SOUTH AFRICAN DEFERRED TAX PRACTICES WITHIN THE CONTEXT OF POSITIVE AND NORMATIVE ACCOUNTING THEORIES

by

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ABSTRACT

The primary purpose of this study is to establish whether, by examining the responses to various pronouncements covering deferred taxation, a comprehensive theory of accounting can be said to exist in South Africa.

Four case studies were conducted on the responses to the various pronouncements issued by the Accounting Practices Committee on deferred tax. The respondents to these pronouncements were surveyed to establish their perception and understanding of various aspects of accounting theory, deferred taxation and corporate management's influence on the accounting standard setting process.

The results of the study indicate that, although the recognition of a positive theory of accounting cannot be conclusively shown to exist, certain of the factors that can be said to drive the accounting standard setting process are identified. A positive relationship is perceived to exist between the accounting standard setting process and management compensation.

OPSOMMING

Die primêre doel van hierdie navorsing is om vas te stel, deur middel van die ondersoek van skriftelike reaksies op verskeie verklarings betreffende uitgestelde belasting, of omvattende rekeningkundige teorie in Suid-Afrika bestaan.

Vier gevalle studies is uitgevoer op die reaksies op die verskeie verklarings oor uitgestelde belasting, wat deur die Rekeningkundige Praktykekomitee uitgereik is. Die respondente op hierdie verklarings is ondervra om hul begrip en insig van verskeie aspekte van rekeningkundige teorie, uitgestelde belasting en korporatiewe bestuursinvloede op die vasstellingsproses van rekeningkundige standaarde, te bepaal.

Die resultate van die navorsing dui aan, dat, ondanks die feit dat die bestaan van positiewe rekeningkundige teorie nie onteenseglik bewys kan word nie, sekere van die faktore wat die vasstellingsproses van rekeningkundige standaarde beinvloed, geidentifiseer is. 'n Positiewe verband is aangetref tussen die vasstellingsproses van rekeningkundige standaarde en bestuursvergoeding.

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- To all those others who made a contribution to this study and who are too numerous to mention individually.

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DECLARATION

I declare that

"South African Deferred Tax Practices Within the Context of Positive and Normative Accounting Theories"

is my own work and that all the sources that I have used or have quoted have been indicated and acknowledged by means of appropriate references.

JAMES GRANT SAMKIN
JANUARY 1993

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CHAPTER ONE

INTRODUCTION

1.1 THE RESEARCH TOPIC

This study examines South African deferred taxation practices within the context of the competing positive and normative accounting theories.

The past two decades has witnessed an intensive, vigorous and unresolved debate conducted through the medium of the various accounting research journals world wide as to the validity and conceptual underpinnings of positive accounting theory.

However, in spite of empirical evidence presented by various researchers internationally on accounting theory, a strong body of persuasive theorists strongly contest the existence of positive accounting theory.

Theorists have advanced competing theories as being representationally faithful and accommodative of the divergences and exceptions found in practice. An attempt is made in this study to present a contemporary, comparative profile and status of the progress made on this vexed problem.

1.2 SIGNIFICANCE OF THE RESEARCH

The significance of this research is that it provides one of the most comprehensive studies on the alternative deferred taxation practices employed in South Africa to date. Furthermore, the research provides empirical evidence on the most appropriate deferred taxation practice considered by respondents to be the most appropriate in South Africa.

In addition, the research also examines various aspects considered to be significant to the determination of a positive theory of accounting, and, in particular, will provide the respondents' perception to what they perceive to be corporate managements' influence on the accounting standard setting process in South Africa.

1.3 SCOPE AND LIMITATIONS OF THE STUDY

The primary purpose of the study is to establish whether, by examining the responses to various pronouncements covering deferred taxation, a comprehensive theory of accounting can be said to exist in South Africa.

The objects of this study can be summarised as follows:

- to establish the perceptions and understanding of respondents to the various aspects of accounting theory
- to identify which alternative deferred taxation practice is considered by respondents to be the most appropriate practice for local circumstances
- to establish the views of respondents to the nature of the deferred taxation balance in the balance sheet of companies and its disclosure
- to ascertain the perception of respondents to their interpretation of corporate managements' influence on the standard setting process and
- to identify whether there are any inherent weaknesses in the current standard setting process, and, if so, to suggest amendments and improvements to the standard setting process.

The study has at least two identified limitations. Firstly, only those interested parties who responded to either Discussion Paper 5, the unpublished memorandum, Exposure Draft 61 and Exposure Draft 72 covering deferred taxation, were surveyed to determine their views and opinions. Secondly, only the standard setting process that the current AC 102 statement '*Taxation in Financial Statements*', was subjected to, was examined.

1.4 RESEARCH METHODOLOGY

The research methodology utilised in this study incorporated several approaches and techniques.

- A review of relevant literature relating to positive and normative accounting theories and the role of certain of the philosophies of science in the development of competing accounting theories was undertaken.

- A review of the nature of deferred taxation and the theoretical purpose that underlies the creation of deferred taxation accounts in the financial statements of companies was undertaken. Alternative deferred taxation practices previously considered in South Africa and the effect that those practices have on financial statements were examined.

- Four individual case studies were conducted on the responses by interested parties to the various pronouncements issued by the Accounting Practices Committee on deferred taxation. These pronouncements are Discussion Paper 5, the unpublished memorandum, Exposure Draft 61, and Exposure Draft 72.

- Statistical analysis, using a chi-square goodness-of-fit test and a correlation coefficient matrix, was employed to analyse the responses to the questionnaires that were forwarded to those interested parties who responded to either Discussion Paper 5, the unpublished memorandum, Exposure Draft 61 and Exposure Draft 72, all covering alternative deferred taxation practices.

- A factor analysis of the responses to the questionnaire was employed to establish the validity of the factors identified in the research hypotheses.

- An analysis of the responses to the questionnaire using Cronbach's alpha coefficient to determine the overall reliability of the questionnaire was also explored.

The results obtained herefrom confirmed the appropriateness and relevance of the approaches and techniques used.

1.5 ORGANISATION OF THE STUDY

This chapter delineates the areas of study and discusses the research approach followed.

Chapter two commences with various definitions of accounting theory, followed by an overview of certain of the philosophies of science that have been applied to accounting, and reviews the literature relevant to this study. This literature review will examine the development and structure of the two competing theories considered in this study namely, the positive and normative theories of accounting. Other accounting theories will also be examined.

Chapter three examines the nature of deferred taxation as well as analyses the various deferred taxation practices that have been considered and employed in South Africa, together with the arguments presented in support as well as against the various deferred taxation practices.

The research methodology employed and the development of the questionnaire is explained in detail in Chapter four.

Chapter five describes the statistical procedures used to analyse the questionnaire, presents the findings of the case studies conducted on Discussion Paper 5, the unpublished memorandum, and Exposure Drafts 61 and 72. An analysis of the results of the completed questionnaire is presented.

Chapter six concludes the study by highlighting the salient points that have arisen from the research and identifies areas warranting future research.

CHAPTER TWO

CONCEPTUAL UNDERPINNING OF ACCOUNTING THEORY

2.1 INTRODUCTION

This chapter examines the conceptual underpinnings of accounting accounting theory, the consideration of competing accounting theories and in particular the role of the various philosophies of science in the development of competing accounting theories. In particular, the development and structure of the two primary competing theories of accounting considered here, namely positive and normative theories of accounting, will be examined. In subsequent chapters, the accounting for and disclosure of deferred taxation will be critically examined in the light of these competing accounting theories.

The issue of deferred taxation in South Africa has, since the first pronouncement covering deferred taxation issued in 1972, (Exposure Draft 8 '*Taxation in the Financial Statement of Companies*') been largely unresolved. There has subsequently been one discussion memorandum (DP 5), one unpublished memorandum, two exposure drafts (ED 61 and ED 72), and two AC 102 statements (one AC 102 revised) of generally accepted accounting practice covering this topic, all with the exception of ED 8, offering management a choice between alternative deferred tax practices. Options offered for consideration in these pronouncements have ranged from: the deferred and liability methods, the flow through method of providing for deferred taxation; the creation of a deferred tax asset; and the current generally accepted accounting practice (GAAP) where provision for deferred taxation can be made either comprehensively or on the partial method, using the liability method.

This chapter therefore, must be viewed as the basis against which positive and normative accounting theories as applied to deferred taxation in South Africa will be measured.

2.2 DEFINITIONS OF ACCOUNTING THEORY

It is imperative that we correctly identify the nature of deferred taxation in our accounting framework. Thus, it is instructive to examine the origins of accounting theory and its definition.

The definitions of accounting theory have evolved simultaneously with changes in accounting thought. These definitions have developed, taking into consideration accounting practices that existed at a particular point in time, together with the complexity of business transactions. This evolution is apparent when definitions offered to be those of accounting theory are examined:

> *The central purpose of accounting is to make possible the periodic matching of costs (efforts) and revenues (accomplishments). This concept is the nucleus of accounting theory, and a bench mark that affords a fixed point of reference for accounting discussions (Littleton, 1953, 30).*

The evolutionary process continued with the definition formulated by the Committee on Terminology of the American Institute of Certified Public Accountants in 1961:

> *Accounting is the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the result thereof (1961, 9).*

The American Accounting Association (AAA, 1966, 1) considered that accounting was "...the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by the users of the information''.

All the above definitions, however, relate to practical situations where little or no distinction between accounting theory and practice could be ascertained. It would be more accurate to classify these definitions as descriptions of accounting, where principles or postulates were developed in response to practical requirements that assisted in reducing ambiguities that existed in the definition of practical accounting concepts, such as 'realisation' and 'objectivity', or in the determination of items such as 'value' and 'profit'.

In 1966 the American Accounting Association (AAA) became the first professional body to formally attempt a definition of accounting theory. The definition arrived at by the AAA (ibid, 1), considered accounting theory to be "...a cohesive set of hypothetical, conceptual and pragmatic principles forming a general frame of reference for a field of study''.

During the 1970's and subsequently, the development of accounting theory has been influenced by the ideologies of individual accounting academics, or 'schools' such as the 'Rochester School', to the extent that no universally acceptable single theory of accounting can be said to exist. This statement is supported by the 1977 monograph of the American Accounting Association, '*Statement of Accounting Theory and Theory Acceptance*', where they state:

> *In the view of this committee, a single universally accepted basic accounting theory does not exist at this time. Instead, a multiplicity of theories has been and continues to be proposed (1977, 1),*

a view supported by Belkaoui (1985, 11) in that he considers

> *". . . [n]o present comprehensive theory of accounting exists. Instead, different theories have been and continue to be proposed in the literature. Many of these theories arise from the use of different approaches to the construction of an accounting theory or from the attempt to develop theories of a middle range rather than a single comprehensive theory''.*

Further support for this view point is advanced by Wolk, Francis and Tearney (1984, 2): The term accounting theory is commonly used in financial accounting, but it has no single standardised definition, while Underdown and Taylor (1985, 1) state that "...[a]t present no single general theory of accounting exists which all agree can fulfil these objectives''.

Belkaoui (1985, 10), considers that the primary object of accounting theory is to provide a basis for the prediction and explanation of accounting behaviour and events. This definition does not differ markedly from the definition offered by self proclaimed positivists Watts and Zimmerman (1986, 2), who state that "...the objective of accounting theory is to explain and predict accounting practice''.

These definitions must be compared to a definition presented by Demski (1973, 718) where he argues that "...a primary goal of accounting theory is to explain what accounting alternatives should be used (in some particular circumstance)...'', while the most comprehensive definition of the theory of accounting is offered by Hendriksen (1982, 1):

> *[accounting theory] may be defined as logical reasoning in the form of a set of broad principles that (1) provide a general frame of reference by which accounting practice can be evaluated and (2) guide the development of new practices and procedures. Accounting practice may also be used to explain existing practice to obtain a better understanding of them. But the most important goal of accounting theory should be to provide a coherent set of logical principles that form the general frame of reference for the evaluation and development of sound accounting practice.*

The latter two definitions can be viewed as being normative in nature, while the definitions offered by Belkaoui (1985), and Watts and Zimmerman (1986), can be considered positive in nature.

The traditional approaches to the formulation of accounting theory, namely the inductive and deductive approaches, have their roots in the philosophy of science.

2.3 INTRODUCTION TO THE PHILOSOPHY OF SCIENCE

If accounting is considered to be a science, then attention must be given to the methods used to develop scientific theory. For a theory of accounting to exist, "...accounting must provide a philosophy in the same way as the other sciences have a philosophy which defines the methodology'' (Kaye, 1983, 27). Four philosophical frameworks of scientific theory will be considered, namely the inductivist approach, Karl Popper's falsificationist interpretation, Thomas Kuhn's revolution interpretation, and Imre Lakatos's research programme interpretation. An attempt will be made to establish which, if any, of the competing theories considered above deserve the prestige of being considered more theoretically correct when applied to accounting.

2.3.1 THE INDUCTIVIST APPROACH

The inductivist approach to science is based on inductive reasoning which starts with observation and culminates in the formation of scientific knowledge derived from those observations. According to Chalmers (1982, 13), the naive inductivist considers that observation will provide a secure basis from which scientific knowledge is derived.

This interpretation of scientific method assumes hypotheses are confirmed by research. The critical factor is the existence of a problem considered worthy of research. Without the research problem, no development of a scientific theory can commence. Once the problem to be researched has been identified, it is expressed in the form of a hypothesis expressing the relationship between two or more variables. The hypothesis must be non-ambiguous and formulated in such a way so as to enable the researcher to understand exactly what is being tested.

According to O'Hear, (1989, 25), the inductive method consists of "...a stepwise ascent in science from observation to theory''. These steps consist of the following: firstly, the collection of relevant observations. To legitimise the creation of a theory of induction, (Chalmers, 1982, 4) states that the number of observations must be large, and the observations must be repeated under a wide variety of conditions, without presuppositions. In other words, a large number of independent observations are required before a generalisation can be made. Secondly, the data needs to be tabulated so as to isolate the features which are constantly associated with the phenomenon we are interested in, "...both positively, in the sense of always being there when the phenomenon is, and negatively, in the sense of never being there when the phenomenon is not'' (O'Hear, 1989, 25). Thirdly, if such features are found, we may then conclude that this is the cause of our phenomenon. At this third stage, this cause will always bring about that effect. In other words, a generalisation will be made on the basis of available evidence. The final stage entails the testing of the generalisation under various new conditions.

If sufficient observations of a particular occurrence support a hypothesis, the hypothesis is 'confirmed' and the scientist will be able to establish certain laws and theories. He would then be able to derive various consequences that would serve as explanations and predictions. Derivations of this kind are termed deductive reasoning. An example of logical deduction can take the form of the following syllogism:

Premise 1: If all cricketers are men,
Premise 2: and James is a cricket player,
Conclusion: **James is a man.**

If the premises (1) and (2) are true, then it is self evident that the conclusion must be true. The premises cannot be true and the conclusion false. "The truth of the premises guarantees the truth of the conclusion, which is the strength of a valid deductive argument, but also its weakness" (O'Hear, 1989, 26 - 27).

The inductivist view is that growth in scientific knowledge results from numerous and varied observations "...enabling new concepts to be formed, old ones to be refined, and new lawful relationships between them to be discovered" (Chalmers, 1982, 99).

Although a vast amount of evidence can be identified that may confirm a given hypothesis, it does not necessarily imply that the hypothesis is true. The following example supports this supposition:

> *By questioning every individual watching live rugby matches at various stadiums around the country, the evidence obtained could confirm a theory that all South Africans are rugby supporters. This, however, does not imply that the next South African questioned would be a rugby supporter. The first South African found that was not a rugby supporter would show the theory to be false.*

2.3.2 FALSIFICATIONIST INTERPRETATION

The principal architect of this philosophy of scientific method was Karl Popper. His vision of a scientist was a person who used his imagination freely and creatively to produce bold and far-ranging theories which are then tested as severely as possible against the way the world is, and discarded if found wanting.

Popper (1980, 86), argues that the purpose of research is to falsify hypotheses and not to confirm them. This interpretation is known as falsificationism. According to this philosophy, for a theory to be accepted as scientific it must provide a hypothesis which may be falsified. Scientific theories are therefore those theories that have not yet been falsified. A theory is neither true nor factual but merely not yet shown to be false. In other words, a theory which cannot be falsified by observation is not a scientific theory. As a result, a theory cannot be positively confirmed or proven but merely considered to be well-corroborated.

According to this interpretation, scientific theories are hypotheses which have not yet been falsified. Chalmers (1982, 40), contends that a hypothesis is falsifiable if there exists a logically possible observation statement or set of observation statements that are inconsistent with it, that is, if established as true, would falsify the hypothesis.

A consequence of the requirement that a theory be highly falsifiable is that the theory be clear, precise and unambiguous. The interpretation of either observational or experimental results of a vague theory, where it is not certain what the theory is claiming, can be interpreted so as to be consistent with the results of that test.

Henderson and Pierson (1983, 17), state that progress in science is a result of falsifying hypotheses. The falsification of a hypothesis becomes the scientific landmark. As one hypothesis is falsified it is replaced by another which becomes more difficult to falsify.

Popper's theory of falsification does not solve the problems inherent in induction, but "...rather to side-step it altogether by regarding science in terms of disproof and by suggesting that, in science, proof of an inductive sort has no role to play at all'' (O'Hear, 1989, 37). Under falsificationism, the falsification of a theory may be due to faulty observation. The conclusion to be drawn here is that the fallibility of observation is as much a flaw of falsificationism as it is of inductivism.

2.3.3 REVOLUTION INTERPRETATION

Based on the view that scientific theory is a complex structure of some kind, Kuhn (1970, 6), considered that progress in science is by 'scientific revolution'. In terms of this philosophy, complex scientific theories do not develop by the accretion of knowledge or by the continuous falsification of hypotheses but rather by a series of tradition-shattering revolutions: "...each of them necessitated the community's rejection of one time-honored scientific theory in favour of another incompatible with it'' (Kuhn, ibid).

A feature of this theory is the emphasis placed on the revolutionary character of scientific progress "...where a revolution involves the abandonment of one theoretical structure and its replacement by another, incompatible one'' (Chalmers, 1982, 89).

According to Chalmers (ibid, 90), Kuhn's picture of the way science progresses can be summarised by the following open-ended scheme:

> *pre-science - normal science - crisis-revolution - new normal science - new crisis.*

This view is supported by Henderson and Peirson where they state:

> *Kuhn saw science as an open-ended progression beginning with pre-science followed by normal science, crisis, revolution, new normal science, new crisis and so on (Henderson and Peirson, 1983, 19).*

The pre-science period is considered to be that period where there were no generally accepted ideas or procedures, merely competing viewpoints and confusions. As this confusion gradually diminishes, the scientific community will agree on one of the competing ideas which becomes generally accepted. "Kuhn described this generally accepted body of opinion as a paradigm" (ibid).

Kuhn's vision of science will be examined under the following different headings.

2.3.3.1 Paradigms

There is no precise definition of a paradigm. Chalmers (1982, 91) has described some of the typical components that constitute a paradigm. Firstly, paradigms will include standard ways of applying the fundamental laws to a variety of types of situation. Secondly, instrumentation and instrumental techniques necessary for bringing the laws of the paradigm to bear on the real world will be included in the paradigm. Thirdly, a paradigm will consist of some very general, metaphysical principles that guide work within a paradigm. Finally, all paradigms will contain some very general methodological prescriptions such as, "...[m]ake serious attempts to match your paradigm with nature" (Chalmers, ibid).

Belkaoui (1985, 141) in his examination of the nature of a paradigm, identifies three necessary components: firstly, a major article explicating the idea or exemplar, secondly, theories, and thirdly, methods and techniques.

Taking the principles of a paradigm identified by Chalmers together with the components identified by Belkaoui, it can be established that the paradigm sets the standards for legitimate work within the science it governs.

2.3.3.2 Normal Science

Science is distinguished from non-science by the existence of a paradigm capable of supporting normal science. According to Henderson and Peirson (1983, 19), normal science is present when a paradigm dominates the work of scientists. Normal science is portrayed by Kuhn as a puzzle-solving activity governed by the rules of a paradigm (Chalmers, 1982, 92).

Scientists attempt to articulate a paradigm with the aim of explaining the relationship between the paradigm and nature. As a paradigm is always sufficiently imprecise and open ended, it is assumed that the paradigm guarantees the existence of a solution to any problem. Should a puzzle not be able to be solved, no weakness in the paradigm is considered but rather consideration should be given to the shortcomings of the scientist.

2.3.3.3 Revolutions

Anomalies are solutions contrary to the predictions of the paradigm. The existence of anomalies or failures within a paradigm do not in themselves constitute a crisis. Repeated failures within a paradigm can eventually attain a degree of seriousness that constitutes a serious crisis for the paradigm. This may ultimately lead to the rejection of a paradigm and its replacement by an incompatible alternative.

This process is viewed by Chalmers (1982, 94 - 95) as follows:

> *When anomalies come to be seen as posing serious problems for a paradigm, a period of 'pronounced professional insecurity' sets in. Attempts to solve the problem become more and more radical and the rules set by the paradigm for the solution of problems become progressively more loosened. Normal scientists begin to engage in philosophical and metaphysical disputes and try to defend their innovations, of dubious status from the point of view of the paradigm, by philosophical arguments. Scientists even begin to express openly their discontent with and unease over the reigning paradigm.*

The process of moving from one paradigm to the next is imprecise. Once a paradigm has been weakened and undermined to the extent that its proponents lose confidence in it, the time is ripe for what is termed 'revolution'. When this situation occurs, "...a search for alternatives gains impetus; as alternatives are discerned and discussed, the dissatisfaction is heightened. Schools of thought emerge, and one set of ideas gradually gains ascendency over the alternatives" (Wells 1976, 472). It is at this stage that a new paradigm takes over current scientific thinking. O'Hear (1989, 72) considers this process "...neither wholly rational, nor perhaps according to the ideal of the open scientific community, wholly admirable".

2.3.4 RESEARCH PROGRAMME INTERPRETATION

One of the difficulties experienced with the inductivist and falsificationist interpretations of science is that they fail to take into account the complexity of scientific theories. In an attempt to overcome certain of the objections to the Popperian falsificationism, Lakatos proposed an interpretation based upon scientific research programmes. Chalmers (1982, 80) considers a Lakatosian research programme to be a structure that provides guidance for future research in both a positive and a negative way.

Lakatos (1970, 133) in Lakatos I and A Musgrave (Eds), *Criticism and the Growth of Knowledge*, suggests that a scientific theory is a structure consisting of the negative heuristic or 'hard core' which stipulates that the basic assumptions underlying the programme are inviolate or unfalsifiable. The hard core (or defining characteristic of the programme), should not be questioned by the scientist. Any scientist who modifies the hard core of the research programme is considered to have opted out of that particular research programme. This hard core is protected by the positive heuristic which provides hints or guidelines on how the scientist may develop the research programme.

> *"The protective belt consists not only of explicit auxiliary hypotheses supplementing the hard core but also assumptions underlying the description of the initial conditions and observation statements'' (Chalmers, 1982, 81).*

Early work on a research programme takes place without heed of or in spite of apparent falsifications by observation. A research programme must be given a chance to realise its full potential. Chalmers (ibid, 83), in his discussion of Lakatos's research programme concludes that when a programme has been developed to a stage where it is appropriate to subject it to observational tests it is confirmation rather than falsifications that are of paramount importance.

According to Chalmers (ibid, 84) for a research programme to qualify as progressive or scientific it must satisfy the following two conditions: firstly, it should possess a degree of coherence or a positive heuristic, that is, it should involve the mapping out of future research opportunities, and, secondly, the research programme should lead to the discovery of new phenomena at least occasionally.

2.4 THE PHILOSOPHIES OF SCIENCES APPLIED TO ACCOUNTING

Having examined the various philosophies of science briefly, it is necessary to study how various accounting researchers have attempted to utilise the various philosophies to create an acceptable theory of accounting. This examination can by its very nature not be considered comprehensive, but will serve merely to illustrate how various accounting academics have utilised the four philosophies of science in attempting to establish a comprehensive theory of accounting.

Everingham and Hopkins (revision service 13, 1989, 11) state that the original object of providing for deferred taxation was to match the tax charge that appears in the income statement with the pre-tax income to which it relates. Under the comprehensive method of providing for deferred taxation, essentially an income smoothing technique, any trend in pre-tax income is maintained in after tax income.

Although correct tax allocation is necessary to achieve a proper matching of the tax charge against pre-tax income, this principle, its implementation, and the results reflected in published financial statements have been criticised in South Africa.

In subsequent chapters, this study will attempt to apply the philosophies of science discussed below to deferred taxation in an attempt to establish which, if any, of the alternative philosophies can be applied to deferred taxation.

2.4.1 INDUCTIVE APPROACH TO ACCOUNTING THEORY

As discussed in section 2.3.1 above, the inductive philosophy of science attempts to establish specific relationships from many observations. Various academic accountants have attempted to derive a theory of accounting using this ideology where their objective was "...to draw theoretical and abstract conclusions from rationalizations of accounting practice'' (Belkaoui 1985, 17).

Littleton was credited as being the first accounting academic known to have linked the inductive approach of science to accounting. Littleton (1953, 185) considered that "...both the methods of practice and the explanations of theory of accounting were inductively derived out of experience''. Littleton (ibid) further considered that although experience is not identical to experiment, both involve the use of careful observation. Furthermore, he suggested that a framework of accounting could be created using the inductive approach.

> *"If the action (practice) is verbally associated with a justifying reason (theory), we have a framework of associated ideas which can readily be converted into a statement of an end or objective in association with a means attaining that end. This form of statement for accounting ideas deserves the name 'principle of accounting.' Converting a rule of action into a principle of theory is entirely possible'' (Littleton, ibid, 186).*

Konar (1989, 29) considers that accounting is characterised today by general propositions being formulated through an inductive approach and the principles and techniques being derived by a deductive process. A deficiency of this approach is that observers may make a predetermined value judgement on what data should be observed, and what the relevant relationships between the data are. It is therefor necessary that the delimitation of data be unambigious.

Support for the inductive approach to accounting theory can be found in works by various accounting theorists, including, Schrader (1962), Staubus (1985), and Schrader, Malcom and Willingham (1988). These academics, however, have failed to agree on various fundamental principles. "The inductive approach was used by Staubus to weave observed business practices into a coherent, comprehensive theory of accounting'' (Schrader, et al, 1988, 10). Schrader et al, disagreed with Staubus's contention stating "... we especially emphasize that the inductive method does not deal with the behavior of the accounting practitioner, but with the subject matter of the practitioner's interest ...'' (ibid).

2.4.2 POSITIVIST APPROACH TO ACCOUNTING THEORY

The principal architects of this philosophy as applied to accounting theory are two academics from the 'Rochester School', Watts and Zimmerman. Their award winning papers, '*Towards a Positive Theory of the Determination of Accounting Standards*', published in 1978, '*The Demand for and Supply of Accounting Theories: The Market for Excuses*', published in 1979, together with their book '*Positive Accounting Theory*', published in 1986, form the foundation of this approach to accounting theory.

Watts and Zimmerman (1978, 112) consider that a positive theory of accounting will

> *"...help us to understand better the source of the pressures driving the accounting standard setting process, the effects of various accounting standards on different groups of individuals and the allocation of resources, and why various groups are willing to expend resources to affect the standard-setting process''.*

This approach to accounting theory differs from the other approaches to philosophy considered, as the cornerstone of this approach must be the existence of a "...hypothesis and a theory to collect the data'' (Watts and Zimmerman, 1986, 10). Popper (1980, 59), explains that "[T]heories are nets to catch what we call 'the world': to rationalize, to explain, and to master it".

This approach to the formulation of accounting theory will be expanded on in section 2.7 below.

2.4.3 KUHNIAN APPROACH TO ACCOUNTING THEORY

Based on the Kuhnian philosophy of science, Wells (1976, 471) considers that the five steps necessary for the transition from one paradigm to another are as follows:

1. *Recognition of anomalies*
2. *A period of insecurity*
3. *Development of alternative sets of ideas*
4. *Identification of schools of thought*
5. *Domination of the new practices or ideas,*

and that accounting has taken the first four steps by moving from the historical cost paradigm.

Wells (ibid, 480), considers that if the analogy presented above is correct, "...then it appears that accounting is emerging from a state of crisis. Alternative sets of ideas have been proposed and debated, and schools of thought are beginning to emerge''.

Danos (1977, 746), rejects Well's view that accounting has taken the first four steps by moving from the historical cost paradigm, but rather considers that accounting is still at the pre-science stage and that no paradigm has yet emerged.

> *"What can be anticipated for accounting is not the recurring revolutions of a mature science but the singular revolution of a proto-science adopting scientific methodologies for the first time'' (Danos, 1977, 746).*

Wells has not been the only accounting academic to consider accounting theory from a Kuhnian viewpoint. Sterling in *'A Statement of Basic Accounting Theory: A Review Article'* (1967, 100) states:

> *The committee has invited us to view accounting as a measurement information system. This new view precludes some questions but poses others.*

Sterling (ibid), continues and states: This is a change in 'world view' and is the stuff that revolutions are made of. While no reference to Kuhn is made in the body of his review, in the footnotes Sterling invites the readers to "*see Thomas Kuhn, Structure of Scientific Revolutions*, (Chicago: University of Chicago Press, 1962), p. 90 et passim".

What is significant, and lends credibility to the Kuhnian philosophy of science, is the attempt by the 1977 Committee on Concepts and Standards for External Financial Reports of the American Accounting Association, to view the development of accounting thought as a Kuhnian philosophy. In the *Statement on Accounting Theory and Theory Acceptance*, Chapter 4 is devoted to "...developing a plausible explanation for the lack of progress in achieving accounting theory consensus'' (Peasnell, 1978, 218).

Unlike Wells (1976, 480) who considers that accounting is emerging from a state of crisis, Belkaoui (1985, 141) considers that "...accounting is currently in the crisis stage given the general dissatisfaction with the old matching-attaching approach to the specification of the content of annual reports''. This crisis can be observed in South Africa with the dissatisfaction of current statement AC 102 (revised), *Taxation in Financial Statements*, where there is a movement away from providing deferred tax on the comprehensive basis which has as its foundation the matching concept, to the partial basis of deferred taxation which does not recognise the matching concept, thereby ignoring the hard core of timing differences which represent a potential taxation liability.

Dissatisfaction has also been expressed with the realisation concept as critics view the realisation concept as being a 'barrier to reporting'

> *"...because it precludes any reporting of increases in wealth which have not been confirmed directly by an external market transaction'' (Underdown and Taylor, 1985, 33).*

Belkaoui (1985, 141) identifies seven paradigms that are applicable to accounting. The difficulty in attempting to establish which paradigm can be correctly applied to accounting was identified by the Committee on Concepts and Standards for External Financial Reports of the American Accounting Association where they state:

> *Each of the currently competing accounting paradigms tend to support a different empirical domain over which an accounting theory ought to apply (AAA, 1977, 47).*

2.4.4 ACCOUNTING THEORY AS A LAKATOSIAN RESEARCH PROGRAMME

Mouck considered the interpretation of accounting theory based on a Lakatosian research programme. He considered that the methodology of scientific research programmes developed by Lakatos to be a much more realistic basis for appraisal of scientific inquiry in that not only is Lakatos' methodology of scientific research programmes "...more descriptively accurate regarding the historical practice of science, but also because it embodies a higher level of methodological tolerance and a safeguard against tolerance'' (1990, 238).

The result of this is that a particular accounting theory may be shown to be scientific under Lakatos' methodology even though it would have been considered 'unscientific' using the criteria established by Popper.

Mouck considered that, based on the Chicago version of neo-classical economic theory, the hard core or negative heuristic assumptions underlying the programme could be identified. These assumptions are, according to Mouck (1990, 236), the following:

(i) *Decision-makers have correct knowledge of their economic situation.*

(ii) *Decision-makers prefer the best available alternative given their knowledge of the situation and the means at their disposal.*

(iii) *Given (i) and (ii), situations generate their internal 'logic' and decision-makers act appropriately to the logic of their situation.*

(iv) *Economic units and structures display stable, coordinated behaviour.*

(v) *The wants and preferences of individuals are autonomous with respect to the market system.*

(vi) *All decision-makers are motivated by their narrowly defined self-interest and not by the public interest.*

(vii) *The firm is considered to be a nexus of (explicit or implicit) contracts among self-interested parties.*

As stated in section 2.3.4 above, the hard core of the research programme is inviolate and not subject to modification. The protective belt or positive heuristic can be modified and if necessary replaced if protection of the hard core of the research programme is necessary. Mouck (ibid), considered the protective belt to consist of the following:

(i) *The efficient market hypothesis.*

(ii) *The capital assets pricing model.*

(iii) *The theory of rational expectations.*

(iv) *Contracting and agency theory.*

(v) *A theory of the political process.*

(vi) *Various empirically testable hypotheses.*

(vii) *Various assumptions necessary to implement empirical testing.*

What is apparent from the above discussion, is the inability of accounting academics to agree on which philosophy of science, if any, can be applied to accounting. In order to bring together the various diverse views considered above, it is reasonable to assume that all accounting theories that have been derived from the various philosophies of science, are 'positive theories of accounting'.

The two primary theories of accounting against which the study must be considered will be examined below.

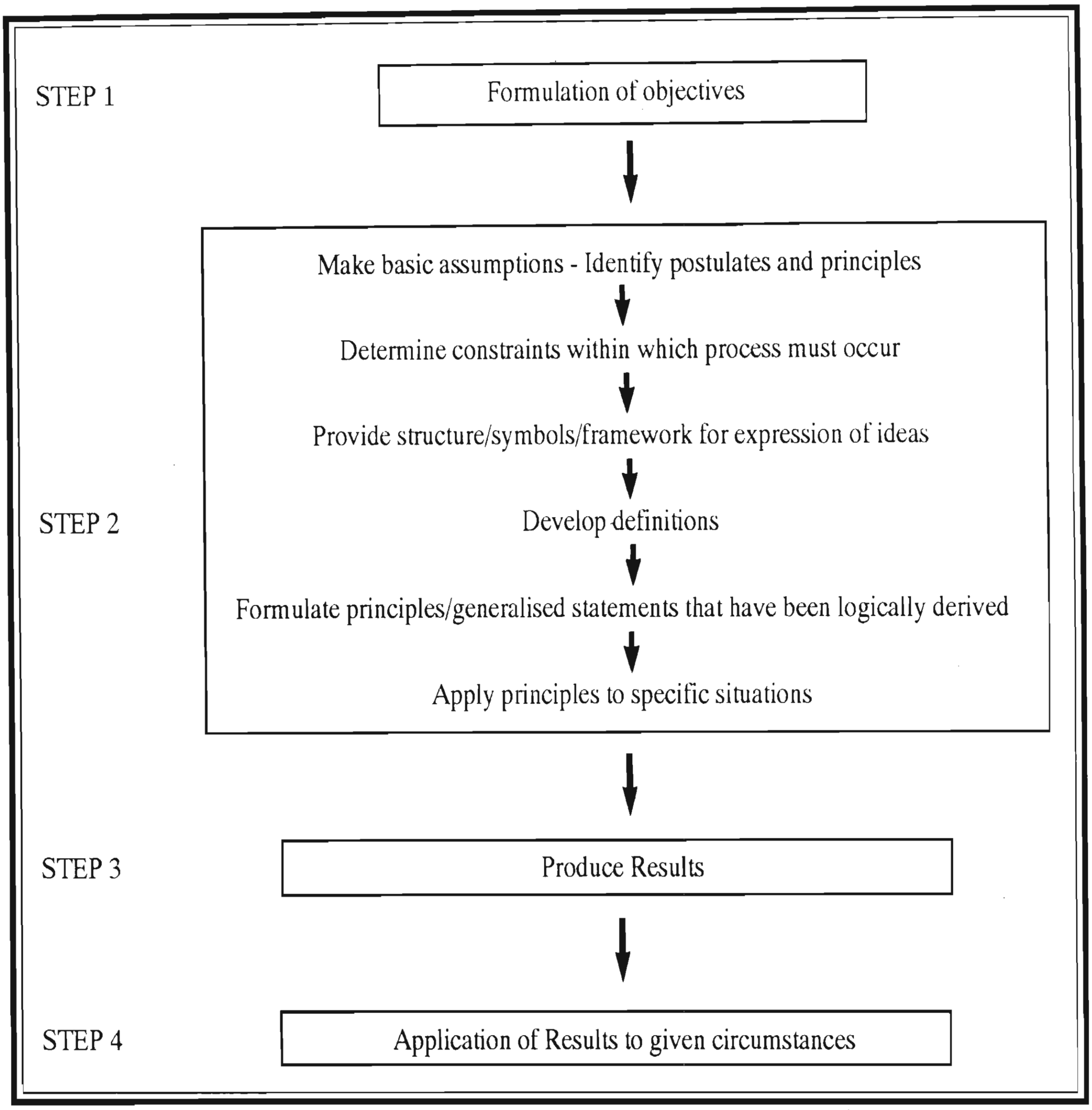
2.5 NORMATIVE THEORIES

Various authors have considered normative theories to be those theories that propose or recommend a specific course of action (Henderson and Peirson, 1983, 10, Glautier and Underdown, 1986, 34, and Hendriksen, 1982, 56).

