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Accounting for Income Taxes: Early Adoption Issues

This study investigates whether the revised AASB 1020 Income Taxes was adopted early by Top 100 publicly listed companies in Australia between 2000 and 2004. We found that only three of the companies adopted the revised standard before its implementation date of 1 January 2005. Interviews with senior company representatives indicated that the three companies had quite different reasons for early adoption. Non-early-adopting companies had considered that the revised standard would not make a material difference to their reporting results. Tax consolidations and the impending international financial reporting standards were regarded as more important issues.

The revision of AASB 1020 *Income Taxes* in December 1999, as part of the international harmonisation program, represented one of the most significant changes to Australian accounting standards (Carlson 2002). While the standard did not become mandatory until 1 January 2005, it was available for early adoption from January 2000. Gujarathi and Hoskin (1992) argue that "early adoption studies are interesting because the accounting change involved therein is neither entirely discretionary nor mandatory" (p. 18). This paper seeks to investigate:

- whether the revised AASB 1020 was adopted before its implementation date by the Top 100 publicly listed companies, by capitalisation, in Australia;
- why and in what circumstances companies would choose to adopt new or revised standards earlier than required; and
- the expected impact of the revised AASB 1020 on companies' financial reports and accounting systems.

The revised standard, initially operative for half-years ending on or after 31 December 2002 and for financial years ending on or after 30 June 2003, required a move from the income-statement method to the balance-sheet method of accounting for income taxes. The rationale for the introduction of the balance-sheet method was that it provided a more comprehensive approach for recording the taxation consequences of transactions recognised in financial reports, and that its application would ensure compatibility with overseas standards. The general principle of the balance-sheet method is that the current and future tax consequences of transactions and other events recognised in an entity's financial statements may give rise to current and deferred tax assets and liabilities.

At 148 pages, the revised AASB 1020 was a long and complex standard. However, it did provide numerous examples of the calculation of the tax base and temporary differences in respect of particular assets and liabilities recognised in the accounting balance sheet (Anonymous 2001, Locke 2002). The disclosure requirements were also significantly increased. It was claimed that almost all entities would be affected to some degree by its introduction, as the revised standard would have both strategic and operational implications (Carlson 2002).

Introduction of the revised standard was subsequently deferred to annual reporting periods beginning on or after 1 January 2005. The AASB took this decision to be consistent with the Financial Reporting Council's (FRC's) decision to adopt international accounting standards by 1 January 2005. The International Accounting Standards Board (IASB) also proposed amendments to its IAS 12 *Income Taxes*. However, the AASB noted that the basic principles reflected in AASB 1020 and IAS 12 were harmonised and that, although the mandatory operative date of AASB 1020 had been deferred pending its replacement by IAS 12, companies could elect to adopt the revised AASB 1020 early (Locke 2002). Companies that chose not to adopt the revised standard early waited to adopt AASB 112, which was based on IAS 12, after 1 January 2005.

Previous research related to companies' decisions to early-adopt an accounting standard is typically framed in positive accounting theory (Watts and Zimmerman 1986, 1990) and is articulated as an accounting policy choice. Fields *et al* (2001) argue that in the 1990s limited progress was made in expanding the understanding of accounting choice. Future research should place more emphasis on costs versus benefits in addressing market imperfections that drive accounting choice.

FUTURE RESEARCH SHOULD PLACE MORE EMPHASIS ON COSTS VERSUS BENEFITS IN ADDRESSING MARKET IMPERFECTIONS THAT DRIVE ACCOUNTING CHOICE.

Accounting for company income taxes has been a controversial issue in the accounting literature for many decades (Psaros *et al* 1997) and has aroused regulatory, academic and professional interest. Research in the United States on the timing of adoption of taxation accounting standards (eg, SFAS 96 and SFAS 109) also highlights the complex and controversial nature of such standards (see Cassidy *et al* 1993, Kuo 1994, Simon and Costigan 1996). For example, in comparing the attitudes and perceptions of financial controllers who adopted SFAS 96 early with those of financial controllers who postponed adoption, Cassidy *et al* (1993) found mixed opinions on the usefulness of the standard. They determined that the effects on the financial statements and the ease of gathering needed data influenced the firms' decisions to early-adopt SFAS 96. However, despite the recent changes to the method of accounting for company income taxes in Australia, few Australian studies have been conducted in this area. Our study of adoption of the revised AASB 1020 provides evidence on the perceived usefulness of the standard by Australian companies.

