



# Reporting News



## COVID-19 Financial Reporting Issues Update

July 2020

The [March 2020 Covid-19 Edition of KPMG's Reporting News](#) outlined a number of financial reporting issues arising as a result of Covid-19. Detailed guidance can be found [here](#).

The New Zealand Government has introduced a number of measures to assist businesses and other organisations in New Zealand. In particular, the wage subsidy and changes to tax deductibility of depreciation of certain properties raise several reporting issues for New Zealand entities. This Update focuses on the accounting issues related to these NZ specific issues.

### Accounting for deferred tax – reintroduction of tax depreciation for certain buildings

As part of its response to Covid-19 the Government has reintroduced a tax deduction for depreciation on commercial and industrial buildings (including hotels and motels) from the 2020-21 income year.

When the tax deduction for depreciation on buildings was removed in 2010, entities that owned such buildings were required to recognise a deferred tax liability. Where entities constructed or acquired buildings subsequently, they would have applied the initial recognition exception ("IRE") (assuming the acquisition did not impact accounting or tax profit and was not part of a business combination) and were not permitted to recognise deferred tax.

Entities that own commercial and industrial buildings will need to consider the deferred tax implications arising from the reintroduction of a tax deduction for depreciation on such buildings, in particular the tax bases attributed to such buildings.

### Calculating deferred tax – relevant accounting guidance from NZ IAS 12

Deferred tax is calculated on the amount of temporary differences, being differences between the carrying amount of an asset or liability in the statement of financial position and its **tax base**. Temporary differences may be either:

- (a) *taxable temporary differences*, which are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled; or
- (b) *deductible temporary differences*, which are temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

When the initial recognition exception is applied, an entity does not recognise subsequent changes in the unrecognised deferred tax liability or asset as the asset is depreciated.

Deferred tax assets and liabilities are measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period and which reflect the manner in which the value of the building is expected to be recovered – through use or sale.

For buildings that are held for use the tax rate is the entity's marginal income tax rate. For investment properties that are measured using the fair value model, there is a rebuttable presumption that the carrying amount of the investment property will be recovered through sale. Accordingly, unless the presumption is rebutted, the measurement of the deferred tax liability or deferred tax asset reflects the tax consequences of recovering the carrying amount of the investment property entirely through sale.

### Are all buildings impacted by the change?

No. Not all buildings qualify. Residential buildings, dwellings and certain short-term accommodation do not qualify. Entities, that hold such assets, will not be able to recognise a tax base, so their current accounting position is unchanged.

### What is the tax base of a building upon change of tax law in 2020?

The tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset.

### When the carrying amount of a building is expected to be recovered entirely through use?

In this case, the tax base will depend on the date the building was acquired or constructed, the revised **tax book value** of the building and the **remaining useful life** of the building over which tax deductions can be made. As long as an asset is "available for use", as defined in tax law, an entity can still claim a tax deduction for depreciation – so this is not expected to be longer than the remaining useful life. We note also that NZ IAS 16 requires entities to review the useful life of an asset at least at each financial year-end, if expectations differ from previous estimates.

### When the carrying amount of a building (held on capital account) is expected to be recovered entirely through sale?

In this case, the tax base of a building, classified as investment property under NZ IAS 40, is limited to tax depreciation to be recovered on sale. So, there will be no change to the tax base of such buildings until the end of 2020-21 income year.

### How are the temporary differences determined?

In our view, when assets are revalued for tax purposes, to the extent that the tax base is increased to the same level as the carrying amount, this increase represents the reversal of the previously determined taxable temporary difference, rather than the origination of a deductible temporary difference - i.e. these are not separate temporary differences for the property, plant and equipment and its subsequent revaluation.

### What is the impact on pre and post-2010 buildings held for use?

	<i>Buildings acquired or constructed before May 2010</i>	<i>Buildings acquired or constructed after May 2010</i>
<b>Tax book value</b>	<ul style="list-style-type: none"> <li>– the adjusted tax book value at the end of the 2010–11 income year, less fit-out deductions taken; plus</li> <li>– non-deductible capital expenditure on the building from the end of the 2010–11 income year to the start of the 2020–21 income year.</li> </ul>	<ul style="list-style-type: none"> <li>— the cost of the building; plus</li> <li>— non-deductible capital expenditure on the building from the time it was acquired until the beginning of the 2020–21 income year.</li> </ul>