According to Henderson and Peirson (1983, 10), "...a common characteristic of all normative theories is that they ultimately depend upon a 'value judgement,...'" which cannot be verified. Glautier and Underdown (1986, 36), consider that normative theories "...rely heavily on deductive reasoning". Deductive reasoning comes about as a result of making observations of a particular event, with the deductive reasoning following from a few implicit or explicit assumptions. The critical process under the deductive process, is the formulation of objectives as different objectives may "...require different structures and result in different principles" (Hendriksen, 1982, 7).

The construction of a theory based on deductive reasoning is illustrated in Figure 2.1 below.

Figure 2.1 : Illustration of Theory Construction based on Deductive Reasoning



Source: Adapted from Henderson and Pierson (1983, 10) and Hendriksen (1982, 7)

A normative theory can be seen as consisting of four distinct parts. The first part of the theory is concerned with establishing what the objective should be, a general statement, while the second part of the theory provides a framework within which the objective will be solved. All these components are necessary for a normative theory to exist. This process can be illustrated with an example of the following theory taken from Henderson and Peirson (1983, 10). *"Personal income tax should be increased to force a decrease in consumption expenditure, in order to reduce inflation"*. Reduced to an Aristotelian syllogism this process can be illustrated as:

Figure 2.2 : Illustration of a Normative Theory

STEP 1:	**Formulation of objective:**	Inflation should be reduced.
STEP 2:	**Make assumptions:**	An increase in personal income tax will reduce consumption expenditure.
	Formulate principles:	A decrease in consumption expenditure will reduce inflationary pressures.
STEP 3:	**Produce results:**	Personal income taxes should be increased.
STEP 4:	**Apply results to given circumstances**	Test whether increases in personal income tax reduces inflation.

Source: Henderson and Peirson (1983, 10)

2.5.1 NATURE OF NORMATIVE ACCOUNTING THEORY

Having established the criteria for a normative theory, it is necessary to validate the nature of normative accounting theory. Henderson and Peirson (1983, 36), state that normative theories of accounting "...recommend or prescribe courses of action or behaviour for accountants. Some normative theories recommend particular measurement practices while others recommend particular interpretations of accounting data".

This view is supported by Hendriksen (1982, 10):

> *Normative theories attempt to prescribe what data ought to be communicated and how they ought to be presented, that is, they attempt to explain what should be rather than what is.*

Watts and Zimmerman (1986, 9), do not disagree with these contentions and provide the following practical example:

> *Normative propositions are concerned with prescriptions. They take the form 'Given the set of conditions C, alternative D should be chosen.' For example, a normative proposition is, 'Since prices are rising, LIFO should be adopted.' This proposition is not refutable.*

Glautier and Underdown (1986, 35 - 36), consider that the normative approach to accounting theory reflects a degree of disillusionment with the problem of relating accounting practice to economic and social realities. Consideration should be given to the development of a comprehensive framework "...which would impose theoretical standards both on the quality of information and on the relevance of the information output of conventional accounting systems''.

Various attempts have been made and continue to be made to create the comprehensive framework envisaged by Glautier and Underdown. This includes *'The Corporate Report'* and *'Sandilands'*, for example, which according to Peasnell, (1978, 223) "...acknowledge the importance of decision-usefulness and rely on the normative-deductive classical literature without getting very bothered about the agonies of paradigm choice''.

Support for normative theories of accounting is provided by Kam (1990, 511), who argues that an overall theory of accounting is normative because it includes at least one 'ought to' statement.

> *"These 'ought to' statements, of course, are what we normally refer to as generally accepted accounting principles. Such a theory would justify what we do in practice, and serve as a standard by which to judge different methods''.*

If, as Kam suggests, the existence of a standard of generally accepted accounting practice implies that accounting theory is normative in nature, then the existence of statement AC 102 (revised) *'Taxation in Financial Statements'* would if reference is made to the following example, lend support to the contention that accounting theory in South Africa is normative in nature.

> *If the objective of financial statements is to match items of income or expense in the income statement of the period to which they relate, then deferred tax* ***ought*** *(emphasis added) to be provided where income or expense items recognised in the current accounting period, are subject to taxation in either an earlier or later period.*

2.5.2 CRITICISMS OF NORMATIVE ACCOUNTING THEORY

Criticisms of normative accounting theory can be categorised into three main areas, scientific, welfare and the deficiency of existing accounting practice.

The first criticism levelled at normative accounting theory relates to the scientific testing of the theory. Nelson, quoted by Henderson and Peirson (1983, 36 - 37) considered normative theories to be 'a priori' theories. Nelson characterised a priori research as semi-research as he considered the research to be concerned with the statement of hypotheses on how accounting should be done, without the testing of those hypotheses.

Peasnell (1978, 222) considered that

> *"[F]or one complaint which has been levelled at those whom the committee refers to as 'normative-deductive theorists' is that their work relies entirely on logic; that is, their theories are not subject to any scientific test, there is no scientific 'confrontation' of theory with reality",*

while Hendriksen (1982, 87), considers that

> *"[T]he inductive-deductive approach to accounting theory has some serious deficiencies. Probably, the most important of these deficiencies is the inability to test the theories empirically''.*

Hendriksen (ibid) considers that a second deficiency of the inductive-deductive approach to accounting theory is that it focuses on the welfare of the individual investor rather than on the welfare of society.

The third criticism of normative theories of accounting can be considered to relate to the deficiencies in existing accounting practice. Henderson and Peirson (1983, 37) state that "[I]n most cases, normative theories of accounting proceed logically from a value judgement about the purpose of accounting or a deficiency of contemporary accounting''. Glautier and Underdown (1986, 36), however in their criticism of the normative approach to the creation of accounting theory state that "...if the assumptions are stated broadly enough to secure general agreement, they may be dismissed as self-evident. Alternatively, if they are stated specifically, they may fail to gain general agreement''. Mattessich (1972, 470), however cautions against the complete elimination of value judgements from accounting as

> *". . . the persistence of value judgements raise the serious question whether modern accounting will be as dogmatic as traditional accounting is. A normative approach which explicates its value judgements and reduces them to more basic levels, which furthermore applies systematic testing procedures to reject inadequate systems, could well be regarded as a nondogmatic approach''.*

2.6 THE CONCEPTUAL FRAMEWORK

As indicated previously, accounting theorists have been unable to develop a universally acceptable comprehensive theory of accounting. Langenderfer (1973, 46), submitted that

> *"[A]ccounting theory has, for the most part, developed out of generalizations from accounting practice rather than out of a framework of objectives and principles which might dictate the measuring and reporting techniques to be followed".*

There was a need for the development of sound and consistent accounting standards to act as a keystone for the development of sound and consistent accounting standards, as well as evaluating the acceptability of alternative accounting methods. These requirements resulted in the preparation of documents such as *The Corporate Report,* culminating in the drafting of various conceptual frameworks of accounting.

The aim of the conceptual framework is that standards will be developed on a framework formulated on deductive reasoning rather than on generalisations based on experience. This approach is supported by Miller (1985, 62), who considered that the three paramount reasons for establishing a conceptual framework were to describe existing practice, prescribe future practice, and to define key items and fundamental issues.

A framework of accounting should, according to Kam (1990, 490), "...provide rules for recognizing certain relevant economic objectives, and also provide a basis for judging whether a given practice is 'good' or 'bad'. In other words, a comprehensive theory should tell us how to properly measure income and capital". This can be seen as agreeing in part to what Solomons (1983, 111), considers to be the five essential components of a conceptual framework:

1. *A statement of the objectives of financial reporting.*
2. *A set of definitions of the elements from which financial statements and other forms of financial reports are to be constructed.*
3. *A specification of the characteristics that financial information must have to qualify it for inclusion in a general purpose financial report.*
4. *A specification of the criteria for deciding when to recognise the various elements of financial statements.*
5. *A set of measurement rules.*

Accepting that the FASB conceptual framework lacked a coherent structure, Miller submitted what she considered to be a complete and effective framework that would achieve the following in the accounting environment in which it is to apply:

> 1 *It should establish the overall objectives of financial reporting.*
>
> 2 *It should identify the entities that use economic resources and should report either publically or to specific groups of users.*
>
> 3 *It should identify the various groups which have a legitimate claim to information about each entity.*
>
> 4 *It should identify the type of information that each reporting entity should provide to the various groups.*
>
> 5 *It should recommend the form of financial reporting needed to provide the information required (Miller, 1987, 6).*

The above objectives by Miller (1985), Solomons (1983) and Miller (1987), can be classified under normative theory in that they call for the evaluation of existing and proposed practices. The conceptual framework would be able to focus attention on those areas that required additional research. In addition, the framework should provide a logical basis from which to continue the development of accounting. Existing accounting statements would be revised to take into account the definitions provided by the conceptual framework, while new accounting statements would be developed on the basis of the conceptual framework.

However, the creation of a comprehensive set of concepts for accounting theory and practice has been criticised, and in some quarters considered unresolved. Bromwich (1980, 288) is of the opinion that "[a] stream of partial standards provides more explicit evidence of activity than do efforts to formulate a comprehensive conceptual accounting framework,..." while Anthony (1987, 75) states that in spite of the conceptual framework project, accounting still lacks a satisfactory conceptual framework. Anthony considers that the primary reason for this is the theoretical nature of the development of a conceptual framework, and the inability of the Financial Accounting Standards Board, (FASB), in identifying and attracting 'qualified conceptualizers' to its staff (ibid, 80). He does, however, concede that an analysis of the existing results suggests that the outline of an acceptable framework does exist (ibid, 81).

There is no reason to consider that the potential failure of the conceptual framework project identified by Anthony may not apply in South Africa. The South African Institute of Chartered Accountants merely adopted the International Accounting Standards Committee's *Framework for the Preparation and Presentation of Financial Statements*, for issue in South Africa after exposing the document in the form of an exposure draft.

2.7 POSITIVE ACCOUNTING THEORY

Accounting theories developed using one of the philosophies of science are known as scientific or positive theories, to distinguish them from prescriptive or normative theories. A theory developed using these methods can be used to explain, to predict, or to both explain and predict. This approach, (also known as the descriptive approach) results in descriptive or positive theories of accounting, which according to Glautier and Underdown (1986, 30) "...explain what accountants do and enable predictions to be made about behaviour, for example how a particular matter will be treated. Thus, it is possible to predict that the receipt of cash will be entered in the debit side of the cash book''.

This contention is supported by Watts and Zimmerman (1986, 8 - 9) where they state

> *"[P]ositive propositions are concerned with how the world works. They take the form 'If A then B' and are refutable. For example, the following is a positive proposition: 'If a firm switches from FIFO to LIFO and the stock market has not anticipated the change, the stock price will rise'. This statement is a prediction that can be refuted by evidence''.*

The contention that positive theories can be used to explain, to predict, or to both explain and predict, has led to Watts and Zimmerman (ibid, 2) defining accounting theory as the explanation and prediction of accounting practice.

Watts and Zimmerman (ibid, 14), consider that the importance of positive theory is that it can provide "...those who must make decisions on accounting policy (corporate managers, public accountants, loan officers, investors, financial analysts, regulators) with predictions of, and explanations for, the consequences of their decisions''.

If Watts and Zimmerman's hypothesis that accounting theory can explain and predict accounting theory is correct, the results of this study should indicate that management of companies would support an accounting statement on deferred taxation that would maximise company profitability (which would in turn maximise their own incentivised compensation).

2.7.1 EVOLUTION OF POSITIVE ACCOUNTING THEORY

Although Watts and Zimmerman considered that their 1978 paper provides the beginning of a positive theory of accounting, they consider that the impetus for modern positive accounting research began in the 1960's with the 1968 study by Ball and Brown (considered a seminal work) which used the Efficient Market Hypothesis, (EMH), to investigate the relationship between accounting earnings and stock prices.

2.7.2 CRITICISMS OF POSITIVE ACCOUNTING THEORY

Criticism levelled against the 1978, 1979 and 1986 works by Watts and Zimmerman has been extensive. In their 1990 paper '*Positive Accounting Theory: A Ten Year Perspective*', Watts and Zimmerman consider certain of the criticisms levelled at their positive accounting research.

Their findings are tabled below.

Table 2.1: Summary of Papers Reviewing Watts and Zimmerman (1978 and 1979)

Authors	*Number of References WZ (1978)*	*WZ (1979)*	*Topic*	*Major Criticisms*
Ball and Foster (1982)	13	1	Review of Empirical Accounting Research	• Firm size and bonus plans can proxy for omitted variables • Weak theoretical underpinning for size-political cost construct • Holdout sample not used
Tinker et al. (1982)	1	4	Positive versus normative theories	• Positive theories are value-laden and mask a conservative bias • Ignores underlying class struggles
Christenson (1983)	6	9	Methodology of Positive Accounting	• Logical Positivism is an obsolete metholdological approach • Approach is a "sociology of accounting" instead of accounting theory • Tests introduce *ad hoc* arguments to excuse the exceptions to the theory • Inappropriate methods are used for constructing explanatory theories
Holthausen and Leftwich (1983)	7	0	Review of "Economic Consequences Literature"	Interpretation of results limited because: • Incomplete political and contracting theories • Specification problems in left-hand-side and right-hand-side variables
Lowe et al. (1983)	0	12	WZ (1979)	• Economic framework is unjustified • Positive approach open to dispute • Nature of proof is unscientific • Contrary evidence presented
McKee et al. (1984)	4	0	Replication of WZ (1978)	• Results do not hold in a new sample • Holdout sample not used • Foreknowledge of sample proportions biases parameter estimates
Whittington (1987)	0	7	Review of WZ (1986)	• Presentation of arguments and evidence is unbalanced • Extreme methodological stance • Positive theories are value-laden • Approach is a "sociology of accounting" instead of accounting theory
Hines (1988)	4	0	Christenson (1983) and Methodology	• Popper is not a practical evaluative guideline for empirical accounting research

Source: Watts RL and JL Zimmerman, 1990, Positive Accounting Theory: A Ten Year Perspective, *The Accounting Review*, pages 141 - 142

This table, however, does not reflect all the criticisms levelled at their work, especially the incisive criticism of their 1986 work by Sterling (1990), who considers that the two pillars upon which Watts and Zimmerman base the legitimacy of their work, that it is a (a) value-free study of (b) accounting practices, cannot be substantiated.

Kam (1990, 512), in his analysis of accounting theory, is critical of the deductive approach to the testing of accounting theories, as he considers this approach to be influenced by the philosophical school of logical positivism.

> *"We are reminded that the scientific method is a human invention, one designed to do a job. We in accounting do not need to emulate the natural sciences. What we are looking for is for empirical substantiation of accounting practices''.*

Mouck (1990, 233) offers the following considerations to the evaluation of positive accounting theory:

> *Since no empirical theory can ever be conclusively proven either true or false, then the most that philosophy of science can hope to achieve is a methodology which can be used to 'reconstruct rationally' the history of scientific practice while offering guidelines for rational appraisal of ongoing scientific endeavour.*

However, in spite of all the criticisms levelled against them, the most damning criticism of the work performed by Watts and Zimmerman is given by Whitley (1988, 643), where he states that

> *"[T]his field is dominated by intellectual values and conventions derived from orthodox economics and, programmatically, at least, from popularised logical empiricist philosophy of the natural sciences. Watts & Zimmerman's Positive Accounting Theory is an attempt to confirm this domination and to colonise doctoral programmes in accounting with these values''.*

Bearing in mind that Watts and Zimmerman attempted to apply the falsificationist philosophy of science to accounting, and considering the criticisms levelled against their approach, it is reasonable to take the following cautionary note by Chalmers (1982, 1) into consideration:

> *Personal opinion or preferences and speculative imaginings have no place in science. Science is objective. Scientific knowledge is reliable knowledge because it is objectively proven knowledge .*

2.8 THE CONTRACTING PROCESS

The modern corporation would not be able to exist without executory contracts. These contracts are necessary to guarantee the free flow of labour, materials and other resources, or to restrict others from utilising the corporation's resources.

Central to this research, is the nature of the contractual relationship between management and owners of business undertakings, and the effect that changes in accounting standards may have on remuneration packages.

2.8.1 AGENCY THEORY AND THE CONTRACTUAL RELATIONSHIP

Business undertakings have seen a significant shift from the traditional owner managed undertakings to modern corporations where there is complete separation of ownership and control. This has resulted in the appointment of professional managers to oversee the running of corporations.

Jensen and Meckling (1976, 308), define an agency relationship "...as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent''. Within the context of a business undertaking, the view taken is that the suppliers of capital are considered the principal, while management of the undertaking is in the hands of the agent.

According to Morris (1987, 47), agency theory is concerned with the principal-agent problem in the separation of ownership and control of a firm, between different suppliers of capital, and the separation of risk bearing, decision making and control functions in firms. Both Jensen and Meckling (1976, 308), and Watts and Zimmerman (1978, 113), assume that individuals are utility maximisers. They will attempt to maximise their own welfare by minimising various identified agency costs. As such, Thornton (1984, 90), argues that agency theory "...sees the demand for financial reporting and auditing as deriving from fundamental assumptions concerning human behaviour and capital markets''.

A direct result of this agency relationship is the concept of financial reporting, where the stewardship of management is evaluated. In South Africa, the concept of financial reporting is reinforced by the legal liability of management to report in terms of the Companies Act of 1973 (as amended), and the Close Corporations Act of 1984 (as amended). In addition to providing the owners of the corporation with information relating to the manner in which their assets have been managed and the returns earned, the financial information portrayed can influence the terms on which additional funding can be obtained, thereby directly affecting the competitive position of the corporation.

What is apparent is that management has an interest in the financial reports provided and as such, plays an influential role in the preparation of the financial statements and in the supply of financial information, especially if remuneration packages are coupled to financial results.

A concern for a certain category of shareholder is voiced by Chen (1975, 538):

> *[the small stockholder] does not have either in law or in fact the capacity to interfere in management. He is no longer an owner of the corporation in the traditional sense. Rather, he is a mere corporate citizen with the sole choice of either retaining or surrendering his citizenship in the corporation concerned. In effect, when an individual invests capital in a large corporation, he grants the management all power to control and use that resource.*

A further consideration to agency theory and the contractual relationship is given by Sinason (1988, 137), who considers that where certainty and measurability exist, management has an agency responsibility to disclose such information in the financial statements.

2.9 OTHER ACCOUNTING THEORIES

Other accounting theories and approaches to accounting will be considered below. The two initial theories to be considered are the proprietary and entity theories. These theories attempt to explain accounting practices within "...the framework of a fairly simple theory" (Henderson and Peirson, 1983, 54).

2.9.1 THE PROPRIETARY THEORY

In terms of the proprietary theory, the proprietor or owner, is considered to be the focus of attention. This is represented by the equation

Assets minus Liabilities = Proprietorship

Kam (1990, 303)

Here, the enterprise is the proprietor's or owner's investment. The assets belong to the owner, while the owner assumes responsibility for all the liabilities. As such, the objective of the proprietary theory is to establish the worth of the owner in his business.

The proprietary theory must consequently be considered balance sheet orientated. Income and expenses are increases or decreases in proprietorship, while interest on loans and income taxes are expenses. Dividends paid are withdrawals of capital.

There is no requirement under the proprietary theory to make any provision for deferred taxation as the owner assumes responsibility for all liabilities.

2.9.2 THE ENTITY THEORY

According to the entity theory, the corporation is considered to have a separate existence, even personality from the providers of capital. The entity theory is based on the equation

Assets = Liabilities plus Shareholders' Equity

Hendriksen (1982, 455)

Chen (1975, 540), states that "...the most significant part of the entity theory is the contention that business earnings are the income of the entity itself until they are transferred to the individual participants''.

In terms of the entity theory, the corporation, rather than the proprietor, is the focus of attention. Any income earned is the property of the corporation until such time as it is distributed in the form of dividends to the providers of capital. As the entity theory emphasises the claims of the providers of capital, the entity theory is considered to have an income statement bias. Interest on loans and income taxes are considered to be income distributions rather than expenses of the corporation.

The provision of deferred taxation on the comprehensive basis is appropriate under the entity theory as the claims of other equity holders (the providers of loan capital and revenue authorities) must be met before distributions in the form of dividends can be made to other providers of capital.

Two behavioral approaches to the formulation of accounting theory will be considered below.

2.9.3 EVENTS THEORY

The events theory is the first behavioral approach to the formulation of accounting theory considered. Hendriksen (1982, 11), includes in this approach, theories of investment valuation, human information processing, predictive indicators, the ethical approach, emphasis on sociological factors, a macroeconomic approach, the pragmatic approach and non specific behavioral objectives.

Like other accounting approaches, the events theory considers that there are many and varied users of financial statements, and that preparers of these statements should not make any predetermined assumptions concerning users requirements. Furthermore, Hendriksen (ibid, 16), argues that

> *"...it is assumed that decision models cannot be formulated either descriptively or normatively with sufficient precision to dictate the types of accounting information relevant as inputs into these decision models''.*

Sorter (1969, 13), considers that proponents of the events theory see the function of accounting as providing information about relevant economic events (such as sales by product line) that would allow individual users to generate their own input values for their own individual decision models.

In terms of the events approach, "...the balance sheet is perceived as an indirect communication of all accounting events relevant to the firm since its inception...'' Sorter (ibid, 15), while the income statement should describe each event "...in a manner facilitating the forecasting of that same event in a future time period given exogenous changes...'' Sorter (ibid, 16).

The deferred taxation charge in the income statement should, on the basis of this theory proposed by Sorter (1969) and Johnson (1970), provide a predictive basis for reliably forecasting future tax payments.

2.9.4 COMMUNICATION THEORY

The communication of accounting information is the one way transmission of information to users of financial information in such a manner so as to enable the recipient to understand the nature and implication of such information, and make decisions based on that information.

Bedford (1965, 196 - 197) considers that within the framework of communication, the following activities should be included:

1 *An event, happening, or situation exists or occurs in the world.*

2 *An observer (the accountant) views the changes and selects the appropriate events (exchanges) and records them by means of a symbolic representation (numbers and classifications) understood by the accountant and users of his reports.*

3 *The observer (accountant), using symbolic representation, reports on a number of events over a period of time.*

4 *The observer (accountant) transmits his reports to receivers.*

5 *The receiver (reader of the accounting report) who understands the reality underlying the symbolic representation of the event then takes action which will modify future events .*

Communication theory considers that,

> *"...the accountant (source) is invested with the responsibility of producing accounting statements (linguistic code) that will carry information messages to users of accounting statements (destination)" Bedford and Baladouni (1962, 654).*

In terms of this theory, an accounting statement on deferred taxation should be formulated in a manner that will enable accountants to transmit information on deferred tax liabilities that will be unambiguous and understood by users of financial statements, and will enable users of those financial statements to take whatever action they consider necessary in the light of the information received.

2.10 SUMMARY

Accounting theory has undergone a comprehensive transformation from being primarily descriptions of accounting practices that assisted in reducing ambiguities in accounting concepts, to where, because of competing ideologies, no single universally acceptable theory of accounting can be said to exist.

The term accounting theory can be considered an enigma because, depending on the view taken by either academics, practitioners, or standard setting bodies, accounting theory can be considered amongst others, either descriptive, scientific, an art or a social science. As a result, the debate on whether or not accounting can be treated as a science will undoubtely continue in the future.

Cognisance should therefore be taken of the following diverse views before a final conclusion can be made. Peasnell (1978, 220) considers that it would be a mistake to treat accounting as a science: "*For to do so is only to run the risk of repeating the mistakes of the social sciences*''. On the other hand, Chalmers (1982, 91) states that much of modern sociology lacks a paradigm and consequently fails to qualify as a science. However, Belkaoui (1985, 141) identified seven paradigms that are applicable to accounting. O'Hear (1989, 1) correctly sums up most of the objections made against considering accounting as a science as follows:

> *Objections to science and scientific research tend to be partial, to some aspects of the application of scientific knowledge, leaving unquestioned most of its applications.*

Mattessich (1972, 476), in his examination of the adoption of scientific methods and the application of this methodology to accounting argues:

> *Accounting, conceived as a normative discipline, cannot rely on formal propositions alone. On the contrary, apart from some normative statements, the substance of accounting ultimately ought to be made up of empirical (positive) propositions,*

a view supported by Wolk et al (1984, 24) where they state, "[A]ccounting theory may be descriptive or normative, depending largely on whether inductive or deductive approaches are used''.

What is patently clear is that in spite of the resources allocated to the creation of a comprehensive framework of accounting to supplant the scientific view of accounting, this venture has been largely unsuccessful for a number of reasons, not least the inability of the accounting academics concerned to agree on what should be incorporated into such a framework.

The next chapter examines the nature of deferred taxation in South Africa, the alternative practices considered, the impact those practices have on financial statements, and concludes with current practice and disclosure.

2.11 REFERENCES: CHAPTER TWO

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CHAPTER THREE

THEORETICAL EXPOSITION OF DEFERRED TAX AND ITS PRACTICE

3.1 INTRODUCTION

In Chapter two, the conceptual underpinnings of accounting theory was examined in order to establish a framework against which the alternative deferred tax practices considered in South Africa would be measured.

This chapter traces the development of deferred taxation in South Africa.

Since the issue of the first pronouncement on deferred taxation, Exposure Draft 8 *'Taxation in the Financial Statements of Companies'* in October 1972, the South African business community and users of financial statements have had to contend with a myriad of alternative, and sometimes contentious deferred taxation practices, issued in various forms. These alternative practices have been issued in the form of a discussion paper, various exposure drafts as well as two statements of generally accepted accounting practice. Not only has the accounting profession and business community had to evaluate these various deferred taxation practices, but they have had to contend with the impact that these alternative practices have on published financial statements.

In spite of the periodic assurances provided by the South African Institute of Chartered Accountants (SAICA) that a single method of accounting for deferred taxation would be mandated 'at some time in the future', this has not (with the exception of Exposure Draft 8), been provided.

The South African business community cannot be considered blameless for this state of affairs as users of published financial statements have been subjected to various deferred tax practices, both codified and un-codified, issued by the business community.

This chapter will examine the nature of deferred taxation and the theoretical purpose that underlies the creation of deferred taxation accounts in financial statements. Thereafter, the alternative deferred tax practices previously considered in South Africa will be examined together with the effect that these practices would have on financial statements. Finally, current practice will be examined and analysed.

3.2 THE NATURE OF DEFERRED TAX

There are various categories of taxpayers, who for sundry reasons, receive special allowances in terms of the Income Tax Act, Act 58 of 1962 as amended. These allowances generally (although not exclusively) occur where taxpayers are engaged in manufacturing operations, township development, the sale of goods where the proceeds from the sale are received in instalments, and farmers. These allowances, if claimed by the taxpayer, result in taxable income computed for tax purposes differing from the accounting net profit before taxation computed by the taxpayer. As a result of the difference between taxable income and net profit before tax, the possibility exists that the taxation charge reflected in the income statement will bear no relationship to the net income before tax figure.

Statement AC 102 (revised), *'Taxation in Financial Statements'* identifies three situations where differences between taxable income and reported income arise:

> *The differences between the amounts of taxable income and reported income may arise from:*
>
> - *permanent differences*
> - *timing differences*
> - *tax losses brought forward (AC 102 (revised), 1989, para .17).*

Where the difference between taxable income and reported income occurs as a result of timing differences, Everingham and Hopkins (revision service 8, 1987, 8) consider that by applying the accruals concept and making an appropriate adjustment to the tax charge in the income statement, the tax charge can be matched to accounting income. This adjustment is, in effect, the nature of deferred taxation.

3.2.1 PERMANENT DIFFERENCES

Permanent differences cause taxable income and accounting income to differ. They are differences which originate in the current period and which do not reverse in subsequent periods.

Permanent differences occur in three circumstances: where revenue or gains are exempt from tax, where expenses or losses are disallowed as deductions by revenue authorities in determining taxable income, and where certain incentive allowances are allowed as a deduction for tax purposes but are not taken into account in arriving at reported income.

Due to the nature of permanent differences, the tax effects of a permanent difference will only be recognised in the income statement of the period in which the permanent difference arises.

3.2.2 TIMING DIFFERENCES

Timing differences are differences between accounting income and taxable income. They arise because certain income and expense items are included in taxable income in periods different to that in which they are recorded in accounting income. Circumstances which give rise to timing differences are identified by Everingham and Hopkins (revision service 13, 1989, 13), Exposure Draft 8 (1972, para .09), AC 102 (1975, para .06) and Exposure Draft 61 (1986, para 13) as being: where income is included in taxable income in a period either earlier or later than the period covered by the income statement, and expenses or losses deducted from income for tax purposes in a period earlier or later than that in which they are charged in the income statement. The nature of a timing difference is such that it will originate in one period and reverse either in one or more subsequent periods. This process of originating and reversing gives rise to the terminology, 'originating' and 'reversing' timing differences.

The existence of timing differences results in the income tax payable in the period under review either increasing or decreasing.

3.2.3 TAX LOSSES BROUGHT FORWARD

Tax losses are losses that have been determined in accordance with income tax legislation and that are available for deduction from future taxable income. Tax losses may arise as a result of permanent differences, timing differences and trading losses. The existence of a tax loss will reduce taxable income in future years provided sufficient taxable income is earned that according to AC 102 (revised), (1989, para .43) will allow "...the tax benefit of the loss to be realised".

Because of the differences between reported net income before taxation and taxable income that may arise as a result of the circumstances identified above, Everingham and Hopkins (revision service 13, 1989, 11) consider that the object of providing for deferred taxation was "...originally to achieve a proper matching of the tax charge against the income to which it relates". This requirement was considered for the first time in South Africa in paragraph .06 of Exposure Draft 8 *'Taxation in the Financial Statements of Companies'*, which required that "[T]he income tax charge in the financial statements should reflect the tax consequences of the net income included in the income statement".

Section 3.4 that follows, identifies the various deferred tax practices that have been considered in South Africa to achieve what the SAICA, and the business community believe would achieve a proper matching of the tax charge against the income to which it relates.

3.3 DEFERRED TAXATION: THE ARGUMENTS

Having examined the nature of deferred taxation, it is appropriate to examine the arguments presented by both the proponents and opponents of deferred taxation.

3.3.1 ARGUMENTS IN FAVOUR OF DEFERRED TAXATION

According to Kam (1990, 336 - 337), proponents of deferred taxation cite five reasons why taxation should be deferred. Because accounting theory recognises the firm as a going concern, proponents of deferred taxation consider that income taxes will continue in the future "...and should be computed under accrual accounting, which may necessitate estimates and deferments".

The second argument favoured is that income taxes are "...justifiably considered an expense of the business, and therefore, as well as with all other expenses, they should be subject to the matching principle" (Kam, 1990, 337). To comply with the matching concept, the income tax expense should be recognised in the period in which government services are used and not necessarily when the tax is paid. Failure to adhere to this principle would violate both the matching and accrual concepts.

The third argument offered by proponents of deferred taxation is based on the direct relationship between the transactions reflected in the income statement the taxation consequences of those transactions. If the relationship between an installment sale transaction and the tax paid is examined, failure to provide for deferred taxation will result in the profit on the sale being accounted for on the accrual basis, while the tax effect on the sale would be accounted for on the cash basis.

The fourth argument suggests that if income taxes were not deferred, the income tax expense could fluctuate with the result that net income would fluctuate. This would according to Kam (ibid), result in net income not being "...representative of the performance of the company with respect to its operations, but would be biased by the cash flow of the tax amount".

The final argument advanced is that should income taxes not be deferred, users of financial statements may be misled about future company cash flows. Kam (ibid) considers that "[T]hey would not be warned about the reversals that would occur because of temporary differences between accounting and taxable income".

3.3.2 ARGUMENTS AGAINST DEFERRED TAXATION

Kam (ibid) states that many accountants believe that the allocation of income taxes should not be attempted. The subscribers to this view, termed the flow through approach, submit the following arguments in support of their approach.

The deferment of income taxes assumes that taxable income will exist in the future and that tax legislation will not differ markedly from that currently in existence. South African supporters of the flow through approach are able to cite "...the willingness of the fiscal authorities to tamper with the tax structure, not only at the time of the annual budget but also between budgets" (Everingham and Hopkins, revision service 14, 1990, 23), and also the revenue authorities apparent willingness to introduce retrospective income tax legislation, as support for their standpoint.

The second argument holds that because it is taxable income rather than accounting income that gives rise to income taxes it is illogical to provide for deferred taxation for the following two reasons: firstly, deferment focuses on "...specific transactions rather than on the totality of operations and secondly it tries to relate income taxes to accounting income when in fact they are a function of taxable income" (Kam, 1990, 338).

Opponents of deferred taxation further argue that income tax cannot be compared to other expenses and, as a result, the matching concept is not applicable to taxes as they are not incurred in the generation of income. Proponents of the flow through approach argue that there are two ways in which income taxes should be viewed. Firstly, if income taxes are to be regarded as an expense, then taxes must be regarded as a 'fee' levied on profitable businesses for the privilege of doing business. Secondly, income tax can be viewed as a distribution of income that has occurred, rather than as an expense which should be deducted directly from retained earnings.

In terms of the theoretical framework of accounting established in Chapter 2, this view is in agreement with the entity theory of accounting.

The fourth argument offered is that a credit or debit deferred taxation balance is created by an accounting procedure. This allocation may not necessarily reflect reality as a credit balance does not represent a present obligation to make a payment to the government.

Supporters of the flow through approach consider this approach simpler to understand. The existence of supplementary additional disclosure in the notes to the financial statements, argue supporters of the flow through approach, should be adequate to enable users of the financial statements to assess the future cash flows of the company.

The final argument offered is that should income taxes not be allocated, larger reported net income would possibly result. According to Kam opponents of deferred taxation claim that firms allocate taxes because

> *"[T]heir fear is that the public will clamour for higher corporate taxes and labour unions will demand higher wages. Public utilities fear that rate increases will not be approved. Deferment of income taxes has become a political issue" (Kam, 1990, 339).*

Having examined the arguments both in favour and against deferred taxation, it is necessary to examine the alternative deferred practices considered in South Africa.

3.4 ALTERNATIVE APPROACHES TO DEFERRED TAX PRACTICES IN SOUTH AFRICA

Before the alternative deferred tax practices considered in South Africa are examined, it is necessary to identify when the first statutory requirement for the disclosure of taxation in the financial statements of companies was promulgated.

The requirement for the disclosure of taxation in the financial statements of companies was incorporated in the provisions of paragraphs 12 (h) and 14 (3) of the eighth schedule of the Companies Act, 1926, introduced by Act 46 of 1952. Paragraph 12 (1)(h) required that the amount provided for taxation in a period, (specifying the taxes) to be disclosed as well as any amount of taxation provided in respect of any other period. If no provision has been made for taxation, paragraph 14 (3) required this fact to be stated together with the reason and the period when taxation was not provided.

Accounting policy disclosure was legislated in by paragraph 14 (5)(b) of the eighth schedule. This required that any change in accounting policy should be disclosed.