HISTORY OF ACCOUNTING FOR TAXATION IN AUSTRALIA

An appreciation of the history of accounting for company taxation in Australia helps in understanding the reasons for the recent changes to the accounting method. Gibson (1984) reported that before 1960 most Australian companies adopted the "taxes payable" method. The Institute of Chartered Accountants in Australia (ICAA) first addressed the issue of tax-effect accounting in November 1967 by issuing an exposure draft on the Treatment of Income Tax in the Accounts of Companies (Wyatt 1997). Three years later, in November 1970, Statement D4, based on comprehensive tax allocation under the liability method, was released. After significant revisions D4 was accepted by the Australian Society of Accountants (ASA) and the two bodies jointly issued Statement DS4 *Accounting for Income Tax* in October 1974. DS4 was subsequently amended and re-issued in July 1976. In 1979 DS4 was re-numbered as Australian Accounting Standard AAS 3 *Accounting for Company Income Tax (Tax-effect Accounting)*. AAS 3 received statutory endorsement as AASB 1020 *Accounting for Income Tax (Tax-effect Accounting)*, effective for financial periods ending on or after 31 December 1989.

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Australian Accounting Research Foundation (AARF) and considered the balance-sheet method, which had earlier been prescribed by the Financial Accounting Standards Board (FASB) in the US. The FASB issued Financial Accounting Standard SFAS 109 *Accounting for Income Taxes* in February 1992 that prescribed a comprehensive balance-sheet method of tax-effect accounting in keeping with its conceptual framework. The International Accounting Standards Committee (IASC) in October 1994 issued Exposure Draft ED 49 *Income Taxes*, which proposed an approach based on that prescribed in SFAS 109. The IASC subsequently issued a revised IAS 12 in October 1996, which was similar to SFAS 109. ED 87 *Income Taxes* was prepared by the Australian Public Sector Accounting Standards Board (PSASB) and the AASB, and was released in December 1997. ED 87 contained proposals aimed at harmonisation with IAS 12 *Income Taxes*. The revised AASB 1020 was issued in December 1999 after consideration of responses to ED 87. AASB 1020 was developed using IAS 12 as a basis, but contained more detailed explanatory material (Keyes 2000).

In July 2004 the AASB issued AASB 112 *Income Taxes*, the Australian equivalent of IAS 12, as part of the FRC's policy of adopting the standards of the IASB for application to reporting periods beginning on or after 1 January 2005. AASB 112 effectively superseded the 1989 version of AASB 1020 *Accounting for Income Tax (Tax-effect Accounting)* and the revised 1999 version of AASB 1020 *Income Taxes*. However, the 1999 version of AASB 1020 was applicable if the standard was early-adopted in an annual reporting period that started before 1 January 2005.

RESEARCH DESIGN

The first stage of this study involved identifying Australia's Top 100 publicly listed companies, by capitalisation. The accounting policies note and financial statements of these companies' annual reports were then examined for the financial years ending 2000 to 2004 to determine how many companies had early-adopted the revised AASB 1020. The financial years ending 2000 to 2004 were chosen because the revised AASB 1020, requiring a move to the balance-sheet method, became available for voluntary adoption in 2000. Three companies were identified as adopting the revised standard before the mandatory implementation date. Of the remaining 97 we found that nine were trusts and funds not subject to income tax, a further nine had adopted other than Australian accounting standards as they were domiciled overseas and one company had been delisted during this period. All three early-adopting companies agreed to participate in interviews to further the study. Seven non-early-adopting companies, from a random sample of 20 companies, also responded to our request for an interview.

