptual problems in IAS 12

1. **The many exceptions in IAS 12** is a first conceptual problem, since they not only lack a theoretical basis but they are also inconsistent with the financial position approach and the balance sheet principles of IAS 12.
2. **The comprehensive nature of DTLs** is a second conceptual problem in IAS 12 since under this model DTLs are insufficiently related to future cash flows. As a result not all DTLs are meeting the definition of a liability in the existing *Conceptual framework* and possibly also not with the *Exposure draft* since there is no expected outflow or transfer of economic resources.
3. **The probability threshold for deferred taxes only** is a third conceptual problem in IAS 12 since both the existing *Conceptual framework* and the *Exposure draft* do not justify a higher recognition threshold for assets than for liabilities.
4. **The lack of discounting** is a fourth conceptual problem in IAS 12. While not a clear deviation from the measurement principles in the *Conceptual framework* and the *Exposure draft*, conceptually, time value should be considered when an entity is given the opportunity to pay income taxes in the future rather than today.

Tax accounting literature study review

Table 1: Overview of tax accounting literature

Primary research area	Paper	Type of research	Contribution to key issues			
			A	B	C	D
Value relevance of interperiod income tax allocation	Chambers, 1968	Theoretical	ü	ü		
	Barton, 1970	Theoretical	ü	ü		
	Buckley, 1972	Theoretical	ü			
	Beaver and Dukes, 1972	Empirical	ü			
	Rayburn, 1986	Empirical	ü			
	Chaney and Jeter, 1994	Empirical	ü	ü		ü
Value relevance of reversing deferred tax balances	Davidson, 1958	Analytical		ü		
	Givoly and Hayn, 1992	Empirical		ü		ü
	Amir et al., 1997	Empirical		ü		
	Schultz and Johnson, 1998	Theoretical		ü		
	Ayers et al., 1998	Empirical		ü	ü	
	Sansing, 1998	Analytical		ü		ü
	White et al., 1998	Theoretical		ü		
	Guenther and Sansing ,2000	Analytical		ü		ü
	Dhaliwal et al., 2000	Empirical		ü		
	Chen and Schoderbek, 2000	Empirical		ü		
	Amir et al., 2001	Analytical		ü		
	Citron, 2001	Empirical		ü		
	Dotan, 2003	Analytical		ü		ü
	Guenther and Sansing ,2004	Analytical		ü		ü
	Gordon and Joos, 2004	Empirical		ü		
Chludck, 2011	Empirical		ü	ü		
Laux, 2013	Empirical		ü		ü	
Brouwer et al., 2015	Theoretical			ü		
Value relevance of valuation allowance	Miller and Skinner, 1998	Empirical			ü	
	Amir and Sougiannis, 1999	Empirical			ü	
	Kumar and Visvanathan, 2003	Empirical			ü	
Deferred taxes and discounting	Nurnberg, 1972	Theoretical				ü
	Wolk and Tearney, 1980	Analytical				ü
	Brown and Lippitt, 1987	Analytical				ü
	Rayburn, 1987	Analytical				ü

Legend of key issues:

- A. Decision usefulness of interperiod income tax allocation
- B. Comprehensive balance sheet approach
- C. Probability threshold for deferred tax assets only
- D. Discounting deferred taxes

The decision usefulness of interperiod income tax allocation

- Interperiod income tax allocation has certain value-relevance for investors (Beaver and Dukes, 1972; Rayburn ,1986 and Chaney and Jeter,1994) .

The value relevance of the balance sheet approach

- Schultz and Johnson (1998) suggest that the origin of temporary differences (Tax-first vs. Book-first) may determine the appropriate accounting model for income taxes.
- Current Book-First temporary differences are value-relevant, while current Tax-First temporary differences are not (Guenther and Sansing, 2000, 2004; Dotan, 2003 and Laux, 2013).
- Tax-First differences have valuation consequences that need to be reflected in the F/S (Guenther and Sansing, 2000, 2004).

Probability threshold for deferred tax assets

- DTAs and DTLs should only be recognised when there is a likelihood that they affect future tax cash flows (Ayers, 1998; Miller and Skinner, 1998 and Amir et al.,1997).

Time value and deferred taxes in IAS 12

- Deferred taxes should be discounted in case the temporary differences themselves are not discounted (Sansing, 1998, Guenther and Sansing, 2000, 2004 and Dotan, 2003).

Model for making deferred taxes relevant

Table 2: A proposal for new income tax accounting principles

Temporary difference	Approach	Method	Thresholds	Measurement
Book-First	Balance sheet	Partial	The same for DTA & DTL	Discounted
Tax-First	Valuation adjustment	Partial	The same for DTA & DTL	Discounted

- A new model for the accounting of income taxes should clearly distinguish between Book-First and Tax-first temporary differences (Schultz and Johnson, 1998; Guenther and Sansing, 2000, 2004; Dotan, 2003 and Laux, 2013).
 - > Balance sheet approach should only be applied to Book-First temporary differences, because only these DTAs and DTLs will result in future tax cash flows;
 - > Valuation adjustment approach should be applied for Tax-First temporary differences since these have valuation consequences that need to be addressed in the valuation of assets and liabilities.
- The current comprehensive approach should be replaced by the partial allocation method so as to remove the asymmetrical verification requirements for DTAs and DTLs and to align them with future tax flows (Chaney and Jeter, 1994; Citron, 2001; Amir et al., 2001; Gordon and Joos, 2004).
- Deferred tax balances should be discounted to reflect the time value of money (e.g. Nurnberg, 1972; Wolk and Tearney, 1980; Rayburn, 1987 and Guenther and Sansing, 2000; 2004).

Conclusion

- We conclude that deferred taxes should only be recognised for temporary differences that will result in actual future tax payments and/or tax receipts.
- Temporary differences for which the tax cash flow has already occurred have valuation implications for the underlying asset or liability and should therefore be accounted for based on the valuation adjustment approach.
- Furthermore, we conclude that partial allocation should replace comprehensive allocation in order to better align deferred taxes with expected future cash flows and thus increase their relevance and understandability.
- Finally, we conclude that deferred tax balances should be measured on a discounted basis to address time value.
- We recommend that the IASB reconsiders its decision to end the project on income taxes, since our results demonstrate that IAS 12's shortcomings can and should be overcome, sooner rather than later