The incorporation of the Eighth Schedule into the Companies Act of 1926 formed the basis upon which the concept of deferred taxation was introduced into South Africa by means of Exposure Draft 8, *'Taxation in the Financial Statements of Companies'*.

The introduction of the Companies Act of 1973 also included requirements for the disclosure of taxation in the financial statements of companies. These requirements, set out in paragraphs 36 and 42 of the fourth schedule to the Act, do not differ markedly from the requirements set out in the Eighth Schedule to the Companies Act of 1926.

Paragraph 36 (g) requires that the amount and classes of taxes provided for in the financial statements be disclosed together with any amount provided in respect of any other financial year. Should taxation not be provided for in a particular year, paragraph 42 requires that the fact and the reason for not providing taxation to be stated (Companies Act 1973, as amended).

3.4.1 SITUATION PRIOR TO 1972

The overriding purpose of the Accounting Principles Committee (APC) issuing Exposure Draft 1, *'The Disclosure of Accounting Policies'*, in 1971, was to establish the accounting policies to be followed where financial statements included significant items which depended substantially on judgement. This exposure draft must be seen as the formal response to the paragraph 14 (5)(b) requirement of the eighth schedule of the Companies Act, Act 46 of 1926 that required accounting policy disclosure. This initiated the formal standard setting process in South Africa.

Exposure Draft 1 (1971, para 12) recognised that, in the course of practice, a variety of accounting principles had developed that were designed to "...provide consistent, fair and as nearly as possible objective solutions to these problems in particular circumstances...". The accounting principles identified by Exposure Draft 1 that required disclosure in financial statements were the principles for calculating items such as depreciation, the amount at which inventories were to be stated, and deferred taxation.

In terms of Exposure Draft 1, companies were required to disclose their accounting policies by way of a note. However, where accounting policies departed from those laid down by the then National Council of Chartered Accountants, the departure and the financial effects were to be estimated and disclosed.

The conclusion that is drawn herefrom is that although the concept of deferred taxation was formally recognised in South Africa prior to 1971, it was at that stage not mandatory for companies to provide for deferred taxation. However, where deferred taxation was not provided for, the financial effects, together with the reason for non disclosure, were to be stated.

Prior to the issue of Exposure Draft 1, accounting theory in South Africa could not be considered prescriptive, a position that remains unchanged. As discussed in Chapter 2, positive accounting theory attempts to explain and predict accounting practice "...rather than to tell practitioners and firms what accounting procedures they ought to use" (Kam, 1990, 491). This positive approach to accounting theory must be compared to the normative approach. Normative theory contains a 'should' or 'ought' statement. According to Kam (ibid, 490) the normative approach to accounting theory has been the approach taken by standard setting bodies:

> *The notion is that we must find what is best or most feasible and prescribe this as the way something in practice should be done (ibid).*

3.4.2 EXPOSURE DRAFT 8

The first attempt in South Africa to formalise the requirement that companies provide for deferred taxation was contained in Exposure Draft 8, *'Taxation in the Financial Statements of Companies'*. This exposure draft was issued by the Accounting Practices Committee of the SAICA, as a supplement to the October 1972 issue of *'The South African Chartered*

Accountant'. This exposure draft canvassed the opinions of members as to whether or not the tax charge in the income statement should only reflect the assessed tax for the period or according to Leader (1972, 359) "...whether it should be an adjusted and to some extent hypothetical charge based on the income as reported, assessable or not".

To comply with the matching and prudence concepts (first expounded in Exposure Draft 1), Exposure Draft 8 required the mandatory creation of a deferred taxation account. A provision would be made for deferred taxation so that together with the current assessable tax, the tax charge for the period would be directly related to the profits for the period. Exposure Draft 8 did, however, recognise that the existence of permanent differences would prevent matching from being completely achieved.

The significant features of Exposure Draft 8 can be summarised as follows: firstly, a deferred tax account will be created to which adjustments will be debited or credited. Unlike the successor to Exposure Draft 8, AC 102, *'Taxation in the Financial Statements of Companies'*, no allowances were considered for exceptional circumstances (where a deferred tax account would be meaningless). Secondly, no alternative deferred tax practices were considered in Exposure Draft 8. From an examination of paragraph .14 of Exposure Draft 8, together with the appendix providing examples of the accounting effects of the deferred tax recommendations, it is apparent that the preparers of this document required deferred taxation to be provided for on the liability method:

> *The deferred tax liability at the end of the accounting period is to be calculated at the rates of tax applicable to that period. This will mean that the amount so set aside will be affected in future periods by changes in the rate of normal tax (ibid).*

Thirdly, although this exposure draft did not specify whether the comprehensive or partial basis of providing for deferred tax be used, it is apparent that the preparers of the statement required deferred taxation to be provided on the comprehensive basis.

The explanatory notes and definitions contained in paragraph .06 of Exposure Draft 8 (1972) stated that

> *"[T]he income tax charge in the financial statements **should** (emphasis added) reflect the tax consequences of the net income included in the income statement"* .

From the existence of other normative statements included in various paragraphs of exposure Draft 8, it is clear that based on the framework of accounting theory established in Chapter 2 that this exposure draft must be considered normative in nature.

Unfortunately, the responses by interested parties to this exposure draft are no longer available from the archives of the South African Institute of Chartered Accountants and, as a result, cannot be subject to further study.

3.4.3 GAAP 1.002 / AC 102

The first formal statement on deferred taxation in South Africa was issued during July 1975 under the serial number GAAP 1.002, *'Taxation in the Financial Statements of Companies'*. This statement was applicable to financial statements in respect of periods ended on or after 1 January 1976.

Two years later this statement was subject to criticism and attack. Divaris, writing a series of four articles that appeared in *'Businessman's Law'* during 1978, attacked the foundation of the statement. In the first of these articles *'The Emperor's New Clothes: Why Defer to Deferred Taxation?'*, Divaris voiced his concern as:

> *What worries me most is the failure of this statement (which goes by the absurd acronym and serial number of GAAP 1.002) to carry any conviction. It is the only document of its kind to be issued by the organized accounting profession, and purports to lay down a method of accounting for all companies and, indirectly, to prescribe a particular course of action to auditors. It follows that it is a document of tremendous importance. One would expect it to stand on its own, with arguments unshakably* (sic) *persuasive and with conclusions undeniably justified (1978, 63 - 64).*

This attack by Divaris can be seen as justified if certain of the requirements of AC 102 (1975) are examined. Unlike Exposure Draft 8, which made the creation of a deferred tax account mandatory, (see 3.4.2 above), the provision of deferred taxation was not mandatory under AC 102 (1975).

> *"In exceptional circumstances where it is inappropriate to set aside an amount for deferred tax, this fact and the reasons therefor must be clearly stated in the financial statements" (AC 102 (1975), para .06).*

Statement AC 102 (1975) provided companies with two alternative methods for calculating deferred tax, namely the 'deferral' and 'liability' methods. Statement AC 102 (1975) indicated in paragraph .12 that the 'deferral' method was widely used overseas but that in South Africa there was considerable support for, and research being pursued in relation to the use of the 'liability' method. The SAICA stated in paragraph .12 of AC 102 (1975) that although the two alternative methods of calculating deferred taxation had different effects on the company's periodic operating results, and thus earnings per share, it was inappropriate to prefer the use of one of these methods over the other. The statement stated however that once one of the methods of accounting for deferred taxation gained acceptance in South Africa, that method would be made mandatory.

The issue of AC 102 (1975) did not result in immediate compliance by companies with this statement. Everingham (1976(a) , 110) in one of the first South African articles covering deferred taxation, stated that the primary argument used by companies not wishing to make provision for deferred taxation was that due to the continual replacement of assets, the effects of inflation and business expansion, the amount set aside for deferred taxation is seldom, if ever, used. This statement can be seen as prophetic because, as Everingham illustrated in a survey of the patterns of deferred taxation balances of major industrial companies published in *Accountancy SA* later (1984, 251- 257), the balances on the deferred taxation accounts had increased out of all proportion to theoretically comparable amounts.

Everingham (1976(a), 110) examined the financial statements of Abercom Investments Limited for the year ending 30 June 1975. The accounting policy of Abercom Investments Limited towards deferred taxation was that since the group will continue to invest in plant and machinery and since such allowances will continue to be granted by the government, the directors concluded that the group had no real liability for taxation on timing differences. No provision was therefore made for deferred taxation.

This accounting policy by Abercom Investments Limited illustrates the initial resistance by companies towards the concept of deferred taxation. Although Abercom Investments Limited did not consider that they had a liability for tax arising from timing differences, the accounting policy detailed above was for financial statements ending on a date before the effective date that statement AC 102 (1975) became mandatory.

The two alternative methods of providing for deferred taxation considered by AC 102 (1975) will be examined below.

3.4.3.1 Liability Method

According to Discussion Paper 5, the liablility method of providing for deferred taxation is based on the concept that the balance sheet of a company should always reflect the amount of deferred taxation that would become payable should all timining differences eventually reverse.

Based on this definition, Everingham and Hopkins (revision service 13, 1989, 16) state that the liability method of providing for deferred taxation views the deferred tax balance as representing a future tax liability, while Rosenfield and Dent (1983, 47) consider that

> *"[U]nder the liability theory of deferred taxes, a liability is presented in the current balance sheet for income taxes on income that has been reported in current or prior income statements and is expected to be reflected in taxable income in future income tax returns".*

Under the liability method, the deferred tax balance is maintained at the current statutory tax rate applicable to companies as this tax rate is the best indicator of the potential liability should the company cease trading. The deferred tax account in the balance sheet must reflect the net effect of all timing differences calculated at the present rate of tax. Adjustments resulting from changes to the statutory tax rate will have to be reflected through a charge in the current years' income statement.

The advantages of the liability method of providing for deferred taxation has been identified by Everingham and Hopkins (revision service 13, 1989, 17) as being that the calculations of deferred taxation are simple, the current tax rate is the best indicator of the potential liability, and the balance on the deferred tax account may be reconciled at any time.

Disadvantages have also been identified with the liability method. McKenzie (1980, 409) considers that the liability method ignores the going concern concept in that the liability created represents the total taxation that would be payable by the company should operations cease immediately and all assets are realised at their book value. Other criticisms of the liability method identified by McKenzie (ibid) can be summarised as follows: it is unnecessarily conservative to treat the total of unreversed differences at any point in time as a liability, and there is no actual liability in that the Receiver of Revenue does not have a claim against the company. This criticism is conceded by Everingham and Hopkins (revision service 13, 1989, 17) where they state "[T]he validity of the liability method may be disputed on the basis that there is no legal liability at balance sheet date".

Because of the criticisms of the liability method of providing for deferred taxation considered above, McKenzie (1980, 409) questions whether the financial statements prepared using the liability method would fairly present the financial position of the entity. Furthermore, Everingham (1976(b), 209) argues that where there is an increase in the statutory tax rate, the liability method does not comply with the matching concept in that the current year's profits would be burdened with an adjustment relating to prior year's balance on deferred taxation.

The liability method of providing for deferred taxation can be seen as being balance sheet orientated, because, under the liability method, the deferred tax balance is viewed as a future liability. Davis (1984, 24) states that the proponents of the liability method view this method of providing for deferred taxation as being the method that best reflects the economic resources and obligations of an entity.

As the liability method of providing for deferred taxation is balance sheet rather than income statement orientated, it is, in terms of the theoretical framework established in Chapter 2, appropriate to the proprietary method of accounting.

3.4.3.2 Deferral Method

The deferral method of providing for deferred taxation is, according to Discussion Paper 5 (1983, para.10), based on the concept that the taxation charge in the income statement should be in accordance with the matching concept and reflect the taxation charge or relief attributable to the earnings to which it relates. The taxation rate used in the calculation of the deferred taxation balance under the deferral method is the tax rate in effect in the year that the timing difference originates.

Gush (1976, 165) and Everingham and Hopkins (revision service 13, 1989, 14) identify three recognised ways for accounting for deferred taxation under the deferral method. These are, by dealing with assets individually, in other words utilising separate computations for each individual transaction; by dealing with assets in groups, that is by using a separate calculation for each group of timing differences; and by working on net reversing and originating differences or the net charge method.

Everingham and Hopkins (ibid), in a detailed evaluation of the deferral taxation method, consider that in the year that a timing difference originates, a taxation benefit or charge is deferred until the relevant timing difference is reversed when it is matched and reflected in the income statement. Under the deferral method, the deferred taxation balance does not represent a liability due by the company but is regarded as representing deferred revenue and expenditure. The deferral method appears, according to McKenzie (1980, 407) to be more in line with the concept of deferred taxation outlined in GAAP 1.002.

This approach, supported by Davies, Paterson and Wilson in *Generally Accepted Accounting Practice in the United Kingdom* (UK GAAP) (1990, 840), places the emphasis on the profit and loss account by quantifying the extent that it has been affected by the taxation deferrals that have arisen as a result of timing differences.

Like the liability method of providing for deferred taxation, the deferral method has been subject to certain criticisms which are examined below.

Davis (1984, 23) states that the basic premise of the deferral method, the matching concept, is vulnerable to attack: "*Proponents of the deferred method have misapplied the matching concept by confusing the tax charge with an expense or cost*". Taxation is charged on profits earned from operations and does not form part of the revenue earning process.

Davies et al (1990, 840) writing in UK GAAP state that under the deferral method, deferred tax balances can be more correctly viewed as deferred income and expenditure

> *"...which could be said to represent the tax benefit or cost derived from the effect of timing differences quantified by reference to the rate of tax ruling at the date that the timing differences originated".*

Under the deferral method, the tax rate used is always the rate of tax ruling in the year that the timing differences arose. Changes in the statutory tax rate do not result in changes to existing deferred tax balances because unlike the liability method, the balance on the deferred tax account does not reflect the present liability that may arise in the future.

Proponents of the deferral method have argued that this method is the most conceptually pure method of accounting for deferred taxation on timing differences. Davies et al (ibid) state that they base this claim on the premise that the fundamental purpose of accounting for deferred taxation "...is the inter-period allocation of tax expense with taxable profits; in other words it is an application of the matching concept, which is profit and loss driven".

From the above descriptions, the deferral method can be considered income statement based.

Without the benefit of the responses to Exposure Draft 8, certainty cannot be obtained with regard to which theory of accounting can be said to apply to AC 102. Guidance must therefor be sought from statement AC 102 itself. The explanatory notes to AC 102 (1975, para .03) consider that

> *"[T]he income tax charge in the financial statements* ***<u>should</u>*** *(emphasis added) reflect the tax consequences of the net income (or loss) shown in the income statement".*

In addition, other paragraphs in the statement prescribe particular courses of action in specific circumstances. Statement AC 102, '*Taxation in the Financial Statements of Companies*' must therefore, in terms of the framework of accounting theory established in Chapter 2, be considered normative in nature.

3.4.4 DISCUSSION PAPER 5

Discussion Paper 5 (DP 5), issued during October 1983, canvassed opinions from members on what was seen by the Accounting Practices Committee (APC) as being a number of contentious issues. The major problem identified by Discussion Paper 5 (also referred to in Macgregor ID (Ed) *'A Survey of Financial Reporting in South Africa 1982'*, (1983, 10) and confirmed by Everingham (1984, 255) in his study of the deferred tax balances of certain companies falling within the industrial sector of the Johannesburg Stock Exchange, was that in an expanding enterprise no significant reversal of the cumulative timing differences occurred. This resulted in ever increasing amounts being set aside for taxation which could not be considered an actual liability of the undertaking.

Everingham's findings are tabled below.

Table 3.1 Schedule of Aggregate Balances of Selected Items of Top 19 Companies (Sasol excluded)

	Year 1	*Year 2*	*Year 3*	*Year 4*	*Year 5*	*Compound annual growth*
Deferred tax balance	**362,5**	**441,1**	**566,1**	**814,9**	**1 142,4**	**33,2%**
(a) Total Equity	4 896,9	5 311,9	6 279,1	9 215,1	11 429,5	23,6%
Deferred Tax as a %	7,40	8,36	9,02	8,84	10,00	
(b) Plant and Machinery (Gross)	3 781,40	4 275,0	5 181,9	6 623,0	8 856,8	22,8%
Deferred Tax as a %	9,59	10,39	10,92	12,30	13,36	
(c) Plant and Machinery (Net)	2 307,8	2 746,5	3 353,2	4 188,4	5 528,8	24,4%
Deferred Tax as a %	15,71	16,17	16,88	19,45	20,68	
(d) Capital Employed	6 741,1	7 899,1	9 812,5	12 357,7	17 695,1	27,3%
Deferred Tax as a %	5,38	5,62	5,77	6,59	6,46	
(e) Total Assets	9 831,6	11 075,2	14 176,9	17 765,4	22 473,8	22,9%
Deferred Tax as a %	3,69	4,01	3,99	4,59	5,09	
Accumulated Depreciation	1 431,1	1 486	1 828,7	2 434,6	3 028	20,6%
as a % of gross plant and machinery	38,5	35,3	35,3	36,8	35,4	

Source: Accountancy SA February 1984, 255

The results contained in the table allowed Everingham (1984, 255) to conclude that "[t]hese figures provide strong empirical support to the contention that deferred tax balances are growing at an inordinately rapid rate".

In order to consider alleviating the identified problem of ever increasing deferred tax balances, Discussion Paper 5 sought the opinion of members of the SAICA as well as other interested parties as to whether deferred taxes should continue to be accounted for on the basis of AC 102 (1975) or whether a partial allocation basis of accounting for deferred taxation should be permitted.

Discussion Paper 5 recognised that both the deferral and liability methods comply with the requirements of AC 102 (1975), but once again, the SAICA did not consider that this opportunity warranted limiting the choice of accounting for deferred taxation to one alternative.

The partial allocation basis of accounting for deferred taxation was introduced for formal consideration in a South African context in paragraphs .14 to .20 of Discussion Paper 5. This method would allow deferred taxation to be provided on the partial allocation basis under certain circumstances. This would result in the taxation effects of certain timing differences being excluded where there is reasonable evidence that those timing differences will not reverse for some considerable period of time.

Discussion Paper 5, although acknowledging that the partial allocation basis of providing deferred taxation is not recognised in terms of AC 102 (1975), justified the introduction of this basis by arguing that since the issue of IAS 12 by the International Accounting Standards Committee in 1979, this method has been used in South Africa. This statement is however not supported by the findings of *'A Survey of Financial Reporting in South Africa 1982'*, published by the SAICA in 1983. These findings are tabled below. For comparative purposes, the findings of the 1981 *'Survey of Financial Reporting in South Africa 1980'* are reflected.

Deferred taxation policy followed

Table 3.2: Comparison of Deferred Taxation Practices, 1977 to 1982

	1982	1981	1980	1979	1978	1977
	%	%	%	%	%	%
Liability method	78	76	73	73	67	63
Deferred method	10	10	13	10	15	14
Both methods used	3	*	-	-	-	-
Method not stated	2	2	3	-	4	8
Deferred tax not provided	6	12	2	-	5	6
Tax equalisation	1	-	5	-	-	-
Not applicable no timing differences	-	-	4	17	9	9
	----	----	----	----	----	----
	100	100	100	100	100	100
	===	===	===	===	===	===

Source: *A Survey of Financial Reporting in South Africa 1982* page 139 and *A Survey of Financial Reporting in South Africa 1980* page 125

Discussion Paper 5 further justified the introduction of the partial method of providing for deferred taxation by arguing that this method is permitted in some countries, including the United Kingdom, following the issue in that country of SSAP 15. Furthermore, Discussion Paper 5 (1983, para .16) stated that [in the United Kingdom]

> *"...[m]any companies ceased to provide for any deferred tax on timing differences which they could demonstrate, with reasonable probability, would continue into the future or would be replaced by new timing differences. Provision was only made for those timing differences which could be expected to reverse in the foreseeable future".*

Despite the possibility of an inadequate provision for deferred tax in recessionary periods which would result in reductions of capital investment programmes, paragraph .17 of Discussion Paper 5 states that there is a strong body of opinion

> *"...which sees little logic in continuing to provide for deferred tax in circumstances in which projections indicate that the deferred tax credit will continue to increase in value for the foreseeable future".*

Proponents of the partial approach to deferred taxation consider that under the comprehensive allocation basis, all or part of the deferred tax account in the balance sheet lacks economic reality in a going concern situation.

Discussion Paper 5, paragraph .18, states that the then latest UK pronouncement, ED 33, develops the partial approach further in that it proposes that provision for deferred tax is only made to the extent that it is probable that a liability will crystallise. The situation may occur that deferred tax would not be provided despite the presence of timing differences.

In paragraph .19 of Discussion Paper 5, the Accounting Practices Committee (APC) detailed the matters that respondents should consider before the partial allocation basis would be adopted. These included the criteria to be used in determining which timing differences should be provided for, whether 'hard core' (timing differences which do not reverse in practice) be ignored, what time period should be used, whether unprovided timing differences should be disclosed as a contingent liability, can the partial allocation basis be conceptually justified, and should the partial allocation basis utilise the liability or deferral method of calculating deferred taxation?

Paragraph .20 of Discussion Paper 5 recommends that the requirement of AC 102 (1975) for the full application of deferred tax on all timing differences should continue. The APC further recommended that preparers of financial statements should be encouraged to analyse the deferred tax balance. This should be between the amount relating to timing differences that are likely to reverse in short term, (say three years), and the amount relating to timing differences that are unlikely to reverse in the short term; this would establish whether or not it would be practical to adopt the partial allocation basis of providing for deferred taxation in South Africa.

The questionnaire attached to Discussion Paper 5 provides guidance on which accounting theory can be considered applicable to Discussion Paper 5. In view of the nature of the questions respondents were required to answer, Discussion Paper 5, must in terms of the framework of accounting established in Chapter 2, be considered normative in nature.

If, as Watts and Zimmerman (1978, 113) contend that management plays a central role in the determination of accounting standards, it would be reasonable to expect that support for the partial allocation basis of providing for deferred taxation would be found in the responses from companies that responded to Discussion Paper 5.

The responses to Discussion Paper 5 are examined in detail in Chapter 5.

3.4.5 UNPUBLISHED MEMORANDUM

Following the failure of The South African Institute of Chartered Accountants to obtain consensus from their members through Discussion Paper 5 (on whether the partial allocation or the comprehensive allocation approach be used), an unpublished memorandum prepared by the Accounting Practices Committee (APC) was issued during November 1984. The purpose of this memorandum was to consider the overall approach to deferred taxation, and not to consider ancillary matters such as the LIFO reserve and changes in tax rates. The three possible approaches to deferred taxation delineated by the memorandum were

- *to ignore deferred tax and have no interperiod tax allocation (flow through approach)*
- *to provide for deferred tax on some but not all timing differences (partial allocation approach)*
- *to provide deferred tax on substantially all timing differences (comprehensive allocation approach) (SAICA, 1984, para 2).*

The three approaches considered by the memorandum will be discussed in detail below.

3.4.5.1 The Flow Through Approach

Under the flow through approach, no provision is made for deferred taxation. As a result, there is no accounting for originating and reversing timing differences.

The arguments offered by the memorandum, both in favour and against the flow through approach, are presented below.

The proponents of the flow through approach to deferred taxation offer four arguments in favour of applying this approach to deferred taxation. Firstly, it is the taxation calculated according to the income tax assessment that represents the amount that should be charged against income to correctly match revenues and costs. Additional disclosure could be made in the notes to the financial statements providing information on timing differences and changes to income tax legislation.

The second argument offered in support of this approach is that the flow through method of providing for deferred taxation is not contrary to the prudence concept which, according to (AC 101, 1974, para .07), requires companies to provide for all known liabilities. Deferred taxation is not considered to be a liability and the provision for deferred taxation in respect of timing differences is tantamount to being a method of tax equalisation or income smoothing, which should not be an objective of financial reporting.

The third advantage of the flow through approach is that it is simple with the resultant practical advantage that the computation of the amount due is easy and the need to make unnecessary subjective assessments is alleviated. The cash outflow that would occur during the following financial period is reflected.

Finally, users of financial statements are provided with all the necessary information relating to the income taxes incurred up to the balance sheet date, as well as the factors that may cause changes in the incidence or rate of incidence of income taxes the enterprise will incur in the future.

Opponents of the flow through approach consider that, although complexities have arisen in the application of deferred taxation (such as the increasing deferred tax balances alluded to in 3.4.3 above), this does not necessarily indicate that the deferred taxation concepts are incorrect. Four arguments are also offered against the flow through approach. Firstly, transactions have economic consequences and the taxation effects of these should be fully disclosed in financial statements. Secondly, the flow through approach contravenes the matching concept. Originating and reversing timing differences match the tax effects of revenue, expense, gain or loss with the period in which accounting recognition is given to those items. Thirdly, the flow through approach produces results that are not meaningful. Only the reduction in the current year's taxation is reported but the costs associated with the giving up of an asset's tax deductibility is ignored. Finally, financial statements are prepared on the accrual basis, while accounting for taxation on the flow through basis would be tantamount to accounting for this item on the cash basis, which would not be the consistent application of a fundamental accounting principle.

3.4.5.2 The Partial Allocation Approach

The memorandum issued by the SAICA (1984, para 14) considered that the partial allocation approach entails providing for deferred tax on some but not all timing differences. The memorandum provides the philosophy behind this approach.

> *"The partial allocation approach is based on the premise that, whilst deferred tax should be provided on timing differences, there exists a hard core of timing differences which never reverse. This core is likely to be ongoing for most companies and therefore it is not considered necessary to provide deferred tax on these timing differences. The partial allocation approach recognises and provides deferred tax only on those differences which can be expected to reverse in the foreseeable future" (ibid).*

The arguments offered by the memorandum, both in favour and against the partial allocation approach, are presented below.

Three arguments are offered in favour of the partial allocation approach. These are, firstly, in an inflationary environment the liability for deferred taxation will never be paid and as such does not represent a liability which should be disclosed in the financial statements. Secondly, as many timing differences are of a recurring nature, which, when they reverse, are replaced by new originating timing differences, the taxation liability is postponed indefinitely. Finally, supporters of the partial allocation approach argue that this approach reflects the financial reality of the enterprise and results in better presentation of financial information to users in that the substance of the issue rather than the form is reflected.

The arguments against the partial allocation approach to deferred taxation are as follows: Financial statements should report the financial transactions of the period and their consequences. A timing difference is a non permanent feature that will inevitably reverse. The very nature of a timing differences results in both favourable and unfavourable cash flow implications.

The second argument advanced by the opponents of this approach is that as assets and liabilities result from past or current transactions, it is according to SAICA (1984 para 19) "...inappropriate to omit accounting for an event because of a yet-to-be-committed and yet-to-be-recorded future transaction may nullify it".

Thirdly, the partial allocation approach does not comply with the matching concept. Fourthly, the partial allocation approach is very subjective and could lead to the manipulation of results either deliberately or unwittingly.

Finally, opponents of the partial allocation approach state that this approach ignores the fact that each recorded transaction has direct taxation consequences. Increased timing differences result from separate and distinct transactions which must be accounted for as such.

3.4.5.3 The Comprehensive Allocation Approach

Under this approach deferred taxation is required to be provided on substantially all timing differences.

Arguments, both in favour and against the comprehensive allocation approach, offered by the memorandum are discussed below.

The first argument presented in favour of this approach is that the economic relationship between financial transactions and their related taxation consequences are reflected in the financial statements of the same period. Secondly, accounting for income tax on the accrual basis produces results that are meaningful and does not result in benefits and costs being mismatched.

Thirdly, only current and past transactions are dealt with as the prediction of future events and future growth projections are not a consequence of applying the going concern concept. Finally, this approach provides a more objective measure of performance than either the partial or partial allocation approach and according to SAICA (1984, para 27) "...contains none of the subjective assumptions which are inherent in the partial allocation approach".

The comprehensive allocation approach is criticised as having certain practical deficiencies. These have been identified as the existence of significant deferred taxation balances disclosed in the balance sheets of certain companies and their continued growth at an accelerated rate, and confusion as to the nature of deferred taxation balances by certain users and preparers of financial statements. These users and preparers do not consider deferred taxation to represent a true liability.

The second argument offered against the comprehensive allocation approach is that there are two methods of accounting for deferred taxation, the liability method and the deferral method. Each of these methods reflect a different income figure for the year which could represent a deficiency in current accounting practice.

Although the arguments, both for and against the comprehensive allocation method have been presented above, a factor that compounds the problem associated with the comprehensive allocation approach is that users of this approach were provided with a choice of four alternative comprehensive allocation approaches. These approaches are discussed below.

The first comprehensive allocation approach required the nature of the deferred taxation timing difference to be determined. This approach focused on the nature of individual timing differences and analysed how they should be disclosed in published financial statements. What is unique about this approach is that the economic nature of timing differences are analysed between those timing differences which according to SAICA (ibid, para 34) "...give rise to true tax liabilities and assets and those which affect the carrying values of the assets or liabilities which give rise to them".

The second approach required an analysis of the deferred taxation balance. This approach differs from the alternative discussed above in the method of balance sheet presentation. According to SAICA (ibid, para 45), the nature of the timing difference determines whether the "...deferred tax balance should be disclosed as a liability or whether it may more appropriately be reflected as part of shareholders' interests as a deferred benefit." This approach formed the basis of Exposure Draft 61, discussed in section 3.4.6 below.

The third alternative required the deferred taxation balance to be analysed into its short and long term components. This alternative suggested that the comprehensive allocation basis be combined with an estimation of cash flow. Short term, noncash adjustment such as comprehensive allocation deferred taxation provisions distort the cash flow picture. This could be alleviated by disclosing in the income statement the amount of the taxation charge which is expected to impact on future cash flows. Should deferred taxation provisions not be made, a danger exists that excessive dividends may be declared which will result in capital maintenance not being maintained. To overcome this SAICA (1984, para 58) suggests that provisions for deferred taxation "...could be made 'below the line' in the income statement and the long term portion of deferred tax treated as part of nondistributable reserves...", an approach which could be viewed as a type of taxation equalisation account.

The fourth alternative offered for consideration was the system of comprehensive allocation presently in operation. This alternative has been considered in detail in section 3.4.3 above.

The memorandum presented interested parties with alternative deferred tax practices for consideration. Arguments were presented for and against each alternative method of accounting for deferred taxation in a fair and objective manner. The responses by interested parties to the memorandum assists in making a direct contribution to the development of accounting theory in South Africa.

If Watts and Zimmerman's conclusion (1978, 112) is considered to be correct: that corporate management is one of the parties who expend resources to influence the setting of accounting standards, and that individuals act so as to maximise their own utility, then it would be reasonable to assume that the alternative considered most appropriate by respondents in managerial positions responding on behalf of companies would be for them to select the alternative deferred taxation practice that would minimise the taxation charge in the income statement.

A detailed evaluation of the responses of interested parties to the unpublished memorandum is presented in Chapter 5.

3.4.6 EXPOSURE DRAFT 61

According to McDonald (1988, 228), Exposure Draft 61 issued in January 1986 proposed a treatment that was unique "...to the extent that it had not been adopted elsewhere in the world". A treatment was proposed that would emphasise both the income statement and balance sheet treatment of deferred taxation. According to the technical commentary issued by the APC to accompany Exposure Draft 61, the treatment proposed by this exposure draft was presented in response to the comments received on the memorandum examined above.

The issue of Exposure Draft 61 must be criticised on the grounds that, although the approach appears to be conceptually sound, the SAICA did not believe that the exposure draft would obtain support from other members of the International Accounting Standards Committee. In a letter to the Secretary General of the International Accounting Standards Committee, GV Terry (1988, letter), the technical director of the SAICA stated:

> *The approach taken in the document is somewhat different from that taken in other countries, but we believe does merit consideration. Clearly it is not feasible for our standard setting body to go against world wide trends and therefore it is unlikely that this document will be codified as a standard unless there is some support for the approach elsewhere.*

In her article *'Deferred Taxation - The Background to ED 72'*, McDonald (1988, 228) identified three advantages of the Exposure Draft 61 approach. They were, that the nature of the deferred taxation balance would be more clearly defined for users of financial statements, that large deferred taxation balances relating to advance allowances on capital expenditure would "...cease to fall into the classification of liabilities..."(ibid) , and those balances classified as deferred benefits would be computed on the deferral method and, as a result, would not be subject to adjustments in the event of future changes in the statutory tax rate. This, it is submitted, would assist in compliance with one of the objects of financial statements according to Exposure Draft 61, namely

> *"...to match revenues and expenses of a period and so arrive at a fair presentation of the results of operations for that period. Accordingly, the income tax charge in the income statement should reflect the tax consequences of the income or loss reported in the income statement" (Exposure Draft 61, 1986, para .03).*

A significant departure from both AC 102 (1975) and Discussion Paper 5 is in the definition of permanent differences. Exposure Draft 61 (1986, para .11) considers that tax concessions (that result in permanent differences)

> *"...relate to the acquisition of the relevant asset and consequently the benefit of the allowance is matched with the cost of the asset and recognised on a systematic basis over the period that the asset is depreciated. The deferred portion of the benefit is accounted for in the same manner as other deferred tax benefits and separately identified if material".*

Everingham and Hopkins (revision service 11, 1988, 23) argued that the nature of the timing difference should determine the treatment accorded to them:

> *Although this may result in a 'mixed' method, the use of a hybrid approach may be more in accordance with reality than when applying exclusively the deferral method or the liability method.*

Paragraphs .17 to .21 of Exposure Draft 61 differed markedly from Exposure Draft 8, Discussion Paper 5, and AC 102 (1975) with regard to the accounting treatment of permanent differences. Exposure Draft 61 required that permanent differences which occured as a result of incentive allowances on capital assets be matched with the cost of the asset and recognised on a systematic basis over the period that the asset is depreciated. The deferred portion of the benefit should be accounted for in the same manner as other deferred taxation benefits.

Paragraph .17, in examining the nature of timing differences, evaluated whether "...the item had been included in taxable income before or after its inclusion in the financial statements" Everingham and Hopkins clarify the treatment of timing differences as

> *"[T]hose arising from items of income or expense which are recognised in taxable income in a period prior to that in which they are recognised in reported income".*

and

> *"[T]hose arising from items of income or expense which are recognised in taxable income in a period subsequent to that in which they are recognised in reported income" (Everingham and Hopkins, revision service 11, 1988, 23).*

In the first instance, where the tax benefit or sacrifice from the timing difference has already occurred (ie, the timing difference has been recognised in taxable income, such as initial and wear and tear allowances), the tax effect of the timing difference does not give rise to an estimated tax liability or asset that will need to be settled in the future.

Three additional aspects were considered by Exposure Draft 61. These are, that the tax effect of the timing differences is only recognised when the tax benefit or sacrifice has occurred (1986, para .19 and Everingham and Hopkins, revision service 11, 1988, 23). An example of this particular situation is provided by Exposure Draft 61. The exposure draft considers that in the situation where a tax loss occurs and where an initial allowance has been granted, a tax benefit will not occur. The benefit will only occur when the tax loss is claimed against future tax payable. The second aspect considered by Exposure Draft 61 (1986, para .20) was the tax effect of timing differences. The tax effects of timing differences in this category do not yet form part of owners' equity. These items would need to be separately disclosed in the balance sheet and brought to account in the income statement as the items which gave rise to the timing differences are recognised. Everingham and Hopkins (revision service 11, 1988, 23) suggest that the items be disclosed as a single line item in the balance sheet immediately below owner's equity.

The second category of timing differences considered by Exposure Draft 61 (1986, para .21) is when the tax benefit or sacrifice is to occur in future periods based on a current or past transaction, the timing difference will give rise to an estimated tax liability or asset that will be settled in the future:

> *Until settled, the tax effect of this timing difference is reflected separately as a liability or asset in the balance sheet because it involves an estimated future sacrifice of economic resources or a future receipt of economic benefits resulting from a current or past transaction.*

Under the method of accounting for deferred taxes proposed by Exposure Draft 61, the effect of changes in the tax rates will be dependent on the classification of the timing differences. Where timing differences are accounted for as benefits or sacrifices, the recognition of which is deferred to a future period, Exposure Draft 61 (ibid, para .22) states that the tax effect would be based on the tax rate applicable in the period in which the timing difference arose. As this tax rate would be known, no adjustments for subsequent changes in tax rates would be necessary. In circumstances where timing differences are accounted for as future estimated tax assets or liabilities, the estimate is based on the tax rate expected to be in effect when the tax asset or liability is settled, ie when the timing difference reverses. The best estimate of this is the current tax rate. They must therefore be adjusted "...as would be the case with the liability method" (Everingham and Hopkins, revision service 11, 1988, 24).

