




ED 155 sub 3

New South Wales
T R E A S U R Y

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Our Reference:
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Dear Professor Boymal

**Exposure Draft 155 Financial Reporting by Whole of Government –
Comments on the treatment of deferred tax in the general government sector**

I refer to the request for comments on Exposure Draft ED 155 *Financial Reporting by Whole of Government*. Please find attached a short comment paper by NSW Treasury regarding the issue of deferred tax, referred to in the Exposure Draft.

The Illustrative Example to ED 155 currently provides that the mirror to the deferred tax liability recognised by the Public Non-Financial Corporation (PNFC) and Public Financial Corporation (PFC) sectors is not recognised by the General Government Sector (GGS). This is also referred to in Reconciliation note r(ii).

NSW Treasury disagrees with this conclusion and believes that deferred tax balances are controlled by the GGS, as a result of its control relationship over the PNFC/PFC sectors. In NSW Treasury's view, the AASB has not given sufficient consideration to the issue of control in its initial deliberations (refer AASB Agenda Paper 11.2). The AASB should revisit this issue, in light of the attached comments, before finalising the Standard.

If NSW Treasury's view is accepted, this would give rise to an additional convergence difference between the Government Finance Statistics (GFS) and Generally Accounted Accounting Principles (GAAP).

Finally, irrespective of the final position on the issue of the GGS mirror deferred tax asset, the AASB needs to consider whether the deferred tax expense is a 'transaction' or 'other economic flow' for the PNFC/PFC.

If you have any queries regarding the attached paper, please contact me on (02) 9228 3019 or Dianne McHugh on (02) 9228 5340.

Yours faithfully

Robert Williams
for Secretary

TREATMENT OF DEFERRED TAX UNDER GFS / GAAP

1. Issue

Under GFS, deferred tax is not recognised as either a transaction or other economic flow. Therefore, only the current tax expense/revenue is recognised.

In contrast, under the GAAP framework, PNFCs and PFCs recognise deferred tax assets / liabilities (in accordance with AASB 112 *Income Taxes*) and in New South Wales the GGS has recognised revenue / assets to mirror the position reported by PNFCs and PFCs. This is then eliminated on consolidation at the whole of government level.

At a minimum, this issue will give rise to a GFS/GAAP convergence difference for the PNFC and PFC sectors (i.e. as deferred tax is recognised under GAAP but not under GFS). The question is, whether there is a similar GFS/GAAP convergence difference for the GGS, in terms of the mirror deferred tax revenue/ asset. Therefore, this paper examines whether:

- the GGS should recognise as revenue / asset the deferred tax of the PNFCs and PFCs.
- deferred tax revenue / expenses are transactions or other economic flows¹.

2. Background

2.1 Accounting Standard requirements

AASB 1049 *Financial Reporting of General Government Sectors by Governments* requires the General Government Sector (GGS) financial report to be prepared in a manner consistent with other Australian Accounting Standards, unless otherwise specified in the Standard. From the GGS perspective, the relevant Standard for the treatment of any revenue / asset relating to the PNFC/PFC deferred tax liability/expense is AASB 1004 *Contributions*. AASB 112 is not applicable to the tax collector.

AASB 1004 states that income from the contribution of an asset to the entity must be recognised when and only when the following conditions have been satisfied (AASB 1004, para 9):

- The entity obtains control of the contribution or the right to receive the contribution;
- It is probable that the economic benefits comprising the contribution will flow to the entity; and
- The amount of the contribution can be measured reliably.

Also, AAS 31 *Financial Reporting by Government* provides that tax revenues should be recognised when the underlying transaction or event which gives rise to the government's right to collect the tax occurs and can be measured reliably (AAS 31, para 15.2.1).

¹ Even if it is not accepted that a mirror deferred tax asset/ revenue is recognised by the GGS, this question arises from the viewpoint of the PNFC/PFC sectors.

2.2 AASB view

Australia's Heads of Treasuries Accounting and Reporting Advisory Committee (HoTARAC) raised this issue with the AASB. In the AASB's response (letter dated 19 March 2007), they concluded that the GGS should not recognise the deferred tax balances. In coming to this conclusion, they argued that, consistent with the principles in AASB 1004, the GGS should not recognise the deferred tax revenue / asset until the tax equivalent event or transaction has occurred. They argued that from a PNFC/PFC viewpoint, the 'event' is the recognition of the underlying assets / liabilities, but from the GGS's perspective, it is the occurrence of taxable transactions.

Further, the AASB Agenda Paper 11.2, which addressed this issue also stated:

“We acknowledge that the issue is complicated by the fact that the GGS controls the PNFC/PFC and thereby arguably controls the contribution. That issue starts to get into the consolidation question. Therefore, consistent with the principles that GGS does not consolidate PNFC/PFC, we do not believe that it is appropriate for it to recognise revenue / asset as a counter to the PNFC / PFC deferred tax liability.” (Refer 'Staff Response 1', p 2)

The AASB decided that it was not necessary to amend AASB 1049 in response to this issue, but will include it in a list of possible improvements for consideration at a future meeting (refer AASB Minutes of 15 March 2007). However, the Illustrative Example to ED 155 currently assumes that the mirror to the deferred tax liability recognised by the PNFC/PFC sectors is not recognised by the GGS (refer Reconciliation note r(ii)).

