

# 19

DEFERRED TAX

FINANCIAL REPORTING  
STANDARD



ACCOUNTING  
STANDARDS  
BOARD

*Financial Reporting Standard 19  
'Deferred Tax' is issued by the  
Accounting Standards Board in respect  
of its application in the United Kingdom  
and by the Institute of Chartered  
Accountants in Ireland in respect of its  
application in the Republic of Ireland.*

# 19

DEFERRED TAX



ACCOUNTING  
STANDARDS  
BOARD

*Financial Reporting Standard 19 is set out in paragraphs 1-72.*

*The Statement of Standard Accounting Practice, which comprises the paragraphs set in bold type, should be read in the context of the Objective as stated in paragraph 1 and the definitions set out in paragraph 2 and also of the Foreword to Accounting Standards and the Statement of Principles for Financial Reporting currently in issue.*

*The explanatory paragraphs contained in the FRS shall be regarded as part of the Statement of Standard Accounting Practice insofar as they assist in interpreting that statement.*

*Appendix V 'The development of the FRS' reviews considerations and arguments that were thought significant by members of the Board in reaching the conclusions on the FRS.*

# CONTENTS

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Paragraphs

## SUMMARY

### FINANCIAL REPORTING STANDARD 19

<b>Objective</b>	<b>1</b>
<b>Definitions</b>	<b>2</b>
<b>Scope</b>	<b>3-6</b>
<b>Recognition of deferred tax assets and liabilities</b>	<b>7-33</b>
General requirements	7-8
Allowances for fixed asset expenditure	9-11
Non-monetary assets—revaluations and gains on disposal	12-20
Assets continuously revalued to fair value with changes in fair value recognised in the profit and loss account	12-13
Other non-monetary assets	14-20
Unremitted earnings of subsidiaries, associates and joint ventures	21-22
Deferred tax assets	23-33
General requirements	23
Suitable taxable profits	24-25
Deferred tax assets that can be recovered against deferred tax liabilities	26
Deferred tax assets that cannot be recovered against deferred tax liabilities	27-32
Reassessment of recoverability	33
<b>Recognition in the statements of performance</b>	<b>34-36</b>
<b>Measurement</b>	<b>37-54</b>
Tax rates	37-41
Discounting	42-54
Criteria for discounting	42-46
Scheduling the cash flows to be discounted	47-51
Discount rates	52-54

<b><i>Presentation</i></b>	<b>55-59</b>
<i>Presentation in the balance sheet</i>	55-58
<i>Presentation in the statements of performance</i>	59
<b><i>Disclosures</i></b>	<b>60-65</b>
<i>Deferred tax included in the statements of performance</i>	60
<i>Deferred tax included in the balance sheet</i>	61-63
<i>Circumstances affecting current and future tax charges</i>	64-65
<b><i>Date from which effective</i></b>	<b>66</b>
<b><i>Withdrawal of SSAP 15 and amendment of other accounting standards</i></b>	<b>67-72</b>

## **ADOPTION OF FRS 19 BY THE BOARD**

### **APPENDICES**

- I DISCOUNTING EXAMPLE**
- II DISCLOSURE ILLUSTRATIONS**
- III NOTE ON LEGAL REQUIREMENTS**
- IV COMPLIANCE WITH INTERNATIONAL ACCOUNTING STANDARDS**
- V THE DEVELOPMENT OF THE FRS**

## SUMMARY

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- a Financial Reporting Standard 19 'Deferred Tax' requires full provision to be made for deferred tax assets and liabilities arising from timing differences between the recognition of gains and losses in the financial statements and their recognition in a tax computation.
- b The general principle underlying the requirements is that deferred tax should be recognised as a liability or asset if the transactions or events that give the entity an obligation to pay more tax in future or a right to pay less tax in future have occurred by the balance sheet date. The FRS:
- (a) *requires deferred tax to be recognised on most types of timing difference, including those attributable to:*
- accelerated capital allowances
  - accruals for pension costs and other post-retirement benefits that will be deductible for tax purposes only when paid
  - elimination of unrealised intragroup profits on consolidation
  - unrelieved tax losses
  - other sources of short-term timing differences

*(b) prohibits the recognition of deferred tax on timing differences arising when:*

- a fixed asset is revalued without there being any commitment to sell the asset
- the gain on sale of an asset is rolled over into replacement assets
- the remittance of a subsidiary, associate or joint venture's earnings would cause tax to be payable, but no commitment has been made to the remittance of the earnings.

*(c) requires deferred tax assets to be recognised to the extent that it is regarded as more likely than not that they will be recovered.*

- c** As an exception to the general requirement not to recognise deferred tax on revaluation gains and losses, the FRS requires deferred tax to be recognised when assets are continuously revalued to fair value, with changes in fair value being recognised in the profit and loss account.
- d** The FRS permits but does not require entities to adopt a policy of discounting deferred tax assets and liabilities.
- e** The FRS includes other requirements regarding the measurement and presentation of deferred tax assets and liabilities. These include requirements for the deferred tax to be:
- measured using tax rates that have been enacted or substantively enacted
  - presented separately on the face of the balance sheet if the amounts are so material that, in the absence of such disclosure, readers may misinterpret the financial statements.

- f The FRS requires information to be disclosed about factors affecting current and future tax charges. A key element of this is a requirement to disclose a reconciliation of the current tax charge for the period to the charge that would arise if the profits reported in the financial statements were charged at a standard rate of tax.
  
- g The FRS amends FRS 7 'Fair Values in Acquisition Accounting'. The amendment requires deferred tax recognised in a fair value exercise to be measured in accordance with the requirements of the FRS. Thus, deferred tax would not be recognised on an adjustment to recognise a non-monetary asset acquired with the business at its fair value on acquisition.

## FINANCIAL REPORTING STANDARD 19

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### OBJECTIVE

- 1 The objective of this FRS is to ensure that:
  - (a) future tax consequences of past transactions and events are recognised as liabilities or assets in the financial statements; and
  - (b) the financial statements disclose any other special circumstances that may have an effect on future tax charges.

### DEFINITIONS

- 2 The following definitions shall apply in the FRS and in particular in the Statement of Standard Accounting Practice set out **in bold type**.

#### *Current tax:-*

The amount of tax estimated to be payable or recoverable in respect of the taxable profit or loss for a period, along with adjustments to estimates in respect of previous periods.

#### *Deferred tax:-*

Estimated future tax consequences of transactions and events recognised in the financial statements of the current and previous periods.

*Permanent differences:-*

Differences between an entity's taxable profits and its results as stated in the financial statements that arise because certain types of income and expenditure are non-taxable or disallowable, or because certain tax charges or allowances have no corresponding amount in the financial statements.

*Timing differences:-*

Differences between an entity's taxable profits and its results as stated in the financial statements that arise from the inclusion of gains and losses in tax assessments in periods different from those in which they are recognised in financial statements. Timing differences originate in one period and are capable of reversal in one or more subsequent periods.

Timing differences arise when, for example:

- tax deductions for the cost of a fixed asset\* are accelerated or decelerated, ie received before or after the cost of the fixed asset is recognised in the profit and loss account
- pension liabilities are accrued in the financial statements but are allowed for tax purposes only when paid or contributed at a later date
- interest charges or development costs are capitalised on the balance sheet but are treated as revenue expenditure and allowed as incurred for tax purposes

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\* Including deductions for expenditure on infrastructure assets capitalised and depreciated using renewals accounting.

- intragroup profits in stock, unrealised at group level, are reversed on consolidation
- an asset is revalued in the financial statements but the revaluation gain becomes taxable only if and when the asset is sold
- a tax loss is not relieved against past or present taxable profits but can be carried forward to reduce future taxable profits
- the unremitted earnings of subsidiary and associated undertakings and joint ventures are recognised in the group results but will be subject to further taxation only if and when remitted to the parent undertaking.

## SCOPE

- 3 **The FRS applies to all financial statements that are intended to give a true and fair view of a reporting entity's financial position and profit or loss (or income and expenditure) for a period.**
- 4 **The FRS applies to taxes calculated on the basis of taxable profits, including withholding taxes paid on behalf of the reporting entity.**
- 5 In the UK and the Republic of Ireland, the taxes that are calculated on the basis of taxable profits are primarily corporation tax and income tax. Other taxes, such as value added tax and petroleum revenue tax, that are not assessed directly on profits for an accounting period are not within the scope of the FRS.

- 6 Reporting entities applying the Financial Reporting Standard for Smaller Entities (FRSSE) currently applicable are exempt from the FRS.**

## **RECOGNITION OF DEFERRED TAX ASSETS AND LIABILITIES**

### *General requirements*

- 7 Except as set out in paragraphs 9-33, deferred tax:**
- (a) should be recognised in respect of all timing differences that have originated but not reversed by the balance sheet date;**
  - (b) should not be recognised on permanent differences.**
- 8** The requirements of paragraph 7 are not intended to prevent lessors preparing financial statements in accordance with SSAP 21 'Accounting for leases and hire purchase contracts' from allocating profit from transactions over the term of the lease on a post-tax basis and measuring the tax charge and pre-tax profit relating to the accounting period by applying the effective rate of tax to the post-tax profit. The way in which finance lessors should determine the amount of deferred tax to be provided for is illustrated in Part II of the Guidance Notes on SSAP 21.

*Allowances for fixed asset expenditure*

- 9 Deferred tax should be recognised when the allowances for the cost of a fixed asset are received before or after the cost of the fixed asset is recognised in the profit and loss account. However, if and when all conditions for retaining the allowances have been met, the deferred tax should be reversed.**
- 10 If an asset is not being depreciated (and has not otherwise been written down to a carrying value less than cost), the timing difference is the amount of capital allowances received.
- 11 Most capital allowances are received on a conditional basis, ie they are repayable (for example, via a balancing charge) if the assets to which they relate are sold for more than their tax written-down value. However, some, such as industrial buildings allowances, are repayable only if the assets to which they relate are sold within a specified period. Once that period has expired, all conditions for retaining the allowance have been met. At that point, deferred tax that has been recognised (ie on the excess of the allowance over any depreciation) is reversed.

*Non-monetary assets—revaluations and gains on disposal*

*Assets continuously revalued to fair value with changes in fair value recognised in the profit and loss account*

- 12 Deferred tax should be recognised on timing differences arising when an asset is continuously revalued to fair value with changes in fair value being recognised in the profit and loss account.**

- 13 The assets to which paragraph 12 applies are typically investments and current assets that are ‘marked to market’ with fluctuations being recognised in the profit and loss account. In many circumstances, the gains and losses are subject to current tax when they are recognised, and no timing difference (and hence no deferred tax) arises. Paragraph 12 is relevant only if the gains and losses are not taxed until realised at a later date.

*Other non-monetary assets*

- 14 **Deferred tax should not be recognised on timing differences arising when other non-monetary assets are revalued, unless, by the balance sheet date, the reporting entity has:**
- (a) **entered into a binding agreement to sell the revalued assets; and**
  - (b) **recognised the gains and losses expected to arise on sale.**
- 15 **Deferred tax should not be recognised on timing differences arising when non-monetary assets (other than those referred to in paragraph 12) are revalued or sold if, on the basis of all available evidence, it is more likely than not that the taxable gain will be rolled over, being charged to tax only if and when the assets into which the gain has been rolled over are sold.\***
- 16 Where an entity has entered into a binding agreement to sell a fixed asset, such as land and buildings, and has revalued the fixed asset at the net sale proceeds, it will have recognised the expected gain or loss on sale. To the extent that rollover relief is not expected to be obtained and a timing difference has arisen—ie the

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\* or are deemed to have been sold for tax purposes.

gain will not be chargeable to current tax—the FRS requires deferred tax to be recognised.

- 17 An asset may have been purchased with a view to resale. Stock, for example, may be purchased for the sole purpose of resale. But this does not in itself mean that the entity has entered into a binding agreement to sell the asset.
- 18 Stock may be adjusted to its fair value on the acquisition of a business. However, even where such stock has been manufactured under the terms of a binding contract, that contract will generally be treated as an executory contract. The rights and obligations under that contract (and hence the gain on sale) will not have been recognised. In adjusting the value of the stock, the entity is merely recognising a movement in the replacement cost of the stock. In such circumstances, the FRS does not allow provision to be made for deferred tax on the adjustment.
- 19 The requirement not to provide for deferred tax if it is more likely than not that a taxable gain will be rolled over into replacement assets applies only if the terms of the relief are such that the gain will not be taxed unless and until the replacement assets are themselves sold (rollover relief). It does not apply if the terms of the relief are such that taxation of the gain is merely postponed (held over) for a finite period (holdover relief).<sup>\*</sup> Sometimes, holdover relief can be converted into rollover relief if qualifying replacement assets are purchased before the held-over gain crystallises. Where this is the case, the requirements regarding rollover relief apply. However, it may be more difficult to arrive at the conclusion that it is more likely than not that the gain will be rolled over and, in consequence, that no provision is required.

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<sup>\*</sup> At present (December 2000), holdover relief can postpone the payment of tax for up to ten years from acquisition of the replacement asset.

- 20 The need to make a judgement regarding the availability of rollover relief will arise when the entity has not yet reinvested the proceeds of sale in qualifying replacement assets but may still do so within the period allowed by the tax authorities.\* All available evidence, including that provided by events occurring after the balance sheet date, is considered when judging whether it is more likely than not that the gain will be rolled over. The available evidence will change with time and will therefore be reassessed continually until the entity either claims rollover relief or loses its right to do so. Any adjustment to recognise a previously unrecognised deferred tax provision (or to release a provision previously recognised) is a change in estimate, which, in accordance with the requirements of FRS 3 'Reporting Financial Performance', is charged or credited as part of the tax charge for the period in the profit and loss account or statement of total recognised gains and losses.

*Unremitted earnings of subsidiaries, associates and joint ventures*

- 21 **Tax that could be payable (taking account of any double taxation relief) on any future remittance of the past earnings of a subsidiary, associate or joint venture should be provided for only to the extent that, at the balance sheet date:**
- (a) **dividends have been accrued as receivable; or**
  - (b) **a binding agreement to distribute the past earnings in future has been entered into by the subsidiary, associate or joint venture.**

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\* At present (December 2000), within three years of the sale of the original asset.

- 22 It is unlikely that there will be a binding agreement for the future distribution of the past earnings of a subsidiary, associate or joint venture. In most circumstances, therefore, the deferred tax provision comprises only tax that will become payable (taking account of double taxation relief) on receipt of dividends accrued at the balance sheet date.