In the addendum to Exposure Draft 61, the Accounting Practices Committee (APC) stated that although they considered the Exposure Draft 61 approach both conceptually correct and generally acceptable, a dichotomy arises concerning the balance sheet presentation of the deferred tax benefit amount. The technical commentary provided the arguments both in favour of and against the inclusion of deferred tax benefits in owners' equity.

The APC considered that the underlying basis of accounting and reporting is the accounting equation referred to in section 2.9.2 above. This equation:

Assets = Liabilities plus Shareholders' Equity

presupposes that items that are not either assets or liabilities must form part of shareholders' equity. The APC in the addendum to Exposure Draft 61, provides the following two arguments for including deferred tax benefits under shareholders' equity. Firstly,

> *"[T]he Deferred Tax Benefit amount represents a benefit which has been received by the enterprise, the recognition of which is merely being delayed in accordance with the matching concept. It is argued that, on the basis of substance over form, the deferred benefit represents an entitlement of owners and therefore should form part of owners' equity" (Addendum, ED 61),*

and secondly, since a deferred tax benefit is not a liability of the enterprise and it would not be acceptable to consider the deferred tax benefit as a valuation account, the deferred tax benefit must form part of equity.

In terms of the entity theory (on which the above equation is based), the corporation is considered to have a separate existence, even personality, from the providers of capital. If the arguments of Chen (1975, 540) (referred to in section 2.9.2) are considered the first argument presented by the APC in favour of incorporating deferred tax benefits must be viewed as being incorrect. In terms of the entity theory, owners are not entitled to earnings until such time as they have been transferred to the owners by the entity itself.

The APC in the addendum to Exposure Draft 6 offered the following primary argument against the inclusion of deferred tax benefits in owners' equity:

> *Financial statements are prepared on the basis of the accrual or matching concept. To include the Deferred Tax Benefit in owners' equity is inconsistent from two view points:*
>
> - *the treatment would be inconsistent with the generally accepted accounting practice adopted for other similar deferred items*
> - *there would be inconsistency of treatment between the income statement and balance sheet.*

Unlike Exposure Draft 8 and AC 102 (1975), the explanatory notes contained in paragraph .08 of Exposure Draft 61 do not contain any normative statements. Paragraphs .35 to .52 of the exposure draft, however, each contain normative statements. In terms of the framework of accounting established in Chapter 2, Exposure Draft 61 must be considered normative in nature.

Because of the comments of the Accounting Practices Committee in the addendum to Exposure Draft 61, the responses to the unpublished memorandum will provide evidence as to whether any positive elements of accounting theory can be applied to Exposure Draft 61.

Based on the positive theory of accounting outlined in Chapter 2 above, the deferred taxation pratice that best suited management's requirements would be the alternative supported by management in their responses to the exposure draft.

A detailed analysis of the responses to Exposure Draft 61 is undertaken in Chapter 5.

3.4.7 EXPOSURE DRAFT 72

The continuing inability of the accounting profession to provide a definitive statement covering deferred taxation resulted in uncertainty within the business community as to which alternative approach to deferred taxation was the correct one. According to McDonald, this uncertainty was reflected in the use by the business community of the following alternative approaches to deferred taxation:

> *Comprehensive provision on the liability method;*
>
> *Comprehensive provision on the deferral method;*
>
> *Recognising deferred tax benefits and treating the benefit either as a liability or as part of equity;*
>
> *Partial provision on the liability method;*
>
> *Partial provision on the deferral method; and*
>
> *Other experimentation including tax equalisation accounts (McDonald, 1988, 227).*

In an article published in *Accountancy SA,* Terry (1988, 233) argues that

> *"[I]f one examines the trend of deferred tax balances over the past ten years, it is noticeable that the majority of companies' balances have increased consistently over the period"* .

This opinion by Terry is not supported by empirical evidence from a South African source. Other than the study by Everingham reported in *Accountancy SA* (1, 6, 1984) referred to earlier, no other comprehensive study on deferred taxation has been undertaken in South Africa. Everingham's study did, however, reveal results consistent with patterns obtained from studies in the United States and Canada (Everingham and Hopkins, revision service 13, 1989, 32). The only other known study conducted in South Africa was the *'Survey of Financial Reporting in South Africa 1988',* last published by the SAICA in 1989. The validity of the study must be questioned because of its intermittent nature (previous studies were conducted in 1980 and 1982), and the fact that only the accounting policy and disclosure of the top 100 companies according to the Financial Mail ratings were surveyed.

The object of Exposure Draft 72 *'Taxation in Financial Statements'*, issued by the APC in June 1988, was to "...recognise in financial statements the amount of tax which is reasonably estimated will be payable as a consequence of reported income for the period". Like its predecessors, Exposure Draft 61 (1986) and AC 102 (1975), Exposure Draft 72 (1988, para .17) detailed the reasons why differences between the amounts of taxable income and reported income occur. These were identified as permanent differences, timing differences and tax losses. The circumstances where permanent differences and timing differences arise have been detailed above in 3.2.1 and 3.2.2 above.

The partial allocation basis for accounting for deferred taxation was formally introduced into South African accounting standards in paragraph .22 of Exposure Draft 72:

> *There are two common bases for determining deferred taxation. These are the comprehensive allocation basis and the partial allocation basis.*

3.4.7.1 Comprehensive Allocation Basis

Under the comprehensive allocation basis of accounting for deferred taxation propounded by Exposure Draft 72, the tax effects of all timing differences are recognised in the financial statements of the year that the timing differences occurred. This basis of accounting has as its support the matching concept which in terms of AC 101 (1974, para .23), requires that the "...incidence of taxation on all transactions should be recorded in the period in which the transactions are recognised for accounting purposes".

Where timing differences have the effect of postponing the payment of current taxation an accrual for deferred taxation should be made, which, according to AC 102 (1975, para .24) would result in "...both the matching of expense with revenue and the recognition of the liability for taxes payable in the future". Should a timing difference result in a prepayment of taxation, this prepayment should also be recognised to avoid overstating income after taxation when the timing differences reverse.

3.4.7.2 Partial Allocation Basis

The partial allocation basis of accounting for deferred taxation introduced a concept previously not considered by the accounting profession in South Africa. Discussion Paper 5 and the memorandum had merely sought the opinions of interested parties on the partial allocation basis of providing for deferred taxation. According to Exposure Draft 72 (1988, para .25) the partial allocation basis

> *"...is the method whereby deferred taxation is accounted for in respect of the net amount by which it is probable that any payment of tax will be temporarily deferred or accelerated by timing differences which will reverse in the foreseeable future without being replaced".*

The premise upon which the partial allocation basis operates is that in an enterprise which is not expected to reduce the scale of its operations significantly, there will often exist a hard core of recurring timing differences that are unlikely to reverse and which will result in the permanent deferral of taxation. The adoption of the partial allocation basis of providing for deferred taxation will allow enterprises to provide for taxation only to the extent "...that tax will become payable as a result of the future reversal of existing timing differences" (Exposure Draft 72, 1988, para .26).

Paragraph .28 of Exposure Draft 72 examined the criteria that should be met before the partial allocation basis of providing for deferred taxation is appropriate. This required the enterprise to be a going concern, as well as the ability by management to estimate the taxation that will become payable in respect of timing differences that will not be replaced by recurring timing differences for some considerable period, and after the current period the situation will be unlikely to change so as to result in further taxation liabilities.

Where accounting for deferred tax is made on the partial basis, only those timing differences which will reverse in the foreseeable future without being replaced need to be provided for. In '*Guidelines for Financial Reporting Standards*' Solomons (1989, 63) considers that the partial allocation basis of providing for deferred taxation

> *"...introduces a criterion for the recognition of liabilities that is not used in any other context. Accounts payable (trade creditors) are continually being paid off and replaced, yet their status as liabilities is never questioned. Nonreplacement is not and should not be a criterion for recognition".*

Exposure Draft 72 requires the liability method to be used in computing deferred taxation. Under this method, the tax effects of all timing differences will be determined by using the prevailing tax rate unless information is available that would indicate that another tax rate is more appropriate.

Like Exposure Draft 61, no normative statements are made in the explanatory notes of Exposure Draft 72. Paragraphs .57 to .71 of Exposure Draft 72, however, each contain a normative statement. Exposure Draft 72 must therefore be considered normative in nature.

The responses to Exposure Draft 72 are evaluated in detail in Chapter 5.

3.4.8 AC 102 (revised)

The AC 102 statement was revised and issued during July 1989 and is applicable to financial statements covering all periods commencing on or after 1 July 1989. The revised version of AC 102 considered that

> *"[t]he objective in accounting for taxation is to determine the appropriate amount of tax to be recognised in the financial statements for the period" (1989, .03).*

This revised statement recognises two bases for determining deferred taxation, namely the comprehensive and partial basis. The technical release issued with statement AC 102 - *'Taxation in Financial Statements',* states that this statement differs from Exposure Draft 72 in that Exposure Draft 72

> *"...treated the comprehensive basis as the preferred basis and permitted the use of the partial basis under certain circumstances, whereas AC 102 (revised) treats the two bases on equal terms" (Technical release Exposure Draft 72).*

Other than the revision to AC 102 considered above, the preparers of AC 102 (revised) did not consider it necessary to make any significant alterations to Exposure Draft 72 discussed previously. It is appropriate to consider whether or not statement AC 102 (revised) can be intrepreted as being normative in nature.

As paragraphs .56 to .70 of AC 102 (revised) each contain a normative statement, AC 102 (revised) must be considered to be normative in nature.

3.4.9 OTHER DEFERRED TAX PRACTICES

This section examines various alternative deferred tax practices which, although not codified by statement AC 102 (revised), *'Taxation in Financial Statements'*, are currently used by enterprises to account for and report on deferred taxation.

3.4.9.1 Discounting Deferred Taxation

The discounting of deferred taxation has as its theoretical underpinning the consideration that deferred taxation involves the actual postponement of payment of the taxation liability. Davies et al (1990, 849) argue in *Generally Accepted Accounting Practice in the United Kingdom* that "...it is possible to regard the deferred liability as equivalent to an interest-free loan from the tax authorities".

The discounting of deferred taxation has support from various sources. Rayburn (1987, 45), in advocating that discounting is consistent with the liability method of providing for deferred tax, argues that "[A]ccounting for deferred tax liabilities should be consistent with current measurement theory for other assets and liabilities".

Opponents of this practice argue that a difficulty companies would experience in discounting deferred taxation balances would be how to account for the time value of money. Rayburn (ibid) does not consider this to be a difficulty. He considers that as interest on deferred taxes is not a tax deductible expense, and as most companies are debt leveraged, the after-tax cost of debt would be the preferable discount rate to use for discounting purposes.

3.4.9.2 Tax Equalisation

The practice of utilising a tax equalisation account is to minimise potential future distortions in attributable earnings as a result of the utilisation of existing tax losses and certain accelerated tax allowances. Effectively, this equalisation account is created to smooth the effect that tax allowances and assessed losses have on earnings. According to Everingham and Hopkins (revision service 13, 1989, 46-6) an equalisation account created under these circumstances is clearly a reserve, "...which should not be included in 'Deferred taxation' on the balance sheet". They consider that adjustments of this nature are essentially cosmetic in nature as an "...assessed loss bought forward produces a real benefit in terms of reduced tax payable" which is negated by a tax equalisation adjustment.

3.5 EFFECT OF ALTERNATIVE DEFERRED TAX PRACTICES ON FINANCIAL STATEMENTS

A discussion of the effects that alternative deferred taxation practices have on financial statements appears below.

3.5.1 FLOW THROUGH APPROACH

As stated in 3.4.5.1 above, under the flow through method, no provision is made for deferred taxation. Originating and reversing timing differences are not accounted for. The income statement would disclose as an expense the income tax payable for the year, while the balance sheet reflects an accrual for income tax payable. The notes to the financial statements would disclose the differences between the income tax values of the assets and the amounts at which these assets appear in the balance sheet of the company. As a result, the after tax earnings and consequently earnings per share are not impacted by deferred taxation adjustments.

3.5.2 PARTIAL DEFERRED TAXATION

The partial allocation approach to deferred taxation is based on the premise that there is a hard core of timing differences that do not reverse and consequently it is not necessary to provide deferred taxation on these timing differences. In an expanding captial intensive company, it would be unlikely that a significant deferred taxation balance would be maintained. Adjustments are made to the taxation charge in the income statement for those timing differences that are likely to reverse in the short term. Earnings attributable to shareholders are only reduced by short term deferred tax adjustments.

3.5.3 COMPREHENSIVE ALLOCATION BASIS OF PROVIDING FOR DEFERRED TAXATION

The four alternative applications of the comprehensive allocation approach are discussed below.

3.5.3.1 Analysis of Timing Differences

Under this alternative, it is the economic nature of the timing differences that determine the period in which the timing difference will impact upon taxable income.

The timing differences on instalment sales arise because the gross profit on the instalment sale is included in reported income in the year of sale but it is not reflected in taxable income of that year. As the deferred taxation liability that arises as a result of this timing difference will have to be settled at some time in the future, it is disclosed as a liability under deferred taxation.

The timing differences arising from the taxation allowances granted on manufacturing machinery have already occurred. In other words, the timing differences have been included in the calculation of taxable income but as yet have not been reflected in reported income. Savings made as a result of allowances granted on manufacturing machinery represents according to the memorandum (1984, para 40), a "...using up of a portion of the tax deductibility of the asset, i.e., the tax reducing capacity of the asset is consumed (or used up) more rapidly in taxable income than in reported income". The reduction of future benefits that will be derived from the manufacturing machinery will be reflected as a taxation adjustment figure to fixed assets thereby reducing the carrying value of those assets. This adjustment should be seen as an allocation of cost rather than a provision for a future liability.

3.5.3.2 Analysis of Deferred Taxation Balances

This alternative treatment of deferred taxation is based on the premise that there is "...no one appropriate method of accounting for the tax effects of timing differences" (SAICA, 1984, para 53). It was this approach that was adopted by Exposure Draft 61.

Where income is reflected in the financial statements in a period prior to that in which it included in taxable income, a liability for future taxation arises. This is the situation that occurs with items such as sales by instalment. The liability for future taxation on instalment sales is recognised by inclusion in the balance sheet under deferred taxation.

Where a timing difference has appeared in taxable income in a period prior to that in which it appears in the financial statements, "...a tax benefit or sacrifice arises which may be deferred to a future period, but remains part of shareholders' interest" (ibid).

3.5.3.3 Analysis Into Long and Short Term Obligations

The analysis of deferred taxation into long and short terms emphasises the capital maintenance objective of financial statements. This approach, according to the memorandum (ibid, para 58), is based on the premise that due to the movement away from capital based incentives to labour creating incentives "...we cannot be assured of a continuous growth in timing differences". As a result, should deferred taxation provisions be eliminated, long term capital wastage could occur through the declaration of excessive dividends.

Where deferred taxation is analysed into long and short term components, the provision for deferred taxation is made 'below the line'. Where the whole amount of the deferred taxation balance is classified as long term, the amount would be disclosed as tax equalisation forming part of non distributable reserves.

3.5.3.4 Original AC 102 (1975)

This approach requires deferred taxation to be provided in terms of the comprehensive allocation approach, either on the deferral or liability bases.

3.6 CURRENT PRACTICE

This section identifies certain of the deferred tax practices currently used by companies and reported in their published financial statements. An examination such as this is selective and must not be seen as being comprehensive. It merely serves as an indication of the alternative deferred taxation practices currently utilised by public companies.

These practices will be examined against current reporting requirements to establish whether companies are complying with the requirements of statement AC 102 (revised), *'Taxation in Financial Statements'*.

In the May 1992 issue of *Accountancy SA (9, 5, 139 - 146)*, the judges selected to analyse the annual CA Reporting Award issued by the South African Institute of Chartered Accountants were critical of deferred tax practices employed by companies. In particular, companies were criticised for incorrect application and intrepretation of the deferred tax statement. Certain companies that changed their accounting policy from the comprehensive basis to the partial basis did not make an adjustment to the deferred taxation balance on the balance sheet as required by statement AC 103 (revised), *'Extraordinary Items and Prior Year Adjustments'*.

In addition, the judging panel (1992, 143) stated that certain companies, including South African Breweries Limited, utilised a tax equalisation account to smooth earnings. This is achieved by adjusting the current effective tax rate to the rate which the company anticipates will prevail in future.

A further criticism that the judging panel made was that many companies were not stating the number of years that their forecast period covered (AC 102 (revised) states that the forecast period should cover a period of three years and requires that the forecast to be current). In addition to not stating the forecast period, certain companies were discounting their forecasts to present values which effectively reduces the forecast value of the net timing differences.

Finally, the judging panel (although not stating the companies by name) found that certain companies were using both the partial and comprehensive bases for providing deferred taxation whereas AC 102 (revised) requires that either the partial basis or comprehensive basis be used for calculating deferred taxation.

The accounting policies and notes covering deferred taxation of six selected listed companies are presented below.

Fintech Limited, in its taxation accounting policy (1991, 10) to the financial statements at 28 February 1991, include the following note:

> *A tax equalisation account is used, whereby taxation is charged in the income statement, to minimise the potential future distortions in attributable earnings as a result of the progressive utilisation of the group's significant estimated tax losses.*

Furthermore, in Taxation note 3 to the financial statements (ibid, 17) Fintech Limited stated that the estimated tax losses available for set-off against future taxable income amounted to approximately R70 000 000. During 1991, an amount of R2 730 000 was charged through the income statement as a tax equalisation charge. This charge effectively smooths earnings.

The accounting for deferred taxation by the management of Fintech Limited did not find favour with auditors Fisher Hoffman Stride. In the qualified report of the independent auditors to members of Fintech Limited dated 20 May 1991, the auditors considered that

> *"[A]s set out in note 3 to the financial statements, the group has contrary to generally accepted accounting practice, created a tax equalisation account which cannot objectively be audited. Had this not been effected, the net income attributable to shareholders would have increased by R2 858 000 and earnings per share by 25,7 cents".*

The accounting policy that gave rise to the above qualification must be compared to the accounting policy adopted by Engen Limited in their financial statements at 31 August 1991. The principal accounting policy adopted by Engen Limited (1991, 47) for deferred taxation stated that:

> *Deferred taxation is provided on the liability method using the partial allocation basis. In terms of this basis, provision is only made for deferred taxation on timing differences which are likely to reverse in the foreseeable future. The extent to which provision has not been made for all timing differences existing at year end is disclosed as a contingent liability.*

What can be considered interesting is that in the report of the joint independent auditors, Ernst & Young and Coopers Theron Du Toit, dated 5 November 1991, no reference is made to the tax equalisation account which according to the notes to the financial statements of Engen Limited (1991, 52) "...represents the directors' estimate of the potential tax liability of the group" taking cognisance of various unmentioned external factors which includes changes to tax legislation. The amount of R16 150 000 transferred to the tax equalisation reserve did not form part of the annual taxation charge and consequently did not adversely impact earnings per share.

The auditors of Vaaltrucar Limited, Ernst & Young, did not find fault with the accounting policy adopted by the company in their 1990 financial statements. Note 1.2 to the financial statements covering deferred taxation included the following note:

> *As the plantation timing differences reverse in the year 2004 and due to the uncertainties as to whether these timing differences will be replaced by further timing differences, deferred tax has been raised by present valuing these timing differences at the financing cost in the partnership, namely 20%.*

Although there is merit in the accounting policy adopted by Vaaltrucar Limited (see 3.4.9.1 above), this policy is contrary to the requirements of statement AC 102, *'Taxation in Financial Statements'*.

Vaaltrucar Limited (1990, 17) detailed the change in accounting policy from the comprehensive allocation basis to the partial allocation basis in note 1.9 to the financial statements:

> *The accounting policy on deferred taxation has been changed from the comprehensive allocation basis to the partial allocation basis. Had this policy been followed in the prior year it would have had no effect on the results of the operations for the prior year or on the financial position at the end of the prior year. Had the prior years* (sic) *policy of providing for deferred tax under the comprehensive allocation basis been followed in the current year then this would have reduced earnings by R932 799.*

It is the above situation where the benefit of changing from the comprehensive allocation basis to the partial allocation basis is apparent. This change in accounting policy resulted in earnings per share increasing from 14,1 cents in 1989 to 15,7 cents in 1990 even though income before taxation fell from R3 745 731 in 1989 to R2 780 042. Had the comprehensive allocation basis been maintained during the 1990 financial year, net income after taxation would have reflected R1 663 538 rather than R2 596 337 with earnings per share as 10 cents per share rather than 15,7 cents per share.

Sappi Limited, in their annual report (1990, 45), provide in full for all deferred taxation liabilities on the liability method:

> *No transfers to reserves are made where reductions in taxation payable due to timing differences arising from the accelerated deduction of the cost of certain assets in the determination of taxable income, in relation to the corresponding provision for depreciation in arriving at the reported income before taxation.*

The principal accounting policy of Hunt Leuchars & Hepburn Holdings Limited relating to deferred taxation is as follows:

> *Deferred taxation is provided on the liability method using the partial basis. In terms of the partial basis the tax effects of timing differences are accounted for to the extent that it is probable that a liability will crystallise in the foreseeable future.*

This company does, in the main, comply with the disclosure requirements of statement AC 102 (revised) with regard to deferred taxation disclosure under the partial basis of accounting. Criticism can possibly be levelled at the disclosure in that Hunt Leuchars & Hepburn Holdings Limited consider that "...the tax effects of timing differences are accounted for to the extent that it is probable that a liability will crystallise in the foreseeable future" (1991, 31). No mention is, however, made of one of the criteria laid down by statement AC 102 (revised) before it is appropriate to use the partial basis is that management must be

> *"...able to make a reasonable estimate of the taxation that will become payable in respect of reversing timing differences which will not be replaced by recurring timing differences, for some considerable period (at least three years) ahead" (AC 102 (revised), 1989, para .28).*

Pretoria Portland Cement Company Limited (1991, 37) provide for deferred taxation on the liability method using the partial basis, where the taxation effects of timing differences are accounted for to the extent that the liability will crystallise within the next five years.

Pretoria Portland Cement Company Limited must be criticised on the grounds that when the accounting policy was changed from the comprehensive allocation basis to the partial allocation basis, the requirements of Statement AC 102 (revised) were not complied with. Changes in accounting policy are in terms of statement AC 102 (revised) should be accounted for as follows:

> *Where the introduction of this statement gives rise to a change in accounting policy, the opening balance on the deferred taxation account should be determined in terms of the requirements of this statement and any adjustments arising treated in accordance with the requirements for a change in accounting policy (AC 102, ibid, para .69).*

The financial statements for Malbak Limited (1991, 44) reflect deferred taxation provided for on the partial basis using the liability method. Where full provision has not been made on all timing differences, the extent to which provision has not been made is disclosed by way of a contingent liability.

As with Hunt Leuchars & Hepburn Holdings Limited, Malbak Limited do, in the main, comply with the disclosure requirements of statement AC 102 (revised) as regards deferred taxation disclosure under the partial basis of accounting. Criticism can possibly be levelled at the disclosure of accounting policies by Hunt Leuchars & Hepburn Holdings Limited and Malbak Limited in that these companies do not comply with one of the main requirements laid down by statement AC 102 (revised) before it is appropriate to use the partial basis for accounting for deferred taxation, in that a forecast period of at least three years be used.

3.7 SUMMARY

In their attempt to satisfy as many divergent user groups as possible, the National Council of Chartered Accountants (SA) and it successor, the SAICA have not been able to meet their objective stated in AC 100 '*Preface to Statements of Generally Accepted Accounting Practice*' in that they wished "...to identify those accounting practices that are desirable and thereby narrow the difference and variety of available accounting practices..." (1983, para .06) by providing a definitive statement on deferred taxation since Exposure Draft 8 '*Taxation in the Financial Statements of Companies*' issued in October 1972.

The statements on deferred taxation must not be seen as the only statement where the SAICA has failed to meet its stated objective. Statements AC 109 '*Accounting for Construction Contracts,*' and AC 114 '*Capitalisation of Borrowing Costs*' must be seen as failures in that these statements allow a choice to be made from alternative accounting practices, rather than being definitive. In addition, the SAICA has been unable to finalise a statement or guideline on inflation accounting. This opinion is re-enforced by the editorial to the May 1992 issue of *Accountancy SA*, the opinion which stated that [South African accounting standards] "...are far more flexible and permit many more options than those of other countries. As South Africa emerges from isolation and begins to participate in world markets our standards will be found wanting" (1992, 127).

The existence of normative statements in the various exposure drafts and statements of generally accepted accounting practice covering deferred taxation would suggest that accounting theory in South Africa is normative in nature. For accounting theory to be considered positive in nature a predictive element must be present. Only by examining the responses of interested parties to the exposure drafts and discussion memorandum on deferred taxation will it be possible to establish whether the required predictive element is present.

The next chapter details the research methodology used and examines aspects of the questionnaire forwarded to those parties who participated in the deferred taxation deliberations.

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CHAPTER FOUR

THE STUDY

4.1 INTRODUCTION

This chapter describes the features of the study design. First, an overview of the empirical research methodologies employed in the research process will be provided. Thereafter, the research design, the survey conducted and the sample selected will be described. The development and description of the hypotheses which form the focus of the surveys conducted will be identified.

The results of the surveys will be described in Chapter 5.

4.2 PURPOSE OF THIS RESEARCH

The objective of this research is, in general, to evaluate whether, by examining the responses to exposure drafts and discussion memoranda on deferred taxation, a comprehensive theory of accounting can be said to exist in South Africa. In particular, the purpose of this research it to establish, through the testing of specific hypotheses by empirical means, whether accounting theory in South Africa can be considered to be either positive or normative in nature.

The research also examines the role of corporate management in the setting of statements of Generally Accepted Accounting Practice (GAAP). Interested parties who participated in the deferred taxation deliberations by responding to the discussion paper, memoranda and exposure drafts on deferred taxation are surveyed to establish whether the existence of management compensation plans influenced responses made to any of the proposed accounting statements on deferred taxation issued by the Accounting Practices Committee.

4.3 RESEARCH METHODOLOGY EMPLOYED

According to Leedy (1989, 89), it is the data that dictates the research methodology. In other words, it is the nature of the available data that will determine the research methodology utilised in the research process.

The accounting standard setting process in South Africa requires interested parties (including those with vested interests) to comment on discussion papers, exposure drafts, and, in the case of deferred taxation, an unpublished memoranda. Discussion Paper 5 (1983) required respondents to answer a series of questions on deferred taxation, while the unpublished memoranda (1984) required those parties who responded to Discussion Paper 5 to make specific comments on alternative deferred taxation practices. Exposure Draft 61 (1986) and Exposure Draft 72 (1988) issued for comment by the Accounting Practices Committee, required interested parties to make comments on specific deferred taxation practices.

The availability of the comments by interested parties on Discussion Paper 5, the unpublished memoranda, Exposure Draft 61 and Exposure Draft 72 provide information that is historical in nature and which provides an opportunity to conduct four independent case studies on the responses.

4.3.1 THE NATURE OF A CASE STUDY

A case study is an approach which emphasises the uniqueness of the individual. As a result, Neale and Liebert (1986, 25) argue that case studies are generally not appropriate to the nomothetic approach to research,

> *"...which insists that because science deals with general laws, behaviour should be studied by observing a variety of people with the aim of formulating general laws of behaviour. When researchers in the social sciences are interested in findings of greater generality, the case study is limited in usefulness".*

While a case study is considered limited in its ability to provide positive support for a theory, a case study can provide a source of descriptive information which can be used as supplementary evidence in confirming a theory.

A problem with the use of case studies in research identified by Neale and Liebert (1986, 30) lies in the 'intuitive' nature of the selection process. They argue that "...cases are selected to illustrate a particular point or even confirm a theory". This problem was not considered to be appropriate in this research as there was no selection of individual cases. The proposed case studies will examine all the individual responses to Discussion Paper 5, the unpublished memoranda, Exposure Draft 61 and Exposure Draft 72.

A further aspect to consider when use is made of case studies is that it is not appropriate to make use of a case study either in isolation or to confirm hypotheses that have been developed. Findings of a case study must be used to provide additional supportive evidence to a theory.

4.3.2 THE DESCRIPTIVE SURVEY METHOD

The descriptive or normative survey method is the appropriate research methodology to employ where a clearly defined population exists, and where data is to be obtained from observation. A questionnaire is an acceptable method of obtaining information by observation. The development of the questionnaire will be considered in section 4.6 below.

The development of the hypotheses is examined below.

4.4 DEVELOPMENT OF THE HYPOTHESES

Before research on a problem can commence, the research problem must be narrowed into clearly defined, researchable terms. This process involves the formulation of testable hypotheses that are capable of being refuted. The resultant hypotheses describe the expected or predicted relationships between variables.

The hypotheses relating to the topic have been identified as follows:

Hypothesis 1 *It is hypothesised that, in the opinion of the respondents participating in the survey, accounting theory in South Africa can be considered normative in nature.*

Hypothesis 2 *It is hypothesised that, in the opinion of the respondents participating in the survey, accounting theory in South Africa cannot be considered positive in nature.*

This hypothesis was extended from that developed in Hypothesis 1. If Hypothesis 1 is accepted, this will imply that accounting theory in South Africa cannot be considered positive in nature. Hypotheses 1 and 2 were developed to establish whether accounting theory in South Africa can be considered either normative or positive in nature. As discussed in Chapter 2, a positive theory of accounting was formalised by Watts and Zimmerman (1978), a theoretical approach which remains controversial today. Watts (1977, 54) in an earlier paper justifying the development of the concept of positive accounting theory stated that "[T]he financial accounting theory concentrates on prescription: on what 'should' be the content of financial statements", an approach not agreed to by him. This is the normative approach to accounting theory referred to in Chapter 2.

This approach must be compared to the positive theory of accounting developed by Watts and Zimmerman (1978, 112) which they considered will enable users of financial information

> *"...to understand better the source of the pressures driving the accounting standard-setting process, the effects of various accounting standards on different groups of individuals and the allocation of resources, and why various user groups are willing to expend resources trying to affect the standard-setting process".*

Should the respondents to the survey consider accounting theory in South Africa to be positive in nature, this would confirm Hagerman and Zmijewski's contention that [positive accounting theory] is "...a prerequisite to understanding how firms will react to changes in accounting standards" (1979, 157).

An extensive search has revealed that an investigation of this nature has not, to date, been conducted in South Africa.

<u>**Hypothesis 3**</u> *It is hypothesised that, in the opinion of the respondents participating in the survey, the original objective of providing for deferred taxation, which was to achieve a proper matching of the tax charge against income to which it relates, is appropriate to South Africa.*

The nature of deferred taxation has been explored in Chapter 3. As illustrated, there has been a vigorous and unresolved debate both in South Africa and internationally concerning the nature and accounting for deferred taxation. Briefly, the controversy concerns three factors: the matching concept, which according to Everingham and Hopkins (revision service 13, 1989, 11) was the original objective of providing for deferred taxation, the interpretation factor which according to Hendriksen and van Breda (1992, 708) consider asset and liability valuations that permit economic interpretation both as to the item and its measurement to be paramount, and finally, the group (ibid, 708) that bases its preference on the belief that the predictions of future cash flows are more important than predictions of net income. Financial statements should be drafted in such a manner that users are able to predict future cash flows.

Empirical research covering deferred taxation has, according to Hendriksen and van Breda (1992, 713) not been strongly supportive of the concept of deferred taxation; they refer to a study reported in *The Accounting Review* by Beaver and Dukes (1973, 558) who conclude that "...the premise on which APB Opinion 11 [tax allocation] is based is open to serious question...", and consequently, current tax allocation procedures may not necessarily be optimal.

The formalisation of the partial basis of accounting for deferred taxation in South Africa in the opinion of certain professional accountants and accounting academics, violates the matching concept, one the of fundamental concepts of accounting in South Africa laid down in paragraph .05 of statement AC 101, *'Disclosure of Accounting Policies'*.

This hypothesis has been developed to address an issue that has previously been neglected in prior South African research.

<u>**Hypothesis 4**</u> *It is hypothesised that, in the opinion of the respondents participating in the survey, deferred taxation on the balance sheet of companies represents a liability that will become payable in the future.*

This hypothesis was extended from that developed in Hypothesis 3. If Hypothesis 3 is rejected, this will imply that respondents believe that the matching principle, one of the fundamental accounting concepts is not valid in South Africa.

Hypothesis 5 *It is hypothesised that, in the opinion of the respondents participating in the survey, company management must comply with codified statements of generally accepted accounting practice even though this practice will adversely impact reported earnings.*

Hypothesis 6 *It is hypothesised that, in the opinion of the respondents participating in the survey, the existence of management compensation schemes will influence management's response to an exposure draft that adversely affects reported earnings.*

Hypothesis 7 *It is hypothesised that, in the opinion of the respondents participating in the survey, the implementation of the current statement on deferred taxation resulted in modification to existing management compensation schemes.*

Hypothesis 8 *It is hypothesised that, in the opinion of the respondents participating in the survey, financial statement user groups are willing to expend resources in trying to influence the accounting standard setting process.*

Watts (1977, 54), in outlining a theory for financial statements, bases his approach on price theory on a methodology supported in later research by Watts and Zimmerman (1978, 113). This approach assumes that individuals maximise their own expected utilities and that they are innovative and creative in doing so. A study by Hagerman and Zmijewski (1979, 145) confirms that the existence of a management incentive compensation plan is a factor that will influence management's choice of accounting principles.

> *"If management incentive schemes are related to accounting earnings we expect that management has an incentive to use accounting principles that increase accounting earnings if part of their income is derived from incentive plans" (1979, 145).*

A later study by Murphy (1985, 40) supports this contention and concludes that "...firm performance as measured by the shareholder's realised return, is strongly and positively related to managerial remuneration". The acceptance of hypotheses 5 to 8 would indicate that management is influenced by economic motives in the choice of alternative accounting standards.

Research in this area has been neglected in South Africa.

Hypothesis 9 *It is hypothesised that, in the opinion of the respondents participating in the survey, that corporate deferred taxation practices are consistent with codified generally accepted accounting practice as required by statement AC 102.*

Hypothesis 10 *It is hypothesised that, in the opinion of the respondents participating in the survey, that current deferred tax practices permitted by statute and generally accepted accounting practice are comprehensive enough and embrace all accounting options.*

Hypotheses 9 and 10 were developed to ascertain whether, in the opinion of the respondents, alternative disclosure exists that, although not codified in a statement of generally accepted accounting practice, would, if complied with, still result in fair presentation as contemplated by section 286(3) of the Companies Act, Act 61 of 1973 as amended. Should hypotheses 9 and 10 be rejected this would indicate that the respondents consider that corporate management is allowed too much flexibility in the choice of accounting standards. The introduction of legislation making adherence to statements of Generally Accepted Accounting Practice mandatory, will result in corporate management being unable to manipulate financial statements in a manner that would best suit their own interest.

KG Mockler in a June 1992 letter to members of the South African Institute of Chartered Accountants, solicited responses as to whether the current standard setting body remains the best possible method of setting accounting standards. Furthermore, members were asked to consider whether the Accounting Practices Board, as presently constituted, is still the most appropriate body to issue Statements of Generally Accepted Accounting Practice or whether improvements to the standard setting process could be made.