A qualitative research approach (Patton 1990), involving the use of semi-structured interviews with senior company representatives from the 10 companies, was then undertaken. The questions asked in the interviews sought to determine the reasons for the company adopting or not adopting the revised standard and whether the company had adopted other standards before their mandatory implementation dates. We also sought to determine whether the move from the income-statement method to the balance-sheet method would affect the financial reports and accounting system of the entity, whether any additional costs would be incurred, whether the participants had an opinion on the revised standard and whether participants thought that the revised standard was an improvement in terms of meeting the objectives of general purpose financial reports as defined in SAC 2 *Objective of General Purpose Financial Reporting*. By undertaking interviews we were able to gain insights which would have been difficult or impossible to gain through quantitative analysis alone. Detailed notes of the interviews were compiled using a structured interview format. A description of participant companies according to the Global Industry Classification

TABLE 1: DESCRIPTION OF PARTICIPANTS INTERVIEWED

Company	GISC industry sector	Participant/position
A	20 Industrials	A Controller, financial reporting
B	25 Consumer discretionary	B Manager, global financial reporting
C	60 Financials	C Chief financial officer
D	60 Financials	D Head of finance
E	50 Telecommunications	E Director of business & financial services
F	30 Consumer staples	F Head of group finance
G	30 Consumer staples	G Group corporate accountant
H	60 Financials	H Group taxation manager
I	25 Consumer discretionary	I Group finance manager
J	60 Financials	J Executive manager, group finance

Standard (GICS) indicates that they operate across a range of industries. To protect confidentiality, a unique code was ascribed to participants from the ten companies (see Table 1).

KEY FINDINGS

Early adopters

Interestingly, an industry analysis by GICS indicated that the three early adopting companies were from different industry sectors: Company A was classified as Industrial (GICS 20), Company B as Consumer Discretionary (GICS 25) and Company C as Financial (GICS 60).

Company A advised that it had adopted the revised AASB 1020 from 1 July 2001 because of the merger in August 2001 with its longstanding United Kingdom partner. The board made the decision to adopt the revised AASB 1020 early to ensure alignment between Australian GAAP and UK GAAP on accounting for deferred income tax.[1] The UK accounting standard was very similar to the revised AASB 1020. The early adoption of the revised AASB 1020 did not result in any material change to the consolidated income tax expense for the current or preceding year. However, it did result in a decrease in the balance of retained profits at 1 July 2001 of $174 million, with a corresponding increase in deferred tax liabilities.

The management of Company B adopted the revised AASB 1020 from 1 July 2000 on the grounds that the move towards harmonisation of Australian accounting standards with international accounting standards would inevitably lead to the mandatory adoption of the balance-sheet method in Australia. The manager, global financial reporting, had worked in the UK before joining Company B and was familiar with the balance-sheet method, which had been used there for some time. His experience made implementation of the revised standard easier for the company. One of the benefits of early adoption gained by Company B was the change in the recognition criteria for tax losses from "virtually certain" to "probable". Although Company B did not derive any immediate financial gain or post any transaction related to the change, it was able to maintain the value of the deferred tax asset for longer. At the time of adopting the revised AASB 1020 Company B was able to show that it was "virtually certain" the tax losses would be recouped. By adopting the revised standard, Company B was able to continue to recognise tax losses under the "probable" recognition criteria for a longer period. Management indicated that in time the company would have failed the "virtually certain" test under the old standard, thereby leading to de-recognition of the deferred tax asset in regard to tax losses.[2]

Company C had recently undergone a change of management personnel and the decision to adopt the revised standard early was made by the previous management. Unfortunately the previous management team could not be contacted, and the views of the current chief financial officer were conjectures and not representative of the company's decision-making process at the time. As a result of early adoption, Company C recognised a net deferred tax liability of $13 million as at 30 June 2001.

Non-early adopters

Seven of the companies interviewed chose not to early-adopt the revised standard. The typical reason given for this decision was that the changes proposed in the revised standard would have no material effect on their published financial reports; implementation was not worth the additional resources required. These companies reported that they would adopt the revised standard early only if there were perceived benefits from disclosure or on their financial reports.[3]

At the same time that the revised AASB 1020 became available for early adoption, the Australian government had introduced a tax consolidation regime that enabled companies with 100%-owned subsidiaries to submit a combined tax return. Because of limited technical expertise, management of the non-early-adopting companies chose this option rather than the early adoption of AASB 1020.[4]

The impending introduction of the A-IFRSs on 1 January 2005 also influenced managers' decisions. For example, Participant D stated that while the international standard was short and simplistic, the Australian standard was long and complex. Therefore, it would wait until the international standard was introduced. In a similar vein, Participant F advised that it had considered the revised AASB 1020, but had decided to wait and adopt all of the impending international standards at the same time.