### *Deferred tax assets*

#### *General requirements*

- 23 **Deferred tax assets should be recognised to the extent that they are regarded as recoverable. They should be regarded as recoverable to the extent that, on the basis of all available evidence, it can be regarded as more likely than not that there will be suitable taxable profits from which the future reversal of the underlying timing differences can be deducted.**

#### *Suitable taxable profits*

- 24 Suitable taxable profits from which the future reversal of timing differences could be deducted are those that are:
- (a) generated in the same taxable entity (or in an entity whose profits would be available via group relief) and assessed by the same taxation authority as the income or expenditure giving rise to the deferred tax asset;
  - (b) generated in the same period as that in which the deferred tax asset is expected to reverse, or in a period to which a tax loss arising from the reversal of the deferred tax asset may be carried back or forward; and

- (c) of a type (such as capital or trading) from which the taxation authority allows the reversal of the timing difference to be deducted.
- 25 Account may be taken of tax planning opportunities, ie actions that the entity would take if necessary to create suitable taxable profits. Such actions could include:
- (a) accelerating taxable amounts or deferring claims for writing down allowances to recover losses being carried forward (perhaps before they expire);
  - (b) changing the character of taxable or deductible amounts from trading gains or losses to capital gains or losses or vice versa; or
  - (c) switching from tax-free to taxable investments.

*Deferred tax assets that can be recovered against deferred tax liabilities*

- 26 It can be assumed that the future reversal of any deferred tax liabilities recognised at the balance sheet date will give rise to taxable profits. To the extent that those profits will be suitable for the deduction of the reversing deferred tax asset, the asset can always be regarded as recoverable.

*Deferred tax assets that cannot be recovered against deferred tax liabilities*

- 27 To the extent that the deferred tax asset cannot be recovered against the reversal of deferred tax liabilities, it is necessary to consider the likelihood of there being other suitable taxable profits.

- 28 All available evidence is considered. Historical information about the entity's financial performance and position may provide the most objective evidence. Other evidence may be important if historical information is either not available or of limited relevance because of recent or forthcoming changes in circumstances.
- 29 The existence of unrelieved tax losses of a certain character (for example, trading or capital) at the balance sheet date is strong evidence that there will not be suitable taxable profits of that character in future against which the losses (and other deferred tax assets) can be recovered. In such circumstances, the unrelieved losses (and other deferred tax assets affected) are recognised only if there is other persuasive and reliable evidence suggesting that suitable taxable profits will be generated in future.
- 30 In the case of unrelieved trading losses, such evidence may exist if the loss resulted from an identifiable and non-recurring cause and the reporting entity has otherwise been consistently profitable over a long period, with any past losses being more than offset by income in later periods.
- 31 If an unrelieved capital loss can be relieved only against future capital gains, there is likely to be persuasive and reliable evidence that there will be suitable taxable gains against which the loss can be relieved only to the extent that:
- (a) a potential chargeable gain not expected to be covered by rollover relief is present in assets but has not been recognised as a deferred tax liability;
  - (b) plans are in place for the sale of these assets; and
  - (c) the carried-forward loss will be offset against the resulting chargeable gain for tax purposes.

- 32 If it is expected that it will take some time for tax losses to be relieved, the recoverability of the resulting deferred tax asset is likely to be relatively uncertain. In such circumstances, it may not be appropriate to recognise the deferred tax asset at all.

*Reassessment of recoverability*

- 33 Changes in circumstances from one balance sheet date to the next might affect the extent to which a deferred tax asset is regarded as recoverable and therefore require an adjustment to the amount recognised. For example, an improvement in trading conditions or the acquisition of a new subsidiary might make it more likely that a previously unrecognised tax loss in the acquiring entity will be recovered. As changes in estimates, the resulting movements in the deferred tax balance are required by FRS 3 'Reporting Financial Performance' to be reflected in the results for the period.

**RECOGNITION IN THE STATEMENTS OF PERFORMANCE**

- 34 **Deferred tax should be recognised in the profit and loss account for the period, except to the extent that it is attributable to a gain or loss that is or has been recognised directly in the statement of total recognised gains and losses.**
- 35 **Where a gain or loss is or has been recognised directly in the statement of total recognised gains and losses, deferred tax attributable to that gain or loss should also be recognised directly in that statement.**

- 36 Accounting standards (or, in their absence, legislation) require or permit certain gains or losses to be credited or charged directly in the statement of total recognised gains and losses (ie not in the profit and loss account). The FRS requires any attributable deferred tax to be treated in the same way. In exceptional circumstances it may be difficult to determine the amount of deferred tax that is attributable to gains or losses that have been recognised directly in the statement of total recognised gains and losses. In such circumstances, the attributable deferred tax is based on a reasonable pro rata allocation, or another allocation that is more appropriate in the circumstances.

## MEASUREMENT

### *Tax rates*

- 37 **Deferred tax should be measured at the average tax rates that are expected to apply in the periods in which the timing differences are expected to reverse, based on tax rates and laws that have been enacted or substantively enacted by the balance sheet date.**
- 38 It will normally be necessary to calculate an average tax rate only if the enacted or substantively enacted tax rates are graduated, ie if different rates apply to different levels of taxable income. To calculate the average tax rate it is necessary to estimate the levels of profits expected in the periods in which the timing differences reverse.

- 39 The requirement to calculate an average tax rate is not intended to lead to averaging of different rates expected to apply to different types of taxable profit or in different tax jurisdictions. If different rates of tax apply to different types of taxable profits (for example, trading profits and capital gains), the rate used will reflect the nature of the timing difference. The rates used for measuring deferred tax arising in a specific tax jurisdiction will be the rates expected to apply in that jurisdiction.
- 40 A UK tax rate can be regarded as having been substantively enacted if it is included in either:
- (a) a Bill that has been passed by the House of Commons and is awaiting only passage through the House of Lords and Royal Assent; or
  - (b) a resolution having statutory effect that has been passed under the Provisional Collection of Taxes Act 1968.\*
- 41 A Republic of Ireland tax rate can be regarded as having been substantively enacted if it is included in a Bill that has been passed by the Dail.

### ***Discounting***

#### *Criteria for discounting*

- 42 **Reporting entities are permitted but not required to discount deferred tax assets and liabilities to reflect the time value of money.**

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\* Such a resolution could be used to collect taxes at a new rate before that rate has been enacted. In practice, corporation tax rates are now set a year ahead to avoid having to invoke the Provisional Collection of Taxes Act for the quarterly payment system.

- 43 Requirements and guidance on selecting and changing accounting policies are set out in FRS 18 'Accounting Policies'. Factors that are likely to be especially relevant to selecting a policy of either discounting or not discounting deferred tax include:
- (a) how material the impact of discounting would tend to be to the overall results and position reported in the entity's financial statements;
  - (b) whether the benefits of discounting to users would outweigh the costs of collating the necessary information and performing discounting calculations; and
  - (c) whether there is an established industry practice, adherence to which would enhance comparability.
- 44 **If a reporting entity adopts a policy of discounting, all deferred tax (and recoverable advance corporation tax<sup>\*</sup>) balances that have been measured by reference to undiscounted cash flows and for which the impact of discounting is material should be discounted.**
- 45 Certain timing differences, such as those arising on:
- provisions for pension costs and other long-term liabilities
  - a lessor's investment in finance leases,

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*\* Advance corporation tax (ACT) was abolished in 1999. ACT that had been paid but not relieved by that date may still be recoverable under the shadow ACT system. FRS 16 'Current Tax' sets out requirements and guidance regarding the recognition of recoverable ACT.*

are measured by reference to cash flows that have already been discounted. The deferred tax provisions to which they give rise already incorporate discounting. They are not eligible for further discounting and are not subject to any of the detailed requirements for discounting, or disclosures of amounts arising from discounting, in the FRS. They are disclosed as if they were undiscounted amounts.

- 46 Timing differences that are eligible for discounting include those arising from accelerated capital allowances, revaluation gains and losses and carried-forward tax losses. (However, as noted in paragraph 32, if it is expected that it will take some time for tax losses to be relieved, it may not be appropriate to recognise the losses as an asset at all.)

*Scheduling the cash flows to be discounted*

- 47 **If deferred tax balances are discounted, the discount period(s) should be the number of years between the balance sheet date and the date(s) on which it is estimated that the underlying timing differences will reverse. Assumptions made when estimating the date(s) of reversal should be consistent with those made elsewhere in the financial statements. The scheduling of the reversal(s) should take into account the remaining tax effects of transactions that have already been reflected in the financial statements. However, no account should be taken either of other timing differences expected to arise on future transactions or of future tax losses.**

- 48 Where, for example, assets are depreciated over their useful economic lives but receive capital allowances early in their lives, the timing of the reversal of accelerated capital allowances is determined:
- (a) by scheduling all expected future movements (increases as well as decreases) in the accelerated capital allowances on assets that are held at the balance sheet date, taking account of both future depreciation patterns and the expected timing of remaining capital allowances to be received on these assets; but
  - (b) without taking into consideration timing differences that might arise on fixed assets to be purchased in future.

The assumptions about future depreciation charges and residual value should be consistent with those used to account for the related fixed assets. It may be possible to use approximations or averages to simplify the calculations without introducing material errors. Illustrative examples are given below and in Appendix I.

- 49 A timing difference might be expected to reverse in a period in which it is also expected that the entity will make tax losses. In this situation, the reversal of the timing difference may not have an incremental effect on a tax payment until an even later period, when the future losses are relieved. However, the FRS requires deferred tax to be discounted without taking into consideration the possibility of future losses.

**Simple example illustrating the scheduling of the reversal of accelerated capital allowances on a single asset**

An entity purchases an asset for £100,000 at the start of 20X0. It is estimated that the asset will have a useful economic life of ten years and no residual value. Capital allowances can be claimed at a rate of 25 per cent of cost in each of the first four years.

At the end of 20X0, there is a timing difference of £15,000, which is the difference between the allowances of £25,000 received and the depreciation of £10,000. The timing difference is treated as reversing according to the following schedule (even if the entity expects to make losses at some point during the life of the asset):

Years from now:	1	2	3	4	5	6	7	8	9	Total
Depreciation (£000)	10	10	10	10	10	10	10	10	10	90
Allowances (£000)	25	25	25	-	-	-	-	-	-	75
(Increase)/Reversal	(15)	(15)	(15)	10	10	10	10	10	10	15

- 50 Where deferred tax is recognised on changes in the carrying amount of an asset that is revalued to fair value (ie as required by paragraph 12), the objective is to provide for the incremental tax that the entity will pay or recover on selling the asset, above the amount that it would have paid if it had purchased the asset at its carrying amount at the balance sheet date. The timing difference is therefore discounted from the future date on which it is estimated that the tax will become payable, taking account of any available reliefs.

- 51 The amount of tax that will be payable and the time at which it is likely to be paid may be uncertain and, hence, may have to be estimated on the basis of available evidence. Where the entity holds a portfolio of assets for investment or trading purposes, evidence can be obtained from historical data regarding average turnover periods, average amounts of tax paid as a percentage of the book gain and other variables. But evidence of how these variables are likely to change in future also has to be considered.

*Discount rates*

- 52 **If deferred tax balances are discounted, the discount rates used should be the post-tax yields to maturity that could be obtained at the balance sheet date on government bonds with maturity dates and in currencies similar to those of the deferred tax assets or liabilities.**
- 53 The yields to maturity on government bonds can be obtained from published sources. The post-tax yield is estimated by deducting tax at the rate at which it would be paid by an entity holding the bond, based on enacted or substantively enacted tax rates and laws.
- 54 The need to match the discount rate with the maturity date and currency of the deferred tax asset or liability in theory requires a different discount rate to be applied to each year in which a timing difference is forecast to reverse and for each different tax jurisdiction. It may, however, be possible to use approximations and averages to simplify the calculations without introducing material errors. This is illustrated in the example in Appendix I.

## PRESENTATION

### *Presentation in the balance sheet*

- 55 **With the exception of deferred tax relating to a defined benefit asset or liability recognised in accordance with FRS 17 ‘Retirement Benefits’\*:**
- (a) **net deferred tax liabilities should be classified as provisions for liabilities and charges.**
  - (b) **net deferred tax assets should be classified as debtors, as a separate subheading of debtors where material.**
- 56 **Deferred tax debit and credit balances should be offset within the above headings to the extent, and only to the extent, that they:**
- (a) **relate to taxes levied by the same tax authority; and**
  - (b) **arise in the same taxable entity or in a group of taxable entities where the tax losses of one entity can reduce the taxable profits of another.**

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\* FRS 17 requires such deferred tax to be offset against the defined benefit asset or liability to which it relates.

- 57 Typically, each company in the UK is a single taxable entity and can offset current corporation tax payable to the Inland Revenue against current corporation tax due from the Inland Revenue. Where this is the case, deferred tax balances relating to the corporation tax of a single company are offset on the balance sheet. It may be appropriate to offset the deferred tax assets and liabilities of different entities within the same tax jurisdiction. This will be the case if and to the extent that the entities are treated as a group for tax purposes, being able to use the tax losses of one entity to reduce the amount of tax paid by another. The deferred tax assets and liabilities of different entities cannot be offset when they relate to taxes levied in different jurisdictions.
- 58 **Deferred tax liabilities and assets should be disclosed separately on the face of the balance sheet if the amounts are so material in the context of the total net current assets or net assets that, in the absence of such disclosure, readers may misinterpret the financial statements.**

*Presentation in the statements of performance*

- 59 **All deferred tax recognised in the profit and loss account should be included within the heading ‘tax on profit or loss on ordinary activities’.**

## DISCLOSURES

### *Deferred tax included in the statements of performance*

- 60 The notes to the financial statements should disclose the amount of deferred tax charged or credited within:
- (a) tax on ordinary activities in the profit and loss account, separately disclosing material components, including those attributable to:
    - (i) changes in deferred tax balances (before discounting, where applicable) arising from:
      - the origination and reversal of timing differences;
      - changes in tax rates and laws; and
      - adjustments to the estimated recoverable amount of deferred tax assets arising in previous periods.
    - (ii) where applicable, changes in the amounts of discount deducted in arriving at the deferred tax balance.
  - (b) tax charged or credited directly in the statement of total recognised gains and losses for the period, separately disclosing material components, including those listed in (a) above.

*Deferred tax included in the balance sheet*

- 61 The financial statements should disclose:**
- (a) the total deferred tax balance (before discounting, where applicable), showing the amount recognised for each significant type of timing difference separately;**
  - (b) the impact of discounting on, and the discounted amount of, the deferred tax balance; and**
  - (c) the movement between the opening and closing net deferred tax balance, analysing separately:**
    - (i) the amount charged or credited in the profit and loss account for the period;**
    - (ii) the amount charged or credited directly in the statement of total recognised gains and losses for the period; and**
    - (iii) movements arising from the acquisition or disposal of businesses.**
- 62 The financial statements should disclose the amount of a deferred tax asset and the nature of the evidence supporting its recognition if:**
- (a) the recoverability of the deferred tax asset is dependent on future taxable profits in excess of those arising from the reversal of deferred tax liabilities; and**
  - (b) the reporting entity has suffered a loss in either the current or preceding period in the tax jurisdiction to which the deferred tax asset relates.**

- 63 The evidence supporting the recognition of the deferred tax asset is the specific circumstances that make it reasonable to forecast that there will be future profits against which the deferred tax assets can be recovered. Such circumstances are discussed in paragraphs 28-31.