Hypothesis 11 *It is hypothesised that, in the opinion of the respondents participating in the survey, that legislation should be incorporated into the Companies Act making adherence to statements of generally accepted accounting practice mandatory.*

This hypothesis was developed in response to hypotheses 9 to 11 and in response to what is perceived to be dissatisfaction of members with the current standard setting process. This dissatisfaction has been recognised by the South African Institute of Chartered Accountants in that in the 1 June 1992 newsletter to members from the chief executive, Mr KG Mockler,

> *"[I]t was agreed that it should be suggested to the Standing Advisory Committee on Company Law that accounting standards should be given legal backing. This could be achieved by amending Section 286 (3) of the Companies Act to require that financial statements should be prepared in conformity with Statements of Generally Accepted Accounting Practice".*

An amendment to the Companies Act, Act 61 of 1973 as amended, making adherence to statements of generally accepted accounting practice mandatory will result in financial statements having more credibility than they currently have.

4.5 SURVEY DESIGN AND TECHNIQUES USED

In this section, the survey design used in surveying the opinions of the participants in the deferred taxation deliberations will be discussed.

4.5.1 THE USE OF SURVEYS

The purpose of a survey is, according to Neale and Liebert (1986, 49) to determine the frequency of some characteristics in the population. On the basis of the results of the survey, generalisations can be made about the population as a whole. Neale and Liebert (ibid), however, caution against the use of generalisations:

> *They involve an inference and can only be made according to a series of assumptions and rules that tend to assure their legitimatacy within certain bounds.*

Two types of surveys can be identified. These are described by Oppenheim (1992, 12) as "...the descriptive, enumerative, census-type of survey; and the analytic, relational type of survey...".

A descriptive survey can be considered to be a fact finding survey. Researchers are provided with information about what proportion of a population reflect a certain characteristic, or how often certain events occur together. A descriptive survey will not reflect casual relationships between one variable and another. The sample being surveyed must be fully representative of the population as a whole before meaningful conclusions can be drawn.

An actuarial survey examines group differences from which relationships between variables can be inferred.

A descriptive survey was considered appropriate to canvass opinions from respondents to the discussion paper and exposure drafts.

4.5.2 THE POPULATION

The population included all those interested parties who responded to Discussion Paper 5, the unpublished memorandum on deferred taxation, Exposure Draft 61 and Exposure Draft 72. Respondents also included those interested parties who participated in discussion groups that studied and responded to the discussion paper and exposure drafts.

The South African Institute of Chartered Accountants (SAICA) provided their files containing copies of the responses to Discussion Paper 5, Exposure Draft 61 and Exposure Draft 72, as well as providing the Accounting Practices Committee (APC) and Accounting Practice Board (APB) minute books for research purposes.

It was not possible to consider the respondents to Exposure Draft 8 as part of the sample as these records are no longer available from the South African Institute of Chartered Accountants.

The aim of the study was not to obtain the opinions of all recipients of the discussion paper and exposure drafts, but rather to confine the study to those who actively participated in the deferred taxation deliberations. These respondents were chosen for the following reasons:

- they were the interested parties who partook in the deferred taxation deliberations and as such were considered to have an in depth knowledge of the subject,

- they represented user groups of financial statements and responded on behalf of those user groups, and

- they represented management of companies and part of their remuneration may have been in the form of incentives provided by their employer companies.

The population consisted of 53 respondents to Discussion Paper 5, 47 respondents to the unpublished memorandum, 53 respondents to Exposure Draft 61, and 40 respondents to Exposure Draft 72. Questionnaires were sent to all the respondents of the Discussion Paper, unpublished memoranda and exposure drafts. Where individual members of discussion groups were readily identifiable from the responses forwarded by respondents to the SAICA, questionnaires were sent to these participants.

4.5.3 THE SAMPLE

An objective of scientific research is to provide a basis upon which firm conclusions can be drawn about people or specific groups of people. If the basis of scientific research is the inductivist approach referred to in Chapter 2, we can, according to Neale and Liebert (1986,31) "...express this same fact by saying that social science research typically tries to understand a segment of the world, a population, on the basis of observing a smaller segment, a sample".

Although various sampling techniques have been developed to accurately select a representative sample from a given population, a factor which needs to be determined in advance is the size of the required sample. In establishing what an adequate sample size would be, Leedy (1989, 156) has one basic rule: "[T]he larger the sample, the better". Should the population sampled not be representative of the population as a whole, then the results of the survey would not be representative of the sample.

Taking Leedy's rule and because of the feasibility, it was decided to use the whole population as the sample.

As certain of the respondents commented on more than one document, these respondents were only included once in the sample.

4.6 DEVELOPMENT OF THE QUESTIONNAIRE: GENERAL CONSIDERATIONS

This section reviews the development of the questionnaire and the collection of the relevant data.

4.6.1 COLLECTION OF DATA

4.6.1.1 Method of Data Collection

There are three accepted techniques of data collection when descriptive surveys are undertaken. These are classified by Neale and Liebert (1986, 52) as being the distributed questionnaire, the phone survey and the systematic interview. The choice of the survey depends, according to Crimp (1990, 38), on the following: the subject of the survey, the nature of the survey population and the research budget. Each of the three descriptive methods are discussed below.

A distributed survey requires respondents to complete a questionnaire that is mailed to them, while a phone survey requires respondents to respond in a telephone interview to specific questions put to them, while in a systematic survey, data is collected by either direct observation or personal interview with the respondent.

As the opinions of respondents to the discussion paper and exposure drafts were being surveyed it was not possible to obtain the required information by observation. This factor dictated that a distributed survey be undertaken.

Once the decision was taken to undertake a distributed survey, two additional factors warranted consideration: the degree of structure of the questions; whether the questions were open or closed and the degree of disguise of the questions.

4.6.1.1.1 Degree of Structure

The degree of structure refers to the nature of the questions asked in a questionnaire. A questionnaire that is highly structured provides the respondent with a predetermined question and a range of responses that are also predetermined.

The nature of the research topic dictated that the questionnaire should by highly structured with respondents being given a number of fixed alternatives from which to select. In addition to the fixed responses given, respondents were given the opportunity of clarifying their responses or providing additional information to certain questions. This will be considered further in section 4.6.1.2 below.

The respondents were not required to answer any open ended questions in the survey.

4.6.1.1.2 Degree of Disguise

The degree of disguise refers to the extent to which the objectives of the survey are obvious from the questions asked. Disguise may be necessary because answers may be influenced by predetermined opinions the respondent may have on the topic.

In order to make respondents aware of topic being researched, a covering letter explaining the topic was sent to each person in the sample. Where terminology was considered to be ambiguous, a definition was provided. The aim was for the questionnaire to be totally undisguised.

Certain of the terminology in the questionnaire was considered to be possibly unfamiliar to certain respondents, and to avoid ambiguity in terminology, definitions were provided for the terms 'positive accounting theory', 'normative accounting theory', 'flow through method' of providing for deferred taxation and the 'hybrid method' of providing for deferred taxation.

4.6.1.1.3 Method of Administration

As discussed in section 4.6.1.1 above, questionnaires can be administered by mail, personnel or telephonic interview. As the sample included respondents from all parts of South Africa, the use of personnel and telephonic interviews was considered to be inappropriate.

The questionnaire was posted to all respondents together with an appeal for cooperation from both the researcher and his supervisor in the completion of the questionnaire. A postage paid reply envelope was enclosed to facilitate the return of the completed questionnaires.

As mail questionnaires provide little control in securing a reply from the respondent, it is necessary to appeal for cooperation in the completion of the questionnaire. A factor that must be considered here is that the sample is made up of those interested parties who responded either to the discussion paper, the unpublished memorandum or exposure drafts. Oppenheim (1992, 105) in considering response rates to questionnaires states that it is the topic and the degree of interest the respondents have in the topic that will determine the response rate:

> *...questionnaires will often be completed successfully if the topic is of intrinsic interest to respondents, or if they believe that their responses will have a direct influence on policy.*

Administering questionnaires by mail has certain advantages. Firstly, it provides respondents with the opportunity to answer the questionnaire in their own time and at their own pace. Other advantages identified by Oppenheim (1992, 102) is the low cost of data collection and processing, the avoidance of interviewer bias, and the ability to reach respondents at widely dispersed locations. In addition, a mail questionnaire allows the respondent to be more frank on what can be considered sensitive issues. The questions covering management compensation schemes were considered sensitive and allowance had to be made for different opinions.

Disadvantages experienced with mail questionnaires are considered to include the general low response rate and consequent bias associated with this. A second problem associated with mail questionnaires is sequence bias. It is not possible for the researcher to control the order in which questions are answered. Respondents will be able to study the entire questionnaire and make responses based on the entire questionnaire. Furthermore, the researcher is unable to monitor incomplete questionnaires or prevent the passing on of the questionnaire to others. Mail questionnaires do not normally provide the researcher with any opportunity to clarify any questions that are not fully understood. To overcome this problem, the researchers' work telephone number was included in the covering letter inviting respondents to contact him should they experience any difficulties with the questionnaire. It was considered that the respondents should not experience any difficulty with the standard of language used in the questionnaire.

4.6.1.2 Description of Questionnaire

The questionnaire can, in the light of the above discussions, be described as structured and undisguised. The advantages and disadvantages of using this type of questionnaire are considered below.

4.6.1.2.1 Simplicity

The advantage of a structured undisguised question is the simplicity of analysis and administration. Respondents should have little difficulty in answering the questionnaire. They are required to select the response they consider the most appropriate from the alternatives provided. This method relieves the respondent of having to convert their thoughts to writing.

4.6.1.2.2 Reliability

The reliability of the questionnaire needs to be established. This includes the following factors:

- Should the respondent not have altered his opinion, the response if the respondent is asked the same question again, should remain unchanged.

- Reliability is increased because the frame of reference is obvious from the stated alternatives. By providing the respondent with a specific range of replies from which to choose, the question itself may become clearer to the respondent. In answering the question 'Financial statements should recognise deferred tax accounted for on the comprehensive basis', the respondent no choice but to use one of the following alternatives, strongly agree, agree, disagree or strongly disagree. Interpretation would be impossible if each respondent was to answer the question in their own words.

- The reliability of fixed alternative questions is sometimes associated with a loss of validity. This is because answers may not necessarily reflect the respondent's opinion. This potential disadvantage was overcome by providing respondents with the facility to make comments on certain questions. Respondents were not provided with the opportunity to make a 'no opinion' form of response. This alternative was excluded as it was considered that the respondents having partaken in the deferred tax deliberations would have specific views on the subject.

- Stated alternative responses may also lower validity where the response categories themselves introduce bias. This would be particularly appropriate where a response is omitted. To overcome this care was taken to ensure that the full range of responses was provided for.

The development of the questionnaire is considered in section 4.7 below.

4.7 DEVELOPMENT OF THE QUESTIONNAIRE: PRACTICAL CONSIDERATIONS

The procedure used for developing the questionnaire was that used by Jackson (1983, 122) and is illustrated below.

FIGURE 4.1: Outline of the Procedure Followed in the Development of the Questionnaire

STEP 1	SPECIFY WHAT INFORMATION WILL BE SOUGHT
STEP 2	DETERMINE TYPE OF QUESTIONNAIRE AND METHOD OF ADMINISTRATION
STEP 3	DETERMINE THE CONTENT OF INDIVIDUAL QUESTIONS
STEP 4	DETERMINE THE FORM OF RESPONSE TO EACH QUESTION
STEP 5	DETERMINE THE NUMBER OF QUESTIONS AND SEQUENCE OF EACH QUESTION
STEP 6	RE-EXAMINE STEPS 1 TO 5 AND REVISE IF NECESSARY
STEP 7	PRETEST THE QUESTIONNAIRE AND REVISE IF NECESSARY

Source: Jackson (1983, 122)

4.7.1 SPECIFICATION OF INFORMATION SOUGHT

The information required from respondents was divided into four specific areas divided into five distinct questions each containing subquestions. The areas covered in the questionnaire were designed to ascertain respondents' opinions to various aspects relating to accounting theory, deferred taxation, management compensation schemes and the accounting standard setting process.

4.7.2 DETERMINATION OF TYPE OF QUESTIONNAIRE AND METHOD OF ADMINISTRATION

As discussed in section 4.6.1.2, the questionnaire to be completed by the interested parties that participated in the deferred taxation deliberations, was described as being structured and undisguised. The questionnaire was distributed as a mail survey.

4.7.3 DETERMINATION OF THE CONTENT OF INDIVIDUAL QUESTIONS

The content of a questionnaire is determined by the nature of the research to be undertaken. The information required to be obtained from the respondent, the degree of disguise of the questions, and the administration of the questionnaire influenced the content of individual questions. Crimp (1990, 93) recommended that as each question is formulated, the following questions need to be asked:

- Do the respondents have the information?
- Will the respondents understand the question?
- Are the respondents likely to give a true answer?

Each of these factors is considered below.

4.7.3.1 Do the respondents have the necessary information?

In the research process where questionnaires are used, it is necessary that the researcher be confident that the respondents have the necessary information at their disposal to answer the questions posed. Furthermore, the researcher must be satisfied that the answers the respondents provide will be reliable.

As the respondents were all participants in the standard setting process, it is assumed that they have the necessary information and experience to enable them to answer the questionnaire and provide reliable answers.

4.7.3.2 Will the respondents understand the question?

In order to avoid various interpretations of terminology used in the questionnaire, definitions of two methods of accounting for deferred taxation and definitions of accounting theory were provided.

4.7.3.3 Are the respondents likely to give a true answer?

If the respondent has the required information and understands the question, the question of whether a true answer will be elicited must be raised. Crimp (1990, 95) considers that the following factors will prevent a true response from being provided:

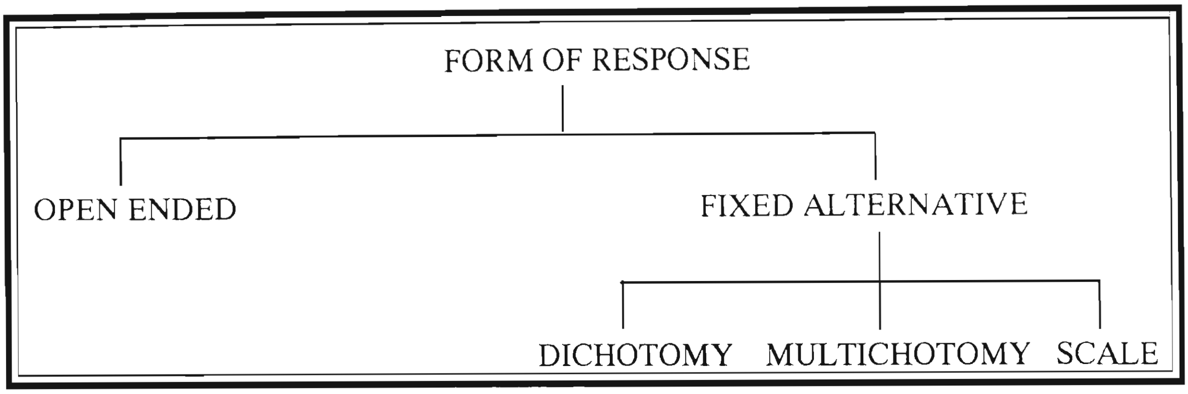
- The respondent may find it difficult to verbalise.
- The respondent's memory may be defective.
- The respondent may be reluctant, or unwilling, to answer the question.

Given the population of respondents sampled, it was considered that none of the above factors would prove to be an impediment that would prevent true responses from being provided.

4.7.4 DETERMINATION OF THE FORM OF RESPONSE TO EACH QUESTION

The alternative forms of response to a question are illustrated in Figure 4.2 below. As the fixed response format was predominately used in the questionnaire, a decision needed to be taken as to the form of response suitable for individual questions.

FIGURE 4.2: Forms of Response to a Question



Source: Jackson (1983, 131)

The questionnaire contained a limited number of open ended questions.

4.7.4.1 Dichotomous Question

A dichotomous question is a question that allows for only two alternatives. Certain of the questions in the questionnaire limited the respondents choice to YES and NO. Question 2.1 taken from the questionnaire. '*Do you consider that this original objective of providing for deferred taxation should continue to be applied in South Africa'?* provides an example of this.

4.7.4.2 Multichotomous Question

A multichotomous question is a question that has a number of fixed alternatives. The respondent is required to select the alternative that most closely corresponds with his opinion on the subject. This type of multiple choice question does not usually permit the respondent to elaborate on his position although it does allow for more alternatives and finer distinction between viewpoints than the dichotomous question.

All the questions in the questionnaire contained dichotomous and multichotomous questions as the information sought related purely to opinions on accounting theory, deferred taxation, management compensation schemes and the accounting standard setting process.

4.7.4.3 Scale

The use of a scale requires the respondent to choose an answer that best suits his opinion. In this form the question is multichotomous within the framework of a fixed alternative scale.

The nature of the questions asked suited the adoption of an Likert scale as the intention was to test respondents opinion and strength of opinion on various issues surrounding accounting theory, the accounting standard setting process and various aspects regarding deferred taxation.

The Likert scale is discussed below.

4.7.4.3.1 Likert Scale

The Likert scaling method allows the respondent to express their feelings in response to a particular statement made in the questionnaire. The diagrammatic rating scale based on the Likert approach is as follows:

Strongly agree	Slightly agree	Neither agree nor disagree	Slightly disagree	Strongly disagree

A modified Likert scale was considered suitable for certain of the questions posed in the questionnaire. These questions related to opinions regarding various aspects of accounting theory, deferred taxation, management compensation schemes, and the accounting standard setting process.

The Likert scale was considered to be appropriate for the questionnaire as respondents would be able to select an option that best corresponded with their opinion.

4.7.5 DETERMINATION OF THE NUMBER OF QUESTIONS AND THE SEQUENCE OF QUESTIONS

The number of questions in the questionnaire should be sufficient to ensure that all issues are covered adequately without alienating the respondent because of the length of the questionnaire. The questionnaire consisted of 5 sections each of which had several parts. It was considered that the questionnaire did not contain an excessive number of questions and it was estimated that the questionnaire would take approximately 30 minutes to complete.

The questionnaire commenced with questions relating to accounting theory and followed with questions relating to various aspects of deferred taxation. This was the sequence followed in Chapters 2 and 3. Questions relating to management compensation schemes and the standard setting process followed.

4.7.6 REEXAMINATION OF STEPS 1 TO 5

Steps 1 to 5 were thoroughly reexamined. This was to ensure that none of the questions posed were confusing, ambiguous or were likely to introduce bias. The reexamination also included the sequence of questions and the suitability of the response categories selected for each question.

4.7.7 PRETESTING AND REVISION OF THE QUESTIONNAIRE

The final stage in the questionnaire construction was to pretest the questionnaire. The purpose of this pretest was to identify whether any of the questions were ambiguous, to ensure that all the questions were understandable, and all possible aspects of the research topic were covered.

Colleagues in the Department of Accountancy, a senior colleague in the Department of Business Administration at the University of Durban-Westville and a senior colleague from the Department of Accounting at the University of Cape Town were requested to assist in the pretesting of the questionnaire. While the sample selected for pretesting the questionnaire was not representative of the sample selected for surveying, this was not considered to be a problem as the pretest was used to test the questionnaire before final drafting. The results of the pretest were not included in the final analysis.

4.7.7.1 Results of the Pretest

Colleagues recommended that grammatical changes to questions be made to focus the respondents attention on the attitude scale provided rather than possibly responding either YES or NO.

4.8 SUMMARY

Chapter 4 considered aspects of the research methodology and questionnaire design used to determine the views of respondents to the various issued surrounding deferred taxation. The sample that was used in the research was described and the procedures used to obtain the sample were discussed. It is considered that the methodology used and the nature of the questionnaire was adequate to provide meaningful results which are reflected in Chapter 5.

4.9 REFERENCES: CHAPTER FOUR

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CHAPTER FIVE

ANALYSIS OF RESEARCH FINDINGS

5.1 INTRODUCTION

The preceding chapters outlined the nature and purpose of the study, together with the conceptual and research literature relating to it.

Chapter 4 crystallised the research methodology employed to determine whether a comprehensive theory of accounting can be said to exist in South Africa. This chapter presents, analyses and evaluates the responses to Exposure Draft 8, Discussion Paper 5, the unpublished memorandum and Exposure Drafts 61 and 72 by means of individual case studies. In addition, the responses to the questionnaire will be evaluated to establish whether sufficient evidence is available to pronounce on whether or not a comprehensive theory of accounting can be said to exist in South Africa.

For presentation purposes, as a result of the large number of responses analysed, the respondents are identified fully in Appendix 2.

5.2 ANALYSIS OF RESPONSES TO EXPOSURE DRAFT 8

As explained in Chapter 3 (section 3.4.2), the responses by interested parties to this exposure draft are no longer available from the archives of the South African Institute of Chartered Accountants, and, as a result, cannot be subjected to a case study analysis.

5.3 ANALYSIS OF RESPONSES TO DISCUSSION PAPER 5

Discussion Paper 5 as discussed in Chapter 3, was designed to elicit the views of respondents on certain matters raised in the discussion paper. Respondents were required to answer a series of questions based on the available alternative methods of accounting for deferred taxation presented by Discussion Paper 5.

The responses to Discussion Paper 5 will be examined under the following sub-headings: Regional Associations, Firms of Chartered Accountants, Major Companies, Universities, Members of the Accounting Practices Board and Individuals. No cognisance will be taken of those questions relating to alternative accounting methodology.

5.3.1 REGIONAL ASSOCIATIONS

Responses of the regional associations are contained in Table 5.1 below. Of the nine regional associations that provided completed questionnaires, two regional associations believed that only the liability method of providing for deferred taxation should be permitted, while seven regional associations were of the opinion that both the deferral and liability methods of providing for deferred taxation was acceptable. Six regional associations believed that a choice should be made in the future, limiting the choice of accounting for deferred taxation. On the question of whether the partial allocation basis of providing for deferred taxation should be permitted, opinions were divided. The Cape Regional Association Discussion group did not submit a completed questionnaire but was of the opinion that deferred taxation should be provided for in full or not at all.

Table 5.1: Responses of Regional Associations of Chartered Accountants to Discussion Paper 5

	Permit deferral method only	Permit liability method only	Permit both methods	If both methods permitted, should choice be limited at some future date?	Should partial application of deferred tax be permitted now?	Should partial application of deferred tax be permitted at some future date?
Cape Society Discussion Group (Cotten)			YES	YES	YES	
Durban Regional Association			YES	NO	YES	
Johannesburg Regional Association			YES	NO	YES	
Kimberley Regional Association		YES			NO	NO
Midlands Regional Association			YES	YES	NO	NO
Noordelike Voorstede Besprekingsgroep			YES	YES	YES	
Port Elizabeth Regional Association			YES	YES	YES	
Western Cape Regional Association			YES	YES	NO	NO
Wes-Transvaalse Streeksvereniging		YES		YES	NO	NO

5.3.2 FIRMS OF CHARTERED ACCOUNTANTS

The responses of firms of Chartered Accountants to Discussion Paper 5 are contained in Table 5.2 below. Of the firms that responded to Discussion Paper 5, only three firms were of the opinion that both methods of providing for deferred taxation should be permitted, while the remaining firms considered that the liability method to be the correct method. Nine firms believed that partial allocation basis should be introduced, while three firms opposed this basis of providing for deferred taxation. One respondent, Meyernel, Altman & Brugman did not respond to this question.

It must be noted that absolute consensus was not always forthcoming from the partners in firms of Chartered Accountants who responded to Discussion Paper 5. Table 5.2 reflects the majority views expressed.

Table 5.2: Responses of Firms of Chartered Accountants to Discussion Paper 5

	Permit deferral method only	Permit liability method only	Permit both methods	If both methods permitted, should choice be limited at some future date?	Should partial application of deferred tax be permitted now?	Should partial application of deferred tax be permitted at some future date?
Alex. Aiken & Carter, Johannesburg		YES			YES	
Arthur Young & Company, Cape Town			YES	YES	NO	NO
Deloitte Haskins + Sells, Executive Office			YES	YES	YES	
Fisher Hoffman Stride, Johannesburg			YES	YES	YES	
Hudson, Langham, Morrison & Co		YES			YES	
Ian V. Fletcher		YES			YES	
Meyernel, Altmann & Brugman		YES				
Peat Marwick, Johannesburg		YES			YES	
Pim Goldby		YES			YES	
Price Waterhouse, Durban		YES			NO	NO
Price Waterhouse, Johannesburg		YES			YES	
Spencer Steward & Co		YES			NO	NO
Theron van der Poel, Johannesburg		YES			YES	YES

5.3.3 MAJOR COMPANIES

The responses from companies to Discussion Paper 5 must, in the light of subsequent responses to Exposure Drafts 61 and 72, be considered to be disappointing as in total only six companies responded to this discussion paper. One possible reason is that Discussion Paper 5 merely sought to ascertain whether changes to AC 102 (1975) were warranted and no need was perceived by companies to lobby for changes to the existing accounting statement on deferred taxation.

As can be seen from Table 5.3 below, the responses of companies to Discussion Paper 5 did not provide any clear guidance to the Accounting Practices Committee (APC) as to whether any changes in AC 102 (1975) were warranted.

Anglo-Alpha Limited, in a written response (1984, letter), felt that it was preferable for only one method of providing for deferred taxation to be permitted, that being the liability method. The concept of distinguishing between short term and long term timing differences was supported by Anglo-Alpha Limited.

Barclays National Bank Limited, in their written response (1984, letter) supported the change to the partial application method as "...it would assist the Bank in its capital reserves and also this is the method adopted for UK reporting purposes".

5.3.4 UNIVERSITIES

As can be seen from Table 5.3 below, the APC did not obtain clear guidance from responding universities as to whether changes in AC 102 '*Taxation in the Financial Statements of Companies*' were warranted.

5.3.5 MEMBERS OF THE ACCOUNTING PRACTICES BOARD

In addition to the sole response from a member of the Accounting Practices Board detailed in Table 5.3 below, the Chamber of Mines of South Africa in their written response (1984, letter), did not support any attempt to prescribe either the deferral or liability method of accounting for deferred taxation. In not discounting the partial allocation approach to deferred taxation, the Chamber of Mines of South Africa supported a period of experimentation during which time "...the long and short-term nature of could be researched...".

Table 5.3: Responses of Universities, Major Companies and Member of Accounting Practices Board to Discussion Paper 5

	Permit deferral method only	Permit liability method only	Permit both methods	If both methods permitted, should choice be limited at some future date?	Should partial application of deferred tax be permitted now?	Should partial application of deferred tax be permitted at some future date?
MAJOR COMPANIES						
Barlow Rand Limited		YES			NO	NO
Blochfin (Pty) Ltd			YES	NO	YES	
Boart International		YES			NO	NO
Moore Paragon SA (Pty) Ltd			YES	YES		YES
UNIVERSITIES						
Rhodes University, Grahamstown			YES	NO	NO	NO
University of Cape Town		YES			YES	
University of Natal, Durban			YES	NO	YES	
University of Witwatersrand			YES	NO	NO	NO
MEMBER OF ACCOUNTING PRACTICES BOARD						
The Southern African Institute of Chartered Secretaries and Administrators		YES			NO	NO

5.3.6 INDIVIDUALS

As with the universities and companies that responded to Discussion Paper 5, the Accounting Practices Committee (APC) did not obtain any clear guidance as to whether individuals believed changes to AC 102 '*Taxation in the Financial Statements of Companies*' was warranted.

The responses of individuals are detailed in Table 5.4 below. Twelve of the respondents were of the opinion that the partial allocation approach to deferred taxation should not be permitted at the current time, while eight individuals supported the partial allocation approach either at the present time, or at some time in the future.

From the responses provided to Discussion Paper 5, no clear evidence was discerned of any interested parties attempting to influence the accounting standard setting process. As stated in 5.3.3 above, a possible reason for the lack of response from major companies to Discussion Paper 5 was that the stated objective of the discussion paper was "...to ascertain whether changes are required to statement of Generally Accepted Accounting Practice AC 102 based on experience gained in South Africa since its introduction in 1975...". Furthermore, no lobbying on behalf of major companies was required as the alternative deferred taxation practices presented in Discussion Paper 5 would not have adversely impacted either accounting or contracting costs.

Table 5.4: Responses of Individuals to Discussion Paper 5

	Permit deferral method only	Permit liability method only	Permit both methods	If both methods permitted, should choice be limited at some future date?	Should partial application of deferred tax be permitted now?	Should partial application of deferred tax be permitted at some future date?
Bauer BG		YES			NO	NO
Beauclerk PW			YES	YES	NO	
Clee JJ		YES			NO	NO
Edrich JTW		YES			NO	YES
Jankelowitz EM			YES	YES	NO	NO
Knight M		YES			NO	
Lumb RL			YES	NO	YES	
Pavitt B		YES			NO	NO
Slack PK			YES	YES	NO	YES
Smith WRM		YES			YES	
Taylor RM		YES			YES	
Tonelli F	YES				NO	NO
van Wyk MF		YES			NO	NO
Visser GJ		YES			NO	NO
Westcott DJ			YES	NO	YES	
Whittaker RA		YES			YES	
Wixley TA			YES	NO	NO	NO
Wood RJ		YES			YES	

In a letter forwarded to recipients of the unpublished memorandum, the then Director of Accounting of the South African Institute of Chartered Accountants, Ms Una Curtis (1984, letter) stated that the responses to Discussion Paper 5 resulted in a lack of clear guidance from 'members' as "...of the 52 (sic) respondents, 26 advocated the partial allocation approach and 26 the comprehensive allocation approach".

Caution must however be exercised to Ms Curtis's statement as equal weighting was given to both individual as well as combined responses from regional society discussion groups or firms of Chartered Accountants with a number of partners.

5.4 ANALYSIS OF RESPONSES TO UNPUBLISHED MEMORANDUM

As the responses to Discussion Paper 5 were, in the opinion of the APC diverse, with no clear direction being apparent, the APC found it necessary to obtain additional comments on certain specific aspects of deferred taxation. To assist in achieving this goal, a memorandum on deferred taxation was issued to commentators "... and other persons whom it is expected will be significantly affected by deferred taxation, should be approached again on this matter" (Curtis, 1984, letter).

As discussed in Chapter 3, the memorandum included a discussion of the various aspects of deferred taxation considered by the APC as being pertinent to the respondents deliberations. Respondents were required to consider the arguments, outlined in Chapter 3, to the alternative treatments of deferred taxation identified by the APC, namely:

- *to ignore deferred tax entirely and have no interperiod tax allocation (flow through approach)*
- *to provide for deferred tax on some but not all timing differences (partial allocation approach)*
- *to provide deferred tax on substantially all timing differences (comprehensive allocation approach) (SAICA, 1984, para 2).*

The alternatives favoured by each of the respondents to the memorandum are detailed in Table 5.5 on the next page. Additional comments from the respondents will be analysed under the alternatives identified above.

Table 5.5: Responses to Unpublished Memorandum

	FLOW THROUGH BASIS	PARTIAL ALLOCATION BASIS	NATURE OF TIMING DIFFERENCE	COMPREHENSIVE ANALYSIS OF DEFERRED TAX BALANCE	ANALYSIS LONG/SHORT TERMS	AC 102 (1975)	OTHER RESPONSES
MAJOR COMPANIES							
Abercom Group Limited						YES	
Anglo-Alpha Limited				YES			
Barlow Rand Limited				YES			
Blue Circle Limited				YES			
Consol Limited				YES			
Dorbyl Limited		YES					
Federale Volksbeleggings Beperk & Sentrachem Limited							DISCUSSED IN TEXT
Hunt Leuchars & Hepburn Limited		YES		YES			
The Imperial Cold Storage and Supply Company, Limited				YES			
I D C				YES			
OK Bazaars (1929) Limited							COMPREHENSIVE - NO PREFERENCE SPECIFIED
Plascon Evans Paints Limited						YES	
Rembrandt Group Limited		YES					
South African Marine Corporation Limited						YES	
FIRMS OF CHARTERED ACCOUNTANTS							
Alex. Aiken & Carter				YES			
Arthur Andersen & Co				YES			
Arthur Young & Company				YES			
Deloitte Haskins + Sells							DISCUSSED IN TEXT
Ernst & Whinney				YES			
Fisher Hoffman Stride		YES					
Peat Marwick, Johannesburg		YES					
Price Waterhouse, Durban						YES	
Price Waterhouse, Johannesburg		YES					
Theron van der Poel				YES			
UNIVERSITIES							
University of Natal, Durban	YES						
University of South Africa			YES				
OTHERS							
Alridge SJ				YES			
Davis ML		YES					
Durban Chamber of Commerce						YES	
Qually CR		YES					
Riche FG							NO PREFERENCE EXPRESSED
Smith WRM						YES	
Wixley T			YES				
MEMBERS OF ACCOUNTING PRACTICES BOARD							
Chamber of Mines of South Africa				YES			
South African Federated Chamber of Industries (Mobil Oil)						YES	
The Johannesburg Stock Exchange			YES				
The Southern African Institute of Chartered Secretaries and Administrators				YES			
REGIONAL ASSOCIATIONS							
Cape Town Discussion Group (Brown)		YES					
Cape Town Disc. Group (van Maaren)							COMPREHENSIVE - NO PREFERENCE SPECIFIED
Cape Society Disc. Group (Cotten)				YES			
Cape Regional Association (Rechtman)						YES	
David Strachan & Tayler Study Group		YES				YES	
Durban Regional Association Study		YES					
Noordelike Voorstede Besprekingsgroep				YES			
Port Elizabeth Regional Association				YES			
Wes-Transvaalse Streeksvereniging						YES	

5.4.1 FLOW THROUGH APPROACH

This approach found favour only with members of the University of Natal, Durban (UND) discussion group. In a comprehensive submission on the discussion memorandum, the members of the UND discussion group not only accepted the arguments contained in the memorandum to be convincing, but provided the following additional arguments in support of the flow through approach, with full financial statement disclosure.

Firstly, UND considered that one of the fundamental objectives of financial statements is "...to provide investors, creditors and other interested parties with information about the amount and timing of cash flows to and from the entity to enable them to assess the amount, timing and uncertainty of future cash flows to and from the entity and to themselves..." (1985, letter). Secondly, accounting on the accrual basis, together with the separate disclosure of extraordinary and other items, determines the profit before taxation figure which represents income from ongoing operations. It is this figure that assists the user of financial statements to predict future profits and cash flows from operations. Thirdly, the provision of deferred taxation in financial statements hampers users in that they are unable to readily establish the tax levied for the years reported on, or predict future taxation charges. The user "...must attempt to reverse the deferrals in order to establish the past, and to analyse the deferrals to predict the future..." (ibid).

The UND discussion group concluded that the flow-through approach,

> *"...by recognising the tax charge for the year in the income statement, and by disclosing fully the effects of timing differences that do and those that do not give rise to any future tax liability or asset, satisfies the users' need for information to enable him to assess the amount and timing of cash flows" (ibid).*

The approach followed by UND places the emphasis on users of financial statements and the necessity that users should be able to predict the nature and timing of cash flows to and from the enterprise. This approach also found sympathy with certain members of the University of South Africa (UNISA) discussion group as well as a member of a Cape Regional Association discussion group member.

In rejecting the flow through basis of accounting for deferred taxation, Hunt Leuchars & Hepburn Limited (1985, letter) argued that: Firstly, there was no sympathy or belief in the opinion that taxes are not an expense and represent merely a distribution of profits. Secondly, the cash tax position can be identified by referring to the note on taxation in the financial statements of companies, and finally, taxation, like income and expense items, should be accounted for on the accrual basis.

5.4.2 PARTIAL ALLOCATION APPROACH

Supporters of the partial allocation approach can be identified in Table 5.5. Specific comments by these respondents are considered below.

Dorbyl Limited's (1985, letter) response to the discussion memorandum argued that recognition should be given to the fact that there is a deferred tax liability made up of both short and long term portions. Timing differences that arise from fixed assets would be considered long term, while those arising from current assets should be considered short term. Deferred taxation arising from short term timing differences would be accounted for in the income statement with the credit being made against a 'Deferred Tax Lability' account which would be disclosed in the balance sheet "...together with outside shareholders interest etc..." (Dorbyl Limited, 1985, letter). Any long term liabilities should be shown by way of a note to the financial statements. Changes in the tax rate would require adjustment to be made to both the long term and short term liabilities.