Early adoption of other standards

During the interviews we discussed other issues related to the early adoption of accounting standards. Participants were asked whether their companies had adopted accounting standards before the mandatory implementation date. This question sought to determine why and in what circumstances the company would early-adopt accounting standards. Company B did not have any history of early adoption, but chose to early-adopt the revised AASB 1020 because of the benefits previously mentioned. Management indicated that it was not prepared to wait for the mandatory implementation date to report these benefits in the financial statements. Company D had early-adopted ED 39 *Concise Annual Reports*, which later became AASB 1039, in 1998 as management considered that ED 39 would provide more meaningful information to users of the annual reports in line with SAC 2. Interestingly, the company also achieved considerable cost savings because it was able to produce 150,000 copies of the concise annual report and needed only 30,000 full reports.

For the financial year ending 2000, Company F early-adopted three standards: AASB 1037 *Self-Generating and Regenerating Assets*, AASB 1010 *Recoverable Amount of Non-Current Assets* and AASB 1041 *Revaluation of Non-Current Assets*. AASB 1037 required the company to move from a cost to a market value for its self-generating and regenerating assets. Management concluded that early adoption would give a financial benefit because of a valuation increment of $13 million to profit-and-loss. Early adoption of AASB 1010 and AASB 1041 was undertaken, as management determined that the cost measurement basis would provide a financial advantage in regard to lower depreciation, thereby resulting in a higher return on capital. It was estimated that the depreciation charge would be $300 million less than under the fair-value model, with ongoing depreciation savings. Recording these assets at cost also resulted in savings in regard to less onerous valuation requirements.

Company F also early-adopted AASB 1005 *Segment Reporting* for the financial year ended 2001. Although this standard did not give the company any financial advantage, as it was a disclosure standard, management considered that it provided more meaningful information to users of annual reports. The early adoption of AASB 1005 did not require prior-year comparisons and therefore no additional costs were incurred. Management perceived that early adoption of accounting standards highlighted the company as a leader in company financial reporting.

Company J also early-adopted AASB 1005 *Segment Reporting* for the financial year ending 2001. The company was registered with the Securities and Exchange Commission in the US and early adoption of AASB 1005 ensured compliance with US GAAP. The company also early-adopted AASB 1041 *Revaluation of Non-Current Assets* as management considered that the greater disclosure requirements would provide more meaningful information to the users of the company's annual reports.

The other participating companies advised that they had never adopted an accounting standard before the mandatory implementation date. Company G was not one of the top 20 publicly listed companies and therefore did not seek to be a market leader in the implementation of accounting standards, but rather was content to follow other Top 100 companies. Company I had no history of early adoption and would consider such action only if it positively affected the profit-and-loss.

Impact of revised AASB 1020 on financial reports

Participants were asked whether the revised standard would affect the company's financial reports in terms of profitability, financial position and financial ratios. All participants indicated that the effect of implementation on their company's financial reports, and subsequent financial ratios, would be immaterial. For example, Company E indicated that as a result of this immaterial effect there was no need to educate the market about the changes. Participants were also aware that because of the less stringent recognition criteria from "virtually certain" to "probable", the recognition of a deferred tax asset in regard to tax losses could be of future benefit.[5]

Impact of revised AASB 1020 on accounting systems

Participants were asked what effect the implementation of the revised AASB 1020 would have on the company's accounting system. This question was asked to ascertain whether there were additional costs that may have deterred companies from early adoption of the revised AASB 1020. Company A had produced a training tax guide and redesigned their chart of accounts to achieve easier implementation. Company B owned one building and therefore there was a minimal effect on their accounting system. The organisation did not have a complex structure, had very little debt and used a basic accounting system. The manager, global financial reporting, performed the calculations for income taxes manually and reportedly made small adjustments for depreciation, hedges and derivatives.