*Circumstances affecting current and future tax charges*

- 64 **The notes to the financial statements should highlight circumstances that affect the current and total tax charges or credits for the current period or may affect the current and total tax charges or credits in future periods. This disclosure (illustrated in Appendix II) should include:**
- (a) **a reconciliation of the current tax charge or credit on ordinary activities for the period reported in the profit and loss account to the current tax charge that would result from applying a relevant standard rate of tax to the profit on ordinary activities before tax. Either the monetary amounts or the rates (as a percentage of profits on ordinary activities before tax) may be reconciled. Where material, positive amounts should not be offset against negative amounts or vice versa: they should be shown as separate reconciling items. The basis on which the standard rate of tax has been determined should be disclosed.**

- (b) —if assets have been revalued in the financial statements without deferred tax having been recognised on the revaluation gain or loss, or if the market values of assets that have not been revalued have been disclosed in a note—an estimate of tax that could be payable or recoverable if the assets were sold at the values shown, the circumstances in which the tax would be payable or recoverable and an indication of the amount that may become payable or recoverable in the foreseeable future.
- (c) —if the reporting entity has sold (or entered into a binding agreement to sell) an asset but has not recognised deferred tax on a taxable gain because the gain has been or is expected to be rolled over into replacement assets—the conditions that will have to be met to obtain the rollover relief and an estimate of the tax that would become payable if those conditions were not met.
- (d) —if a deferred tax asset has not been recognised on the grounds that there is insufficient evidence that the asset will be recoverable—the amount that has not been recognised and the circumstances in which the asset would be recovered.
- (e) —if any other deferred tax has not been recognised—the nature of the amounts not recognised, the circumstances in which the tax would become payable or recoverable and an indication of the amount that may become payable or recoverable in the foreseeable future.

- 65 Relevant ‘standard’ tax rates vary from entity to entity. A relevant rate for a group whose profits are earned primarily in the UK is the standard rate of corporation tax in the UK, even if some of the group’s operations are conducted in other countries. The impact of different rates of tax applied to profits earned in other countries would be shown as a reconciling item. The standard rate of tax in the UK might be regarded as being of limited relevance for a group that operates primarily outside the UK. For such a group, it may be more appropriate to use the average rate of tax (weighted in proportion to accounting profits) applicable across the group. Such a reconciliation could be performed by preparing and aggregating separate reconciliations for each country using the local rate of tax as the standard tax rate for each reconciliation.

#### **DATE FROM WHICH EFFECTIVE**

- 66 **The accounting practices set out in the FRS should be regarded as standard for financial statements relating to accounting periods ending on or after 23 January 2002. Earlier adoption is encouraged.**

#### **WITHDRAWAL OF SSAP 15 AND AMENDMENT OF OTHER ACCOUNTING STANDARDS**

- 67 **The FRS supersedes SSAP 15 ‘Accounting for deferred tax’.**
- 68 **In paragraph 7 of SSAP 4 ‘Accounting for government grants’, paragraphs 8 and 41 of FRS 12 ‘Provisions, Contingent Liabilities and Contingent Assets’, and paragraph 1 of the summary in FRS 12, the references to SSAP 15 ‘Accounting for deferred tax’ are replaced by references to FRS 19 ‘Deferred Tax’.**

**69 SSAP 17 ‘Accounting for post balance sheet events’ is amended as follows:**

**(a) in paragraph 11 the words “the effects of changes in taxation” are deleted.**

**(b) in the examples of adjusting events given in the Appendix, item (g) is deleted.**

**70 Paragraphs 54 and 92 of FRS 2 ‘Accounting for Subsidiary Undertakings’ are deleted.**

**71 FRS 7 ‘Fair Values in Acquisition Accounting’ is amended as follows:**

**(a) paragraphs 21 and 22 are replaced by:**

“21 Deferred tax on adjustments to record assets and liabilities at their fair values should be recognised in accordance with the requirements of FRS 19 ‘Deferred Tax’.

22 Deferred tax assets that were not regarded as recoverable and hence were not recognised before the acquisition may, as a consequence of the acquisition, satisfy the recognition criteria of FRS 19. Assets of the acquired entity should be recognised in the fair value exercise. Those of the acquirer or other entities within the acquiring group should be recognised as a credit to the tax charge in the post-acquisition period.”

**(b) paragraphs 74 and 75 are replaced by:**

“74 Adjustments to record assets and liabilities of the acquired entity at their fair values are treated in the same way as they would be if they were timing differences arising in the entity’s own accounts. For example, a non-monetary asset, such as a building, would be valued on acquisition at its market value. Any tax that would become payable if the asset were sold at that value would be provided for only if, before the acquisition, the acquired entity had entered into a binding agreement to sell the asset and rollover relief was not available.

75 There might be deferred tax assets, typically unrelieved tax losses, that were not recognised before the acquisition because there was insufficient evidence that they would be recoverable. The acquisition might make the recovery of the losses sufficiently likely to enable them to be recognised as assets in accordance with the criteria set out in FRS 19 ‘Deferred Tax’. If the losses had arisen in the acquired entity, they would be regarded as contingent assets that had crystallised as a result of the acquisition and hence, consistently with paragraph 37, would be recognised as assets in the fair value exercise. If the losses had arisen in the acquiring group, they would not be assets of the acquired entity and hence would not be recognised in the fair value exercise.”

- 72 The Guidance Notes to SSAP 21 'Accounting for leases and hire purchase contracts' were issued by the former Accounting Standards Committee of the CCAB and were not adopted by the Board. Nonetheless, it would be consistent with the FRS if paragraphs 170 and 173-175 of the Notes, and the references to them in paragraphs 47, 101 and 110, were deemed to be deleted.

## **ADOPTION OF FRS 19 BY THE BOARD**

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*Financial Reporting Standard 19 ‘Deferred Tax’ was approved for issue by a vote of nine of the ten members of the Accounting Standards Board. Ms Sharp, recognising that she had not participated in the Board’s key earlier debates in the development of this standard and its important role in promoting international convergence, abstained from voting in accordance with the Board’s agreed procedure for newly appointed members.*

Sir David Tweedie (Chairman)

Allan Cook CBE (Technical Director)

David Allvey

Ian Brindle

Dr John Buchanan

John Coombe

Huw Jones

Professor Geoffrey Whittington

Ken Wild

## APPENDIX I

### DISCOUNTING EXAMPLE

- 1 This appendix illustrates how deferred tax arising from accelerated capital allowances on a plant and machinery pool is discounted.

#### *Assumptions*

- 2 A company that operates solely in the UK depreciates its plant and machinery on a straight-line basis over 10 years. Residual value is estimated to be 1/11th of cost. The company receives capital allowances at a rate of 25 per cent per year on a reducing balance basis. It is taxed on its profits at 30 per cent.
- 3 The company has three groups of assets costing £1,100 each, purchased six years, three years and one year ago (in each case at the end of the financial year). The net book value of plant and machinery at the balance sheet date (year 0) is:

Original cost	£ 3,300
Cumulative depreciation	(1,000)
Net book value	<u>2,300</u>

- 4 The tax written-down values of the plant and machinery pool, and the consequential timing difference, at the balance sheet date are:

Net book value	£ 2,300
Tax written-down value	(1,114)
Timing difference at end of year 0	<u>1,186</u>

*Scheduling the reversal of the deferred tax liability*

- 5 The future reversals of the liability are scheduled in Table 1 below. The future depreciation of the existing pool of fixed assets (column b) is compared with the future writing-down allowances available on the pool (column c) to determine the years of reversal of the capital allowances (column d). When forecasting capital allowances for future periods, it is assumed that allowances will be claimed as early as possible and that the residual values of the assets will equal those forecast for depreciation purposes.

TABLE 1

Years from now	Depreciation £	Capital allowances £	Reversal of timing difference £	Deferred tax liability (undiscounted) £
a	b	c	d = b-c	e = d x 30%
1	300	278	22	7
2	300	209	91	27
3	300	157	143	43
4	300	93	207	62
5	200	69	131	39
6	200	52	148	44
7	200	14	186	56
8	100	11	89	27
9	100	(17)*	117	35
10+	-	(52)	52	16
Total	2,000†	814	1,186	356

\* It is assumed that the plant and machinery pool on which the writing-down allowances are claimed will continue beyond year 9 and hence that the incremental effect of the sale of the third asset in year 9 will be to reduce the writing-down allowances obtained in that and following years.

† The future depreciation and capital allowances are £300 less than the net book value and tax written-down value respectively owing to the assumption that assets will be sold for £100 in each of years 4, 7 and 9.

*Discount rates*

- 6 The prices of and yields on UK Treasury gilts are published in the Financial Times. An appropriate post-tax rate is obtained by deducting the rate of tax that the entity pays on investment income (30 per cent) from these returns.

TABLE 2

Published information				Post-tax return (Bid yield less tax of 30%)
Years to maturity	Coupon rate %	Bid Price	Bid Yield %	
1	6	99.37	6.67	4.7
3	7	102.82	6.01	4.2
5	6.5	104.27	5.55	3.9
9	7.2	114.16	5.29	3.7
30	6	114.00	5.09	3.6

Appropriate rates of return for other maturity dates are estimated by interpolation. See column f of Table 3 below.

*Discounting the liability*

- 7 Table 3 below illustrates how the discounted liability of £290 is calculated. The guidance in the FRS notes that it may be possible to use simplifying assumptions without introducing material errors into the measurement of the discounted liability. In this example, all timing differences reversing in years 10 onwards are treated as reversing in year 10.

TABLE 3

Years from now	Deferred tax liability (undiscounted) £	Discount rate %		Deferred tax liability (discounted) £
<b>a</b>	<b>e</b> (from Table 1)	<b>f</b> (from Table 2)		<b>g</b> = $e/[(1+f)^a]$
1	7	4.7		7
2	27	4.4	i	25
3	43	4.2		38
4	62	4.0	i	53
5	39	3.9		33
6	44	3.8	i	35
7	56	3.8	i	43
8	27	3.7	i	20
9	35	3.7		25
10+	16	3.7	i	11
Total	356			290

i = estimate based on interpolation of rates known for years 1,3,5,9 and 30\*

- 8 The discount reduces the deferred tax liability at year 0 by £66, ie from £356 to £290.

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\* In practice, it might be possible to limit the number of rates used without introducing material differences. For example, in the above illustration, the rates could be simplified to:

4.5 per cent for short-term reversals (years 1-4)

3.8 per cent for medium-term reversals (years 5-9)

3.7 per cent for long-term reversals (years 10+).

## **APPENDIX II**

### **DISCLOSURE ILLUSTRATIONS**

The following illustrates how the disclosures required by paragraphs 60-65 of the FRS could be presented in the notes to the accounts. (Not illustrated is the disclosure that would be required of any deferred tax that had been charged or credited in the statement of total recognised gains and losses for the period.)

In this illustration, the analysis of the deferred tax charge for the period required by paragraph 60(a) of the FRS has been combined with the analysis of the current tax charge for the period required by paragraph 17 of FRS 16 'Current Tax'.

The reconciliation of the tax charge, illustrated as a reconciliation of monetary amounts in note 1(b) below, could alternatively be given as a reconciliation of the standard rate of tax to the effective rate.

**1 TAX ON PROFIT ON ORDINARY ACTIVITIES**

(a) Analysis of charge in period	200Y		200X	
	£m	£m	£m	£m
<i>Current tax:</i>				
UK corporation tax on profits of the period	40		26	
Adjustments in respect of previous periods	<u>4</u>		<u>(6)</u>	
		44		20
Foreign tax		<u>12</u>		<u>16</u>
<i>Total current tax (note 1(b))</i>		<b>56</b>		<b>36</b>
<i>Deferred tax:</i>				
Origination and reversal of timing differences	67		60	
Effect of increased tax rate on opening liability	12		-	
Increase in discount	<u>(14)</u>		<u>(33)</u>	
<i>Total deferred tax (note 2)</i>		<b>65</b>		<b>27</b>
<i>Tax on profit on ordinary activities</i>		<u><b>121</b></u>		<u><b>63</b></u>

**(b) Factors affecting tax charge for period**

The tax assessed for the period is lower than the standard rate of corporation tax in the UK (31 per cent). The differences are explained below:

	<b>200Y</b>	200X
	<u>£m</u>	<u>£m</u>
Profit on ordinary activities before tax	<u><b>361</b></u>	<u>327</u>
Profit on ordinary activities multiplied by standard rate of corporation tax in the UK of 31% (200X: 30%)	<b>112</b>	98
<i>Effects of:</i>		
Expenses not deductible for tax purposes (primarily goodwill amortisation)	<b>22</b>	10
Capital allowances for period in excess of depreciation	<b>(58)</b>	(54)
Utilisation of tax losses	<b>(17)</b>	(18)
Rollover relief on profit on disposal of property	<b>(10)</b>	-
Higher tax rates on overseas earnings	<b>3</b>	6
Adjustments to tax charge in respect of previous periods	<u><b>4</b></u>	<u>(6)</u>
<i>Current tax charge for period (note 1(a))</i>	<u><b>56</b></u>	<u>36</u>

**(c) Factors that may affect future tax charges**

Based on current capital investment plans, the group expects to continue to be able to claim capital allowances in excess of depreciation in future years but at a slightly lower level than in the current year.

The group has now used all brought-forward tax losses, which have significantly reduced tax payments in recent years.

No provision has been made for deferred tax on gains recognised on revaluing property to its market value or on the sale of properties where potentially taxable gains have been rolled over into replacement assets. Such tax would become payable only if the property were sold without it being possible to claim rollover relief. The total amount unprovided for is £21 million. At present, it is not envisaged that any tax will become payable in the foreseeable future.

The group's overseas tax rates are higher than those in the UK primarily because the profits earned in country X are taxed at a rate of 45 per cent. The group expects a reduction in future tax rates following a recent announcement that the rate of tax in that country is to reduce to 40 per cent.

No deferred tax is recognised on the unremitted earnings of overseas subsidiaries, associates and joint ventures. As the earnings are continually reinvested by the group, no tax is expected to be payable on them in the foreseeable future.

**2 PROVISION FOR DEFERRED TAX**

	<b>31.12.200Y</b>	31.12.200X
	<b>£m</b>	£m
Accelerated capital allowances	<b>426</b>	356
Tax losses carried forward	<u>-</u>	<u>(9)</u>
<i>Undiscounted provision for deferred tax</i>	<b>426</b>	347
Discount	<u>(80)</u>	<u>(66)</u>
<i>Discounted provision for deferred tax</i>	<u><b>346</b></u>	<u>281</u>
Provision at start of period	<b>281</b>	
Deferred tax charge in profit and loss account for period (note 1)	<u>65</u>	
Provision at end of period	<u><b>346</b></u>	

## APPENDIX III

### NOTE ON LEGAL REQUIREMENTS

#### *Great Britain*

- 1 The Companies Act 1985 sets out requirements for companies on accounting for provisions and current assets in general and deferred tax in particular. The main requirements that are directly relevant are set out in Schedule 4 and are summarised below.
- 2 Schedule 4 does not apply to banking and insurance companies and groups, nor to small companies to the extent that they choose instead to comply with the reduced requirements set out in Schedule 8. Requirements corresponding to those of Schedule 4 are set out for banking companies and groups in Schedule 9 and for insurance companies and groups in Schedule 9A.