	<i>Buildings acquired or constructed before May 2010</i>	<i>Buildings acquired or constructed after May 2010</i>
<b>Tax base</b>	<ul style="list-style-type: none"> <li>– The tax base for pre-2010 buildings will therefore be the tax book value as described above adjusted as necessary to reflect the tax deductions available over the remaining useful life of the building.</li> </ul>	<ul style="list-style-type: none"> <li>– The tax book value for post-2010 buildings also needs to be adjusted as necessary to reflect the tax deductions available over the remaining useful life of the building.</li> </ul>
<b>Calculation of deferred tax</b>	<ul style="list-style-type: none"> <li>– Deferred tax is calculated on the difference between the carrying value of the building and the tax base.</li> </ul>	<ul style="list-style-type: none"> <li>– For post-2010 buildings the reintroduction of the tax base, in our view, represents the reversal of the previously unrecognised temporary difference (being application of the IRE) and not a new deductible temporary difference.</li> <li>– Hence deferred tax is recognised only for the excess of the tax base over the carrying amount.</li> </ul>

### What are the practical considerations?

Practically it will be important for entities to have records to track capital costs since May 2010.

To the extent the law change results in a deferred tax asset, entities will need to consider whether the recognition criteria are satisfied.

### Where in the financial statements will the deferred tax impact be recognised?

The change in deferred tax will be reflected in the statement of financial performance in tax expense with a corresponding change recognised in the statement of financial position. The principle in NZ IAS 12 is that tax follows the underlying transaction. Depreciation on buildings will be reflected in the profit or loss. Therefore, any change in deferred tax as a result of the reintroduction of a tax deduction for depreciation should also be reflected in profit or loss, even if the revaluation model is applied, because the change in tax base is not related to an accounting revaluation of an earlier or future period.

## When will the deferred tax impact be recognised?

In New Zealand generally a law is considered substantially enacted when it has passed the third reading in the Parliament.

The change to tax law passed the third reading in Parliament on 17 March 2020 and received Royal Assent on 25 March 2020. Therefore, the deferred tax impact should be recognised for all reporting periods ended after 17 March 2020.

### Example: Deferred tax on buildings

This example aims to illustrate the impact of the change in tax law on buildings acquired before 21 May 2010 and after 21 May 2010.

#### Basic fact pattern

- Entity A has a balance date of 30 June.
- On 1 April 2010, Entity A acquired a building (Building Z) for \$100, and a tax base of \$100.
- On 23 May 2010 Entity A acquired Building Y, also for \$100, and a tax base of zero. Neither of the building acquisitions was part of a business combination.
- The buildings are accounted for using the cost model under NZ IAS 16. Their carrying value is expected to be recovered entirely through use.
- Building Z was depreciated on a straight-line basis at 2% for accounting and tax purposes. No accounting depreciation is charged in the year of purchase.
- On 21 May 2010 the Government removed the tax deduction for depreciation effective from the 2012 income year.
- Consequently, the tax base reduced to nil and the entity recognised a deferred tax liability in respect of Building Z.
- In March 2020 the Government reintroduced a tax deduction for buildings at a rate of 1.5% straight-line from the 2021 income year, based on the tax book value at 30 June 2010. (The alternative is 2% diminishing value, which is not applied in this example).

#### Building Z (acquired 1 April 2010)

- IRE didn't apply because Building Z was acquired prior to the tax law change in May 2010.
- At the time of the law change the tax base of Building Z is restated to reflect the future tax deductions available over the remainder of the accounting useful life.
- The tax base of Building Z is \$57.60. This represents the tax book value of the building (\$96 as at 2012) adjusted to reflect the fact the remaining useful life of the building at 2020 is 40 years.
- The maximum amount that will be deducted for tax purposes is \$57.60 ( $96 * 1.5% * 40$ ).
- At 30 June 2020, the carrying amount of the building for accounting purposes was \$80.

- Entity A recognises a deferred tax liability of \$6.27  $[(80-57.60)*28%]$  - a reduction of \$16.69 from the previous year.