Company D reported no impact, but indicated that it was concerned about whether it had the necessary data in regard to its properties. Company E had estimated that conversion to the balance-sheet method would entail a cost of $300,000 for software changes. However, this amount was deemed to be immaterial, as the company had net assets of $47.8 million and assets of $94.7 million. Company F reported that the implementation would require technical training for staff as well as changes to the accounting system. Company G indicated that its accounting system would need to be revised, which would be costly and time-consuming, with non-current assets being the greatest issue. Company H said it would use software provided by one of the big accounting firms. The cost would be capitalised and written off over two years. Again, this cost was considered to be immaterial. Company I would not implement a new accounting system, but would manually establish the tax base and carrying amounts of assets and liabilities. Company J indicated that it would be implementing the balance-sheet method in 2005, as a sub-set of the international accounting standards, therefore there was no discernible cost in accounting for income taxes.

Opinion of the revised standard

Participants were asked for their opinion of the revised AASB 1020. Seven of the 10 participants expressed the view that the revised standard requiring the balance-sheet method was conceptually better than the income-statement method. The balance sheet method was seen as more consistent with the international standards and the US approach. It was now easier to recognise tax losses under the "probability" criteria and it was considered that the disclosure requirements provided better information to users. However, some concerns were expressed about establishing the tax base and cost base of non-current assets. Company F in particular expressed concern that while goodwill was regarded as an exemption under the standard, the treatment of brands was not. The adoption of international standards in Australia also meant that there would be less opportunity for Australian companies to influence the AASB decisions on accounting standards.

Three of the companies expressed negative views about the revised standard. They could not see any logic in the balance-sheet method, and believed the revised standard did not provide additional benefits and therefore may have no material effect. A view was also expressed that the adoption of the revised standard did not advance financial accounting, as the tax effect of the asset revaluation reserve and foreign currency translation reserve may never be realised.

The objectives of GPFRs as defined in SAC 2

Participants were asked whether they thought that the revised standard provided more useful information to users, greater assistance to management in discharging their accountability and better information about performance, financial position, and financing and investing activities. Four participants responded that they thought the revised standard provided better disclosure, thereby assisting in the discharge of accountability. More detail was required about non-current assets, current and deferred income taxes, and deferred tax assets and liabilities. Components of the deferred tax base were better understood. However, greater risk was perceived to be associated with recognition of tax losses because of the less stringent requirements. Three participants reported that they thought the revised standard had minimal impact on reporting and that users were not getting any more information as there were few differences between the old and new standards.

CONCLUSION

This study found that only three of the Top 100 publicly listed companies, by capitalisation, in Australia had chosen to early-adopt the balance-sheet method of accounting for income taxes, despite a lead time of five years. As pointed out by Watts and Zimmerman (1990), managers do not make an accounting-policy choice in isolation. Our study found that the introduction of the tax consolidation regime and the impending introduction of the A-IFRSs on 1 January 2005 also influenced the decision to early-adopt AASB 1020. Companies had also assessed the costs versus benefits (Fields *et al* 2001) of adopting the balance-sheet method. In regard to adopting accounting standards before the mandatory implementation date, our study indicates that managers will choose to early-adopt a new or revised standard only if there is a material benefit on the company's financial reports or to their accounting practices. Material benefits were perceived to be the provision of more meaningful information to users, financial benefits (or no additional costs), as well as identifying the company as a leader in financial reporting. Seven of the 10 senior company representatives interviewed expressed a favourable opinion of the balance-sheet method. Further research could now be undertaken to determine the effect of the transition to the balance-sheet method of accounting for income taxes on all publicly listed companies in Australia.

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NOTES

1 FRS 19 *Deferred Tax* was issued in the UK on 7 December 2000 and became effective for years ending on or after 23 January 2002. Early adoption was encouraged.

2 As a result of this finding we searched all companies outside of the Top 100 and were able to identify a further nine companies that had early-adopted AASB 1020, of which five had tax losses.

3 AARF received 19 comment letters in response to ED 87. Most supported international harmonisation and the move to the balance-sheet method. However, concerns were expressed about costs exceeding benefits, recognition of deferred taxes, staff training and systems update.

4 An examination of the Top 100 companies showed that 78 companies of the remaining 81 chose to enter into the tax consolidation regime.

5 However, a search of annual reports for 2004 indicates that for some companies with tax losses the hurdle requirement of "probable" could still not be met.

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