#### *Recognition and measurement*

- 3 Paragraph 12(b) of Schedule 4 states the general requirement to provide for all liabilities that have arisen in respect of the financial year to which the accounts relate or a previous financial year. Under the full provision method of accounting for deferred tax a timing difference is viewed as creating a liability because, as a result of that timing difference, a future tax assessment will be higher than it would otherwise have been (whether or not the timing difference will be replaced).

4 Paragraph 89 of Schedule 4 defines provisions as:

“any amount retained as reasonably necessary for the purposes of providing for any liability or loss which is either likely to be incurred, or certain to be incurred but uncertain as to amount or as to the date on which it will arise.”

The deferred tax liabilities provided for in accordance with the FRS, which are typically uncertain in terms of both timing and amount, are categorised as provisions in the balance sheet formats prescribed by Schedule 4.

- 5 The reference to “liability or loss” in the definition of provisions needs to be considered in conjunction with the general requirement that the liabilities have arisen or are likely to arise *in respect of the financial year to which the accounts relate [or a previous financial year]*. Thus deferred tax can be regarded as giving rise to a liability that is required to be provided for only if the events causing the future reversal of a timing difference (such as a commitment to sell a revalued asset or to remit overseas earnings) have occurred before the end of the financial year. Without that past event the future ‘liability’ does not relate to the financial year or a previous financial year.
- 6 In addition to covering liabilities that are certain to be incurred the statutory definition also refers to liabilities as losses that are likely to be incurred. Typically, if the events causing the future reversal of a timing difference have occurred, the deferred tax liability, although not certain, is likely to be incurred. An exception is the deferred tax that might be payable following the sale of a fixed asset, if it is not yet certain whether rollover relief will be obtained. The FRS requires such deferred tax to be provided for only if it is likely that rollover relief will not be obtained. The amount unprovided for is regarded as a contingent liability.

- 7 Paragraph 34(3)(b) of Schedule 4 allows taxation to be transferred to or from the revaluation reserve if it relates to any profit or loss credited or debited to that reserve. Paragraph 34(4) requires the treatment for taxation purposes of amounts credited or debited to the revaluation reserve to be disclosed. The FRS requires the deferred tax to be included either in the profit and loss account or directly in the statement of total recognised gains and losses and requires the amounts to be disclosed.

*Presentation and disclosure*

- 8 Paragraph 3(6) of Schedule 4 requires the profit and loss accounts of companies to show the profit or loss on ordinary activities before taxation.
- 9 The balance sheet formats set out in Schedule 4 require provisions for taxation, including deferred taxation, to be included within the total for provisions for liabilities and charges. Provisions for taxation need not be shown separately on the face of the balance sheet (paragraph 3(4)), providing that material amounts are disclosed in a note to the accounts. Paragraph 47 requires the provision for deferred taxation to be shown separately from any other tax provision. Paragraph 46 requires the movements on provisions for taxation to be disclosed in a note to the accounts.
- 10 Paragraph 5 of Schedule 4 states that assets and income should not be offset against liabilities and expenditure in the balance sheet and profit and loss account. Deferred tax debit and credit balances that arise with the same taxation authority and that the entity would have a right to settle on a net basis are not separate assets and liabilities and should therefore be shown on a net basis in the financial statements. Net debit balances, however, must be shown as assets rather than as negative amounts within provisions. The formats

set out in Schedule 4 do not specify a heading for net deferred tax assets but paragraph 3(2) permits assets not covered by the prescribed headings to be included in the balance sheet. The FRS requires material deferred tax assets to be included as a separate subheading within debtors. Note (5) on the balance sheet formats requires the amount falling due after more than one year to be shown separately for each item included under debtors.

- 11 Paragraph 50(2) of Schedule 4 requires the following information to be given in respect of any contingent liability not provided for:
- (a) the amount or estimated amount of that liability;
  - (b) its legal nature; and
  - (c) whether any valuable security has been provided by the company in connection with that liability, and if so, what.

Any deferred tax not provided for because it is expected that rollover relief will be obtained is a contingent liability. The FRS requires the estimated amount and the circumstances in which it will become payable to be disclosed.

- 12 Paragraph 54(2) of Schedule 4 requires any special circumstances affecting the liability to tax on profits, income or capital gains for the current or future years to be disclosed. The FRS details specific circumstances that should be disclosed.

*Impact on distributable profits*

- 13 As discussed in paragraphs 3 and 4 above, the deferred tax provisions that are required to be recognised by the FRS are, in general, regarded as liabilities that arise from past events and, hence, as ‘provisions for liabilities and charges’ of the type given in paragraph 89 of Schedule 4. Section 275(1) requires provisions of the type mentioned in paragraph 89 of Schedule 4 to be treated as realised losses for the purposes of determining a company’s profits available for distribution.
- 14 The FRS additionally requires deferred tax to be provided for when assets are revalued to their fair values with changes being recorded in the profit and loss account. In such circumstances, the purpose of the deferred tax is to recognise the tax attributable to the gain resulting from the change in fair value. As such a gain on which deferred tax is provided for is regarded as unrealised, the deferred tax on that gain should be treated as a reduction in that unrealised gain rather than a realised loss. The fact that the deferred tax is presented with other tax provisions within the heading ‘provisions for liabilities and charges’ does not alter that position.

***Northern Ireland***

- 15 The statutory requirements in Northern Ireland are set out in Schedule 4 to the Companies (Northern Ireland) Order 1986. They are identical to and have the same paragraph references as those cited above for Great Britain.

***Republic of Ireland***

- 16 The statutory requirements in the Republic of Ireland that correspond to those listed above for Great Britain are shown in the following table.

<i>Great Britain</i>	<i>Republic of Ireland</i>
section 275(1) of the Companies Act 1985	section 45(4) of the Companies (Amendment) Act 1983 and paragraphs 69 and 70 of the Schedule to the Companies (Amendment) Act 1986.
Schedule 4 to the Companies Act 1985:	Companies (Amendment) Act 1986:
paragraph 3(2), 3(4) and 3(6)	section 4(12), 4(6) and 4(16)
paragraph 5	section 4(11)
paragraph 12(b)	section 5(c)(ii)

Schedule 4 to the Companies Act 1985:	The Schedule to the Companies (Amendment) Act 1986:
note (5) on the formats	note 4 on the formats
paragraph 34(4)	paragraph 22(5)
paragraph 46	paragraph 32
paragraph 47	paragraph 33
paragraph 50(2)	paragraph 36(2)
paragraph 54(2)	paragraph 40(2)
paragraph 89	paragraph 70
Schedule 8 to the Companies Act 1985	no equivalent
Schedule 9 to the Companies Act 1985	European Communities (Credit Institutions: Accounts) Regulations 1992
Schedule 9A to the Companies Act 1985	European Communities (Insurance Undertakings: Accounts) Regulations 1996

- 17 There is no equivalent to paragraph 34(3)(b) of Schedule 4 to the Companies Act 1985.

## APPENDIX IV

### COMPLIANCE WITH INTERNATIONAL ACCOUNTING STANDARDS

- 1 The International Accounting Standard (IAS) that addresses deferred tax is IAS 12 (revised 1996) 'Income Taxes'. Like the FRS, IAS 12 (revised) requires deferred tax to be recognised on a full provision basis. But it requires deferred tax to be recognised on the basis of 'temporary differences' rather than on the basis of obligations arising from timing differences. The conceptual differences between temporary differences and timing differences are explained in Appendix V 'The development of the FRS'. This appendix sets out the resulting differences in the requirements of the two standards.
- 2 The circumstances in which deferred tax is provided for are wider under IAS 12 (revised) than under the FRS. This is for two reasons: temporary differences can arise from both timing and permanent differences; and IAS 12 (revised) requires provisions to be made even when the critical events causing the deferred tax to become payable in future have not occurred by the balance sheet date. The main areas where compliance with IAS 12 (revised) could require additional provisions to be recognised by UK and Irish companies are set out in the following table.

*Differences between the recognition requirements of IAS 12 (revised 1996) and those of the FRS*

Circumstances giving rise to deferred tax	Deferred tax required to be recognised:	
	by FRS 19	by IAS 12 (revised 1996)
1 Revaluation of non-monetary assets	Provision is required only if either: (a) the asset is revalued to fair value each period with changes in fair value being recognised in the profit and loss account; or (b) the entity has entered into a binding agreement to sell the revalued asset, has revalued the asset to its selling price and does not expect to obtain rollover relief.	Provision is required whether or not it is intended that the asset will be sold and whether or not rollover relief could be claimed.
2 Sale of assets, where gain has been or might be rolled over into replacement assets.	Provision is required only if rollover relief has not been obtained and is not expected to be obtained.	Provision is required. The deferred tax is measured on the difference between the replacement asset's cost and its tax base (ie cost less taxable gain rolled over).

Circumstances giving rise to deferred tax	Deferred tax required to be recognised:	
	by FRS 19	by IAS 12 (revised 1996)
3 Adjustments to recognise assets and liabilities at their fair values on the acquisition of a business.	The amendment to FRS 7 'Fair Values in Acquisition Accounting' introduced by FRS 19 requires deferred tax to be provided for as if the adjustments had been gains or losses recognised before the acquisition. Deferred tax would not normally be recognised on adjusting non-monetary assets to market values. No provision is recognised in respect of acquired goodwill.	Provision is made for all differences between the fair values recognised for assets and liabilities and their tax bases. The only exception is that no provision is required in respect of the temporary difference arising on the recognition of non-deductible goodwill.
4 Unremitted earnings of subsidiaries, associates and joint ventures.	Provision is required only to the extent that dividends payable by a subsidiary, associate or joint venture have been accrued at the balance sheet date or a binding agreement to distribute the past earnings in future has been made.	Provision is required on the unremitted earnings of associates in all circumstances. Provision is required on the unremitted profits of subsidiaries, branches and joint ventures if either the parent/investor is unable to control the timing of the remittance of the earnings or it is probable that remittance will take place in the foreseeable future.

Circumstances giving rise to deferred tax	Deferred tax required to be recognised:	
	by FRS 19	by IAS 12 (revised 1996)
5 Exchange differences arising on consolidation of non-monetary assets of an entity accounted for under the temporal method.	No provision is required because there is no timing difference.	Provision is required on the temporary difference between the carrying amount (at historical exchange rates) and the tax base (at balance sheet date exchange rates).
6 Unrealised intragroup profits (for example, in stock) are eliminated on consolidation.	Provision is required on the timing difference, ie the profit that has been taxed but not recognised in the consolidated financial statements. It is therefore measured using the supplying company's rate of tax.	Provision is required on the temporary difference. IAS 12 (revised) states that this is the difference between the (reduced) carrying amount of the stock in the balance sheet and its higher tax base (the amount paid by the receiving company). The provision is measured using the receiving company's rate of tax.

- 3 The requirements in the FRS regarding the rates of tax used to measure deferred tax assets and liabilities are very similar to those in IAS 12 (revised). However, IAS 12 (revised) does not permit deferred tax balances to be discounted.

- 4 The FRS requires deferred tax to be shown separately on the face of the balance sheet if the amounts are so material that failure to do so could cause readers to misinterpret the financial statements. IAS 12 (revised) requires all (material) deferred tax balances to be shown separately on the face of the balance sheet.
- 5 The amendment to FRS 7 'Fair Values in Acquisition Accounting' introduced by FRS 19 refers to previously unrecognised deferred tax assets (typically carried forward losses) that meet the criteria for recognition as a result of the acquisition. The amendment requires the benefit of the assets to be recognised as part of the fair value exercise only if the assets have arisen in the acquired entity: if the assets have arisen in the acquiring entity, the benefit is required to be recognised as part of post-acquisition performance. IAS 22 'Business Combinations' requires the benefit to be recognised as part of the fair value exercise whether the assets have arisen in the acquired or the acquiring entities.
- 6 The disclosures required by the FRS are similar overall to those required by IAS 12 (revised). The main differences comprise:
  - (a) *disclosures required by IAS 12 (revised) but not by FRS 19:*
    - the aggregate amount of temporary differences associated with investments in subsidiaries, branches, associates and joint ventures for which deferred tax liabilities have not been recognised
    - the tax expense relating to discontinued operations;

(b) *disclosures required by FRS 19 but not by IAS 12 (revised):*

- disclosures of the effects of discounting
- a general explanation of circumstances that have affected the current and total tax charges for the current period or that may affect the charges in future periods
- the circumstances in which deferred tax relating to revaluation and rolled over gains (and other deferred tax unprovided for) would become payable and an indication of the amounts that are expected to become payable in the foreseeable future;

(c) *other differences*

IAS 12 (revised) requires disclosure of a reconciliation of the entity's actual tax charge (current and deferred) for the period to the tax that would be payable using a standard rate of tax. The FRS requires a different reconciliation to be disclosed: a reconciliation of the *current* tax assessed for the period to a standard rate of tax. (It is of note, however, that although the two reconciliations are different, the IAS 12 (revised) reconciliation can be constructed from information required to be disclosed by the FRS.)

## APPENDIX V

### THE DEVELOPMENT OF THE FRS

#### Contents

	<i>Paragraphs</i>
<b>Requirement for full provision</b>	<b>1-22</b>
<i>The source of deferred tax</i>	1-3
<i>Three methods of accounting for tax</i>	4-11
<i>Reasons for rejecting the partial provision method</i>	12-19
<i>Reasons for rejecting flow-through accounting</i>	20-22
<b>Recognition criteria—incremental liability approach</b>	<b>23-75</b>
<i>Overview</i>	23-27
<i>Reasons for rejecting the temporary difference approach</i>	28-37
<i>Reasons for adopting the incremental liability approach</i>	38-52
<i>Detailed aspects of the recognition requirements</i>	53-75
<b>Recoverability of deferred tax assets</b>	<b>76-79</b>
<b>Measurement—tax rates</b>	<b>80-83</b>
<b>Measurement—discounting</b>	<b>84-123</b>
<i>Overview</i>	84
<i>Arguments for and against discounting</i>	85-99
<i>Reasons for making discounting optional</i>	100-105
<i>Detailed requirements for discounting</i>	106-123
<b>Presentation of deferred tax balances</b>	<b>124-130</b>
<b>Disclosures</b>	<b>131-138</b>
<b>Amendment to FRS 7</b>	<b>139-146</b>
<b>Changes to requirements proposed in FRED 19</b>	

## THE DEVELOPMENT OF THE FRS

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### REQUIREMENT FOR FULL PROVISION

#### *The source of deferred tax*

- 1 In most tax jurisdictions, including the UK and the Republic of Ireland, the starting point for computing corporation tax is the accounting profit as reported in the financial statements. However, adjustments are made to the accounting profit to arrive at taxable profits. These differences can be analysed into two types: ‘permanent’ and ‘timing’.
- 2 Permanent differences arise because certain gains or losses that are recognised in the financial statements are not taxable or tax-deductible at all. An example is a non-taxable government grant. Timing differences arise when gains or losses are recognised in accounting profits in periods different from those in which they are recognised in taxable profits. An example is a capital allowance that is obtained before the depreciation of the asset to which it relates is recognised in the financial statements.
- 3 Because timing differences reverse, tax charged in later periods may be increased or reduced as a result of transactions or events that have taken place before the balance sheet date. The issue in accounting for deferred tax is the extent to which provision should be made for the future tax consequences of past transactions and events. Three different methods—flow-through accounting, full provision and partial provision—exist.