3. Analysis

3.1 Recognition of deferred tax asset / revenue

New South Wales recognises revenue / assets in the GGS to mirror the deferred tax position reported by PNFCs and PFCs. NSW Treasury believes that this treatment is permitted by current GAAP and disagrees with the AASB's above conclusion. This is premised on the view that 'control' of the deferred tax contribution is obtained at the same time that the PNFC/PFCs recognise the associated deferred tax expenses/liabilities. This is on the basis:

- The tax equivalents regime is a 'closed system' where the tax collector is the GGS and the PNFC/PFC entities are required to fully comply with the income tax legislation and deferred tax accounting.
- The GGS controls these sectors and as such it controls the mirror deferred tax asset / revenue taken up by the PNFC/PFC sectors.

Further, NSW Treasury argues that the other two criteria of 'probability' and 'reliable measurement' in AASB 1004 are also satisfied on the basis that:

- The probability of the PNFC/PFC paying the tax is the same probability of the GGS receiving it. Therefore, if the PNFC/PFC can recognise the liability based on probability, the GGS can recognise it on the same basis.
- As the GGS sector controls the PNFC/PFC entities, the amounts are reliably measurable.

The AASB staff response in Agenda Paper 11.2, acknowledged that because of this control relationship, the GGS arguably controls the contribution. However, the AASB dismissed this argument as this ‘starts to get into the consolidation question’, and on the basis that the GGS does not consolidate PNFC/PFC. NSW Treasury believes that this argument is invalid and notes that AASB 1049, para 11(a) “...prohibits the consolidation of controlled entities in other sectors”. But that equally explicitly acknowledges that the GGS sector controls the other sectors and also controls the mirror deferred tax asset / revenue.

The other argument advanced by the AASB was that from the GGS perspective, the tax equivalent ‘event’ that gives rise to control has not occurred. In contrast, the AASB points out that from the viewpoint of the PNFC/PFC, the ‘event’ is the recognition of the underlying assets/liabilities. However, NSW Treasury argues that, given the control relationship between the sectors, the ‘event’ is the same for all sectors.

The concept that the relevant ‘event’ for tax revenue is the ‘taxable event’ is not included in AASB 1004. Rather, it is part of AAS 31 (para 15.2.1). Also, the AAS 31 reference is clearly in regard to the tax collected external to government, and not the tax equivalents regime operating within jurisdictions. As discussed, the primary difference is that the tax equivalents system is a ‘closed system’ entirely within government control.

Further, determining the ‘event’ that gives rise to control and recognition is a question of judgement. That is, the premise of accrual accounting is that items are recognised as incurred or earned, which maybe at an earlier point than the legal liability. In terms of tax equivalents, the ‘event’ could be argued to occur at various points e.g. the recognition of the underlying asset/liability (or the economic event that gives rise to a future tax asset/liability – per AASB 112, first paragraph under ‘Objective’) or the taxable event. The choice of the ‘event’ depends on when control is obtained; when it is probable and when the amount can be measured reliably. Given the nature of the tax equivalent regime, it may be argued that the ‘event’ that gives rise to the PNFC/PFC deferred tax liabilities/expenses is the same ‘event’ that gives rise to the GGS’s mirror deferred tax asset/revenue.

Finally, if the AASB’s argument is accepted, NSW Treasury question the conceptual basis for the recognition of deferred taxes/liabilities under AASB 112. That is, why is it acceptable to recognise deferred taxes/liabilities based on the underlying assets/liabilities of the taxpayer, yet not recognise the asymmetrical treatment for the tax collector, where the tax collector is in a position to control the taxpayer?

3.2 Transaction or other economic flow

Where deferred tax is recognised under GAAP, a question arises as to whether the associated expense/revenue is a ‘transaction’ or ‘other economic flow’ under AASB 1049 and GFS/GAAP. Under GFS, deferred tax is not recognised either as a transaction or other economic flow. Even if it is not accepted that a mirror deferred tax asset/ revenue is recognised by the GGS (refer 3.1 above), this question arises from the viewpoint of the PNFC/PFC sectors. This needs to be addressed by the AASB. This is because GAAP prevails over GFS, unless otherwise indicated.

There are a number of different arguments regarding this issue. For example, some argue that, because GFS does not recognise deferred tax assets / liabilities, and because AASB 1049 states that amounts must be classified as transactions or other economic flows in a manner consistent with the principles in the ABS GFS Manual, that the outcome which best aligns with those principles is to treat all deferred tax expenses/revenues as an ‘other economic flow’. This is also akin to treating the movement as a revaluation, which is the approach adopted in regard to doubtful debts (refer AASB 1049, para 31(g)).

An alternative argument is that where the deferred tax arises from a movement in an asset or liability that itself is recognised as a transaction, then the associated deferred tax on that movement should also be recognised as a transaction (but not otherwise). This would mean that deferred tax would need to be dissected between transactions and other economic flows, depending on treatment of the underlying asset / liability.

Finally, some argue that if a mirror deferred asset/revenue is recognised by the GGS to reflect the PNFC/PFC treatment, then the entire deferred tax expense/revenue is a transaction, because in a 'closed' tax equivalent system within government, it is a 'mutually agreed interaction' which satisfies the definition of a 'transaction'.

4. Conclusion

NSW Treasury is of the view that because of the nature of the tax equivalent system in the public sector and the control relationship between the GGS and PNFC/PFC sectors, a mirror revenue/ asset should be recognised by the GGS to counter the PNFC/PFC tax balances. This would give rise to an additional GFS/GAAP convergence difference.

However, irrespective of the outcome on the above issue, the AASB will need to examine whether deferred tax expenses/revenue are 'transactions' or 'other economic flows' under GFS/GAAP convergence.