Reporting date	Carrying amount	Tax base	Temporary difference	Initial recognition exception	Adjusted temporary difference	Deferred tax liability/(asset) @28%	P&L tax expense/(credit)
30 June 2010	100	2	98	0	98	27.44	27.44
30 June 2011	98	0	98	0	98	27.44	0
30 June 2012	96	0	96	0	96	26.88	(0.56)
↓							
30 June 2019	82	0	82	0	82	22.96	(0.56)
30 June 2020	80	57.60	22.40	0	22.40	6.27	(16.69)

#### Building Y acquired on 23 May 2010

In addition to the above basic fact pattern:

- IRE was applied because Building Y was acquired post the tax law change in May 2010.
- The tax base of the building at 30 June 2020 is \$60. This represents the original cost of the building (\$100) adjusted to reflect the fact the remaining useful life of the building at 2020 is 40 years. Hence the maximum amount that will be deducted is \$60 ( $100 * 1.5% * 40$ ).
- At 30 June 2020, the carrying amount of the building for accounting purposes was \$80.
- As the carrying amount of the building is greater than the tax base, reintroduction of the tax deduction is, in our view, considered a reversal of the previous unrecognised temporary difference at 30 June 2020.
- The entity recognises a deferred tax asset of \$0  $[(80-60)-20 (IRE)] * 28%$ .

Reporting date	Carrying amount	Tax base	Temporary difference	Initial recognition exception	Adjusted temporary difference	Deferred tax liability/(asset) @28%
30 June 2010	100	0	100	100	0	0
30 June 2011	98	0	98	98	0	0
30 June 2012	96	0	96	96	0	0
↓						
30 June 2019	82	0	82	82	0	0
30 June 2020	80	60	20	20	0	0

In this case the tax base is lower than the carrying amount, which means only a portion of the IRE is reversed and no deferred tax is recognised.

#### Accounting for the wage subsidy

The New Zealand Government introduced a wage subsidy to support businesses and other organisations through the impact of Covid-19. To receive the wage subsidy entities must satisfy a number of conditions entities, including:

- a decline in revenue (actual or predicted) of at least 30% in the period between January 2020 and 9 June 2020. The scheme has recently been extended and the decline in revenue for the period beyond the initial scheme is now 50%;

- retention of the named employees for a period of 12 weeks (duration of the initial subsidy). This is a further 8 weeks under the wage subsidy extension;
- have taken steps to mitigate the financial impacts of COVID-19, these may include:
  - drawing on cash reserves<sup>1</sup>;
  - activating a business continuity plan;
  - making an insurance claim;
  - proactively engaged with the entity's bankers;
- seeking advice and support from various bodies e.g. Chamber of Commerce, relevant industry associations, regional business partner programmes; and
- Pay the named employees at a minimum:
  - for any work they do at normal rates;
  - at least 80% of their income where reasonably possible;
  - the full subsidy amount for each named employee or their full salary where they earn less than the subsidy.

### How should entities account for the wage subsidy – as an agent or a principal?

While entities are required to pass the wage subsidy received onto its employees, it is the entity that applies for the subsidy and the entity, not the employee, that must meet the conditions to be eligible.

The entity is not collecting the wage subsidy on behalf of its employee as an agent, rather its eligibility for the wage subsidy is what allows it to receive the funds. The entity should therefore recognise the wage subsidy as a principal and apply NZ IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*.

### How should the Government Grant be accounted for?

#### Initial recognition

Government grants are recognised when there is reasonable assurance that the entity will comply with the relevant conditions and the grant will be received (NZ IAS 20.7).

This means that entities that have applied and/or received the wage subsidy will need to assess whether they will comply with the conditions related to the grant (as noted above). Receipt of the grant itself is not sufficient evidence that the conditions will be met. In some cases, assessing whether the conditions will be satisfied is subjective. In this case management will need to exercise judgment and document the basis on which they believe the conditions will be satisfied. In relation to the wage subsidy, for example, management will need to consider whether the actions to be taken to mitigate the financial impacts will be adequate and whether the predicted decline in revenues will be less than 30% (or 50% for the period beyond the initial scheme).

Recent events have indicated that some entities may not have been entitled to the wage subsidy as the predicted decreases in revenue were inaccurate when the subsidy

was applied for, and in other cases, application of mitigating steps may have been questionable.

If management is not satisfied that the conditions will be met, the entity should recognise any grant received as a liability and not deferred income. Note – this is not a financial liability as the liability does not arise from a contractual obligation.

#### Profit and loss recognition

Government grants are recognised in profit or loss on a systematic basis as the entity recognises as expenses the costs that the grants are intended to compensate (NZ IAS 20.12). To the extent that the wage subsidy relates to income, entities will recognise the grant as income (or a reduction in wage expense) as the related wages expense is recognised in profit or loss.