### ***Three methods of accounting for tax***

#### *Flow-through accounting*

- 4 Flow-through accounting makes no provision at all for deferred tax. Rather, tax is accounted for as it is assessed.
- 5 The rationale for this method of accounting is that tax is assessed annually on profits as determined for tax purposes, not on accounting profits. The tax authorities impose a single tax assessment on the entity and that is its only liability to tax for that period. Any tax assessed in future years will depend on future events and hence is not a present liability as defined in the Board's Statement of Principles for Financial Reporting.
- 6 Supporters of flow-through accounting also argue that it is the most transparent and intuitively sensible way of communicating an entity's tax position. The financial statements show the actual tax charge for the year in the clearest possible manner, and the associated notes (which would disclose such matters as accumulated timing differences and the items reconciling the actual tax charge to a standard rate) would be no more detailed and possibly more intelligible than those resulting from other possible accounting methods.

- 7 Some supporters of flow-through accounting further argue that even if, in principle, timing differences did give rise to tax liabilities,\* in practice such liabilities could not always be measured reliably. The future tax consequences of current transactions depend upon a complex interaction of future events, such as the profitability, investment and financing transactions of the entity, and changes in tax rates and laws. Only those that could be measured reliably—typically very short-term discrete timing differences—should be provided for. Thus they advocate a modified flow-through approach.

*Full provision method*

- 8 The full provision method is based on the view that every transaction has a tax consequence and it is possible to make a reasonable estimate of the future tax consequences of transactions that have occurred by the balance sheet date. Such future tax consequences cannot be avoided: whatever happens in future, the entity will pay less or more tax as a result of the reversal of a timing difference that exists at the balance sheet date than it would have done in the absence of that timing difference. Deferred tax should therefore be provided for in full on timing differences.

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\* To avoid making the text unduly cumbersome, this discussion focuses on deferred tax liabilities (which tend to be more significant and frequent than deferred tax assets). The same principles extend to deferred tax assets, although the precise arguments may be slightly different.

*Partial provision method*

- 9 The partial provision method also starts from the premise that the future reversal of timing differences gives rise to a tax asset or liability. However, rather than focusing on the individual components of the tax computation, the partial provision method emphasises the interaction of those components in a single net assessment. To the extent that timing differences are expected to continue in future (ie the existing timing differences being replaced by future timing differences as they reverse), the tax is viewed as being deferred permanently.
- 10 Where, for example, fixed asset expenditure attracts tax deductions before the fixed assets are depreciated, timing differences arise. The timing differences increase with time under conditions of inflation or expansion, with the result that new timing differences more than replace those that reverse. In consequence, effective tax rates are reduced. The partial provision method allows the lower effective tax rates to be reflected in the profit and loss account, to the extent that the reduction is not expected to reverse in future years.
- 11 The attraction of the partial provision method is that it reflects an entity's ongoing effective tax rate. It results in tax charges that reflect the amount of tax that it is expected will actually be paid and excludes amounts that are expected to be deferred 'permanently'.

***Reasons for rejecting the partial provision method***

- 12 The FRS supersedes SSAP 15 ‘Accounting for deferred tax’. SSAP 15 required deferred tax to be accounted for using the partial provision method.
- 13 SSAP 15 and the partial provision method were first implemented in the UK and the Republic of Ireland in 1978, when they were viewed as a pragmatic response to the corporation tax system of the time. A key feature of that system was very generous capital and stock allowances: companies could deduct for tax purposes 100 per cent of the cost of plant and equipment in the year of purchase and inflationary increases in the value of stock. The effect of these deductions was that companies could indefinitely postpone payment of some or all of their deferred tax and paid tax at well below the enacted rate of 52 per cent.
- 14 The partial provision method allowed companies to avoid creating provisions for tax that they argued they were unlikely to pay. However, by the early 1990s, concerns were being expressed about the method and the way in which it was being applied. It was noted in particular that:
  - the recognition rules and anticipation of future events were subjective and inconsistent with the principles underlying other aspects of accounting.
  - the partial provision method had not been regarded as appropriate for dealing with the long-term deferred tax assets associated with provisions for post-retirement benefits. As a result, SSAP 15 had been amended in 1992 to permit such assets to be accounted for on a full provision basis. The amendment introduced inconsistencies into SSAP 15.

- there were variations in the way in which SSAP 15 was applied in practice. Different entities within the same industry and with similar prospects seemed to take quite different views on the levels of provisions necessary. There was evidence that some companies provided for deferred tax in full for simplicity's sake rather than because their circumstances required it. The different approaches being taken reduced the comparability of financial statements.
  - because of its recognition rules and anticipation of future events, the partial provision method was increasingly being rejected by standard-setters in other countries. The US Financial Accounting Standards Board (FASB) had issued a standard FAS 109 'Accounting for Income Taxes' requiring full provision. The International Accounting Standards Committee (IASC) had published proposals for similar requirements and other standard-setters had started to move in the same direction.
- 15 When rejecting the partial provision method, the FASB and IASC argued in particular that:
- (a) every tax timing difference represented a real liability, since every one would reverse and, whatever else happened, an entity would pay more tax in future as a result of the reversal than it would have done in the absence of the timing difference.
  - (b) it was only the impact of new timing differences arising in future that prevented the total liability from reducing. It was inappropriate (and inconsistent with other areas of accounting) to take account of future transactions when measuring an existing liability.

- (c) the assessment of the liability using the partial provision method relied on management intentions regarding future events. Standard-setters were uncomfortable with this, having already embodied in a number of other standards the principle that liabilities should be determined on the basis of obligations rather than management decisions or intentions.
- 16 In view of the criticisms of the partial provision method, the Board decided to review SSAP 15. In 1995 it published a Discussion Paper ‘Accounting for Tax’. The Discussion Paper proposed that SSAP 15 should be replaced with an FRS requiring full provision for deferred tax.
- 17 Most respondents to the Discussion Paper opposed the move to full provision at that stage, preferring instead to retain the partial provision method. In the meantime, however, IASC had approved its standard, IAS 12 (revised 1996) ‘Income Taxes’, which required use of the full provision method. The Board reconsidered the arguments and arrived at the view that:
- whilst it did not agree with all of the criticisms of the partial provision method expressed internationally and could see the logic for all three methods of accounting for tax, it shared some of the concerns regarding the subjectivity of the partial provision method and its reliance on future events; and
  - as more companies adopted international accounting standards, the partial provision method would become less well understood and accepted, particularly as it was regarded as less prudent than the internationally accepted method. Hence, the retention of the partial provision method in the UK could damage the credibility of UK financial reporting.

- 18 For these reasons, the Board took the view that deferred tax was not an area where a good case could be made for departing from principles that had been widely accepted internationally. Following informal consultations, it developed a draft FRS, FRED 19 'Deferred Tax', which proposed requirements based more closely on a full provision method. The FRED was published for consultation in August 1999.
- 19 The responses to FRED 19 indicated that, whilst many amongst the financial community remained disappointed that there had not been international acceptance of the partial provision method, most accepted the arguments for greater harmonisation with international practice and supported the proposed move to a full provision method.

***Reasons for rejecting flow-through accounting***

- 20 For the reasons outlined in paragraphs 5-7 above, a number of Board members believe that the clearest and most transparent method of communicating an entity's tax position is by flow-through accounting combined with detailed disclosures. The possibility of moving to flow-through accounting was therefore suggested in the Board's Discussion Paper.
- 21 However, flow-through accounting would not have moved UK accounting more into line with international practice and received little support from those responding to the Board's Discussion Paper. Most respondents agreed with the view that taxable profit was, in both form and substance, an adjusted accounting profit and that it was possible to attribute tax effects to individual transactions. Further, they

regarded tax systems as sufficiently stable to allow reasonable estimates to be made of the deferred tax consequences of events reported up to the balance sheet date. They added their concerns that flow-through accounting would make their results more volatile, could sometimes understate an entity's liability to tax and that any modification to it would require arbitrary cut-off points that could be difficult to rationalise.

- 22 In view of the lack of support from respondents and the Board's commitment to international harmonisation, Board members who would have preferred flow-through accounting accepted that the FRS should instead require full provision for deferred tax.

## **RECOGNITION CRITERIA— INCREMENTAL LIABILITY APPROACH**

### ***Overview***

- 23 Traditionally, deferred tax has been identified and recognised on the basis of timing differences. And, even under full provision methods, not all types of timing difference have necessarily been provided for. Varying approaches have been taken, depending on views regarding the nature and purpose of deferred tax.
- 24 A completely different approach, which requires deferred tax to be recognised on 'temporary' rather than timing differences, was developed for FAS 109 and adopted in IAS 12 (revised).

- 25 Given that the move to full provision accounting in the UK was driven primarily by international harmonisation, it would have been ideal if the requirements of the FRS could have mirrored those of IAS 12 (revised). However, the Board did not accept some of the assumptions underlying the temporary difference approach and opposed some of the practical consequences of the approach. The Board therefore considered alternative approaches that did not rely on the same assumptions and were designed to be consistent with its Statement of Principles for Financial Reporting.
- 26 The Board developed two approaches. The first required deferred tax to be recognised only when it could be regarded as meeting the definition of an asset or a liability in its own right (the 'incremental liability' approach). The second required deferred tax to be recognised as a necessary adjustment to the values at which other assets and liabilities were recognised (the 'valuation adjustment' approach).
- 27 Most Board members preferred the incremental liability approach and based the requirements of FRED 19 on this approach. A majority of respondents who expressed a preference supported the proposed approach, with the rest supporting either a valuation adjustment approach or full harmonisation with IAS 12 (revised). The incremental liability approach therefore remains the approach on which the requirements in the FRS have been based.

### ***Reasons for rejecting the temporary difference approach***

#### *The meaning of ‘temporary difference’*

- 28 A temporary difference is defined as any difference between the amount at which an asset or liability is recognised in financial statements and its tax base. The tax base is the amount that will be deductible or taxable in respect of the asset or liability in the future.
- 29 Most temporary differences are created by timing differences. For example, the tax base of a fixed asset that attracts capital allowances is its cost less allowances received. A temporary difference arises if the tax base is less than the net book value recognised in the financial statements. The temporary difference equals the timing difference created if the allowances received have exceeded depreciation.
- 30 But temporary differences can also be created by permanent differences between accounting profits and taxable profits. If a government grant is non-taxable, any portion that is deferred as a liability has a tax base of zero. Similarly, a non-deductible cost capitalised as an asset has a tax base of zero. In some tax jurisdictions, certain fixed asset expenditure is ‘super-deductible’ and qualifies for tax allowances for, say, 150 per cent of cost. The tax base will initially be greater than cost. In each of these cases, a temporary difference arises as soon as the asset or liability is recognised.

*Rationale for the temporary difference approach*

- 31 The rationale for recognising deferred tax on temporary differences is that the entity should provide for the unavoidable tax consequences of recovering the carrying values of assets or settling liabilities at the amounts shown in the accounts. It is argued that it is inherent in the carrying value of an asset that the asset will generate pre-tax cash flows of at least equal to that carrying value. Any tax payable on generating such cash flows is therefore inherently a liability of the entity. The temporary difference measures the amount on which tax will be payable.

*Reasons for rejecting the temporary difference approach*

- 32 The Board did not accept one of the fundamental assumptions underlying the temporary difference approach, ie that the carrying value of an asset represented the minimum *pre-tax* cash flows that the asset would generate. It identified circumstances in which tax cash flows might also be reflected in the carrying value. For example, if an entity had bought a non-deductible asset for 100 and carried it at its historical cost of 100, this would not be because it had expected to generate pre-tax cash flows of 100, on which it would pay tax of 33. Rather it would have expected to generate pre-tax cash flows of at least 150, on which it would pay tax of 50. The carrying value of 100 would therefore have already taken account of future tax cash flows.
- 33 The circumstances in which future tax cash flows are *not* reflected in the carrying value of an asset (and hence should potentially be provided for) are those in which there has been a timing difference. This could

arise when one of the future tax cash flows inherent in the original cost of an asset had been received without the asset having been depreciated (as would be the case on receipt of an accelerated capital allowance). Or it could arise when an asset had been revalued to a market value that assumed the whole cost was deductible.

- 34 Thus the Board concluded that deferred tax should be provided for on timing but not permanent differences.
- 35 IASC board members also had concerns about the need to provide for deferred tax on permanent differences. They decided that, as an exception to the general rule that deferred tax should be provided for on all temporary differences, IAS 12 (revised) should not require recognition of deferred tax arising on initial recognition of an asset or liability (ie permanent differences).
- 36 In the Board's view, a standard based on timing differences would be preferable to IAS 12 (revised), which is based on temporary differences but permits exceptions for temporary differences that are not timing differences. In the Board's view, a timing difference approach would not only be easier to justify conceptually, it would also be simpler to understand and apply. Timing differences are relatively easily identified from tax computations. Temporary differences can be more difficult to identify and measure. A substantial amount of guidance was required in IAS 12 (revised).
- 37 A substantial majority of respondents to FRED 19 supported the Board's decision not to adopt the temporary difference approach.

## ***Reasons for adopting the incremental liability approach***

### *Overview*

- 38 There are two different views on how an approach based on timing differences should be implemented. The first view is that deferred tax should be recognised only when it meets the strict criteria for recognition as a liability (or asset) in its own right—the incremental liability approach. The alternative view is that deferred tax should be recognised even if it does not itself meet the strict recognition criteria if it can be regarded as a necessary adjustment to the values at which other assets and liabilities are recognised—the valuation adjustment approach. The requirements of the FRS are based on an incremental liability approach.

### *Incremental liability approach*

- 39 The Board’s Statement of Principles for Financial Reporting defines liabilities as “obligations of an entity to transfer economic benefits as a result of past transactions or events”.<sup>\*</sup> The assessment of whether deferred tax is a liability requires conclusions to be reached about whether the transactions and events giving rise to an obligation to pay tax in future (the obligating events) are past events, ie have occurred at the balance sheet date.