The Rembrandt Group Limited (1985, letter), in supporting the partial allocation, approach stated that this approach recognises differing circumstances:

> *It would allow an enterprise that does not regularly replace capital assets to provide fully for future- payable deferred tax which would otherwise have a material affect* (sic) *on reported earnings while in cases where replacement is an integral part of business existence it does not demand provision of a non-payable liability.*

In accepting the partial allocation basis as being appropriate to the plantation sector of the group, Hunt Leuchars & Hepburn Limited (1985, letter) stated that

> *"[T]he regenerative nature of the business necessitates ongoing capital expenditure, which subject to changes in tax legislation, will guarantee new originating timing differences. These originating timing differences therefore give rise to a permanent core of timing differences".*

Additional support for Hunt Leuchars & Hepburn Limited's position (ibid) was that while there was no intention of disposing of the plantation other than by the sale of shares in the plantation owning company, deferred taxation should not be provided for. In addition, no deferred taxation would be provided on that plant and equipment which forms an integral part of the plantation business. However, the tax effect of timing differences not accounted for would be disclosed as a note to the financial statements.

Fisher Hoffman Stride (1985, letter) considered the comprehensive allocation approach to be in need of revision as it contained significant deficiencies, the major one being the build up of large deferred taxation balances which on a going concern basis may never reverse, a view supported by CR Qually (1985, letter). Confusion arises as to whether these deferred taxation balances represent 'true' liabilities. Fisher Hoffman Stride (1985, letter) were of the opinion that "...the partial approach results in the financial statements giving a fairer presentation of the substance and financial reality of the operations".

RA Whittaker, replying on behalf of Price Waterhouse, Johannesburg (1985 letter) was of the opinion that 'Generally Accepted Accounting Practice' must by its nature be generally accepted in both the South African commercial and industrial world. Whittaker submitted that the South African Institute of Chartered Accountants cannot make generally accepted accounting practice but merely formalise it. In supporting this statement, Whittaker (ibid) argues that, as a number of public and other companies have tended to follow the United Kingdom approach "[I] therefore believe we should follow practice, and amend our GAAP to cover this so that it could be dealt with in an orderly rather than an ad hoc manner".

In his support of the partial allocation basis, ML Davis (1985, letter) submitted that financial statements represent economic truths, and that the partial allocation basis represents the "...economic realities relating to the entity's real and payable obligations". Davis concluded that firstly, liabilities for taxation should only be raised if they in fact will become payable. Secondly, to satisfy the prudence concept, existing balances on deferred taxation should be transferred to a non distributable reserve or maintained as deferred taxation, and finally, future adjustments to estimates should not be treated as extraordinary items.

The Durban Regional Association Study Group (1985, letter), viewed the partial allocation basis of providing for deferred taxation as being appropriate only when sophisticated management systems and regularly reviewed budgets are maintained, and the business operates in a "...reasonable stable environment where the business is not subject to violent fluctuations which makes the forecasting of future events impossible".

5.4.3 COMPREHENSIVE ALLOCATION APPROACH

As discussed in Chapter 3 above, four alternative deferred taxation practices were presented. The responses provided by respondents are discussed below.

5.4.3.1 Nature of Timing Difference

This alternative found support from the members of the discussion group of the University of South Africa (1985, letter) as well as qualified support from CR Qually (1985, letter). Further support for this alternative came from the Johannesburg Stock Exchange (JSE) (1985, letter) and T Wixley of Arthur Young (1985, letter), who stated "[I] believe that this fits the accounting model and our existing set of accounting rules better than any of the other alternatives".

5.4.3.2 Analysis of Deferred Taxation Balance

Anglo-Alpha Limited (1985, letter) in their response to the memorandum considered that as all the alternative applications of deferred taxation provided in the memoranda had their merits, "...it may not be possible to select one particular method to the exclusion of the others, as it is necessary to examine which method is most appropriate to the circumstances of a particular company or industry". Due to the capital intensive nature of their business and the necessity of substantial investment in fixed assets, Anglo-Alpha Limited were of the unanimous opinion that this approach is the most appropriate method for their capital intensive group.

Barlow Rand Limited, in their submission (1985, letter), agreed to the views expressed in the memoranda that the partial approach

- *Was born out of expediency rather than sound logical concepts;*
- *Is very subjective, and would lead to manipulation;*
- *Ignores the fact that each recorded transaction has a direct tax consequence;*
- *Is based on a presumption that timing differences recur.*

Barlow Rand Limited (ibid) stated that the group was in favour of the comprehensive allocation approach and intended retaining it as group policy as this approach appeared to add to the quality of financial statements.

Blue Circle Limited (1985, letter) in supporting the analysis of the deferred taxation balance option, were of the opinion that this approach satisfied the matching concept, which they believed to be important. In addition, Blue Circle Limited (ibid) argued that under this option, capital would remain intact, and that dividends would not be paid out of funds which "...could sooner or later be required by the Revenue Authorities".

The Chamber of Mines of South Africa (1985, letter) believed that the split between 'deferred tax benefits' (part of shareholders' funds) and deferred taxation (a liability) would improve the company's debt to equity ratio. In addition, the analysis of deferred taxation balance would likely reduce the scale of the problem related to the tax rate changes. The Chamber of Mines was of the opinion however, that the AC 102 (1975) approach to be the most reasonable and practical.

The Noordelike Voorstede Besprekingsgroep (1985, letter), in supporting this deferred taxation alternative, considered this alternative to

> *"... tref 'n logiese onderskeid tussen uitgestelde voordele en toekomstige verpligtinge gegrond op transaksies wat in 'n spesifieke finansiële jaar plaasgevind het. Die toevallingsgrondslag en die paringsbegrip word gehandhaaf en die wese van die uitgestelde voordeel word korrek in die balansstaat as 'n nie-verdeelbare reserwe weergegee. Die probleem van 'n heffing 'bo die lyn' in die inkomstestaat wat direk na 'n reserwe in aandeelhouersbelang, wat nie onaangewende inkomste is nie, geneem word, kan by wyse van 'n aantekening oorkom word.*

In examining the comprehensive allocation basis of accounting for deferred taxation, Hunt Leuchars & Hepburn Limited (1985, letter) considered that "[T]here are no concepts or aspects about this method to which we take exception and endorse this method fully". As far as which comprehensive allocation method is most applicable, Hunt Leuchars & Hepburn Limited considered that the "...technique of analysing timing differences in relation to the timing of income and expense from a taxable income or reported income point of view is considered to be a fundamental criteria in the treatment of deferred taxation". This disclosure was considered by Hunt Leuchars & Hepburn Limited to be the most meaningful, and could not be subject to attack from a subjectivity point of view.

Alex. Aiken & Carter (1985, letter) believed that this alternative achieves fair presentation in both the income statement and the balance sheet. To support their submission, Alex. Aiken & Carter included a copy of the 1984 financial statements of their client Anglo-Alpha Limited who had adopted this alternative in accounting for deferred taxation.

Ernst & Whinney (1985, letter) in supporting the analysis of deferred taxation balances alternative, advanced in their submission that

> *"[W]e therefore believe that the comprehensive allocation approach is correct and that in determining the quantum of the amounts to be recognised in the balance sheet of the reporting entity, that the nature of the deferred tax timing differences should be established and separately addressed".*

5.4.3.3 Analysis into Long and Short Term Portions

This alternative found favour with Arthur Young & Company. In their response, Arthur Young & Company (1985, letter) stated that [this approach]

> *"...was favoured as the most acceptable method of applying the comprehensive Allocation Approach. It was suggested however that earnings per share should be calculated after the tax equalisation charge had been adjusted even though this would lead, in effect to non articulation of income statement and balance sheet".*

5.4.3.4 AC 102 (1975)

Support for the alternative of providing for deferred taxation on the comprehensive basis was given by Abercom Group Limited (1985, letter) who were of the opinion that the calculation and presentation of deferred taxation should be kept as simple as possible. For this reason, deferred taxation should be calculated using the liability method on the comprehensive allocation basis.

The Durban Chamber of Commerce (1985, letter) in recommending that the comprehensive allocation approach to deferred taxation be retained, was of the opinion that the approach adopted to deferred taxation "...should be internationally acceptable and conform with approaches adopted elsewhere".

Mobil Oil, in a telex to the South African Federated Chamber of Industries, suggested that the then existing statement AC 102 continue to be used, arguing

> *"...if taxation is considered to be an expense and the concepts of allocation and matching are accepted, than it becomes necessary to match the tax charge against the profit to which it relates by providing deferred taxation on substantially all timing differences" (1985, telex).*

The South African Marine Corporation Limited, in their submission and recommendation that AC 102 in its then present form be retained, considered deferred taxation to be a liability which is "...almost certain to crystallise in the future" (1985, letter).

Price Waterhouse Durban (1985, letter), in favouring the comprehensive approach to deferred taxation as contained in AC 102 argued that...

- *taxation is a normal business expense and should be provided for in the normal way*
- *matching, prudence and accrual concepts of accounting are maintained*
- *it is not subjective and therefore not open to management manipulation*
- *results in greater comparability of financial statements*
- *approach is applied consistently in expansionary and recessionary times*
- *present results are not affected by future expectations.*

In supporting the retention of AC 102 (1975), Theron van der Poel (1985, letter) stated that they felt that:

(a) *die omvattende toewysingsbenadering gevolg moet word;*

(b) *en wel volgens die metode soos huidiglik voorgestel in RE 102;*

(c) *met moontlike onderskeid tussen items wat aanspreeklikhede verteenwoordig en uitgestelde voordele, beide op die inkomstestaat en die balansstaat.*

Deloitte Haskins + Sells, Executive Office (1985, letter), although acknowledging the comprehensive approach to be sound, considered there to be resistance to providing for deferred taxation on this basis. In order to overcome this problem, Deloitte Haskins + Sells (ibid) provided the following approach: Timing differences that will result in an actual liability should be provided for on the liability method by adjusting the taxation charge in the income statement. The remaining timing differences "...which will not result in an actual taxation liability, should be appropriated to reserves 'below the line' ". The taxation charge in the income statement would not require an adjustment.

Sentrachem Limited and Federale Volksbeleggings Beperk, in a joint response (1985, letter) believed that

> *"Daar is ooreengekom veral na aanleiding van die interpretasie deur finansiële instellings, dat uitgestelde belasting nog 'n reserwe, nog 'n verpligting is maar dat dit beskou moet word as 'n gedeelte van die vaste kapitaal van 'n onderneming".*

However, Sentrachem Limited and Federale Volksbeleggings Beperk (ibid) felt that "...uitgestelde belasting voorsein behoort te word op die omvattende toewysingsbenadering".

Although the unpublished memorandum merely sought the views of interested parties on alternative deferred taxation practices, the evidence presented in Table 5.5 together with the responses discussed above would suggest that the preferred method of accounting for deferred taxation was the comprehensive basis, with the deferred taxation balances being analysed into its short and long term components.

As was the case with Discussion Paper 5, it does not appear that any significant lobbying of the standard setting process occurred as the unpublished memorandum did not have the status of a statement of generally accepted accounting practice.

5.5 ANALYSIS OF RESPONSES TO EXPOSURE DRAFT 61

Exposure Draft 61, *Taxation in Financial Statements*, required respondents to state whether or not they agreed with the Exposure Draft, and to comment specifically "...on the points raised in the technical commentary and advance sound arguments in support of their preference". These were whether the Deferred Tax Benefit should be included in owner's equity, and whether tax losses carried forward to future periods may be offset against Deferred Tax Liabilities and not against existing Deferred Tax Benefits.

Responses to Exposure Draft 61 will be examined again under the already used sub-headings: Regional Associations, Firms of Chartered Accountants, Major Companies, Universities, Members of the Accounting Practices Board and Individuals. No cognisance will be taken of the arguments (if any) in support of the inclusion or exclusion of deferred tax benefits from owner's equity, contained in the technical commentary.

From the Exposure Draft 61 case study, conclusive evidence of the lobbying of the accounting standard setting process will be highlighted.

5.5.1 REGIONAL ASSOCIATIONS

The responses from the individual regional associations that responded to Exposure Draft 61 are detailed in Table 5.6 below.

As the comments from the Cape Town Discussion Group (van Maaren) (1986, letter), Die Noordelike Voorstede Besprekingsgroep (1986, letter) and the Port Elizabeth Regional Association Study Group (1986, letter) were concerned mainly with aspects of an editorial nature, it was not possible to establish whether these study groups supported the issue of

Exposure Draft 61. In addition, the Noordelike Voorstede Besprekingsgroep (1986, letter) were unable to decide whether deferred taxation should be included or excluded from owner's equity:

> *Die groep kon nie konsensus bereik of die uitgestelde belastingvoordele by eienaarsbeland ingesluit moet word of nie en beveel aan dat die Rekeningkundige Praktykekomitee weer baie deeglik oor hierdie aspek moet besin.*

The David Strachan & Tayler Study Group (1986, letter), a Cape Society Discussion Group (Cotten) (1986, letter) and the Midlands Regional Association (1986, letter) and the Cape Regional Association (Rechtman, 1986, letter) all supported the exclusion of deferred taxation from owner's equity. The Midlands Regional Association was of the view that the exposure draft was more relevant to large enterprises rather than small closely owned enterprises.

Exposure Draft 61 was opposed by the Durban Regional Association Study Group. In its response to the exposure draft, the association stated (1986, minutes) that the

> *"...majority of the group tended to favour the UK approach of permitting partial provision for deferred tax but with full disclosure in the notes to the financial statements of the effect if full deferred tax was provided. There was a minority view, however, in favour of the exposure draft".*

Table 5.6: Responses of Regional Associations of Chartered Accountants to Exposure Draft 61

	Support reissue of AC 102	Support principles outlined in ED 61	Qualified support for principles outlined in ED 61	Oppose principles outlined in ED 61	Unable to establish support from response	Status-quo to remain
Cape Regional Association (Rechtman)			YES			
Cape Town Disc. Group (van Maaren)					YES	
Cape Society Discussion Group (Cotten)					YES	
David Strachan & Tayler Study Group		YES				
Durban Regional Association Study Group				YES		
Midlands Regional Association					YES	
Noordelike Voorstede Besprekingsgroep					YES	
Port Elizabeth Regional Association			YES			
Pretoria Regional Society				YES		

5.5.2 FIRMS OF CHARTERED ACCOUNTANTS

The comments of firms of Chartered Accountants that responded to Exposure Draft 61 are detailed in Table 5.7 below.

Fisher Hoffman Stride, in two letters opposing Exposure Draft 61 (1986, letters), appeared to be motivated by an influential client, Kirsh Trading Limited. In supporting the partial approach to deferred taxation as the only practical means of dealing with increasing deferred tax balances, Fisher Hoffman Stride (1986, letter) described the proposals outlined in Exposure Draft 61 as conceptually unsound and if applied "...will in many cases conflict with the substance of business reality".

Kessel Feinstein (1986, letter), while supporting the reissue of a statement of generally accepted accounting practice for taxation in financial statements, did not accept that accounting practice should be based on the two categories of timing differences outlined in Exposure Draft 61. Kessel Feinstein, in an opinion supported by Levisohn Laser (1986, letter), were of the view that those timing differences that are expected to result in an actual liability in the foreseeable future should be provided for on the liability method by adjusting the taxation charge in the income statement. Those timing differences that are not expected to result in a liability in the foreseeable future should not impact earnings per share. The deferred taxation charge should, according to Kessel Feinstein (1986, letter) be "...computed on the liability method and apprporiated below the line".

Aiken & Carter, Johannesburg (1986, letter) agreed with the classification of timing differences into two categories. In support of their response they (ibid) stated that

> *"[W]e believe that this treatment overcomes a major difficulty with the previous approach: having to choose either the deferral or the liability method for all timing differences..."*

Deloitte Haskins + Sells, Executive Office (1986, letter) in responding to ED 61 considered that "...the Institute has produced an exposure draft which is conceptually sound and contains a number of suggested improvements to the requirements of AC 102". However, although Deloitte Haskins + Sells supported the conceptual reasons underlying the classification of timing differences, they considered that this classification would present practical difficulties on implementation, a view expressed by a number of their clients.

Arthur Young, Johannesburg (1986, letter) in welcoming the principle of comprehensive allocation in accounting for the deferred taxation effects of timing differences, anticipated that the proposed statement would introduce further complexities in an area that already causes some difficulties for preparers which may "...cause barriers to implementation when considered against the possibility of enhanced information to users of financial statements".

Deloitte Haskins + Sells appear to be expressing concern over what Watts and Zimmerman (1978, 116) and Henderson and Peirson (1983, 226) termed bookkeeping costs. The opposition expressed by their clients to Exposure Draft 61 may be due to the additional bookkeeping costs incurred should Exposure Draft 61 become a statement of generally accepted accounting practice. Support for this view is provided by Watts and Zimmerman (1978, 116) where they state

> *"[C]hanges in accounting procedures are not costless to firms. Accounting standard changes which either increase disclosure or require corporations to change accounting methods increase a firms' bookkeeping costs (including any necessary increases in accountants' salaries to compensate for additional training)".*

Table 5.7: Responses of Firms of Chartered Accountants to Exposure Draft 61

	Support reissue of AC 102	Support principles outlined in ED 61	Qualified support for principles outlined in ED 61	Oppose principles outlined in ED 61	Unable to establish support from response	Status-quo to remain
Aiken & Carter		YES				
Arthur Andersen & Company		YES				
Arthur Young & Company		YES				
Bruwer PC & Partners					YES	
Coopers & Lybrand		YES				
Deloitte Haskins + Sells		YES				
Ernst & Whinney		YES				
Fisher Hoffman Stride (x2)				YES		
Kessel Feinstein	YES			YES		
Levisohn Laser				YES		
Pim Goldby		YES				

5.5.3 MAJOR COMPANIES

The comments from the major companies that responded to Exposure Draft 61 are detailed in Table 5.8 below.

Opponents of Exposure Draft 61 can be categorised into two divisions: those who objected to the exposure draft on the grounds of complexity, and those companies, predominately in the furniture industry, who believed that they would be predjuced by the exposure draft.

Ellerine Holdings Limited (1986, letter) in their submission were of the opinion that financial statements should be prepared on a going concern basis and on the basis of 'substance over form'. The company was of the opinion that

> *"[T]he substance of business reality is that tax deferred by the debtors* (sic) *allowance is unlikely to be paid unless there is a severe downturn in business or the allowance is withdrawn by legislation".*

Ellerine Holdings Limited (1986, letter) considered that business reality would best be presented by adopting the 'partial approach' as applied in the UK or the 'hard core approach' "...whereby full provision is made for deferred tax but on the balance sheet the provision is split into that portion likely to reverse (shown as a liability) and that portion which is likely to continue (shown as part of owners equity (sic))".

Abercom Group Limited (1986, letter) opposed Exposure Draft 61 on the grounds of complexity. In their submission, the company queried why the accounting profession cannot

> *"...come out with a statement of requirements based on simplicity, ease of understanding and a method that is simple to control from an administrative point of view".*

Blue Circle Limited (1986, letter) in raising the question why the existing status-quo should not remain, agreed that the concept of splitting the deferred taxation balance into its 'liability' and 'benefits' components was generally sound. However, Blue Circle Limited (ibid) believed that "...the application thereof creates other problems which seem to outweigh the potential advantages".

General Mining Union Corporation Limited (Gencor) (1986, letter), in a comprehensive submission supporting Exposure Draft 61, states:

> *Perhaps the most positive aspect of the exposure draft is that it advocates, in effect, that the particular method that ought to be adopted in accounting for so called deferred taxation is dictated by the classification of underlying timing differences according to the effects thereof on taxation actually payable.*

Amalgamated Retail Limited (Amrel) (1986, letter) believed that the concepts proposed in the Exposure Draft to be highly theoretical and unnecessarily complex. In comments specific to the furniture industry, Amrel was of the opinion that

> *"[T]he accounting treatment proposed in Exposure Draft 61 are clearly detrimental to companies with large hire purchase (section 24 allowances). In times of rapidly rising prices, furniture companies' investments in debtors grow significantly annually, thus resulting in a continued increase in the deferred tax liability in the balance sheet".*

Amrel (ibid) stated that past experience has shown that this deferred tax account would never be paid as long as the section 24 allowance continued to be granted as new timing differences are always greater than the timing differences on old debts that are reversing.

Adcock-Ingram Limited (1986, letter) was of the opinion that Exposure Draft 61 was a conceptually sound basis for providing for deferred taxation.

> *"The accountants of the world are confused as to what method to use, while the South Africans have taken the initiative and come up with an innovative method in providing for deferred tax".*

Kirsh Trading Limited (1986, letter) concurred with the view of their auditors, Fisher Hoffman Stride on Exposure Draft 61. In their submission, Kirsh Trading Limited stated that in addition to the views expressed by their auditors (referred to in 5.5.2 above), "[O]ur bankers, financial analysts and other parties, neither regard deferred tax as equity or a liability and the treatment of deferred tax is confusing" (ibid). Furthermore, the company believed that on a going concern basis, deferred tax will not become payable unless the debtors' book reduces which in their opinion was unlikely. Finally, earnings per share will be detrimentally affected in the furniture industry as compared to a capital intensive industry.

Anglo-Alpha Limited (1986, letter) submitted that Exposure Draft 61 was "...incomplete/inclusive - and therefore unacceptable - as it fails to deal with the major practical problem of ever increasing deferred balances which are unlikely to be utilized".

AW Alison, responding on behalf of the McCarthy Group Limited (1986, letter), stated that the the view expressed in the letter represents both the view of the McCarthy Group and a study group of the Durban Regional Association of Accountants and Auditors, of which he is chairman. In the response, the McCarthy Group (ibid) were of the opinion that "...the partial approach to deferred taxation still provides the best means of achieving the stated objectives of deferred taxation".

RS Schur in providing identical responses for both World Furnishers Administration (Pty) Ltd (1986, letter) and Bradlow's Stores Limited (1986, letter) believed that

> *"...taxation which is deferred in terms of the HP debtors* (sic) *allowance is unlikely to be paid, and would only become payable if there was an extremely severe downturn in business conditions, or unless the allowance in terms of Section 24 was withdrawn".*

A more beneficial approach considered by Bradlow's Stores Limited (1986, letter) and World Furnishers Administration (Pty) Ltd (1986, letter) would be either the partial approach or the hard core approach.

Barlow Rand Limited (1986, letter) responded by stating that the method of calculating and disclosing deferred taxation proposed in Exposure Draft 61 to be neither conservative nor desirable. Furthermore, Barlow Rand Limited provided an indication that they would not comply with a statement of generally accepted accounting practice that arose from Exposure Draft 61 stating that "...in the event that the exposure draft attracts substantial support, we respectfully request the opportunity to discuss this further with yourselves".

The evidence of lobbying against this exposure draft and in favour of the partial allocation approach is apparent from the submission of companies, particularly those with significant Sec 24 allowances.

Table 5.8: Responses of Major Companies to Exposure Draft 61

	Support reissue of AC 102	Support principles outlined in ED 61	Qualified support for principles outlined in ED 61	Oppose principles outlined in ED 61	Unable to establish support from response	Status-quo to remain
Abercom Group Limited				YES		
Adcock-Ingram Limited		YES				
Amalgamated Retail Limited				YES		
Anglo-Alpha Limited				YES		
Barlow Rand Limited				YES		
Bradlow's Stores Limited				YES		
Blue Circle Limited			YES			YES
Consol Limited		YES				
Dorbyl Limited		YES				
Ellerine Holdings Limited				YES		
General Tyre & Rubber Company (SA) Limited		YES				
General Mining Union Corporation Limited		YES				
Imperial Cold Storage and Supply Company, Limited				YES		
Kirsh Trading Limited				YES		
McCarthy Group Limited				YES		
Murray & Roberts Holdings Limited				YES		
Murray & Roberts Limited				YES		
Nampak Limited					YES	
Plate Glass & Shatterprufe Industries Limited					YES	
Plascon-Evans Paint Limited						YES
Sapeko Estates (Pty) Limited		YES				
Sentrachem Limited		YES				
Standard Bank Investment Corporation Limited		YES				
World Furnishers Administration (Pty) Limited				YES		

5.5.4 UNIVERSITIES

The responses of the universities that responded to Exposure Draft 61 are detailed in Table 5.9 below.

The proposals outlined in Exposure Draft 61 was supported by the University of South Africa (UNISA). In their response, UNISA stated that the principles envisaged in the statement should create a proper and well-designed basis whereby the different tax matters can be highlighted.

The University of Natal, Durban (1986, letter) in its response believed that the flow through approach, together with full disclosure of current and cumulative deferrals in the notes to the financial statements, would represent what has actually happened more faithfully than a system of deferred tax.

The 1986 BCom (Hons) group from the University of the Witwatersrand (1986, letter) felt that in spite of the practical problems that faced Exposure Draft 61, the exposure draft "...is an important step in presenting users with useful information through the disclosure of timing differences according to their nature".

Table 5.9: Responses of Universities to Exposure Draft 61

	Support reissue of AC 102	Support principles outlined in ED 61	Qualified support for principles outlined in ED 61	Oppose principles outlined in ED 61	Unable to establish support from response	Status-quo to remain
University of Natal, Durban				YES		
University of South Africa		YES				
University of Witwatersrand		YES				

5.5.5 MEMBERS OF THE ACCOUNTING PRACTICES BOARD

The responses of members of the Accounting Practices Board to Exposure Draft 61 are detailed in Table 5.10 below. Both members of the Accounting Practices Board that responded to Exposure Draft 61 supported the exposure draft with the division of timing differences into two separate categories.

Table 5.10: Responses of Members of the Accounting Practices Board to Exposure Draft 61

	Support reissue of AC 102	Support principles outlined in ED 61	Qualified support for principles outlined in ED 61	Oppose principles outlined in ED 61	Unable to establish support from response	Status-quo to remain
Chamber of Mines of South Africa		YES				
The South African Institute of Chartered Secretaries and Administrators		YES				

5.5.6 INDIVIDUALS

The responses to Exposure Draft 61 from individuals are detailed in Table 5.11 below. As there were no comments from individuals that have not been discussed elsewhere, a detailed analysis of the comments has not been made.

Table 5.11: Responses of Individuals to Exposure Draft 61

	Support reissue of AC 102	Support principles outlined in ED 61	Qualified support for principles outlined in ED 61	Oppose principles outlined in ED 61	Unable to establish support from response	Status-quo to remain
Davis ML				YES		
Reuvers FJ		YES				
Wixley T				YES		

The evidence provided in this case study supports the view that the majority of respondents to Exposure Draft 61 supported the provision of deferred taxation on the comprehensive basis although not necessarily on the basis outlined in Exposure Draft 61. The main lobbying against the provisions outlined in Exposure Draft 61 came from those companies, particularly in the furniture industry who believed they would be prejudiced by the issue of Exposure Draft 61 as a statement of generally accepted accounting practice.

5.6 ANALYSIS OF RESPONSES TO EXPOSURE DRAFT 72

Responses to Exposure Draft 72 will also be examined under the following sub-headings: Regional Associations, Firms of Chartered Accountants, Major Companies, Universities, Members of the Accounting Practices Board and Individuals.

5.6.1 REGIONAL ASSOCIATIONS

The responses from the individual regional associations that responded to Exposure Draft 72 are detailed in Table 5.12 below. As certain of the comments made by various regional associations were of an editorial nature, it was not possible to establish whether these associations supported or opposed the issue of Exposure Draft 72.

The Port Elizabeth Regional Association in their response (1988, letter) considered that although the proposed statement could well be appropriate in other countries, it was inappropriate to introduce the statement in South Africa at this time. Arguments in support of their view included the uncertainty regarding the future of South African tax legislation, the inability of the government to lead the country through a steady economic cycle, periods of high interest rates and restrictions on cash flow following economic downturns, and political uncertainty. These factors, in the opinion of the Port Elizabeth Regional Association, mitigate against a change to partial accounting for deferred tax, although the proposals could well be supported by groups which see a change from the present system as being in their interests.

The Bloemfontein Regional Association of Chartered Accountants (1988, letter) in their submission considered that the choice between the comprehensive and partial allocation basis for providing for deferred taxation may lead to the manipulation of earnings per share figures:

> *Die algemene gevoel onder die lede was dat die keuse tussen die omvattende en gedeeltelike toewysingsgrondslae vir uitgestelde belasting die ruimte laat ontstaan vir die manipulasie van verdienste per aandeel. Die deursnee-belegger het nie altyd insae tot die detail finansiële jaarstate nie en reageer somtyds bloot op die gepubliseerde prysverdienste-verhoudings volgens Effektebeursverslae. Maatskappye kan dus hierdie verhouding na goeddunke manipuleer.*

The Cape Society Discussion Group lead by M Bourne (1988, letter) in a virtually unanimous disagreement with the partial allocation basis basis provided the following reasons in support of their postion. Firstly, the use of both the comprehensive and partial allocation basis will result in the loss of comparability between companies as income statements would reflect materially different amounts of net income in similar circumstances. Secondly, the ability of management groups in South Africa to forecast the movement of timing differences was questioned. Thirdly, this discussion group (ibid) "...seriously questioned the ability of the audit practitioner to obtain reasonable assurance about the forecasts to be made and the resulting fair presentation of deferred taxation in the income statement". Fourthly, contrary to studies that have shown the income statement to be the most important item in financial statements, the partial allocation basis places a greater emphasis on the information presented in the balance sheet. Finally, in spite of the safeguards in paragraphs 28 to 36, "...the group felt that the partial allocation basis will not result in a prudent presentation of financial information in practice" (ibid).

A second Cape Society Discussion group also lead by M Bourne (1988, letter) submitted that objective of generally accepted accounting practice in South Africa is to standardise reporting practice. The codification of a single method of accounting for deferred taxation will result in conformity of accounting practices and comparability of financial statements; however, Exposure Draft 72 would not achieve this objective as it allowed for two methods of accounting for deferred taxation.

While recognising that theoretically the partial allocation basis results in fairer presentation, a Cape Society Discussion Group (Bourne, 1988, letter) expressed concern about the practicalities of implementing this basis. In particular, the subjectivity allowed by Exposure Draft 72 in the application of the partial allocation basis will result in the principle of 'verifiability' being difficult to achieve, the reliability of three year forecasts taking the uncertain economic and political circumstances, and the term 'reasonable estimate' allows for manipulation by management of the bottom line figures.In concluding, the discussion group were of the opinion that of the two methods presented for consideration in Exposure Draft 72, the comprehensive allocation basis was the more practically acceptable (ibid).

Table 5.12: Responses of Regional Associations of Chartered Accountants to Exposure Draft 72

	Support reissue AC 102	Support comprehensive allocation	Support partial allocation	Unable to establish from response
Bloemfontein Streeksvereniging		YES		
Cape Society Discussion Group (Bourne) - No 1		YES	YES	
Cape Society Discussion Group (Cotten)				YES
Cape Society Discussion Group (Bourne) - No 2			YES	
David Strachan & Tayler Study Group			YES	
Durban Regional Association Study Group				YES
NOFS Regional Association				YES
Noordelike Voorstede Besprekingsgroep				YES
Port Elizabeth Regional Association		YES		

5.6.2 FIRMS OF CHARTERED ACCOUNTANTS

The comments of firms of Chartered Accountants that responded to ED 72 are reflected in Table 5.13 below.

Price Waterhouse (1988, letter) supported the proposed statement only in that the withdrawal of the option to use either the 'deferral' or 'liability' method brings South Africa into line with the rest of the world. Price Waterhouse (ibid) did however make the observation that "[T]he partial allocation basis (which we do not support) appears to become an entrenched concept in South Africa". A further concern was that by "...retaining the option of using either the partial or the comprehensive basis of allocation may give rise to the same problems that bedevil AC 102 which permits either of two methods to be used". In concluding, Price Waterhouse (ibid) stated that "[T]he accounting standard should be prescriptive and require the comprehensive basis of allocation in all circumstances" .

In supporting the general principle that the partial allocation basis of providing for deferred taxation be permitted in certain circumstances, Ernst & Whinney, Johannesburg (1988, letter), believed that the correct application of this basis would better reflect economic reality where growing deferred tax balances will never be 'paid' on a net basis.

WP Lubbe, responding on behalf of Meyernel, Altmann & Brugman, (1988, letter) stated that

> *"Ek stem nie daarmee saam dat die gedeeltelike toewysingsgrondslag gebruik kan word nie. Een rede daarvoor is geleë in paragraaf.51, wat onder andere meld: 'Effektiewelik ontstaan 'n voorwaardelike aanspreeklikheid ten opsigte van die onvoorsiene uitgestelde belasting wanneer die gedeeltelike toewysingsgrondslag aangewendword.' Ek stem saam dat die omvattende toewysingsgrondslag gebruik moet word, maar die toegewing dat 'n gedeeltelike toewysingsgrondslag gebruik gaan word, gaan net verwaaring skep".*

Aiken & Peat, Johannesburg (1988, letter), in a majority view of partners, believed that the proposed statement should not offer a choice of methods. "The standard setter should determine the method most appropriate in clearly defined circumstances and all financial statements should apply the same principles". In disagreeing with the conceptual soundness of the partial approach, Aiken and Peat, Johannesburg (ibid) argued that a taxation liability exists and that timing differences affect only the timing of the payment of taxation in respect of reported income that is deferred. This deferral of payment "...is usually the result of sympathetic treatment by the legislature of taxpayers who do not have the cash to pay tax in the year of accrual because the tax has not yet been received (eg debtors allowances (sic)) or as an incentive to invest in plant (accelerated wear and tear allowances)".

Furthermore, Aiken & Peat, Johannesburg (ibid), believed that the introduction of the partial allocation basis would introduce an element of subjectivity into financial reporting as (the partial allocation basis) is heavily reliant on management's opinions. This would "...lead to a further deterioration in the comparability of one enterprise with another as one would be more conservative than another in its application".

Arthur Young (1988, letter) in responding to Exposure Draft 72, considered that the partial allocation basis of deferred taxation was intended to deal with the problem that the payment of a large portion of the deferred taxation balance reflected in the balance sheet may be indefinitely deferred. Exposure Draft 72 did not, however, deal with the following problems that could arise from its application to the income statement. Firstly, the use of the partial allocation basis may result in fluctuating effective tax rates which would not be desirable.

Secondly, reported income and earnings per share figures could be significantly affected by large deferred taxation debits or credits. This means that the trends that should be an indication of trading results could be disproportionately affected by deferred taxation. Thirdly, reductions in taxation allowances may result in many companies reporting large deferred taxation charges which could affect the solvency and financial ratios of these companies.

To overcome this, Arthur Young (1988, letter), suggested that where the partial allocation basis of accounting for deferred taxation is used, the charge to the income statement be no different to the charge had the comprehensive allocation basis been used. In the balance sheet, that portion of deferred tax which is represented by hard core timing differences would be disclosed as a sub-section of retained income. Those timing differences that are likely to crystallize into an asset or liability will continue to be disclosed and dealt with in the manner outlined by the Exposure Draft 72.

Pim Goldby, Johannesburg (1988, letter) in agreeing that the partial allocation basis be allowed in determining deferred taxation, accepted that this basis may be debatable from a conceptual point of view. However, this method recognises the realities of the situation and will be of practical benefit to companies.

In a majority view of partners, Kessel Feinstein (1988, letter) supported the adoption of Exposure Draft 72. The partners agreed that the basic concepts of matching and prudence could only be met if the taxation charge for the period is matched to the accounting income as directly as possible. However, Kessel Feinstein (ibid) believed that in the interests of providing useful information to users

> *"...we consider that it is pragmatic also to consider cash flows over the foreseeable future, even if, in stressing cash outlays, this does result in a departure from the accrual basis of accounting. (There are already theoretical inconsistencies in GAAP)".*

Table 5.13: Responses of Firms of Chartered Accountants to Exposure Draft 72

	Support reissue AC 102	Support comprehensive allocation	Support partial allocation	Unable to establish from response
Aiken & Peat, Johannesburg		YES		
Arthur Young & Company		YES		
Deloitte Haskins + Sells			YES	
Ernst & Whinney			YES	
Kessel Feinstein			YES	
Meyernel, Altman & Brugman		YES		
Pim Goldby, Johannesburg			YES	
Pim Goldby, Welkom			YES	
Price Waterhouse		YES		

5.6.3 MAJOR COMPANIES

The comments from the major companies who responded to Exposure Draft 72 are detailed in Table 5.14 below.

