

Deferred tax assets (Lecture A805 – 7.19 minutes)

Deferred tax is dealt with in FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* in Section 29 *Income Tax*.

Deferred tax has been a contentious issue for many years and there are many challenges where the concept is concerned.

Deferred tax is the application of the accruals concept. That is, FRS 102 requires the tax effects of transactions to be recognised in the financial statements regardless of when those transactions are assessed for tax. Doing this reduces profit and loss volatility and gives a more accurate earnings profile for the business.

1.1 Recognition of deferred tax assets

‘Deferred tax assets’ are defined as:

Income tax recoverable in future reporting periods in respect of:

- (a) *future tax consequences of transactions and events recognised in the financial statements of the current and previous periods;*
- (b) *the carry forward of unused tax losses; and*
- (c) *the carry forward of unused tax credits.*

FRS 102
Glossary
deferred tax assets

Care must be taken when it comes to recognising a deferred tax asset to ensure that it is only recognised when it is **capable of recovery**. This is especially the case with transactions such as unused tax losses that are available for carry forward. FRS 102, para 29.7 is restrictive where these transactions are concerned and states:

*Unrelieved tax losses and other **deferred tax assets** shall be recognised only to the extent that it is **probable** that they will be recovered against the reversal of **deferred tax liabilities** or other future taxable profits (the very existence of unrelieved tax losses is strong evidence that there may not be other future taxable profits against which the losses will be relieved).*

FRS 102, para 29.7

Hence, prior to the recognition of a deferred tax asset that arises from an entity’s unutilised tax losses, the entity must be satisfied that the entity will have sufficient future taxable profit to recover the deferred tax asset. This will require corroboratory information (such as budgets and forecasts which show the entity will return to profitability, or the securing of a lucrative contract which will enable the entity to generate sufficient taxable profits). Auditors must ensure that they obtain sufficient appropriate audit evidence to corroborate the recognition of a deferred tax asset and that any associated disclosures are adequate.

1.2 FRC Thematic Review on deferred tax assets

On 21 September 2022, the FRC published *Thematic Review: Deferred tax assets*. The FRC were prompted to revisit the topic of deferred tax asset accounting following the Covid-19 pandemic on the basis that the pandemic caused many companies to report losses or reduced profits.

The FRC's Thematic Review involved a selection of 20 companies and how they had recognised and disclosed deferred tax under IAS® 12 *Income Taxes*. While the focus of the FRC's Thematic Review is that of IAS 12, the content may be relevant to UK and Ireland GAAP reporters, where deferred tax assets have arisen from unutilised tax losses.

FRS 102 is brief where deferred tax assets are concerned. In contrast, IAS 12 contains significantly more requirements but both standards take the same stance in terms of only recognising a deferred tax asset when its recovery is probable (i.e. more likely than not). This is notably different than what is required under FRS 102, Section 21 *Provisions and Contingencies* (and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*) in that recognition of a deferred tax asset is not dependent on recovery being virtually certain.

The companies selected in the FRC's sample reported material deferred tax assets (either on a gross basis or offset against an overall deferred tax liability). In most cases, the deferred tax assets included a material amount relating to trading or capital losses.

Availability of future taxable profits

The Thematic Review clarifies that in assessing the availability of future taxable profits, companies should consider all available evidence (negative and positive). In addition, if the company uses forecasts, they should be reasonable, realistic and achievable. Appendix A to the Thematic Review sets out a table of positive and negative evidence:

Positive evidence	Negative evidence
Losses occurred due to identifiable one-time/non-recurring event	A recent history of operating losses for tax purposes
A strong earnings history exclusive of a non-recurring loss	Start-up business
New business opportunities, e.g. new patents	History of significant variances of actual outcomes against business plans
Restructuring or disposal which clearly eliminates the loss sources	Losses of major customers and/or significant contracts
Convincing tax planning strategies	Uncertainty regarding going concern
Firm sales backlog or new contracts	History of restructuring without returning to profitability, or emerging from bankruptcy

Business acquisitions generating sustainable profit margins in the relevant taxable entity sufficient to enable the utilisation of tax losses

Losses expected in early future years

History of unused tax losses and/or credits expiring

The losses relate to core activities and thus may recur

Consistency with going concern conclusion

A company cannot simply recognise a deferred tax asset on the balance sheet just because management concludes the entity is a going concern. Recoverability must always be assessed by reference to forecast future taxable profits.

The FRC found that two companies within their sample disclosed the existence of a material uncertainty related to going concern. One of these companies had not recognised a deferred tax asset in excess of its deferred tax liabilities. The other company disclosed the recognition of deferred tax assets as a major source of estimation uncertainty and stated that the existence of losses as a result of the pandemic resulted in greater uncertainty over the recognition of deferred tax assets.

Period of assessment

The Thematic Review acknowledges that there is no set time limit to the period of any profit forecast. However, the further into the future the forecast goes, the less reliable it becomes. Hence, companies should exercise caution when the assessment period for deferred tax asset recognition exceeds the normal planning cycle.

The FRC confirm that during their review, better disclosures in the financial statements set out the period of assessment that has been used and the basis on which it was selected. In addition, the FRC encourages companies to consider whether, when addressing the recoverability of deferred tax assets, their rationale for the assessment period used should be disclosed as a key judgement.

History of losses – convincing evidence

IAS 12, para 35 states that the existence of unused tax losses is strong evidence that future taxable profit may not be available. FRS 102 takes a similar stance to this in paragraph 29.7 by stating that the very existence of unrelieved tax losses is strong evidence that there may not be other future taxable profits against which the losses will be relieved.

There should be convincing evidence to support the recognition of a deferred tax asset (i.e. evidence that sufficient taxable profit will be available against which the unused tax loss or credit can be used).

The Thematic Review clarifies that it is not sufficient to simply discontinue making losses. Profit forecasts used in assessing whether a deferred tax asset is recognised should be used with caution if these require significant judgements to be made concerning the future. In particular, start-up companies, or companies with a volatile profit (or loss) history may need more extensive convincing evidence than other companies which a history of reliable and stable profit forecasts.

Example – Losses arising due to the pandemic

In the last two years, Vilamoura Ltd has sustained material losses as a result of the Covid-19 pandemic. The draft accounts for the year ended 31 October 2022 show a return to profitability (albeit at a low level) and a deferred tax asset has been recognised in the previous two years as the directors considered the event giving rise to the loss (Covid-19) will not recur.

The Thematic Review clarifies that where material losses have occurred as a result of a specific event which is not expected to recur, such as the Covid-19 pandemic, they will need to consider whether, and how, their business will recover or adapt. The FRC expect companies to disclose the key assumptions made in this respect.

1.3 What UK and Ireland GAAP reporters must consider

The focus of the FRC's Thematic Review is on public interest entities reporting under IAS 12. Deferred tax under IAS 12 is notably different than under FRS 102 as IAS 12 calculates deferred tax using a temporary difference approach (whose focus is on the balance sheet differences between assets and liabilities and their associated tax written down values); whereas FRS 102 uses the timing difference plus approach (whose focus is on the differences inherent between accounting profit and taxable profit – i.e. the profit and loss account). However, some of the content of the Thematic Review is relevant to UK and Ireland GAAP reporters, notably:

- To ensure that deferred tax assets are only recognised when they are capable of recovery.
- To ensure that there is corroboratory evidence that the entity will generate future taxable profit enabling the deferred tax asset to be utilised.
- Ensuring that profit forecasts used when determining whether a deferred tax asset should be recognised are reliable.
- Disclosing information as key sources of estimation uncertainty or judgements (for non-small entities).