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<sup>\*</sup> Paragraph 4.23, *Statement of Principles for Financial Reporting*

- 40 Typically, a series of events must take place before an entity becomes required to pay tax: the entity must undertake a potentially taxable transaction, generate taxable profits and be required by tax laws to pay tax on these profits. The Statement of Principles provides guidance:

“Sometimes a series of events must take place before the entity will have an obligation to transfer economic benefits. In such circumstances, whether the obligation exists depends on whether any of the events that have still to take place are under the entity’s control. If they are, the entity retains discretion to avoid the transfer, so no obligation exists.”\*

Thus the obligating event is the one that leaves the entity with no realistic alternative to paying tax, or in other words the event that will trigger the reversal of a timing difference in future.

- 41 For most types of timing difference, the events that trigger the reversal of the timing difference can be regarded as having taken place by the year-end. Suppose, for example, that the entity has accrued interest on cash deposits, but will pay tax on that interest only when it is received. Having placed the funds on deposit, it has a right to the interest they will generate. And by recognising the right to the interest, it also has to recognise the obligation to pay tax on that interest. The entity no longer has the discretion to avoid paying the tax. And as the future events that will confirm the existence of the liability (ie the inclusion of the interest received in a future tax computation and a request for the payment of tax based on that computation) are relatively certain, they do not affect its recognition.

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\* Paragraph 4.32, *Statement of Principles for Financial Reporting*

- 42 However, this is not the case with timing differences arising when assets are revalued. In the UK, the revaluation of a fixed asset to its replacement cost is not a taxable event. The taxable event is the sale of the revalued asset. Therefore, as long as the management of the entity has the discretion not to sell the fixed asset, the entity does not have an obligation to pay any tax as a result of the increase in value. An obligation can arise only when the reporting entity enters into a binding sale agreement.
- 43 Similarly, a parent company can incur a tax liability when the earnings of overseas subsidiaries, associates and joint ventures are remitted to it, for example by the payment of a dividend. Therefore, the existence of unremitted earnings can be regarded as giving rise to a tax timing difference. However, their existence does not give rise to an obligation to pay tax, as long as the entity has the discretion to avoid remitting the earnings. The obligating event is the distribution of earnings. Hence, the liability arises, and, under an incremental liability approach, should be recognised, only when a dividend is accrued as receivable or a binding agreement has been made for the sale of the investment.
- 44 Following the incremental liability approach, therefore, leads to a conclusion that deferred tax should not be provided for on timing differences arising from revaluation of assets or non-remittance of earnings to the parent entity. The obligating event has not occurred and the entity does not have a liability at the balance sheet date.

*Valuation adjustment approach*

- 45 An alternative view is that, even where timing differences do not give rise to obligations in their own right, recognition of deferred tax could still be argued to be consistent with the Board's Statement of Principles. The argument would be that the deferred tax might need to be provided for in order to ensure that other assets were not valued at more than their economic (ie post-tax) values to the business.
- 46 Suppose, for example, that a company revalued an asset such as a building to its market value of 100. A timing difference would arise because the revaluation gain would be taxable only if and when the asset was sold. This timing difference would not in itself give rise to an obligation to pay more tax in future. But the valuation adjustment argument would be that deferred tax should be provided for to reflect the fact that the economic value to the business was not the market value of 100. Rather, in principle, it was the market value of 100 less the present value of the tax that would be payable on selling the asset for 100.
- 47 The valuation adjustment argument would apply even when the purpose of revaluing the asset to market value was to recognise its replacement cost rather than its net realisable value. It would be argued that the market values were established in the expectation that the full market value would be tax-deductible on sale (or earlier, if capital allowances were available). Unadjusted market value would not reflect that there would be more tax payable on the sale of the existing asset than there would be on the sale of an asset purchased at the market value. The true economic replacement cost of the existing asset would be measured by valuing the asset at the market value of an 'equivalent' asset and then adjusting it by providing for deferred tax.

- 48 The present value of the additional tax paid on the sale of a revalued asset would depend on *when* that tax was paid. Hence, deferred tax provided for on revaluation gains would in theory be discounted. Where an asset was not eligible for capital allowances and there was an assumption that it would be retained in the business (or replaced only when rollover relief could be claimed), the difference in the future tax deductions would materialise only very far into the future or perhaps not at all. In such cases it could be argued that the present value of the tax on the revaluation gain was negligible. A valuation adjustment approach could be simplified to require deferred tax to be provided for on revaluation gains only if it were expected that the timing difference would reverse without rollover relief being obtained.
- 49 In theory, deferred tax provided for as a valuation adjustment rather than as a liability might most appropriately be reflected by netting the tax provision against the value of the asset. However, it is generally accepted, both in the UK and internationally, that an entity's results and position are more clearly communicated if tax effects are shown separately from the items or transactions to which they relate.

*Reasons for adopting the incremental liability approach*

- 50 A minority of Board members favoured the valuation adjustment approach. They regarded it as important that assets recognised at their fair values—and in particular financial assets and assets adjusted to their fair values on acquisition—should be recognised at their true economic fair values, taking into consideration all future cash flows, including tax. Unless a valuation adjustment approach was adopted, assets could be valued at more than their economic (ie

post-tax) recoverable amounts. The Board members also noted that an FRS based on a valuation adjustment approach would more closely align UK accounting requirements with those of IAS 12 (revised).

51 However, most Board members favoured the incremental liability approach. They took the view that:

- the incremental liability approach was more clearly consistent with FRS 12 ‘Provisions, Contingent Liabilities and Contingent Assets’ than one that recognised deferred tax liabilities that were not obligations.
- the valuation adjustment approach relied on theoretical models of the way in which asset values were determined. The fact that these models did not always hold in practice, combined with the difficulty in estimating the amount and timing of tax that was likely to be paid on the possible future sale of an asset, meant that the deferred tax provisions could be somewhat artificial. The tax position would be communicated much more clearly to users by recognising the amounts payable only when the entity became obliged to pay them.
- the effect of the creation and reversal of provisions under a valuation adjustment approach could be simply to standardise the tax charge rather than reflect the accrual and eventual payment of tax. For example, if a revalued asset was recovered through use in the business (ie depreciation) rather than sale, any deferred tax provision recognised on revaluing the asset would simply be reversed over the life of the asset, without any tax having become payable.

- 52 Accepting the views of the majority, the Board chose to base the FRS's requirements on the incremental liability approach. The way in which the detailed requirements fit into that approach is explained below.

***Detailed aspects of the recognition requirements***

*Accelerated capital allowances*

- 53 Capital allowances in excess of depreciation (accelerated capital allowances) give rise to timing differences, the reversals of which occur automatically in future and cannot be avoided by the reporting entity.
- 54 It was suggested to the Board that the receipt of an accelerated capital allowance for the purchase of an asset did not give rise to a deferred tax obligation since it would not in itself increase a future tax assessment. The entity had no more than a contingent liability to repay the allowance—it would be repayable only if the fixed asset was sold. Any future sale was a future event that should not be taken into account at the balance sheet date.
- 55 However, the Board took the view that, in commercial and economic terms, capital allowances were given for the loss arising from the consumption of the service potential of an asset—not simply for the purchase of the asset. An entity that had received capital allowances in excess of depreciation had received allowances in advance, ie on service potential that would be consumed in future. As with any consideration received in advance of performance, the entity had an obligation either to perform or to repay the consideration. This obligation remained until, as a result of future events, the service potential was consumed.

- 56 Hence, the Board concluded that under an incremental liability approach, deferred tax should be provided for on accelerated capital allowances.

*Industrial buildings allowances*

- 57 In general, allowances for capital expenditure are repayable to the tax authorities if the assets purchased are sold for more than their tax written-down value. However, this is not always the case. Industrial buildings allowances (IBAs),\* for example, are repayable only if the building is sold within a certain time—25 years of purchase.
- 58 FRED 19 did not specify whether and for how long deferred tax should be provided for on accelerated IBAs (or similar non-repayable allowances). Several respondents asked for clarification.
- 59 Some argued that, from the outset, the deferred tax was not a liability (or at least was no more than a contingent liability) because, like the deferred tax on a revaluation gain, it would be repayable only upon an uncertain future event within management's control, ie sale within 25 years. It should therefore be provided for only if and when there was an intention or commitment to sell.

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\* IBAs are given for expenditure on some buildings—factories, warehouses and hotels, and any commercial buildings in enterprise zones. Buildings in enterprise zones can qualify for 100 per cent first year allowances. Other industrial buildings receive IBAs at a rate of 4 per cent per year.

- 60 However, the Board noted that in this respect an IBA was no different from other capital allowances—all were repayable only if the asset was sold rather than being consumed within the business. The argument (in paragraph 55 above) for requiring accelerated capital allowances to be recognised as liabilities was that, until the conditions for retaining the allowances had been met (ie through consumption of the asset), they remained unearned—a liability had not been discharged—and hence should be provided for. The deferred tax on an accelerated capital allowance was different from that on a revaluation gain because it arose from a past event. Applying the same argument to accelerated IBAs led the Board to conclude that the deferred tax thereon should be provided for until the condition for retaining the IBAs (ie the expiry of 25 years) had been met. Thus, the FRS clarifies that accelerated capital allowances of all types should be recognised as liabilities until the conditions for retaining them (ie the expiry of 25 years) have been met.
- 61 One respondent further noted that if industrial buildings were not being depreciated (for example, if they were investment properties), and there was no intention of selling them within 25 years, the allowances could be regarded as giving rise to permanent differences. FRED 19 had proposed that deferred tax should not be provided for on permanent differences. The Board considered this suggestion but concluded that the obligation to repay an IBA remained until all conditions for retaining it had been met, irrespective of whether the asset was being depreciated. The requirement to provide for accelerated IBAs until the conditions for retaining them have been met therefore applies to depreciating and non-depreciating assets.

*Infrastructure assets*

- 62 The FRS requires deferred tax to be provided for on all accelerated capital allowances, including those arising on infrastructure assets that, in accordance with the requirements of FRS 15 ‘Tangible Fixed Assets’, are accounted for using renewals accounting. As clarified in the definitions section of the FRS, capital allowances obtained for such assets can give rise to timing differences in the same way as capital allowances obtained for any other assets.

*Assets continuously revalued to fair value with changes recognised in profit and loss account*

- 63 In line with the incremental liability approach on which it was based, FRED 19 proposed that deferred tax should not be recognised on revaluation gains. The rationale was that the rise in value of an asset was not an event that in itself obliged an entity to pay more tax in future.
- 64 A significant number of respondents, whilst accepting this approach for most types of revalued asset, regarded it as inappropriate where assets were ‘marked to market’, ie continuously revalued to fair value with changes being recognised in the profit and loss account. Such assets could include the investments of financial institutions and some commodities.
- 65 The respondents took the view that when assets were marked to market in this way, the gains and losses were recognised in the profit and loss account because, although not necessarily realised, they were readily realisable. To give a true and fair view of the entity’s performance, any tax that would be payable on realising the gains should also be recognised. The

respondents suggested that the arguments that deferred tax provisions on revaluation gains were somewhat artificial (paragraph 51 above) did not hold in these circumstances.

- 66 The Board accepted this view and amended the FRS to require deferred tax to be provided for if it arose when assets were marked to market with gains and losses being recognised in the profit and loss account.

*Current assets (other than those that are marked to market)*

- 67 It is rare for current assets (other than those, such as commodities, that are marked to market with gains and losses being recognised in the profit and loss account) to be held at fair value. But they are more frequently adjusted to their fair values on the acquisition of a business.
- 68 The FRS permits deferred tax to be recognised on the adjustment only if there is a binding agreement for the sale of the asset at the acquisition date and the gains and losses on selling the asset have also been recognised in the fair value exercise.
- 69 It was suggested to the Board that an entity always had a constructive or commercial commitment to sell stock, since that was the whole purpose of purchasing it in the first place. But the Board took the view that, whilst there could be an expectation that stock would be sold, the expectation alone did not give rise to a binding commitment.

- 70 It acknowledged that a binding agreement to sell stock could exist if goods were being manufactured under the terms of a binding contract. In such circumstances, one of the obligations associated with the contract was the obligation to pay tax on the profits made. But if the contract was being accounted for as an executory contract (ie if neither the rights nor the obligations had yet been recognised because both parties had yet to perform), it would be inappropriate to recognise the tax obligation alone.

*Rollover relief*

- 71 As an extension of the requirement not to provide for deferred tax on revaluation gains and losses, the FRS does not require deferred tax to be provided for on taxable gains that have been deferred via ‘rollover relief’.
- 72 Rollover relief can be claimed in a number of tax jurisdictions when the proceeds of sale of ‘qualifying’ assets (such as land and buildings) are reinvested in other qualifying assets within a specified period. The taxable gain is not charged to tax immediately but is instead rolled over into the replacement assets, becoming chargeable only if and when the replacement assets are sold.
- 73 The Board took the view that, where such rollover relief had been obtained, the entity retained the discretion to avoid paying tax on the chargeable gain. That tax would be paid only if and when the replacement assets were sold. Hence, where an entity had sold or agreed to sell an asset and had recognised the gain on sale, it still did not have a liability for any tax if it had already met the conditions for rolling the gain over into a replacement asset. (This would not be the case if the terms of the relief were different and merely postponed the payment of tax for a specified period.)

- 74 It was suggested that the justification for not providing for rolled-over gains (ie that the tax was not a liability because it would be deferred by the purchase of new assets) should also justify providing on a partial basis for accelerated capital allowances. However, the arguments are different. When a gain is rolled over into a replacement asset, it does not enter a tax computation and will not do so unless and until a decision is made to sell the replacement asset. It might not make future tax charges higher than they would otherwise have been. The tax authorities are in effect recognising successive assets as if they were a single asset. So, even using full provision arguments, the deferred tax should not be provided for. In contrast, an accelerated capital allowance will reverse automatically over the life of the asset, entering into a future tax computation and making a future tax assessment higher than it would otherwise have been, whether or not more assets are purchased. The purchase of another asset does not prevent the original accelerated capital allowance from reversing, it merely originates a new one that offsets it.
- 75 Tax legislation may allow rollover relief to be claimed even if the proceeds of sale are not reinvested immediately, but are reinvested within a specified period. In such circumstances, an entity could have sold or entered into a binding agreement to sell one asset by the balance sheet date without being certain that it would be able to roll the gain over into a replacement asset. The Board took the view that in such circumstances the deferred tax represented a contingent liability as defined in FRS 12 'Provisions, Contingent Liabilities and Contingent Assets'. Consistently with the recognition requirements in FRS 12, the FRS requires that for as long as it appears more likely than not that the entity will be able to roll over the gain, the deferred tax on that gain should not be provided for.

## RECOVERABILITY OF DEFERRED TAX ASSETS

*General recognition requirement—transfer of economic benefits*

- 76 Assets or liabilities are recognised only if there is sufficient evidence that the rights or obligations that give rise to them will result in the transfer of economic benefits in future.\* In respect of deferred tax assets and liabilities, there would be such a transfer of economic benefits only if the future reversal of the timing difference had an incremental effect on a future tax payment or receipt. This would be the case only if the reporting entity generated taxable profits in future (or tax losses that could be relieved against past taxable profits). If, instead, it were to generate unrelieved tax losses, the reversal of the timing differences would not result in any cash flows: it would simply alter the amount of losses for which no relief had been received. Deferred tax assets and liabilities should therefore be recognised only when there is evidence that the entity will make sufficient taxable profits in future for the reversal of the timing difference to affect the amount of tax actually paid.