Yskor Beperk (1988, letter) in supporting the partial allocation basis of providing for deferred taxation stated that they "...is van mening dat hierdie metode verval op kapitaal intensiewe bedrywe soos die staalbedryf toepaslik is".

ML Davis, commenting on behalf of Eskom (1988, letter) in opposing the use of the partial allocation method believed that

> *"...the viable alternatives are the comprehensive method of computation or the flow-through method. I now accept that the flow-through method would give rise to temporary potential distortions in the reporting of net income of companies and therefore the method which should be sanctioned by the future statement on Taxation in Financial Statements should be the comprehensive method; which should be computed* ***at its discounted value*** *(sic)".*

The South African Breweries Limited (1988, letter) in lobbying on Exposure Draft 72 supported the accounting treatment advocated by the exposure draft in that as it currently stood, "...AC 102 does not allow management sufficient flexibility to evaluate the tax profile of their business on an ongoing basis and to report to their stakeholders in accordance with that evaluation".

Anglo-Alpha Limited (1988, letter) in their response, accepted the partial allocation basis for providing for deferred taxation in that "...it addresses the problem of ever increasing deferred tax balances which are unlikely to be utilised". Anglo-Alpha Limited did however express the following caveat concerning the partial allocation basis of providing for deferred taxation:

> *There is potential in South Africa for material changes in tax legislation which could cause deferred tax liabilities to crystallise when they would otherwise not have done so. This is of concern because any adjustment required would have to be made through the taxation charge in the income statement. Further, the solvency of the company could be prejudiced where reported earnings have been distributed as dividends to shareholders. Adoption of this basis will put management in an unenviable position ie they are responsible to show that deferred tax is not required. This basis could be open to abuse either intentionally or unintentionally and the integrity of reported profits could thus be questioned.*

The Rusfurn Group Limited, in responding to Exposure Draft 72 (1988, letter), considers that the partial allocation basis of providing for deferred taxation "...enables companies to take advantage of their own particular tax benefits and indeed pass these benefits onto their shareholders" (ibid). In justifying the existence of the 'hard core' of allowances that never reverse The Rusfurn Group Limited stated that "...when the furniture businesses conducted by that company were acquired by Kirsh Trading Limited, the total balance on the deferred taxation account amounting to some R38 million, was reversed back to profits".

Morkels Limited, in taking a contradictory view to The Rusfurn Group Limited, argue in their submission (1988, letter) that "...certain companies in the furniture industry, with the approval of their auditors, have stated that it is reasonably certain that no 'liability' for tax will arise in the foreseeable future (for at least the next three years)". Morkels Limited consider that there can be no doubt that a liability for tax in the furniture industry does in fact exist, the only uncertainty being when payment of the tax will ultimately be made. In concluding their submission, Morkels Limited stated that "[T]here is therefore very little to support the concept of reasonable certainty in respect of instalment sale debtors..." and strongly recommended that amendments be made to Exposure Draft 72 to make it obligatory for full provision to be made for deferred taxation arising out of instalment sale debtors.

General Mining Union Corporation Limited (Gencor) (1988, letter), in a comprehensive submission, considered the exposure draft to be unacceptable in that "...it fails to recognise that timing differences, and in particular their tax effects and implications, are not uniformly similar but, in fact, fall into two main categories according to the respective natures of the timing differences concerned".

As stated in Chapter 3 (3.4.6 above), criticism was levelled at the South African Institute of Chartered Accountants (SAICA), GV Terry, the technical director of the SAICA, stated in a letter to the International Accounting Standards Committee (1987, letter) that "[C]learly it is not feasible for our standard setting body to go against world wide trends". Gencor in their submission (1988, letter) criticised this in that they considered that

> *"[W]hile it is accepted that it is desirable that accounting practice be standardised internationally it is submitted that it should not be achieved at all costs and, in particular, not at the cost of meaningful and fair presentation"* .

In a further criticism, Gencor (ibid) considers that the attempt by GV Terry to establish 'a conceptual case for partial allocation' to be unsuccessful "...and convoluted in the extreme".

Table 5.14: Responses of Major Companies to Exposure Draft 72

	Support reissue AC 102	Support comprehensive allocation	Support partial allocation	Unable to establish from response
Amalgamated Retail Limited			YES	
Anglo-Alpha Limited			YES	
Barlow Rand Limited				YES
Ellerine Holdings Limited			YES	
Eskom		YES		
General Mining Union Corporation Limited		YES		
Morkels Limited				
Murray & Roberts Holdings Limited				YES
Nampak Limited				YES
The Rusfurn Group Limited			YES	
The South African Breweries Limited			YES	
Yskor Beperk			YES	

5.6.4 MEMBERS OF THE ACCOUNTING PRACTICES BOARD

The responses from those members of the Accounting Practices Board are detailed in Table 5.15 below.

In opposing the proposed treatment for deferred taxation outlined in Exposure Draft 72, the Investment Analysts Society of Southern Africa (1988, letter) stated that, although most of their members were not concerned with the technical details of accounting, they were concerned about the principles involved in accounting. In particular, the Investment Analysts Society of Southern Africa considered that the different ways in which companies were treating deferred taxation caused significant distortions in inter company comparisons of earnings.

In believing that the more conservative comprehensive method of providing for deferred taxation to be the correct method (especially for companies providing for deferred taxation on HP sales), the Investment Analysts Society argued that although the partial method of providing for deferred tax has the effect of increasing "reported earnings" of certain companies which is an acceptable scenario in a growth environment, this basis of providing for taxation can cause substantial surprises to investors when a decline in activity occurs.

In their recommendation, the Investment Analysts Society of Southern Africa stated that a standard method of accounting for deferred taxation that provided management with minimum discretion would be the most advantageous.

The Chamber of Mines of South Africa, in their response, expressed serious reservations on what the Chamber considered to be fundamental matters of principle. In a response that appeared to favour the approach outlined in Exposure Draft 61, the Chamber considered that ED 72 failed to recognise that there are two main categories of timing differences "...each affecting taxation payable differently and consequently necessitating different accounting approaches" (1988, letter). In addition, the mandatory application of the liability method outlined in Exposure Draft 72 "...would result in benefits arising (elements of equity) being erroneously reported as 'liabilities'". Furthermore, the partial allocation approach cannot be conceptually justified in that it contradicts the basic principles of prudence, accrual and matching.

The Accepted Accounting Principles Sub-Committee of the Johannesburg Stock Exchange (1988, letter) while understanding the arguments for allowing partial deferred tax were concerned that the deferred taxation options "...are being widened insofar as the partial allocation basis is concerned and feels that this could give rise to serious problems of comparison for non-auditors and non-professional investors". To overcome this, the sub-committee believed that earnings per share should be shown in a supplementary note that would reflect the earnings per share had the comprehensive allocation basis been used.

Table 5.15: Responses of Members of the Accounting Practices Board to Exposure Draft 72

	Support reissue AC 102	Support comprehensive allocation	Support partial allocation	Unable to establish from response
Chamber of Mines of South Africa		YES		
Investment Analysts Society of Southern Africa	YES			
Johannesburg Stock Exchange				YES

5.6.5 UNIVERSITIES

The responses from the universities that commented on Exposure Draft 72 are detailed in Table 5.16 below.

Everingham, in a comprehensive response from the University of Cape Town (1988, letter), suggested that in evaluating any proposed accounting standard, the following four considerations be taken into account:

1 *The proposed accounting practice should be compatible with the concepts stated in AC 101, and the considerations mentioned in statement AC 100.*

2 *The proposed statement should be accommodated within an acceptable conceptual framework.*

3 *Consistent with paragraph .06 of statement AC 100, any new practice should preferably reduce (but certainly not increase) the permissible accounting alternatives.*

4 *Disclosure of supplementary information by way of note does not compensate for application of an inadequate accounting policy.*

Everingham (ibid) stated that in spite of the articles appearing in *Accountancy SA*, August 1988, seeking to provide justification for the partial allocation approach, the articles were deficient in that users needs were not addressed and the focus was placed almost entirely on the balance sheet to the exclusion of the income statement. This was, in Everingham's opinion, a "...fatal omission, and, further, that even from a balance sheet perspective, the partial method does not stand up to scrutiny. In addition, Everingham (ibid) stated that no research of any consequence is cited in support of a move to the partial method.

The partial allocation approach was also rejected by a study group consisting of staff members in the Department of Accountancy at the University of Natal (UND). The study group (1988, letter) were of the opinion that there seems to be nothing "...inherently static or permanent about deferred taxation". According to the UND study group (ibid), it is not the liability that is deferred, but the payment of the liability and then only by virtue of the fact that a reversing timing difference which demands an immediate payment to the fiscus, is replaced by a newly created originating timing difference.

Table 5.16: Responses of Universities to Exposure Draft 72

	Support reissue AC 102	Support comprehensive allocation	Support partial allocation	Unable to establish from response
University of Cape Town		YES		
University of Natal, Durban		YES		

5.6.6 INDIVIDUALS

The responses to Exposure Draft 72 from individual members is detailed in Table 5.17. As there were no comments from individuals that have not been discussed elsewhere, a detailed analysis of comments is not undertaken.

Table 5.17: Responses of Individuals to Exposure Draft 72

	Support reissue AC 102	Support comprehensive allocation	Support partial allocation	Unable to establish from response
de Waal FJ		YES		
Ferreira AS				YES
Karro KG				YES
McGregor GB		YES		
Wayne GP				YES

The evidence in this case study does not provide conclusive evidence that the Accounting Practices Board was justified in issuing a statement of generally accepted accounting practice that permitted the use of the partial allocation basis of accounting for deferred taxation. It appears that the Accounting Practices Board submitted to the pressures of major companies who disregarded the original statement of generally accepted accounting practice, AC 102 '*Taxation in the Financial Statement of Companies*'.

In spite of the comprehensive and convincing arguments against the partial allocation approach to deferred taxation made to the Accounting Practices Committee (APC) by the Port Elizabeth Regional Association (1988, letter), Gencor (1988, letter) and the University of Cape Town (1988, letter), the APC heeded the less convincing and what appears to be self interest arguments by certain companies in favour of the partial allocation approach.

This view is supported by Fouchè (1989, letter) who, in a letter addressed to the Chairman and members (sic), Accounting Practices Board stated:

I as well as the constituent body of APB which I represent, have serious reservations on matters of principle regarding the philosophy, policy and practice advocated in the proposed statement. These have been conveyed to APC, both verbally and in writing, and have also been raised on the occasion of the informal APC presentation to APB. As yet and in the proposed statement in particular, these have not been heeded nor has their validity been logically refuted. On the contrary, it appears that these reservations and concerns are shared by others, including important user bodies" (Fouchè, 1989, letter) .

5.7 RESPONSES TO SURVEY QUESTIONNAIRE

Responses to the survey questionnaire were received from 49 respondents, representing a overall response rate of 28,82 percent. While this response rate can be considered disappointing, the number of responses received does, however, compare favourably with the responses received by the Accounting Practices Committee to Discussion Paper 5 (53 responses), the unpublished memorandum (47 responses), Exposure Drafts 61 (53 responses) and Exposure Draft 72 (40 responses), as well as the experience with those internationally.

Possible reasons for this low response rate could include that

- respondents have become accustomed to the deferred taxation deliberations and feel that they can make no further meaningful contributions,
- respondents, as professional persons, did not have the time available to complete the questionnaire,
- apathy on the part of the respondents,
- companies whose opinions were sought considered the questions relating either to management compensation schemes, or the relationship between management compensation schemes and the accounting standard setting process to be confidential, and
- a perception by respondents that the Accounting Practices Board is pandering to the interests of a few major corporations at the expense of creating sound accounting standards.

5.8 STATISTICAL ANALYSIS OF DATA

The following four statistical procedures were used to analyse the data provided by the respondents to the survey questionnaire on the various issues surrounding deferred taxation. All these procedures were computed on the SPSS Statistical Data Analysis programme:

- Chi-square goodness-of-fit test: This test is based on how good a fit exists between the frequency of observed data and the expected frequency obtained from the hypothesised distribution.

- Pearson's correlation coefficient: This test was used to measure the strength of the linear relationship between variables for certain hypotheses, and, in conjunction with the chi-square goodness-of-fit test, to test the hypotheses developed in Chapter 4.

- Factor analysis: This procedure summarises and reduces the data to a manageable number of factors.

- Cronbach's alpha coefficient: This procedure measures the internal reliability of the questionnaire.

A brief discussion of the various statistical techniques used follows.

5.8.1 CHI-SQUARE GOODNESS-OF-FIT

A chi-square goodness-of-fit test was used to measure how well the observed data fitted the expected data; in other words, to answer the question, does the population have a specific theoretical distribution? The chi-square test was considered appropriate as all the observed frequencies are independent of each other. Under this test, the completion of the questionnaire by a respondent would not have been influenced by any other respondent.

The decision rule when using the chi-square goodness-of-fit test is when calculated $X^2 > X^2_{critical}$, the null hypothesis should be rejected.

5.8.2 PEARSON'S CORRELATION COEFFICIENT

The Pearson's correlation coefficient, also known as the Pearson's r, is, according to Groebner and Shannon (1989, 610) a "...quantitative measure of the linear relationship between two variables". This statistical value may range between - 1.00 and + 1.00. Neale and Liebert (1986, 58) state that both the magnitude and direction of the relationship between the variables are reflected in the correlation coefficient: "The higher the absolute value of r, the larger or stronger the relationship between the two variables, whereas a r of 0.00 indicates that the variables are unrelated".

To obtain further assurance that the sample has not provided misleading data, and to establish whether the linear relationship between the data is significant, the t statistic was computed from the data obtained from the questionnaire. This will, according to Groebner and Shannon (1986, 566), "...support or refute the hypothesis that the population correlation coefficient, p is zero". This will provide additional evidence in the acceptance or rejection of the hypotheses developed in Chapter 4

5.8.3 FACTOR ANALYSIS

A factor analysis was utilised to identify those factors that had common loadings without imposing any preconceived structure on the outcome. Factor analysis has been described by Oppenheim (1992, 166) as an "...analytic statistical tool which may enable us to find out what (if any) are the chief underlying dimensions of a set of variables, attributes, responses or observations". Neale and Liebert (1986, 80) consider that the primary aim of a factor analysis is to "...find a smaller set of dimensions, factors, that can account for the entire array of intercorrelations". These factors are then used to analyse and explain the interrelationship between the variables in the questionnaire in terms of their common underlying factors.

In establishing which factors should be considered significant, Child (1970, 43) states that only those factors "...having latent roots (eigenvalue values) greater than one are considered as common factors".

The factor analysis was extracted using the principal component factor analytic approach. The nine factors that were extracted by the SPSS Statistical Data Analysis programme using this approach were rotated using the Varimax rotation converged in 19 iterations so that (according to Peterson RA, 1988, 492) a more interpretable and unique factor structure can be produced. Peterson (ibid) identified a further advantage to rotation, namely, "[I]n addition to producing a more interpretable factor structure, rotation frequently produces a more reliable or stable factor structure".

5.8.4 CRONBACH'S ALPHA COEFFICIENT

The reliability of the questionnaire used to determine the views of respondents to the various issues surrounding deferred taxation, was established by using Cronbach's alpha coefficient. Oppenheim (1992, 159) states the importance of reliability not only as a precondition for validity, but

> *"...that the measuring instrument will behave in a fashion which is consistent with itself; that a very high proportion of the score on every occasion is due to the underlying scale variable, with a minimum of error".*

In establishing what an acceptable correlation coefficient level is for data interpretation, Oppenheim (1992, 159 -160) considers that

> *"[I]f the reliability of a scale or other measure drops below .80 this means that repeated administrations will cover less than 64 per cent of the same ground, and that the error component is more than one-third; such a measure will come in for serious criticism and might well have to be discarded or rebuilt".*

5.9 TESTING THE HYPOTHESES

The analysis and interpretation of the results are divided into sub-sections that correspond with the hypotheses developed in Chapter 4. Each hypothesis will be discussed using the following structure.

- Results of the statistical tests of hypothesis for the respondents

- Discussion and interpretation of the results

Where a respondent failed to respond to a particular question, either because they did not understand the question or did not wish to express an opinion on the question, it was decided to score these responses '0'. This was also necessary so that when the questionnaire results were processed, error messages would not be generated. With the exception of hypothesis 3, respondents were required to answer a multichotomous question on a modified Likert scale.

The individual hypotheses are discussed below.

5.9.1 HYPOTHESIS 1

H 1 *It is hypothesised that, in the opinion of the respondents participating in the survey, accounting theory in South Africa can be considered normative in nature.*

The null hypothesis developed from the above hypothesis is stated as follows:

H 1_0 *It is hypothesised that, in the opinion of the respondents participating in the survey, accounting theory in South Africa cannot be considered normative in nature.*

The data to test the hypothesis was gathered from Question 1.1 of the questionnaire. The responses are contained in Table 5.18 below.

Table 5.18: Responses to Question 1.1

Category	Cases Observed	Expected	Residual
0	5	12,25	-7,25
1	15	12,25	2,75
2	26	12,25	13,75
3	3	12,25	-9,25
Total	49		
X^2 = 27, 327	DF = 3	Significance = 0,000	

Using an α level of 0,01, the critical value for three degrees of freedom is 11,345. Since $X^2 > X^2_{critical}$, the null hypothesis should be rejected.

It is concluded, therefore, that in the opinion of the respondents to the questionnaire, that accounting theory in South Africa can be considered normative in nature.

5.9.1.1 Hypothesis 1: Discussion and interpretation of results

It is clear from an analysis of the results to Question 1.1 of the questionnaire that the respondents considered accounting theory in South Africa to be normative in nature. This is not surprising in that accounting theory is not presented as a separate subject at undergraduate level at university, and as a result, graduates, particularly those wishing to qualify as Chartered Accountants, have little exposure to pure accounting theory. The exposure that the majority of respondents would have had to accounting theory would have been limited, in all probability, to the theory contained in the series of accounting statements issued by the Accounting Practices Board and in particular, AC 100 *'Preface to Statements of Generally Accepted Accounting Practice'*, AC 101 *'Disclosure of Accounting Policies'*, and AC 000 *'Framework for the Preparation and Presentation of Financial Statements'*. In addition, respondents would have only been subjected to a brief exposé of accounting theory in an introductory undergraduate accounting course. Evidence supporting this opinion was obtained from comments made by individual respondents to the questionnaire such as "*This is not a word with which I am familiar*", in spite of definitions being provided in the questionnaire.

5.9.2 HYPOTHESIS 2

H 2 *It is hypothesised that, in the opinion of the respondents participating in the survey, accounting theory in South Africa cannot be considered positive in nature.*

The following null hypothesis was developed.

H 2_0 *It is hypothesised that, in the opinion of the respondents participating in the survey, accounting theory in South Africa can be considered positive in nature.*

The data to test the hypothesis was gathered from Question 1.2 of the questionnaire. The responses are contained in Table 5.19 below.

Table 5.19: Responses to Question 1.2

Category	Cases Observed	Expected	Residual
0	15	9,80	5,20
1	2	9,80	-7,80
2	9	9,80	-0,80
3	21	9,80	11,20
4	2	9,80	-7,80
Total	49		
$X^2 = 28{,}041$	DF = 4	Significance = 0,000	

Using an α level of 0,01, the critical value for four degrees of freedom is 13,277. Since $X^2 > X^2_{critical}$, the null hypothesis should be rejected.

It is concluded, therefore, that in the opinion of the respondents to the questionnaire, that accounting theory in South Africa cannot be considered positive in nature.

Further data to test hypothesis 2 can be obtained by performing Pearson correlation matrix using the responses to Question 1.2 as a constant with Questions 1.5, 1.6, 1.7 and 1.8 respectively. Each of the questions identified as variables deal with specific aspects of positive accounting theory identified in Chapter 2. For the above questions, respondents were required to answer multichotomous questions on a modified Likert scale. Table 5.20 details the r scores obtained.

Table 5.20: Comparison of r scores Question 1.2 with Questions 1.5, 1.6, 1.7 and 1.8

	Q1.2
Q1.5	0,29
Q1.6	0,21
Q1.7	0,17
Q1.8	0,01

Applying the t test to hypothesis 2, to each of the above r correlation coefficients respectively, in all cases calculated $t < t_{critical}$ value of 2,423 at the 1 percent level of significance. Since $t < t_{critical}$, the null hypothesis must be accepted.

5.9.2.1 Hypothesis 2: Discussion and interpretation of results

The two statistical tests provide contradictory results. While the chi-square goodness-of-fit test requires the rejection of $H\,2_0$, the results of the t test requires $H\,2_0$ to be accepted. Although there is a contradiction in the acceptance/rejection of the null hypothesis, a further analysis of the responses to Questions 1.5 through 1.8 is instructive. Table 5.21 details the r scores of Questions 1.5 through 1.8.

Table 5.21: Matrix of r scores for Questions 1.5, 1.6, 1.7 and 1.8

	Q1.5	Q1.6	Q1.7	Q1.8
Q1.5	1,00			
Q1.6	0,07	1,00		
Q1.7	0,20	0,52	1,00	
Q1.8	0,39	0,33	0,52	1,00

Those r scores > 0,30 provide an indication of a positive correlation between Question 1.8, 1.5, 1.6 and 1.7, while there is an indication of a positive correlation between Questions 1.6 and 1.7.

These correlations are significant in that each of these questions dealt with a specific aspect of positive accounting theory identified in Chapter 2.

As discussed in 5.9.1.1 above, the lack of exposure that the majority of accounting graduates have to accounting theory could possibly explain these contradictory results. This is an area that warrants further study.

5.9.3 HYPOTHESIS 3

H 3 *It is hypothesised that, in the opinion of the respondents participating in the survey, the original objective of providing for deferred taxation, which was to achieve a proper matching of the tax charge against income to which it relates, is appropriate to South Africa.*

The null hypothesis developed from the above hypothesis is stated as follows:

H 3_0 *It is hypothesised that, in the opinion of the respondents participating in the survey, the original objective of providing for deferred taxation, which was to achieve a proper matching of the tax charge against income to which is relates, is not appropriate to South Africa.*

The data to test the hypothesis was gathered from Question 2.1 of the questionnaire. This question required respondents to answer a dichotomous question, either YES or NO. Since DF = 1, it is necessary to apply a correction for continuity to the obtained value for chi-squared (Dominowski, 1980, 347). This is achieved by reducing the absolute value for the difference between f_o and f_e by 0,5 in each category.

The responses are contained in Table 5.22 below.

Table 5.22: Responses to Question 2.1

Category	Cases Observed	Expected	Residual
1	40	24,50	15,50
2	9	24,50	-15,50
Total	49		

X^2 = 18,368 (corrected) DF = 1 Significance = 0,000

Using an α level of 0,01, the critical value for one degree of freedom is 6,635.
Since $X^2 > X^2_{critical}$, the null hypothesis should be rejected.

It is concluded, therefore, that in the opinion of the respondents to the questionnaire, the original objective of providing for deferred taxation, which was to achieve a proper matching of the tax charge against income to which it relates, is appropriate to South Africa.

5.9.3.1 Hypothesis 3: Discussion and interpretation of results

The rejection of the null hypothesis $H\,3_0$, indicates that the majority of the respondents believed that the objective of providing for deferred taxation should continue to apply in South Africa, with only 18,37 percent of respondents to the questionnaire of the opinion that the provision of deferred taxation is no longer relevant. Other information provided by the respondents regarding specific aspects of deferred taxation follows.

Of those respondents who believed that the objective of providing for deferred taxation should continue to apply in South Africa, 67,5 percent of the respondents favoured the comprehensive approach as opposed to 20,0 percent of respondents favouring the partial allocation basis. The remainder of the respondents favoured some other method of providing for deferred taxation.

97,44 percent of respondents either agreed or strongly agreed that the provision of deferred taxation enhances the relevance and reliability aspects of the conceptual framework. The partial allocation basis of providing for deferred taxation did not find much favour with the respondents, with only 35 percent of the respondents either agreeing or strongly agreeing that financial statements should recognise deferred taxation accounted for on this basis. 67,5 percent of the respondents either agreed or strongly agreed that because of the subjective nature of the partial basis of providing for deferred taxation, this basis can be used as an income smoothing technique.

5.9.4 HYPOTHESIS 4

H 4 *It is hypothesised that, in the opinion of the respondents participating in the survey, deferred taxation on the balance sheet of companies represents a liability that will become payable in the future.*

The null hypothesis developed from the above hypothesis can be stated as:

H 4_0 *It is hypothesised that, in the opinion of the respondents participating in the survey, deferred taxation on the balance sheet of companies does not represent a liability that will become payable in the future.*

The data to test the hypothesis was gathered from Question 3.2 of the questionnaire. The responses are contained in Table 5.23 below.

Table 5.23: Responses to Question 3.2

Category	Cases Observed	Expected	Residual
0	1	9,80	-8,80
1	4	9,80	-5,80
2	24	9,80	14,20
3	15	9,80	5,20
4	5	9,80	-4,80
Total	49		
$X^2 = 37{,}020$	DF = 4	Significance = 0,000	

Using an α level of 0,01, the critical value for four degrees of freedom is 13,277. Since $X^2 > X^2_{critical}$, the null hypothesis should be rejected.

It is concluded, therefore, that in the opinion of the respondents participating in the survey, deferred taxation on the balance sheet of companies represents a liability that will become payable in the future.

Further data to test hypothesis 3 was gathered from Questions 3.1 and 3.2 of the questionnaire. These questions contain the crux of the deferred taxation deliberations identified in Chapter 3, namely that companies have argued that since the deferred taxation balance reflected in the balance sheet is unlikely to become payable, there is no need to provide for deferred taxation on these timing differences. A correlation matrix can be used to measure the relationship of the observed data between specific aspects of deferred taxation: does a company have a present obligation for taxes on income that may appear as a result of future income tax assessments, and does the deferred tax liability reflected in the balance sheet represent a true liability of the firm that will become payable in the future?

An analysis of the responses are contained in Table 5.24 below.

Table 5.24: Calculated r score Questions 3.1 and 3.2

	Q3.1	Q3.2
Q3.1	1,00	
Q3.2	0,34	1,00

From the above r correlation coefficient, the calculated t value is 2,478. Since $t > t_{critical}$ value of 2,432 at the 1 percent level of significance, the null hypothesis can be rejected. This rejection of the null hypothesis provides supports to the conclusion drawn above that, in the opinion of the respondents participating in the survey, deferred taxation on the balance sheet of companies represents a liability that will become payable in the future.

5.9.4.1 Hypothesis 4: Discussion and interpretation of results

As discussed in sections 5.5.3 and 5.6.3 above, the primary argument offered by respondents to both Exposure Draft 61 and 72 in favour of the partial allocation approach to deferred taxation is that the deferred taxation liability reflected in the balance sheet of companies is increasing with there being little likelihood of this balance ever being paid. Respondents to the questionnaire however, disagree with this contention believing that deferred taxation does represent a liability that will become payable in the future.

5.9.5 HYPOTHESIS 5

H 5 *It is hypothesised that, in the opinion of the respondents participating in the survey, company management must comply with codified statements of generally accepted accounting practice even though this practice will adversely impact reported earnings.*

The null hypothesis developed from the above hypothesis is:

H 5_0 *It is hypothesised that, in the opinion of the respondents participating in the survey, company management cannot be justified in not complying with codified statements of generally accepted accounting practice if this practice adversely impacts reported earnings.*

The data to test the hypothesis was gathered from Question 3.3 of the questionnaire. The responses are contained in Table 5.25

Table 5.25: Responses to Question 3.3

Category	Cases Observed	Expected	Residual
0	1	9,80	-8,80
1	1	9,80	-8,80
2	16	9,80	6,20
3	18	9,80	8,20
4	13	9,80	3,20
Total	49		
$X^2 = 27,633$	DF = 4	Significance = 0,000	

Using an α level of 0,01, the critical value for four degrees of freedom is 13,277. Since $X^2 > X^2_{critical}$, the null hypothesis should be rejected.

It is concluded, therefore, that in the opinion of the respondents participating in the survey, company management must comply with codified statements of generally accepted accounting practice even though this practice adversely impacts reported earnings.

Further data to test this hypothesis is gathered from Questions 3.3 and 3.4 of the questionnaire. These questions deal with certain elements regarded as critical to validate positive accounting theory, namely, that individuals maximise their own expected utilities and are innovative and creative in doing so. Using a correlation matrix, the results are illustrated in Table 5.26 below.

Table 5.26: Calculated r scores Questions 3.3 and 3.4

	Q3.3	Q3.4
Q3.3	1,00	
Q3.4	0,58	1,00

From the above r correlation coefficient, the calculated t value is 4,991. Since $t > t_{critical}$ value of 2,423 at the 1 percent level of significance, the null hypothesis must be rejected.

5.9.5.1 Hypothesis 5: Discussion and interpretation of results

It is clear from the responses to both Question 3.3 and 3.4, that respondents do not support reserve accounting adjustments due to increases in the corporate tax rate, or changing from the comprehensive to the partial allocation basis of providing for deferred taxation in order to improve reported earnings. In other words, the respondents believe that management should not be allowed the discretion to manipulate accounting policies so as to maximise or improve reported earnings so as to ultimately maximise their own utility.

One respondent was prepared to reserve account adjustments due to increases in corporate tax rates particularly if the amounts are material in nature.

5.9.6 HYPOTHESIS 6

H 6 *It is hypothesised that, in the opinion of the respondents participating in the survey, the existence of management compensation schemes will influence management's response to an exposure draft that adversely affects reported earnings.*

The null hypothesis developed from the above hypothesis is stated below:

H 6_0 *It is hypothesised that, in the opinion of the respondents participating in the survey, the existence of management compensation schemes will not influence management's response to an exposure draft that adversely affects reported earnings.*

The data to test the hypothesis was gathered from Question 4.10 of the questionnaire. The responses are illustrated in Table 5.27 below.

Table 5.27: Responses to Question 4.10

Category	Cases Observed	Expected	Residual
0	9	12,25	-3,25
1	4	12,25	-8,25
2	25	12,25	12,75
3	11	12,25	-1,25
Total	49		

$X^2 = 19{,}816$ DF = 3 Significance = 0,000

Using an α level of 0,01, the critical value for three degrees of freedom is 11,345. Since $X^2 > X^2_{critical}$, the null hypothesis should be rejected.

It is concluded, therefore, that in the opinion of the respondents participating in the survey, the existence of management compensation schemes will influence management's response to an exposure draft that adversely affects reported earnings.

Further data to test this hypothesis is gathered from Questions 4.10 and 4.12 of the questionnaire. As with hypothesis 5, Questions 4.10 and 4.12 contain factors required to validate positive accounting theory. Watts and Zimmerman (1978, 113) state that "... a precondition of a positive theory of standard setting is understanding management incentives". If this precondition is in fact correct, one would expect that should a portion of managements' remuneration be based on reported profits, there would be a tendency for management to select an accounting standard that would increase reported profits. The results of a correlation matrix between Questions 4.10 and 4.12 are detailed in Table 5.28 below, illustrating the respondents' opinion.

Table 5.28: Calculated r scores for Questions 4.10 and 4.12

	Q4.10	Q4.12
Q4.10	1,00	
Q4.12	0,74	1,00

For the above r correlation coefficient, the calculated t value is 7,543. Since $t > t_{critical}$ value of 2,423 at the 1 percent level of significance, the null hypothesis can be rejected. This supports the conclusion drawn above that, in the opinion of the respondents participating in the survey, the existence of management compensation schemes will influence management's response to an exposure draft that adversely affects reported earnings.

5.9.6.1 Hypothesis 6: Discussion and interpretation of results

72,5 percent of the respondents to the questionnaire either strongly agreed or agreed that management compensation is normally tied to accounting earnings. The responses provided in Questions 4.10 and 4.12 therefore provide a clear indication that respondents are of the view that where proposed changes in accounting standards will have an unfavourable impact on reported earnings and consequently on management compensation schemes, management will be influenced to either lobby against the proposed accounting standard or to respond to the proposed standard disagreeing with its contents, thereby satisfying Watts and Zimmerman's (1978, 113) precondition of a positive theory of standard setting discussed above.

5.9.7 HYPOTHESIS 7

H 7 *It is hypothesised that, in the opinion of the respondents participating in the survey, the implementation of the current statement on deferred taxation resulted in modification to existing management compensation schemes.*

The null hypothesis developed from the above hypothesis is stated below:

H 7_0 *It is hypothesised that, in the opinion of the respondents participating in the survey, the implementation of the current statement on deferred taxation did not result in modification to existing management compensation schemes.*

The data to test the hypothesis was gathered from Question 4.13 of the questionnaire. The responses are contained in Table 5.29.

Table 5.29: Responses to Question 4.13

Category	Cases Observed	Expected	Residual
0	19	16,33	2,67
2	11	16,33	-5,33
3	19	16,33	2,67
Total	49		
$X^2 = 2{,}612$	DF = 2	Significance = 0,271	

Using an α level of 0,01, the critical value for two degrees of freedom is 9,210. Since $X^2 < X^2_{critical}$, the null hypothesis should be accepted.

It is concluded, therefore, that in the opinion of the respondents participating in the survey, the implementation of the current statement on deferred taxation did not result in any modification to existing management compensation schemes. There is however, no additional empirical evidence to support this conclusion.

5.9.7.1 Hypothesis 7: Discussion and interpretation of results

While six respondents admitted to the existence of management incentive/compensation schemes in their employer companies, these respondents indicated that there had been no change to the management compensation scheme as a result of the current AC 102 statement on deferred taxation. In addition, no changes had been made to the management compensation scheme in response to changes in any other statement of generally accepted accounting practice.

For the six respondents who provided details of the existence of management compensation schemes in their employer companies, five were participants in share incentive schemes, while the value of the bonus paid to the sixth participant was dependent upon achieving a rate of return on capital invested. Of these six respondents, five stated that certain contractual obligations existed between the participants in the compensation scheme and the company. This contractual relationship between the company and the participants in the management compensation scheme is referred to as contracting costs by Henderson and Peirson (1983, 226), an element of positive accounting theory.

These responses, although a tenuous basis upon which to base a conclusion, provide supplementary evidence confirming the acceptance of hypothesis H 7_0.

5.9.8 HYPOTHESIS 8

> **H 8** *It is hypothesised that, in the opinion of the respondents participating in the survey, financial statement user groups are willing to expend resources in trying to influence the accounting standard setting process.*

The null hypothesis developed from the above hypothesis is stated below:

> **H 8_0** *It is hypothesised that, in the opinion of the respondents participating in the survey, financial statement user groups are unwilling to expend resources in trying to influence the accounting standard setting process.*

The data to test the hypothesis was gathered from Question 5.5 of the questionnaire. The responses are contained in Table 5.30 below.

Table 5.30: Responses to Question 5.5

Category	Cases Observed	Expected	Residual
0	4	9,80	-5,80
1	1	9,80	-8,80
2	25	9,80	15,20
3	18	9,80	8,20
4	1	9,80	-8,80
Total	49		

$X^2 = 49{,}673$ DF = 4 Significance = 0,000

Using an α level of 0,01, the critical value for four degrees of freedom is 13,277. Since $X^2 > X^2_{critical}$, the null hypothesis should be rejected.

It is concluded, therefore, that in the opinion of the respondents participating in the survey, that financial statement user groups are willing to expend resources in trying to influence the accounting standard setting process.

5.9.8.1 Hypothesis 8: Discussion and interpretation of results

While the analysis of responses to Question 5.5 indicate that 57,78 percent of the respondents to this question either agree or strongly agree that financial statement user groups are willing to expend resources in trying to influence the accounting standard setting process, additional comments on the standard setting process is considered instructive.

Only 51,28 percent of the respondents responding to the question on whether the Accounting Practices Board (APB) is representative of all potential users of financial statements agreed that this was the position. While the questionnaire did not require respondents to state who, in addition to the existing membership should comprise the APB, one respondent submitted that unions be made members of APB!

