Depreciation on long-lived buildings – accounting impact of 2010 tax changes

The Accounting Standards Review Board (ASRB)[1] and Financial Reporting Standards Board (FRSB)[2] are aware of serious concerns about the accounting consequences of recent changes in tax legislation announced in the 2010 Budget. These concerns relate to entities that report under New Zealand equivalents to International Financial Reporting Standards (NZ IFRS) and are required to account for deferred tax under NZ IAS 12 *Income Taxes* (NZ IAS 12).

In this communiqué, we outline the accounting issue and potential responses within the context of the New Zealand financial reporting framework. We also recommend that affected entities discuss this important issue with their advisers and consider the wider commercial implications.

The accounting impact of the 2010 Budget changes

In the 2010 Budget Statement, the government announced (and subsequently enacted) legislation to effectively remove tax deductions for depreciation on buildings with expected lives of 50 years or more. This change in tax legislation is expected to have a significant impact on those entities with existing buildings that have expected lives of 50 years or more and are not intended for sale. The Boards understand that, in these circumstances, application of the requirements of NZ IAS 12 could cause a substantial increase in the amount of deferred tax liability recognised for accounting purposes, with a correspondingly large tax expense in the year the change is recognised.

Essentially, the accounting standard treats the loss of tax deductions for depreciation as creating an obligation to pay more tax in the future, because the entity can no longer claim depreciation as a deduction against taxable income generated from using the building over its expected useful life. However, the Boards are also aware that many do not regard this increased deferred tax liability for accounting purposes as a 'real' liability in an economic sense, particularly when any potential impact on future tax payments is unlikely to occur for decades and/or the impact of the loss in future tax deductions has been factored into the carrying value of buildings measured at fair value.

Therefore, some have suggested that changes be made to NZ IAS 12, or the international standard issued by the International Accounting Standards Board (IASB), upon which NZ IAS 12 is based. This suggestion is discussed below, after first outlining the role of IFRS in the New Zealand financial reporting framework, to provide the context in which this suggestion must be considered.

The role of IFRS in the New Zealand financial reporting framework

When New Zealand adopted International Financial Reporting Standards (IFRS) several years ago, it joined a global trend in moving from local accounting standards to IFRS. For example, Australia and the European Union adopted IFRS in 2005, and many more countries have adopted or are in the process of doing so. The US recently announced that it will decide next year whether, when and how IFRS should be incorporated into the US financial reporting system. The global spread of IFRS results from demands from the world's capital markets for a single accounting language, to help investors and to reduce compliance costs for multinational companies.

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[1] The ASRB is an independent Crown entity established under the Financial Reporting Act 1993. Its primary functions include reviewing and approving financial reporting standards.

[2] The FRSB is a national board of the New Zealand Institute of Chartered Accountants. Its primary functions include developing financial reporting standards, which are then submitted to the ASRB for its review and approval.

In order for New Zealand entities to gain the benefits from adopting IFRS, processes were put into place to ensure that profit-oriented entities reporting under New Zealand financial reporting standards were able to claim full compliance with IFRS. Hence, under ASRB Release 8 *The Role of the Accounting Standards Review Board and the Nature of Approved Financial Reporting Standards*, when a New Zealand standard is developed from an IFRS, recognition and measurement requirements of the IFRS are not amended (and disclosure requirements are not reduced) for profit-oriented entities. This process means that a profit-oriented entity is able to simultaneously comply with both NZ IFRS and IFRS.

Suggestions for addressing the accounting implications

In order to address concerns about the accounting implications of the loss of depreciation deductions for tax purposes, some have suggested that amendments be made to NZ IAS 12. However, this would mean that NZ IFRS is no longer aligned with IFRS, and so profit-oriented entities would be unable to comply with both local and international accounting standards – thereby undermining the fundamental objective of New Zealand's adoption of IFRS.

In addition, any change to accounting standards – either locally or at the international level – can only be made after a formal due process. This process takes time to complete, and could not be completed before New Zealand entities are required to account for the change in tax legislation, such as those entities with June 2010 balance dates.

Therefore, while the Boards acknowledge the serious concerns that have been raised about the accounting impact of the recent tax changes for entities required to comply with NZ IAS 12, the suggestion to make changes to the standard is not a viable solution, both because of time constraints and the wider implications for the New Zealand financial reporting framework.

Nevertheless, the FRSB will write to the IASB to explain the situation in New Zealand. The IASB currently has a limited-scope project in which amendments to IAS 12 are being considered. And if the New Zealand situation is unable to be addressed in the limited-scope project, we will urge the IASB to consider the concerns about the standard in any subsequent project to comprehensively review IAS 12.

Other implications of the change

Given that any potential changes to accounting standards are unlikely to occur in the short term, it is important that affected entities consider the implications of the tax changes. Over and above the financial statement impact, entities should consider the wider practical implications, for example, impacts on debt covenants if deferred tax liabilities are not excluded, and impacts on profit announcements and other communications with investors and other stakeholders. We therefore recommend that affected entities consult their advisers to discuss this issue further.

Kevin Simpkins
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