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\* Chapter 4, *Statement of Principles for Financial Reporting*.

*Deferred tax liabilities*

- 77 In theory, therefore, there could be circumstances in which entities need not recognise deferred tax liabilities. However, the FRS requires all deferred tax liabilities to be recognised, without referring at all to future tax losses. The Board's rationale for this proposal was that:
- it was very unlikely that there would be persuasive evidence on which to base a prudent and reliable prediction that an entity that was a going concern was more likely than not to make tax losses in future that would remain unrelieved; and
  - a requirement to make a judgement on this matter would make the FRS more difficult to understand and apply.

*Deferred tax assets*

- 78 With deferred tax assets, the situation is slightly different. To recover a deferred tax asset, an entity would have to do more than simply *not make losses* in future: it would have to *make sufficient profits* that would be charged to tax if it were not for the reversal of the timing difference. Further, the need for prudence would suggest that more evidence of the likelihood of future profits was needed for recognition of a deferred tax asset than for recognition of a deferred tax liability. For these reasons, the FRS permits deferred tax assets to be recognised only when, on the basis of available evidence, it is more likely than not that there will be taxable profits in future against which the deferred tax asset can be offset. The requirements are the same as those of both FAS 109 and IAS 12 (revised).

- 79 SSAP 15 permitted deferred tax assets arising from tax losses to be recognised only if the availability of future taxable profits against which the losses could be offset was “assured beyond reasonable doubt”. The Board agreed that the recognition of tax losses as assets should be restricted, since the very existence of losses provided strong evidence that they would not be recovered. However, in the Board’s view, it was more appropriate to restrict the recognition of the losses by emphasising that the ‘more likely than not’ threshold must be met rather than by setting a recognition threshold that was higher than that set for other deferred tax assets (such as those arising on accruals for retirement benefits).

### **MEASUREMENT—TAX RATES**

- 80 The FRS follows IAS 12 (revised) in requiring deferred tax to be measured using tax rates that have been enacted or substantively enacted by the balance sheet date.
- 81 Although it could be argued that the rates used should instead be the best estimates of the future rates that would apply, the Board concluded that:
- given that future tax rates are influenced by political and economic considerations that are very difficult to predict, the best estimates of future tax rates would normally be the most recently enacted or substantively enacted rates
  - where there was evidence of possible future changes (for example, when proposals had been announced for consultation), it was generally difficult for individuals to assess the likelihood that the changes would be enacted. Different views could be taken and different rates used by different entities. Given that these entities would actually be paying tax at the same rate, such inconsistencies would be unhelpful.

- 82 Guidance has been given on the meaning of ‘substantively enacted’ in the UK and the Republic of Ireland to help ensure that the requirement is interpreted consistently. In developing this guidance the Board considered, but rejected, suggestions that a Budget announcement should be viewed as substantive enactment in the UK providing that the changes were very likely to be enacted. The Board took the view that ‘substantive enactment’ meant that the process of enactment was substantively complete. Whilst in some circumstances it could be very likely that a change proposed at the first reading of a Finance Bill would be enacted, the process of enactment was not at that stage substantively complete. In particular, the Bill still had to pass through committee and two further readings in the House of Commons. Similarly, in the Republic of Ireland, the process of enactment would not be substantively complete until the Bill had been passed by the Dail.
- 83 The FRS requires that, where tax rates are graduated—ie where different tax rates apply to different bands of taxable profit—entities should use the *average* rate expected to be paid in the year in which the timing difference reverses. IAS 12 (revised) has the same requirement. The Board was aware that arguments could be made for using instead the rate that applied to the bottom, or the top, band of taxable profits. However, it believed that there were insufficient grounds for departing from international practice in this respect, in particular because most UK companies were unaffected by graduated tax rates.

## MEASUREMENT—DISCOUNTING

### *Overview*

- 84 FRED 19 tentatively proposed that deferred tax balances should be discounted where the effect of discounting was material and asked for respondents' views on the proposal. In the light of the responses received, the Board decided that the FRS should neither prohibit nor require discounting but should allow entities a choice of accounting policy.

### *Arguments for and against discounting*

#### *Conceptual validity*

- 85 A key feature of the UK tax system is that there can be a significant delay between the recognition of certain items in the accounts and their recognition in a tax computation and vice versa. The delay suggests that there would be a case for discounting deferred tax assets and liabilities where the effect was material. However, views differ on whether there is a conceptual justification for discounting certain deferred tax balances, such as those arising from accelerated capital allowances.
- 86 The purpose of discounting is to measure future cash flows at their present value. It is therefore valid to discount deferred tax balances only if they can be viewed as representing future cash flows that are not already measured at their present value.

- 87 There are some types of timing differences that clearly represent future tax cash flows. Where, for example, an accrual is made for expenses that are to be paid far into the future and tax relief will be received only when the expenses are paid, the tax relief represents a future tax cash flow that should be discounted to its present value. In practice, however, it is rarely necessary to perform separate discounting calculations for this type of deferred tax, since long-term accruals, such as those for retirement benefits, are usually themselves measured on a discounted basis. Thus the timing differences already incorporate discounting and it is not appropriate to discount the resulting deferred tax as well.
- 88 Separate discounting would, however, be required if the timing difference giving rise to a future tax cash flow were not discounted. An example of such a timing difference is that provided for (in the limited circumstances set out in paragraph 12 of the FRS) on revaluation gains. Discounting of deferred tax on revaluation gains is discussed in paragraphs 47 and 48 above.
- 89 More controversial is the issue of whether it is valid to discount deferred tax when tax cash flows have already occurred. This situation arises most commonly when capital allowances have been received before an asset has been depreciated.
- 90 Undoubtedly, an entity that receives a capital allowance as soon as it purchases an asset is better off than one that receives the same allowance as it depreciates the asset. *Without discounting*, this benefit materialises in the form of higher interest income over the period in which the asset is being depreciated. *With discounting*, the benefit of the additional interest income is pulled forward and recognised immediately.

91 The question is whether the benefit should be recognised immediately by discounting. One view—typically held by those who regard deferred tax as an adjustment to the values at which other assets are recognised rather than as a liability in its own right—is that it should not. Those holding this view argue that:

- the deferred tax provision represents a cash inflow that has already been received. It is therefore already stated at its present value. There are no future tax cash flows to occur.
- the carrying value of an asset reflects the present value of the future economic benefits that it will generate. At the outset, one of these future benefits is the present value of the capital allowance that will be received (including the value of receiving it early in the life of the asset). Once the capital allowance has been received, the remaining future benefits are reduced by that amount. The reduction in the value of the asset is recognised by providing for deferred tax. If the amount provided for is discounted, the entity is recognising a ‘gain’ that has not necessarily been earned.
- the cash outflow arising from the purchase of a fixed asset is recognised as depreciation evenly over the life of the asset. If the cash inflow arising from a capital allowance is seen as an adjustment to the value of the asset, it too should be recognised evenly over the life of the asset.

- 92 However, a different view can be taken under the incremental liability approach required by the FRS. Under this approach, an accelerated capital allowance is viewed as a liability that will be repaid in the form of higher tax assessments in the future. Although one tax cash flow has already occurred, creating the timing difference, it can be argued that there will be a second tax cash flow when, on reversal of the timing difference, a future tax payment is higher than it would otherwise have been. And, where the higher future tax payment will occur some distance into the future, it is valid to discount it to reflect the fact that, at the balance sheet date, it represents a lower obligation than a liability that is payable immediately.
- 93 Another way of viewing the accelerated capital allowance is as an interest-free loan from the tax authorities. And just as it can be argued that an interest-free loan is a smaller obligation than a loan paying a commercial rate of interest, so it can be argued that a deferred tax liability should be discounted.
- 94 The different conclusions on discounting that are reached depending on whether deferred tax is rationalised as a liability or a valuation adjustment can be reconciled. When a capital allowance is received, the cash-generating capability of the fixed asset (and hence its value in *absolute* terms) is reduced by the amount of that past tax cash flow. A valuation adjustment approach seeks to recognise that absolute reduction in future cash flows. However, if deferred tax is rationalised as a liability, all that is being provided for is the additional tax cash flows that the entity will pay *relative* to the tax that it would have paid had it not received capital allowances until they were earned. The liability is being measured without reference to changes in the values of fixed assets.

*Cost/benefit considerations*

- 95 One of the messages that emerged strongly from the responses to FRED 19 was that for most industries the benefits of discounting were not perceived to outweigh the costs.
- 96 Significant time and effort may be required to collate the information required to discount accelerated capital allowances and perform the discounting calculations, especially for large organisations with operations spread across a wide range of tax jurisdictions. Some respondents argued that they would have to collate substantial amounts of information even if only to establish that the impact of discounting was not material in that period.
- 97 There were also reservations expressed about the benefit of discounting to users of financial statements. Users who responded to the FRED were divided in their opinions. And preparers were concerned that the impact on the profit and loss account would be difficult to understand: movements caused, for example, by changes in discount rate from one period to the next could be difficult to explain to users.
- 98 Support for discounting was strong only from companies for which the effect of discounting would be fundamental.

*International practice*

- 99 Both IAS 12 (revised) and the US accounting standard FAS 109 prohibit discounting of deferred tax balances. IASC took the view that the scheduling of the reversal of timing differences was often impracticable or highly complex and hence that it should not be made mandatory. It rejected the possibility of permitting discounting without requiring it, because the option would make the results of different entities less comparable. It is, however, now reconsidering, as part of a general project on discounting, whether deferred tax should be discounted.

***Reasons for making discounting optional***

- 100 One Board member opposed discounting, primarily on the grounds that it impeded international harmonisation. The Board member also took the view (explained in paragraphs 89–91 above) that discounting was conceptually wrong for timing differences—such as accelerated capital allowances—where tax cash flows had already occurred.
- 101 The rest of the Board supported discounting in principle, regarding it as consistent with the incremental liability approach on which the FRS requirements were based and as a means of providing more relevant information to users. However, taking into consideration the practical arguments made by respondents, the Board concluded that:
- (a) in many circumstances, the costs were widely perceived to outweigh the benefits. Discounting should not be required in those circumstances.

- (b) this was especially the case given that discounting was not yet well established in the context of deferred tax (either in theory or in practice). A methodology was being introduced in the UK before an international consensus had been reached.
  - (c) providing that discounting was applied consistently from one period to the next, and the impact of discounting on the financial statements was highlighted clearly, there would not be a serious loss of comparability if not all entities discounted deferred tax.
- 102 The Board considered first whether it could achieve its aims by emphasising that discounting was required only where the effect was genuinely material to the overall results and performance portrayed in the financial statements. It considered whether ‘indicators of materiality’ could be prescribed to make it easier for companies to determine that the effect would not be material.
- 103 However, it took the view that such indicators would be difficult to define other than in vague (and hence not very useful) terms. Further, basing decisions on discounting purely on materiality would not entirely eliminate the practical problems. First, there would remain some companies for which the effect of discounting deferred tax would border on being material. Such companies would certainly have to perform discounting calculations and would probably take the view that they should report discounted amounts, even though they would probably regard the costs as exceeding the benefits.

- 104 The second problem would be that by concentrating only on materiality, it would be difficult to emphasise the importance of consistency. For some companies, the effect of discounting could be material in some periods but not others. In such circumstances, it could be argued that it was more important that the company reported consistently from one period to the next (either discounting or not) than that it discounted only when the effect was material.
- 105 For these reasons, the Board concluded that the FRS should not require all entities to discount deferred tax. Instead, it should allow them a choice of accounting policy that they would then apply consistently. In taking this approach, the FRS has followed a precedent set in FRS 15 'Tangible Fixed Assets', which allows entities a choice of policies with regard to capitalisation of finance costs attributable to the construction of a fixed asset. The factors set out in paragraph 101 above are very similar to those that led the Board to permit a choice of policies in FRS 15.

### ***Detailed requirements for discounting***

#### *The 'full reversal' approach to scheduling reversals*

- 106 To discount a deferred tax liability or asset, it is necessary to forecast the timing of the future cash flows that the deferred tax represents. Two alternative approaches were considered by the Board:
- *the full reversal basis*, whereby the future cash flows are treated as occurring when the timing differences constituting the deferred tax balance at the year-end are expected to reverse
  - *the net reversal basis*, whereby the future cash flows are treated as occurring when the timing differences as a whole (ie after taking account of new timing differences to replace those that reverse) are expected to reduce.

- 107 The rationale for the full reversal basis is the same as that for full provision accounting: every individual timing difference reverses and, when it does so, has an incremental or decremental effect on future cash flows. Similarly, the rationale for the net reversal basis is the same as that for the partial provision method: the deferred tax is viewed as a homogeneous whole and is regarded as giving rise to a future cash flow only to the extent that reversing timing differences will not be replaced by new originating timing differences.
- 108 The Board took the view that the net reversal basis for discounting could be justified only within a partial provision framework. Within a full provision framework, it would be inconsistent not to treat the cash flows as occurring when the individual timing differences reversed. The FRS therefore requires that where deferred tax is discounted, it is to be discounted on a full reversal basis.
- 109 The FRS does, however, require the scheduling of reversals to take account of the remaining capital allowances to be received on the existing assets on which the timing differences have arisen. It was suggested that the remaining capital allowances should be ignored on the grounds that they were future events that created further timing differences (rather than delaying the reversal of the existing timing differences). The existing timing differences would be viewed as reversing as soon as further depreciation occurred. However, the Board did not view the remaining capital allowances as arising from future events. Rather it regarded the allowances, like depreciation, as one of the expected consequences of a past event (the purchase of an asset) that had to be taken into account in measuring the tax liability arising from that event.

*Future losses*

- 110 Future tax losses could affect the time at which deferred tax liabilities and assets were paid or recovered. Suppose, for example, that an accelerated capital allowance was expected to reverse over the next five years but that the entity expected to generate in that period tax losses that would themselves be relieved only in later periods. The deferred tax liability would not have an incremental effect on the amount of tax actually paid until the future losses were relieved. It could therefore be argued that the liability should be discounted further to reflect the expected delay.
- 111 However, in addition to possible conceptual reasons, the Board concluded that there were practical reasons why possible future losses should not be taken into account when assessing the period over which deferred tax assets and liabilities were discounted:
- (a) whilst little judgement was required to schedule the reversal of timing differences, far more judgement would be required if predictions regarding future tax losses had to be made. It would be difficult to forecast patterns of future losses reliably, especially those expected to arise in later years (ie those for which discounting would be most relevant). The discounting calculations could be more difficult to perform and the discounted amount could be significantly less reliable.