While the majority of the respondents (69,23 percent) agreed that the current standard setting process in South Africa to be the best method available, certain specific comments made by the respondents regarding the standard setting process and the APB in particular need to be examined. The completed questionnaires included five specific references either to the lack of independence of members comprising the APB, or suggested that the vested interests that hamper the standard setting process be removed. The opinion of certain respondents can be summed up by the opinion of a particular respondent:

> *Current standards are set by the requirements of a few big companies and the backing of a big audit firm. A more democratic standard should be used where a majority of users decide on standards and not the biggest.*

This respondents view that "current standards are set by the requirements of a few big firms" appears to be well grounded if the response by Barlow Rand Limited (1986, letter) to Exposure Draft 61 is scrutinised. In their response, Barlow Rand Limited stated that

> *"[W]e are concerned about ED 61, and, in the event that the exposure draft attracts substantial support, we respectfully request the opportunity to discuss this further with yourselves".*

5.9.9 HYPOTHESIS 9

H 9 *It is hypothesised that, in the opinion of the respondents participating in the survey, that corporate deferred taxation practices are consistent with codified generally accepted accounting practice as required by statement AC 102.*

The null hypothesis developed from the above hypothesis can be stated as:

H 9_0 *It is hypothesised that, in the opinion of the respondents participating in the survey, that corporate deferred taxation practices are not consistent with codified generally accepted accounting practice as required by statement AC 102.*

The data to test the hypothesis was gathered from Question 2.10 of the questionnaire. The responses are contained in Table 5.31 below.

Table 5.31: Responses to Question 2.10

Category	Cases Observed	Expected	Residual
0	10	12,25	-2,25
1	1	12,25	-11,25
2	20	12,25	7,75
3	18	12,25	5,25
Total	49		

$X^2 = 18,347$ DF = 3 Significance = 0,000

Using an α level of 0,01, the critical value for three degrees of freedom is 11,345. Since $X^2 > X^2_{critical}$, the null hypothesis should be rejected.

It is concluded, therefore, that in the opinion of the respondents participating in the survey, corporate deferred taxation practices are consistent with codified generally accepted accounting practice as required by statement AC 102.

5.9.9.1 Hypothesis 9: Discussion and interpretation of results

Although the statistical test results in the rejection of $H\ 9_0$, an analysis of the responses to the questionnaire reflect that only 53,84 percent of the respondents answering Question 2.10 either agree or strongly agree that corporate practices currently in operation are consistent with codified generally accepted accounting practice. This would tend to indicate that the respondents to the questionnaire are aware of occasions where non compliance with statements of generally accepted accounting practice occur, particularly in respect of deferred taxation.

5.9.10 HYPOTHESIS 10

> **H 10** *It is hypothesised that, in the opinion of the respondents participating in the survey, that current deferred tax practices permitted by statute and generally accepted accounting practice are comprehensive enough and embrace all accounting options.*

The null hypothesis developed from the above hypothesis is stated below:

> **$H\ 10_0$** *It is hypothesised that, in opinion of the respondents participating in the survey, that current deferred tax practices permitted by statute and generally accepted accounting practice are not comprehensive enough and do not embrace all accounting options.*

The data to test the hypothesis was gathered from Question 2.11 of the questionnaire. The responses are contained in Table 5.32 below.

Table 5.32: Responses to Question 2.11

Category	Cases Observed	Expected	Residual
0	11	9,80	1,20
1	1	9,80	-8,80
2	23	9,80	13,20
3	13	9,80	3,20
4	1	9,80	-8,80
Total	49		
$X^2 = 27,327$	DF = 4	Significance = 0,000	

Using an α level of 0,01, the critical value for three degrees of freedom is 13,277. Since $X^2 > X^2_{critical}$, the null hypothesis should be rejected.

It is concluded, therefore, that in the opinion of the respondents participating in the survey, current deferred tax practices permitted by statute and generally accepted accounting practice are comprehensive enough and embrace all accounting options.

5.9.10.1 Hypothesis 10: Discussion and interpretation of results

The responses to Question 2.11 indicate that 63,16 percent of the respondents who completed this question either agreed or strongly agreed that current practices permitted by statute and generally accepted accounting practice are comprehensive enough to embrace all options. It is clear therefor that the respondents to the questionnaire consider alternative deferred taxation practices such as the creation of tax equalisation accounts or the discounting of deferred taxation to be unacceptable.

Kessel Feinstein (1988, letter) in their response to Exposure Draft 72, recommended that the use of tax equalisation accounts to smooth earnings should be specifically prohibited in any statement on accounting for deferred taxation. This would, in the opinion of the partners of Kessel Feinstein (ibid)

> *"... assist individual members of the profession in discouraging this practice, which has been adopted by some quoted companies. It would also assist in the prevention of opinion shopping. Unless specififically prohibited, the practice will spread".*

5.9.11 HYPOTHESIS 11

H 11 *It is hypothesised that, in the opinion of the respondents participating in the survey, that legislation should be incorporated into the Companies Act making adherence to statements of generally accepted accounting practice mandatory.*

The null hypothesis developed from the above hypothesis is stated below:

H 11_0 *It is hypothesised that, in the opinion of the respondents participating in the survey, that legislation need not be incorporated into the Companies Act making adherence to statements of generally accepted accounting practice mandatory.*

The data to test the hypothesis was gathered from Question 5.7 of the questionnaire. The responses are contained in Table 5.33 below.

Table 5.33: Responses to Question 5.7

Category	Cases Observed	Expected	Residual
0	2	9,80	-7,80
1	11	9,80	1,20
2	27	9,80	17,20
3	7	9,80	-2,80
4	2	9,80	-7,80
Total	49		
$X^2 = 43{,}551$	DF = 4	Significance = 0,000	

Using an α level of 0,01, the critical value for four degrees of freedom is 13,277. Since $X^2 > X^2_{critical}$, the null hypothesis should be rejected.

It is concluded, therefore, that in the opinion of the respondents participating in the survey, that legislation should be incorporated into the Companies Act making adherence to statements of generally accepted accounting practice mandatory.

5.9.11.1 Hypothesis 11: Discussion and interpretation of results

It is clear from the analysis of the responses to Question 5.7 that the majority of respondents (80,85 percent) either agree or strongly agree that legislation should be incorporated into the Companies Act, making adherence with statements of generally accepted accounting practice mandatory.

One reason for this view is that respondents are possibly dissatisfied with what they perceive as the failure of certain companies to comply with AC 103 (revised) '*Extraordinary Items and Prior Year Adjustments*' when changing from the comprehensive allocation basis to partial allocation basis of providing for deferred tax.

5.10 FACTOR ANALYSIS: DISCUSSION AND INTERPRETATION OF RESULTS

The factors identified by the factor analysis represent the hypothetical grouping of statements which are perceived to represent the factors under investigation.

Child (1970, 45) established that the guidelines used to interpret factors should be those items with loadings greater than ± 0,30. In addition to discussing the loading of the item, the amount of the variation explained by the factor will be discussed in terms of its eigenvalue after rotation.

The factors extracted by the factor analysis are reflected in Table 5.34.

Ten items represented by Questions 2.2 through 2.11 have high loadings on Factor 1 and together represent 8,73 percent of the total variance, or 92,32 percent of the variance accounted for by Factor 1, with Factor 1 accounting for 20,53 percent of the common variance. This factor represents various views regarding deferred taxation.

Factor 2 represents 16,82 percent of the common variance. Items representing Questions 4.6 through 4.13 have high loadings on Factor 2 and together represent 93,25 of the variance accounted for by Factor 2 and 7,23 percent of the total variance. This factor covers a particular dimension of management compensation schemes.

Three factors have high loadings on Factor 3 which accounts for 8,19 percent of the total variance. These high loading factors are represented by Questions 5.2 through 5.4 and account for 68,62 percent of the variance accounted for by Factor 3 and 2,59 percent of the total

Table 5.34: Factors Extracted by Factor Analysis

FACTOR ANALYSIS

Verimax - Rotated Factor Matrix

Question n=49	FACTOR 1	FACTOR 2	FACTOR 3	FACTOR 4	FACTOR 5	FACTOR 6	FACTOR 7	FACTOR 8	FACTOR 9	h^2
2.8	**0.89562**	0.06219	0.10106	-0.14778	0.01890	-0.15769	-0.05907	-0.14042	-0.11375	0.89942
2.4	**0.87056**	0.09825	0.08963	-0.11985	0.21941	-0.15066	0.09363	-0.00086	-0.04077	0.87119
2.5	**0.84921**	-0.05739	-0.07014	-0.01652	0.16740	0.00692	0.13948	0.13449	-0.33188	0.90540
2.3	**0.84698**	0.03992	0.04751	0.02905	0.21619	-0.11491	0.12868	-0.11425	-0.23768	0.86812
2.7	**0.84126**	-0.13187	0.17085	0.01234	-0.19875	0.21969	0.20369	-0.09766	0.00287	0.89325
2.10	**0.83242**	0.04451	0.25874	0.07262	-0.08409	0.18869	0.13588	-0.11001	0.17068	0.86950
2.6	**0.83120**	0.05680	0.11009	-0.11657	0.07198	-0.11205	-0.17283	-0.14214	-0.06129	0.79139
2.9	**0.80726**	-0.02354	0.03252	-0.06249	-0.10126	0.07149	-0.14373	0.23147	-0.08290	0.75366
2.11	**0.79043**	0.02560	0.19094	-0.04030	-0.12850	0.19088	0.02226	-0.05096	0.09740	0.72904
2.2	**0.67565**	-0.10274	0.12219	-0.00392	-0.48078	-0.05987	-0.09426	0.12624	0.32189	0.84517
4.10	0.00719	**0.89543**	-0.02166	-0.05047	-0.07431	-0.09682	-0.02637	0.06212	0.02683	0.82503
4.6	0.03036	**0.88689**	0.00596	0.02550	-0.03305	-0.03282	0.10673	0.13463	0.15109	0.84270
4.11	0.01093	**0.88477**	0.07161	0.08715	-0.04911	-0.12316	-0.12358	0.15543	0.01525	0.85290
4.9	-0.04779	**0.87532**	0.02947	0.07374	0.08679	-0.20963	0.05729	-0.07032	0.07842	0.84063
4.12	0.05924	**0.85598**	-0.12724	-0.03354	0.00964	-0.03616	-0.05788	-0.02231	0.16562	0.78620
4.7	0.04981	**0.85140**	0.04589	0.10979	0.07152	0.01983	0.13112	-0.11780	0.16372	0.80490
4.8	0.02102	**0.76292**	-0.04707	0.05316	0.19160	0.10355	-0.06538	-0.34391	-0.19147	0.79417
4.13	-0.06846	**0.68600**	0.06165	-0.06069	0.16168	0.28110	0.23258	0.27706	-0.20990	0.76284
5.4	0.24657	0.06482	**0.87402**	-0.02293	-0.01064	0.04364	-0.01484	0.07801	-0.11787	0.85165
5.3	0.36060	0.13221	**0.80388**	0.00558	-0.19610	-0.08656	0.08527	0.16521	0.03011	0.87519
5.2	0.11248	-0.14787	**0.78225**	-0.12088	0.21731	0.18841	-0.08907	-0.07680	0.00439	0.75762
5.6	-0.10479	0.12112	-0.19982	**0.76443**	-0.05393	0.10288	-0.11760	0.19377	0.09838	0.72448
5.5	-0.04461	0.10866	-0.12922	**0.67852**	0.14484	-0.00214	0.23481	0.26769	0.03680	0.64002
5.7	-0.14391	0.10776	-0.37982	**0.58326**	-0.12698	0.18686	-0.21951	-0.09257	-0.07603	0.63035
1.2	0.16065	0.16466	0.24747	**0.56614**	-0.05913	-0.02771	0.17129	-0.40315	0.04483	0.63282
1.1	-0.11461	-0.15214	0.15769	**0.54913**	-0.05401	0.13728	0.07799	-0.06194	0.02686	0.39510
3.3	0.01372	-0.04333	-0.07999	-0.05617	**0.84608**	0.01690	-0.17525	0.16604	0.13020	0.80299
3.4	0.13157	0.19621	0.21286	-0.05037	**0.78346**	-0.28334	0.03683	0.07169	0.06270	0.80817
1.8	0.12200	-0.16333	-0.09327	0.10060	-0.20931	**0.73846**	0.23014	0.18860	-0.01093	0.73817
1.5	-0.11291	-0.12392	0.28030	0.32712	0.03187	**0.72516**	-0.05753	-0.17434	0.07781	0.78031
1.6	0.07037	0.02754	0.05961	0.10600	-0.05523	0.16392	**0.80704**	0.04943	0.14001	0.72378
1.4	0.12379	-0.05457	0.32058	0.12053	-0.01737	0.38092	**-0.63278**	0.26482	0.09097	0.75982
1.7	0.31063	0.13258	0.13071	0.15693	-0.23270	0.37849	**0.61310**	0.32845	-0.15136	0.85987
3.5	-0.20958	0.10756	0.23962	0.18006	0.29619	0.04716	0.06586	**0.74830**	0.00095	0.79958
3.1	-0.21907	0.28953	0.00414	0.08704	0.10547	-0.03692	-0.05415	0.04125	**0.75024**	0.71939
3.2	-0.15236	0.15858	-0.31746	0.11239	0.38809	0.28939	0.06774	-0.12827	**0.53304**	0.70131
Σa^2; Σh^2	7.39066	6.05653	2.94659	2.34580	2.33122	2.02770	1.97350	1.60596	1.45819	28.13614
% common variance	26.27	21.53	10.47	8.34	8.28	7.21	7.01	5.71	5.18	100.00
% total variance	20.53	16.82	8.19	6.52	6.48	5.63	5.48	4.46	4.05	78.16

variance. This factor deals with the existing accounting standard setting process in South Africa.

Factor 4 represents 6,52 percent of the total variance. High loading factors are represented by Questions 5.5 through 5.7 and Questions 1.1 and 1.2 and together represent 85,56 percent of the variance accounted for by Factor 4 or 2,57 percent of the total variance. This factor is concerned with various aspects of accounting theory including the lobbying process in the standard setting process and management discretion in the choice of accounting standards.

Two items, Questions 3.3 and 3.4 have high loadings on Factor 5 which accounts for 6,48 percent of the total variance. These factors account for 57,04 percent of the variance accounted for by Factor 5 and 1,70 percent of the total variance. Factor 5 appears to be concerned with managements' discretion in not complying with existing statements of generally accepted accounting practice if these practices reduce current year's earnings.

Factor 6 accounts for 5,63 percent of the total variance. Two items represented by questions 1.5 and 1.8 account for 52,83 percent of the variance accounted for by Factor 6 and 1,37 percent of the total variance. Factor 6 covers a particular dimension of positive accounting theory.

Three items represented by Questions 1.4, 1.6 and 1.7 account for 72,3 percent of the variance represented by Factor 7 and 1,83 percent of the total variance. Factor 7 represents 5,48 percent of the total variance explained by this factor. As with Factor 6, Factor 7 is concerned primarily with specific aspects of positive accounting theory.

Factor 8 represents 4,46 percent of the total variance. One item represented by Question 3.5 accounts for 34,87 percent of this variance and 0,72 percent of the total variance. This factor appears to be concerned with alternative, as yet, uncodified deferred taxation practices.

Factor 9 represents 4,05 percent of the total variance. Two items representing Questions 3.1 and 3.2 account for 58,09 percent of this variance and 1,08 percent of the total variance. This factor is concerned with whether deferred taxation represents an actual liability of the firm that will become payable in the future.

5.11 CRONBACH'S ALPHA COEFFICIENT: DISCUSSION AND INTERPRETATION OF RESULTS

Evaluating the statistical data in terms of Cronbach's alpha coefficient, and using the reliability guideline of 0,80 suggested by Oppenheim (1992, 159), it can be concluded that with an overall value of 0,8162 that the internal consistency of the questionnaire determining the views of respondents to the various issues surrounding deferred taxation has been established.

5.12 SUMMARY

This chapter described the findings and results of the four independent case studies of responses by interested parties to Discussion Paper 5, the unpublished memorandum, Exposure Draft 61, and Exposure Draft 72.

From the results of the case studies, the following tentative conclusions can be drawn:

- individual members of the South African Institute of Chartered Accountants will be more inclined to respond to a structured questionnaire (as was the case in Discussion Paper 5)

- the more complex the exposure draft, the less likely it appears to be that individual members of the South African Institute of Chartered Accountants would respond to the exposure draft

- companies will lobby in favour of a proposed statement of generally accepted accounting practice that they perceive will result in sustainable increased earnings

Furthermore, the responses of these case studies, in particular those on Exposure Draft 61 and Exposure Draft 72, provide supplementary evidence to hypothesis 8 that resources are expended in attempting to influence the standard setting process.

The statistical methods employed to analyse the responses to the survey questionnaire were described. The chi-square goodness-of-fit and the Pearson's r correlation coefficients were used to test the hypotheses developed in Chapter 4. A factor analysis summarised the data and the resultant factors were compared to the hypotheses tested. Cronbach's alpha coefficient was calculated to establish the validity of the composition of the questionnaire used.

The results of the eleven hypotheses tested were described, each of which provides information about respondents views to various issues surrounding deferred taxation. These tests reveal that respondents believe that:

- accounting theory in South Africa can be considered normative in nature
- the object of providing for deferred taxation, to achieve a proper matching of the tax charge against the income to which it related, is appropriate in South Africa
- deferred taxation represents a liability that will become payable in the future
- corporate management must comply with codified statements of generally accepted accounting practice even though this practice adversely impacts reported earnings
- the existence of management compensation schemes will influence managements' response to an exposure draft, which, if formalised and presented as a statement of generally accepted accounting practice, will adversely affect reported earnings
- the implementation of the current statement on deferred taxation, AC 102 (revised) *Taxation in Financial Statements*, did not result in modification to existing compensation schemes
- financial statement user groups are willing to expend resources in trying to influence the standard setting process
- corporate deferred taxation practices are consistent with codified generally accepted accounting practice as required by statement AC 102
- current South African deferred taxation practices are comprehensive and inclusive of all possible accounting options
- legislation should be incorporated into the Companies Act making adherence to statements of generally accepted accounting practice mandatory in future.

These findings, together with the results of the case studies, provide the necessary platform on which various conclusions and recommendations can be made.

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CHAPTER SIX

CONCLUSIONS AND RECOMMENDATIONS

6.1 INTRODUCTION

This chapter analyses and evaluates the overall findings of the present study, and identifies some areas for future research that has emerged from this investigation.

This study has examined South African deferred taxation practices within the context of the competing positive and normative accounting theories. The literature review discussed the competing theories of accounting and examined various philosophies of science and their relevance to accounting.

The nature of deferred taxation was reviewed and the theoretical purpose that underlies the creation of deferred taxation accounts in the financial statements of companies was examined. Alternative deferred taxation practices employed in South Africa and the effect that these practices have on the results and disclosure in financial statements were also examined.

Four individual case studies were conducted on the responses by interested parties on the pronouncements issued by the Accounting Practices Committee on deferred taxation. A survey questionnaire to determine the views of respondents on the various issues surrounding deferred taxation was forwarded to those interested parties who commented on the various pronouncements on deferred taxation issued by the Accounting Practices Committee.

The conclusions drawn from the results of this study are summarily listed:

- accounting theory in South Africa can be considered normative in nature

- respondents do not appear to be aware of the relationship between positive accounting theory and the standard setting process, indicating a possible lack of appreciation of accounting theory

- the objective of providing for deferred taxation, to achieve a proper matching of the taxation charge against the income to which it relates, is appropriate in South Africa

- deferred taxation represents a liability that will become payable in the future

- corporate management must comply with codified statements of generally accepted accounting practice even though this practice adversely impacts reported earnings

- the existence of management compensation schemes will influence managements' response to an exposure draft which, if formalised and presented as a statement of generally accepted accounting practice, will adversely affect reported earnings

- the implementation of the current statement on deferred taxation, AC 102 (revised) *Taxation in Financial Statements*, did not result in modification to existing compensation schemes

- financial statement user groups are willing to expend resources in trying to influence the standard setting process

- corporate deferred taxation practices are consistent with codified generally accepted accounting practice as required by statement AC 102 (revised)

- current South African deferred taxation practices are comprehensive and inclusive of all possible accounting options.

- legislation should be incorporated into the Companies Act making adherence to statements of generally accepted accounting practice mandatory in future.

The results of the study indicate that, although the recognition of a positive theory of accounting cannot be conclusively shown to exist, certain of the factors that can be said to drive the accounting standard setting process are identified by the respondents. However, it is clear that a positive relationship is perceived to exist between the accounting standard setting process and management compensation.

Based on these findings, certain recommendations concerning accounting theory, the accounting standard setting process and deferred taxation will be made.

6.2 RESPONSE OF PROFESSIONAL MANAGERS TO CHANGES IN ACCOUNTING STANDARDS

The results of this research provide a tentative indication that where management compensation is to be influenced by the issue of an exposure draft which, if pronounced as a statement of generally accepted accounting practice later, will result in a reduction in compensation, management is likely to oppose the content and recommendations of the exposure draft. Furthermore, management, as a member of the financial statement user group, is prepared to expend resources in trying to influence the accounting standard setting process. This view emerges from the case studies examined, particularly the one concerned with Exposure Draft 61. For example, the apparent lobbying of the auditors, Fisher Hoffman Stride by the management of their client Kirsh Trading Limited, who opposed the recommendations contained in Exposure Draft 61, is, it is submitted, an exercise that was not costless.

A statement in the response to Exposure Draft 72 by The South African Breweries Limited (SAB) provides an element of concern. In their response SAB (1988, letter) stated

> *"[I]t is the Group's view that AC 102 does not allow management sufficient flexibility to evaluate the tax profile of their business on an ongoing basis and to report to their stakeholders in accordance with that evaluation".*

While it is accepted that the maximisation of returns to shareholders is one of the primary functions of management, this should not, it is respectfully submitted, be achieved by the influence on statements of generally accepted accounting practice by management to protect their vested interests.

6.3 IMPLICATIONS OF THIS STUDY AS APPLIED TO THE FIELD OF ACCOUNTING

More extensive research is required in South Africa into management compensation schemes and their effect on the standard setting process. However, this is likely to prove difficult due to the "laager mentality" of certain of South African businesses and with what is perceived to be their preoccupation with secrecy. In the light of this study, the following recommendations are appropriate regarding accounting theory, the accounting standard setting process as well as various aspects regarding deferred taxation.

- Consideration needs to be given to incorporating more accounting theory into the undergraduate curricula at universities. Alternatively, the education sub-committee of the South African Institute of Chartered Accountants needs to consider incorporating an accounting theory paper into the final qualifying examinations.

- Research should also be undertaken to determine the extent of the presentation of accounting theory at universities, the reasons for the notable lack of its comprehensive treatment thereof, and its incorporation into the syllabus.

- Amendments need to be incorporated into the Companies Act making adherence to statements of generally accepted accounting practice mandatory (with appropriate penalties for non compliance).

- Whatever method is adopted in the accounting for and provision of deferred taxation, sufficient and appropriate note disclosure should be provided to facilitate the computation of the impact on reported earnings had alternative disclosure been employed.

- Further research should be undertaken, examining the publication of other statements of generally accepted accounting practice and the causation between reported earnings and management's remuneration and their reaction and behaviour towards these new statements.

- Those members of the Accounting Practices Board that are perceived by members to have vested interests that hinder the accounting standard setting process, should be requested to withdraw from serving on the Accounting Practices Board.

- A committee of experts on a particular topic should develop and set accounting standards, with standards being decided on the basis of consensus rather than absolute agreement.

- Members of the South African Institute of Chartered Accountants should be encouraged to become more involved in the initial stages of the accounting standard setting process. This will prevent the standard setting process being "railroaded" by parties wishing to influence the accounting standard .

- The Accounting Practices Committee should educate members in the manner in which they should respond to exposure drafts. This will reduce the large volume of responses where one is unable to determine whether the respondents either support or oppose a proposed statement of generally accepted accounting practice outlined in an exposure draft.

- The South African Institute of Chartered Accountants should reexamine its approach towards the development of statements of generally accepted accounting practice, especially in relation to the voluntary contributions of the members of the Accounting Practices Committee and commentators, and develop a more professional and urgent approach to meet financial statement user needs.

6.4 CONCLUSION

On-going research is essential to any academic discipline with accounting being no exception. Research into theoretical aspects of accounting in South Africa has not been able to compete with the research conducted in the United States of America, Australia and United Kingdom as the resources devoted hereto locally, is minimal. This research will only be conducted and advanced at universities in South Africa if the accounting academic develops an appreciation of accounting theory, finance theory and auditing theory together with an understanding of the relationship among these disciplines.

It is hoped that this thesis is a contribution to that research.

6.5 REFERENCES: CHAPTER SIX

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APPENDIX 1

QUESTIONNAIRE COMPRISING THIS STUDY

University of
Durban-Westville

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4000 SOUTH AFRICA
TELEGRAMS: 'UDWEST'
TELEX: 6-23228 SA
FAX: (031)820-2383
(031)820-9111

DEPARTMENT OF ACCOUNTANCY

LK426
30 July 1992

Dear Respondent

Attached is a questionnaire which is part of a study being conducted by a Master's student in this Department.

I would appreciate your co-operation in his research.

Yours faithfully

D Konar

PROFESSOR D KONAR
SUPERVISOR

University of Durban-Westville

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DEPARTMENT OF ACCOUNTANCY

30 July 1992

Dear Respondent,

I am a lecturer in Financial Accounting at the University of Durban-Westville. I am currently working on the final stages of my M Comm dissertation in the Department of Accountancy at the same university. My supervisor is Professor D Konar of the University of Durban-Westville.

My field of study is "South African deferred tax practices within the context of positive and normative accounting theories".

The empirical work of the dissertation has been completed. A survey of the respondents (including those who participated in discussion groups) to Discussion Paper 5, "Taxation in the Financial Statements of Companies", the unpublished memorandum on deferred taxation issued by the South African Institute of Chartered Accountants, and Exposure Drafts 61 and 72, "Taxation in Financial Statements", will greatly enhance my empirical findings.

All information you supply will be treated in the strictest confidence. Neither your name, the company you represent, or the details you provide will be referred to. Only the analysed results of the survey will be included in my dissertation.

A postage paid addressed envelope is supplied for the return of the completed survey. A speedy return of the completed document will be appreciated.

If you require any further information regarding the survey, please contact me at the university or telephone 820-2549 or 820-2435 (Durban).

Thanking you in advance for your cooperation.

Yours faithfully,

Grant Samkin

G Samkin CA (SA)

QUESTIONNAIRE TO DETERMINE THE VIEWS OF RESPONDENTS TO THE VARIOUS ISSUES SURROUNDING DEFERRED TAXATION

The aim of this questionnaire is to determine the views of respondents to various issues surrounding deferred taxation. In order to avoid any ambiguity, the following definitions relating to the various methods of providing for deferred tax are provided.

"Flow through" method contends that deferred tax should not be provided for in financial statements. Financial statements should reflect the income tax expense as being equal to the income tax expense payable in terms of the income tax return for the year.

"Hybrid basis" combines features of the deferred and liability method of accounting for deferred tax by selecting the most appropriate method of accounting for each particular type of timing differences.
Indicate your response by placing a cross in the appropriate box.

	Strongly Agree	Agree	Disagree	Strongly Disagree
	1	2	3	4
QUESTION 1 There are various approaches to accounting theory. Two of these approaches can be considered either positive or normative. The normative approach to accounting theory considers that accounting theory should prescribe what data ought to be communicated in financial information and how this data should be presented. The positive approach to accounting theory attempts to explain what accountants do thereby enabling predictions to be made about behaviour. In light of the above definitions: Accounting theory in South Africa can be considered either				
1.1 normative in nature				
1.2 positive in nature				
1.3 other (describe)				
1.4 A fundamental principle of accounting, the matching principle, is no longer relevant in South Africa in the light of "deferred tax" statement AC 102 issued in January 1989.				
1.5 The realisation concept can be considered a barrier to financial reporting as this concept precludes the reporting by management of increases in wealth which has not been confirmed by an external market transaction.				

Strongly Agree	Agree	Disagree	Strongly Disagree
1	2	3	4

1.6 In responding to the discussion paper and exposure drafts on deferred taxation, those respondents who are participants in management compensation schemes, had complete and correct knowledge of their economic situation.

1.7 Respondents to the discussion paper and exposure drafts on deferred taxation who participated in management compensation schemes, selected an alternative deferred tax practice that best suited their interest.

1.8 Decision makers in responding to the pronouncements on deferred taxation were motivated by their own narrowly defined self interest and not by the public interest.

QUESTION 2

The original objective of providing for "deferred taxation" was to achieve a proper matching of the tax charge against the income to which it relates.

2.1 Do you consider that this original objective of providing for deferred tax should continue to be applied in South Africa?

Yes No

If you disagree with question 2.1 above, then proceed to Question 3.
If you agree with 2.1 above then:

2.2 Financial statements should recognise deferred tax accounted for on the comprehensive basis.

2.3 Financial statements should recognise deferred tax accounted for on the partial basis.

2.4 It is acceptable for financial statements to account for deferred tax using the "flow through" method.

2.5 It is acceptable for financial statements to account for deferred tax on a "hybrid basis" (where a deferred tax benefit or sacrifice is allocated to some future accounting period).

2.6 It is appropriate that financial statements utilise mechanisms such as a tax equalisation account to minimise the potential of future distortions in attributable earnings as a result of timing differences experienced during the current accounting period.

2.7 The provision for deferred taxation in financial statements enhances the relevance and reliability aspects of the conceptual framework.

2.8 The provision for deferred taxation under the comprehensive basis is tantamount to income smoothing.

Strongly Agree	Agree	Disagree	Strongly Disagree
1	2	3	4

2.9 Because of the subjective nature of the partial basis of providing for deferred taxation, this basis can be utilised as an income smoothing technique.

2.10 Corporate practices currently in operation are consistent with codified generally accepted accounting practice.

2.11 Current practices permitted by statute and codified generally accepted accounting practice are comprehensive enough to embrace all options.

2.12 Which basis of deferred tax accounting do you believe to be the **most appropriate?**

* comprehensive ☐
* partial ☐
* flow through ☐
* hybrid ☐
* other (describe) ☐

....

....

QUESTION 3

Deferred taxation represents a liability in the balance sheet of companies.

3.1 A company has a present obligation for taxes on income that may appear as a result of future income tax assessments.

3.2 The deferred tax liability reflected in the balance sheet represents a true liability of the firm, the entire amount becoming payable in the future.

3.3 Where there is an increase in the corporate tax rate, management is justified in not making an adjustment to the current year's income (if this adjustment reduces the current year's reported earnings) but to adjust the deferred tax liability through reserve accounting.

3.4 Management is justified in changing the accounting policies of companies (e.g. from the comprehensive method of providing for deferred taxation to the partial method of providing for deferred taxation), in order to improve reported earnings.

Strongly Agree	Agree	Disagree	Strongly Disagree
1	2	3	4

3.5 Alternative deferred tax practices exist which, although not codified in the form of a statement of generally accepted accounting practice, would if applied, still result in compliance with the fair presentation requirements of Sec 286(3) of the Companies Act 1973, as amended.

If your answer to question 3.5 above is either strongly agree or agree, briefly describe the practice.

....

....

....

QUESTION 4

Changes in accounting policies mandated by changes in accounting standards influence reported earnings, either positively or negatively.

If you are currently or were previously a financial officer of a company that responded to either the discussion paper or exposure drafts on deferred taxation issued by APC please answer questions 4.1 to 4.5 only. Other respondents are requested to proceed to question 4.6.

4.1 Is a management incentive/compensation scheme in operation in the company you are employed by?

Yes No

4.2 Briefly describe the nature and implementation of the scheme. (The reverse of this page can be used if necessary).

....

....

....

....

....

4.3 Are there certain contractual obligations between the participants of the compensation scheme and the company?

Yes No

4.4 Has the management compensation scheme been altered in response to changes in the statement of generally accepted accounting practice covering deferred taxation?

Yes No

4.5 Have any changes in management compensation schemes been made in response to changes in any other statement of generally accepted accounting practice?

Yes No

If the answer to either 4.4 or 4.5 above is YES, briefly detail what changes were made to the management compensation scheme.

....

....

....

	Strongly Agree	Agree	Disagree	Strongly Disagree
	1	2	3	4
4.6 Management compensation is normally tied to accounting earnings.				
4.7 Management compensation is normally linked to share price performance.				
4.8 Share prices are directly related to earnings that are expected to be generated by the company.				
4.9 Company issued reports that reflect adversely on future cash flow projections affect management compensation during a given period.				
4.10 Changes in accounting policies that may have an unfavourable impact on reported earnings and consequently on management compensation schemes, influence managements' decision to lobby for changes in accounting policy.				
4.11 Management of companies, although complying with statements of generally accepted accounting practice, are able to 'manage' accounting earnings so as to maximise their own compensation.				
4.12 Proposed changes to statements of generally accepted accounting practice which, if implemented, would adversely affect company earnings, influence management to respond to the proposed statement.				
4.13 The implementation of the revised statement AC 102 on deferred taxation has resulted in modifications to existing management compensation schemes.				

Strongly Agree	Agree	Disagree	Strongly Disagree
1	2	3	4

QUESTION 5

The statement on deferred taxation AC 102 was issued by the Accounting Practices Board (APB) after exposure by the Accounting Practices Committee (APC) to interested parties

5.1 Are you familiar with the accounting standard setting process in South Africa?

Yes No

If your answer to 5.1 is YES, then proceed to question 5.2.
If your answer to 5.1 is NO, then proceed to **question 5.5.**

5.2 The current standard setting process in South Africa is the best method available.

If you disagree or strongly disagree with 5.2 above, please indicate briefly what improvements you consider necessary. (Use the reverse of this page if necessary.)

5.3 The APB is representative of all potential users of financial statements.

5.4 The APB fairly represent the interests of their constituents.

5.5 Various user groups, through their representatives on the APB, are willing to expend resources in trying to influence the accounting standard setting process.

5.6 Accounting statements (current and previous) covering deferred taxation have allowed management of companies too much flexibility of choice in accounting for deferred tax.

5.7 Legislation should be incorporated into the Companies Act making adherence to statements of generally accepted accounting practice mandatory.

5.8 Is there any aspect that is covered in this questionnaire that is approached differently in your organisation?

Yes No

If your answer to 5.8 above is YES, briefly describe?
(Use the reverse of this page if necessary.)

APPENDIX 2

RESPONDENTS TO VARIOUS PRONOUNCEMENTS ON DEFERRED TAXATION ISSUED BY ACCOUNTING PRACTICES COMMITTEE

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APPENDIX 3

CORRESPONDENCE

TECHNICAL DIRECTOR, SOUTH AFRICAN INSTITUTE OF CHARTERED ACCOUNTANTS

TO

SECRETARY GENERAL, INTERNATIONAL ACCOUNTING STANDARDS COMMITTEE

GVT/mt

8 April 1987

Mr D Cairns
Secretary General
International Accounting
Standards Committee
41 Kingsway
LONDON
WC2B 6YU

Dear David,

DEFERRED TAXATION

I think Rick Cottrell or Peter Wilmot will have given you a copy of our Institute's Exposure Draft on Taxation in the Financial Statements of Companies which was published in January 1986.

The approach taken in the document is somewhat different from that taken in other countries, but we believe it does merit consideration. Clearly it is not feasible for our standard setting body to go against the worldwide trends and therefore it is unlikely that this document will be codified as a standard unless there is some support for the approach elsewhere.

For your information I enclose a copy of the Discussion Paper published on the topic in October 1983 and a subsequent Memorandum which was issued to all respondents to the Discussion Paper as well as a copy of ED61. You may find them useful in your consideration of IAS12.

Deferred taxation is causing our standard setting body an immense headache and we do hope that some clear direction will be forthcoming in the accounting world in the not too distant future.

Kind regards

Yours sincerely

G V Terry
TECHNICAL DIRECTOR

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