#### Presentation

Government grants related to income (such as the wage subsidy) are presented in profit or loss either:

- on its own or under a general heading such as "Other income"; or
- as a deduction from the related expense, in this case wages.

If an entity has previously established its policy on accounting for government grant, it will need to apply that policy to the wage subsidy received.

#### Other considerations

In some circumstances, wages are not always recognised immediately in profit or loss, they may be capitalised to inventory or a qualifying asset such as property, plant and equipment of an intangible asset. This may mean that recognition of the government grant in profit or loss could be delayed until such time as the inventory is recognised in cost of sales or the related asset is depreciated.

### Entities that have received the wage subsidy but subsequently do not meet the conditions may have to repay the subsidy. How should the entity account for the amount that has to be paid back?

**A:** An entity should initially recognise the full amount of the wage subsidy received as a government grant under NZ IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance* if it assesses it was likely to meet the wage subsidy conditions. Where these conditions are not met subsequently, the subsidy may have to be repaid.

For example:

- Under the terms of the wage subsidy, any amount of the wage subsidy that remains after paying a redundant employee during their notice period must be returned to Work and Income.
- Where the actual decline in revenue was not as great as expected the entity may be required to return the wage subsidy received. Management may wish to consider potential reputational damage associated with retaining the wage subsidy.

<sup>1</sup> We note the wage subsidy conditions were amended and this condition only came into effect on 27 March 2020.

- Where an entity receives an insurance claim it may be required to return the wage subsidy received should it no longer meet the 30% reduction in revenue condition. Revenue is defined for the purposes of the wage subsidy as “the total amount of money a business has earned from its normal business activities, before expenses are deducted. If you are a pre-revenue research and development start-up business, you can include a drop in projected capital income when determining a 30% decrease in revenue.”

We suggest entities seek advice as to whether repayment is required in these situations. Where the wage subsidy becomes repayable an entity should treat this as a change in accounting estimate (NZ IAS 20.32) at the date the subsidy becomes repayable and reduce first any unamortised deferred credit related to the grant. If the repayment amount is greater than this, the balance is recognised as a debit in profit or loss. The entity will recognise a corresponding liability for the amount to be repaid.

### What are the deferred tax implications of the wage subsidy?

**A:** In general, deferred tax is recognised for the estimated future tax effects of temporary differences. Temporary differences are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base.

If the entity has recognised the wage subsidy as a government grant (i.e. deferred income to be recognised in profit or loss on a systematic basis as the entity recognises the related wage expenses), then entity needs to determine the tax base for this deferred income.

Inland Revenue has advised that the wage subsidy is not taxable in the hands of the employer, however there is also no tax deduction when the employer pays the employee’s wages up to the amount of the subsidy. As there are no tax consequences either from receiving or paying out the wage subsidy there is no deferred tax on any deferred income amount relating to the wage subsidy. Wages in excess of the subsidy will however still be tax deductible.

#### Example – wage subsidy

Company A applied for the wage subsidy on 20 March 2020 for 10 full time employees, 3 days after the scheme was announced by the Government on 17 March 2020. Company A met all the conditions for the subsidy at that date and has documented this in the paper presented to the Board on 19 March 2020. Company A has a 31 March 2020 year end and the wage subsidy of \$585 per employee per week for the twelve-week period starting 25 March 2020 was received from the Government on 2 April 2020. Wages are not capitalised to inventory or an asset. Company A records the following journal entries:

	\$	\$
<b>20 March 2020</b>		
Dr Receivable from Government	70 200	
Cr Deferred income		70 200
<i>Recognition of Government grant at date reasonable assurance exists</i>		
<b>31 March 2020</b>		
Dr Deferred income	5 850	
Cr Wage expense/Other income		5 850
<i>Recognition of grant income as wage expense recognised in profit or loss</i>		
<i>*No deferred tax recognised on balance of deferred income (\$64 350) at 31 March 2020</i>		
<b>2 April 2020</b>		
Dr Bank	70 200	
Cr Receivable from Government		70 200
<i>Government grant received</i>		
<b>3 April 2020 – 16 June 2020</b>		
Dr Deferred income	64 350	
Cr Wage expense/Other income		64 350
<i>Recognition of grant income as expense is recognised in profit or loss</i>		

### Further information

Further information on the financial reporting impacts of COVID-19 can be found [here](#). As the situation evolves, we will be releasing more guidance. Please watch this space.

If you have any questions on the above, please contact KPMG’s Accounting Advisory Services Team or your regular KPMG contact.

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