(b) whilst there was a theoretical risk that deferred tax assets would be overstated if future losses were not taken into consideration when estimating the timing of the recovery of the assets, this risk was unlikely to give rise to problems in practice. The overstatement would arise only if future losses were expected to delay significantly the recovery of a deferred tax asset. In such circumstances, it is unlikely that there would be sufficient evidence to support the recognition of the deferred tax asset at all. Guidance to this effect is included in the FRS.

112 For these reasons, the Board concluded that future losses should not be taken into consideration when determining the period over which deferred tax assets and liabilities should be discounted.

*Discount rate*

113 General conclusions on discounting were set out in the Board’s Working Paper ‘Discounting in Financial Reporting’, published in April 1997. The requirements of the FRS are consistent with the conclusions reached in that Paper.

114 Chapter 4 of the Working Paper concluded that the discount rate for a *liability* should reflect only the characteristics of the liability. Hence the discount rate used to measure a liability should not be based on the entity’s cost of capital. Rather it should aim to measure the least cost of settling the liability, which would be either:

- (a) the amount that a third party would have to be paid to take over the liability; or
- (b) the amount that would have to be invested in assets that would grow to match the amount due and settle the liability at the due date.

- 115 In practice, it is unlikely that there would be a third party willing to take over a deferred tax liability. Hence it is necessary to determine the amount that the entity would have to invest at the balance sheet date in assets that would grow to match the liability.
- 116 When deferred tax liabilities are discounted on a full reversal basis, the future cash flows that they represent are relatively certain. In most circumstances, they are fixed at the amount of the timing difference multiplied by the rate of tax paid by the entity. The most appropriate 'matching assets' are therefore those that provide a fixed income that is taxable at the same rate. This is most likely to be government bonds of a maturity date and in a currency similar to those of the deferred tax liability.
- 117 The Working Paper suggested that the rate at which *assets* should be discounted was the rate that the market would expect on an equally risky investment. The rate would be reduced to the extent that any of the risk had been taken into account by lowering the estimates of future cash flows. The FRS requires uncertainty about the recoverability of a deferred tax asset to be taken into account in determining the extent to which the undiscounted asset is recognised. This uncertainty should not therefore be reflected in the discount rate. In other respects, the future cash flows associated with a deferred tax asset are relatively certain. For this reason the return that would be expected by the market is approximately equal to the effective return on a government bond.

- 118 The FRS therefore requires both deferred tax assets and liabilities to be discounted at the effective rates of return on government bonds of maturity dates and in currencies similar to those of the deferred tax. These rates are not only consistent with the conclusions reached in the Working Paper on discounting, they also have the advantage of being simpler to determine and less subjective than other possible rates.
- 119 The FRS requires the government bond rates used to discount deferred tax to be measured on a post-tax basis, ie after taking account of the tax that the reporting entity would pay on income generated by the bonds. This is because the cost of the reversing timing differences is not tax-deductible. The whole reversing timing difference would therefore have to be funded from the post-tax yield on the government bond.

*Presentation of movement in discount*

- 120 When deferred tax is discounted, there is a charge or credit to the profit and loss account each period that represents the movement on the discount. The net movement has three components:
- (a) changes in the underlying timing differences and tax rates;
  - (b) an ‘unwinding’ of the discount on timing differences that had existed at the start of the period (because these differences are now one year closer to reversal); and
  - (c) changes in the rates at which the opening deferred tax balance is discounted.

- 121 The Board takes the view that, in principle, an expense should be measured in the profit and loss account at the present value (when the expense is recognised) of the amount to be paid. Thus, an operating expense that was not payable immediately would be recognised in the profit and loss account at a discounted amount. The additional charge attributable to the unwinding of the discount as the payment date approached would not be presented as an additional operating expense. Rather, because it arose as a consequence of not settling the liability immediately, it would be presented as a financing item, ie next to interest payable and receivable. An argument in support of such an approach is that it avoids the amounts reported as operating profit being distorted by funding decisions: an operating expense that was not payable immediately would be recorded at the same amount whether or not it had been funded. The Board believes that such an approach, which it regards as correct in principle, should be required when it is practicable and results in a presentation that corresponds to the reader's understanding of the underlying economic nature of the transaction.
- 122 However, even though the unwinding of the discount on a deferred tax liability (or asset) can be regarded in principle as a financing item, the FRS does not require it to be shown as part of the financing section in the profit and loss account. The reason is that profit and loss account formats require all of the tax consequences of pre-tax profits to be shown separately, below the subtotal 'profits on ordinary activities before taxation'. The unwinding of a discount on a deferred tax balance, whether viewed conceptually as part of the tax expense or as a finance item, is not part of profits before tax. Hence, it is shown after the subtotal of profits before tax.

- 123 For similar reasons the FRS also requires the movement in the discount attributable to a change in the rate at which the opening deferred tax liability or asset has been discounted to be shown as part of the tax charge.

## **PRESENTATION OF DEFERRED TAX BALANCES**

### *Offset of deferred tax assets and liabilities*

- 124 The Board’s Statement of Principles\* states that:

“If a right to receive future economic benefits and an obligation to transfer future economic benefits exist and the reporting entity has the ability—which is assured—to insist on net settlement of the balances, the right and obligation together form a single net asset or liability regardless of how the parties intend to settle the balances.”

- 125 If this principle is applied, deferred tax debit and credit balances might be regarded as being capable of being offset and presented as a single net asset or liability only if:
- (a) they relate to the same tax authority;
  - (b) they arise within the same taxable entities or within different taxable entities that are entitled to settle their tax liabilities on a net basis; and
  - (c) the timing differences giving rise to a deferred tax asset reverse before or at the same time as those giving rise to a deferred tax liability. (If those giving rise to the liability reverse first, there will be a requirement to pay tax before any entitlement to recover tax.)

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\* Paragraph 4.34, *Statement of Principles for Financial Reporting*

- 126 However, the requirements in the FRS do not restrict the offsetting of deferred tax debit and credit balances to circumstances where the above criteria are met. The Board took the view that:
- (a) it could be argued that all deferred tax balances of a single taxable entity\* with a single tax authority were adjustments to future liabilities of that entity (rather than assets or liabilities in their own right) and so should be shown as a single balance;
  - (b) the costs of scheduling the timings of reversals to measure the extent to which the balances should be offset would greatly exceed any benefit to users. Indeed, the needs of many users would probably best be served by presenting the deferred tax in as uncomplicated a manner as possible.
- 127 The view that a requirement to take account of the timing of reversals would be impracticable has also been taken in IAS 12 (revised). The offset requirements required by the FRS are therefore very similar to those of IAS 12 (revised). A significant difference is that IAS 12 (revised) adds a criterion based on whether or not it is intended that current tax balances will be settled on a net basis. The difference reflects differences between the Board's and IASC's general principles regarding offset.

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\* or of entities within a single tax group, where the losses of one entity could be used to reduce the taxable profits of another.

*Presentation on the face of the balance sheet*

- 128 The requirements for separate presentation of deferred tax (at least in the notes to the accounts) reflect the Board’s view that deferred tax is different from most other debtors and provisions. In general it does not have a direct relationship with future cash receipts or payments. Rather than being a payment or receipt in its own right, it affects other (possibly very distant) future payments, which will also be affected by a number of other factors.
- 129 To identify the deferred tax assets and provisions that should be presented separately on the face of the balance sheet, the Board followed the consensus reached in UITF Abstract 4 in respect of any long-term debtor included within current assets:
- “In most cases, it will be satisfactory to disclose the size ... in the notes to the accounts. There will be some instances, however, where the amount is so material in the context of the total net current assets that in the absence of disclosure ... on the face of the balance sheet readers may misinterpret the accounts.”
- 130 The FRS does not go as far as IAS 12 (revised), which requires all (material) deferred tax balances to be presented separately from other debtors and provisions on the face of the balance sheet. In the Board’s view, such a requirement would add unnecessary detail when deferred tax assets and liabilities did not have a fundamental impact on the company’s net asset or net current asset position.

## DISCLOSURES

### *Unrecognised deferred tax*

- 131 The FRS requires disclosure of the amounts of deferred tax not provided for on the unremitted earnings of subsidiaries, associates and joint ventures only to the extent that the earnings are expected to be remitted in the foreseeable future. Unlike IAS 12 (revised), it does not require any quantification of the total timing differences arising from unremitted earnings because the Board was not persuaded that such a disclosure would provide relevant information to users of financial statements. (In most circumstances, the possibility of all of the earnings being remitted is remote, and the tax that would become payable would be subject to a number of uncertainties.)

### *Other factors affecting future tax charges*

- 132 Companies legislation requires information to be given about special circumstances that have affected the tax charge for the current period and might affect the tax charges of future periods. Users of financial statements frequently told the Board that they particularly valued information that helped them to make more accurate predictions about future tax payments. The FRS therefore specifies the information that an entity should include.
- 133 The Board decided that the requirement to disclose a reconciliation of the entity's *current* tax charge for the period to an 'expected' charge—ie the charge that would result if accounting profits were taxed at a standard rate—was especially important. The reconciliation would provide users of financial statements with a complete picture of the factors that

had influenced the current tax charge for the period. They could then use other information about the company (for example, the nature of its deferred tax liabilities and its capital investment plans) to arrive at a judgement about the extent to which the reconciling items would recur. The requirement received strong support from those responding to the FRED on behalf of institutional investors.

- 134 IAS 12 (revised) and FAS 109 also require reconciliations to be disclosed. However, both of those standards require a reconciliation of the *total* tax charge for the period (ie the total of current and deferred tax) to a standard tax charge. The Board chose to focus the reconciliation on the current tax charge instead because it believed that that was the element of the total tax charge that was of most importance to users. A reconciliation based on the current tax charge was the clearest and most direct way of providing information on the factors that might affect future current tax charges.
- 135 FAS 109 requires the reconciliation to be given only by listed companies. Other entities need disclose only the nature of significant reconciling items. The Board considered whether it should propose a similar distinction in FRED 19. It concluded that a full reconciliation would be of use to the users of the financial statements of all entities. And, since the information would normally be readily available from tax computations, it ought not to be an onerous requirement.

*Other disclosures required by IAS 12 (revised)*

- 136 IAS 12 (revised) requires entities that have recently made losses to explain (where relevant) why they have recognised deferred tax assets.

- 137 It could be argued that this disclosure is not necessary: the recognition of the asset in itself shows that the directors and auditors have satisfied themselves that it is more likely than not that the asset will be recovered.
- 138 However, the Board took the view that additional information about the assumptions underlying the recognition of a deferred tax asset alerted users to the uncertainties surrounding the asset's recoverability and helped them to assess the financial position of the entity. The FRS therefore includes a disclosure requirement identical to that included in IAS 12 (revised).

## **AMENDMENT TO FRS 7**

### *General changes*

- 139 FRS 7 'Fair Values in Acquisition Accounting' aims to recognise in a fair value exercise only the identifiable assets and liabilities of the acquired entity that existed at the date of acquisition. It aims to measure them based on their condition at that date, independent of the intentions of the acquirer. However, its requirements regarding deferred tax (ie to measure the extent to which the liabilities would crystallise considering the enlarged group as a whole) were slightly inconsistent with this general aim, since they had to be consistent with the partial provision method of accounting for deferred tax required by SSAP 15.
- 140 With the replacement of SSAP 15 it is no longer necessary to consider the enlarged group when measuring deferred tax liabilities. The amendment to FRS 7 implemented by the FRS clarifies that this is the case. And it ensures that deferred tax recognised in a fair value exercise is recognised on the same basis as it is recognised in the group financial statements thereafter.

*Previously unrecognised deferred tax assets*

- 141 The amendment to FRS 7 adds guidance on how to treat deferred tax assets—typically, unrelieved tax losses—that were not regarded as recoverable before the acquisition but, as a result of the acquisition, become sufficiently recoverable within the enlarged group to be recognised as assets after the acquisition. FRS 7 previously gave no guidance on whether such assets should be recognised in the fair value exercise or as a credit in the post-acquisition profit and loss account. The Board received anecdotal evidence that practice varied.
- 142 The Board concluded that, if the losses had arisen in the *acquiring group*, it would be inconsistent with the principles of FRS 7 to require them to be recognised as part of the fair value exercise. They could not be regarded as assets of the acquired entity. Rather, as a result of the acquisition, the acquiring group was expected to be more profitable in future. The FRS therefore requires the benefit to be recognised as a credit in the post-acquisition profit and loss account.
- 143 It was less clear how any previously unrecognised losses in the acquired entity should be recognised. One view was that the recoverability of the acquired entity's deferred tax asset stemmed from the future actions of the acquiring group. In its condition before acquisition, the asset had not been recoverable. Hence it was argued that it would be inconsistent with the principles underlying FRS 7 to recognise an asset as part of the fair value exercise. This was the view taken in FRED 19, which proposed that the losses should not be recognised as assets in the fair value exercise.

- 144 However, another view was that deferred tax losses (unlike, say, provisions for future reorganisations) were identifiable contingent assets of the acquired entity that had existed before the acquisition. Especially if a large proportion of the purchase price related to the losses, a requirement not to reflect them as an asset (but to recognise a larger goodwill balance instead) seemed not to reflect the economics of the purchase.
- 145 Those taking this view noted that paragraph 37 of FRS 7 specifically addressed such contingent assets:

“Certain contingent assets and liabilities that crystallise as a result of the acquisition would also be recognised, provided that the underlying contingency was in existence before the acquisition. An example is where the acquired entity has previously entered into a contract that contains a clause under which the obligations are triggered in the event of a change of ownership.”

- 146 After consideration of the arguments, the Board decided that it would be consistent with the treatment of other contingent assets to recognise the recoverable tax losses of an acquired entity in the fair value exercise. The requirements proposed in FRED 19 have therefore been amended in the FRS.

## CHANGES TO REQUIREMENTS PROPOSED IN FRED 19

Change	Paragraph reference:	
	FRS (Requirement)	This Appendix (Explanation)
1 New requirement clarifying that deferred tax should be provided for on capital allowances until all conditions for retaining them have been met. Applies in practice to industrial buildings allowances.	9	57-61
2 New exception to general requirement that deferred tax should not be recognised on revaluation gains and losses. Exception requires deferred tax to be recognised on timing differences arising when an asset or liability is continuously revalued to its fair value with revaluation gains and losses being recognised in the profit and loss account.	12	63-66
3 Discounting made optional (rather than mandatory as had been proposed).	42	100-105

Change	Paragraph reference:	
	FRS (Requirement)	This Appendix (Explanation)
4 Removal of requirement to present as finance costs the movement in deferred tax balances in the year resulting from unwinding of discounts and changes in discount rates. These are now required to be shown as part of the deferred tax charge.	59	120-123
5 Amendment of proposal regarding recognition of deferred tax assets on the acquisition of a business. The FRS requires deferred tax assets of the acquired entity to be included in the fair value exercise, even if they had not been recognised before the acquisition. The FRED had proposed that they should be recognised as credits to post-acquisition profits.	71	141-146

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