CONCEPTS FOR DEFERRED TAX ACCOUNTING

Ancelmus Firdi E.

Abstract

It must be recognized that we are considering tax accounting to be followed in financial statements prepared in accordance with generally accepted accounting principles (GAAP). Financial statements prepared in accordance with tax law and regulation, or fiscal financial statements, may or may not be in accordance with GAAP. Their primary purpose is to be used as a basis for determination of tax liability or compliance, not a fair presentation of financial position or results of operations. Only when the difference between GAAP and tax rules are not material should tax basis statements be considered to be in accordance with GAAP.

Tax Payable (Liability) Method is widely used in Indonesia since it is one of the methods of tax accounting that In line with Indonesian Accounting Standard. (SAK). However this method did not consider the future effects of timing differences between net income accounting based calculation versus net income tax based calculation. Another Liability Method, which is part of deferred tax accounting, was the right method if we want to consider any future tax effect exist because of timing differences.

BACKGROUND

The questions of accounting for taxes relates primarily to reporting of taxes determined based income of the entity. Such taxes are different from taxes levied on compensation paid, duties, real estate, property and other levied collected by tax authorities which are not based upon the income of the entity.

Since the amount of income tax is a function of the calculated income of the entity, it is necessary to have postulates, principles and regulations, which define how certain transaction, are to be included or excluded from the calculation of income. To compound the practical problem further different principles and regulations do exist for the purposes of financial reporting as opposed to the process of the collection of income taxes.

BASIC POSTULATES

General Premises of the preparation of the balance sheet are:

1. Assets should be valued at historical cost. Accounting literature provides for the calculation and reflection of reserves to reflect loss of benefit of the "cost" of assets such as allowances for bad debts and lower of cost or market considerations for inventories.

2. Liabilities should be reflected at the current of the obligation, without reduction for the time value of money.
3. Liabilities should be included if the events giving rise to the obligation have occurred and the amount is capable of being calculated.

General Premises of the preparation of the income statement are:

1. The transactions reflected in the statement must be the result of the completion of the earning process.
2. Gains should no be anticipated and all losses should be provided.
3. There should be a matching of revenues with expenses.

At this point it is well to define two important terms.

Costs	Future benefits that result from the expenditures of the entities assets or incurrence of a liability
Expenses	Those cost which have been used up in the earnings process or have otherwise lost their future benefit to the entity.

ACCOUNTING FOR INCOME TAX

Two thought have developed for the accounting for income taxes. First, and probably the most widely used throughout the world, is the LIABILITY method. The basic tenant of this method is that the reported income tax expense for any period is measured by application of the tax laws and regulations to the summation of the reported transactions for the period under consideration. It has the benefit of simplicity since it does not require other than a calculation of the actual tax liability for the period. Proponents of this method argue that only taxes payable are a liability of the entity. This concept relies heavily on the concepts of the balance sheet. *Caution: the term liability method as used above should not be confused with the term as it is used in deferred tax accounting. They are two different concepts.*

Second is the DEFERRED method. The basic premise is that the income should include a provision for income taxes related to transactions included in the computation of income even if those taxes are not currently payable to the taxing authority. Thus it is necessary to make a calculation separate from the calculation of the actual tax liability in order to make provision for taxes which will be due in the future. Proponents of this method argue that it result in a true matching of revenues with expenses. This method of accounting for income taxes places the emphasis on the statement of income or the performance approach.

A PRACTICAL EXAMPLE

Assume A entity has the following summary of transactions for a three year period:

Year	1	2	3
Sales	100,000	100,000	100,000
Cost of Sales (exc depr)	40,000	40,000	40,000
Book depreciation	30,000	30,000	30,000
Tax depreciation	60,000	20,000	10,000
Tax rate	50%	50%	50%
Capital invested	100,000		
Purchase of PP& E	90,000		

Further the remaining PP&E is abandoned at the end of the three-year life. Finally, for purpose of critical analysis, assume that the volume in units is the same each year as is the cost per unit. Prepare an income statement and balance sheet for each both method!

First of all, we need to calculate the actual income tax payable:

Year	1	2	3
Sales	100,000	100,000	100,000
Cost of Sales (exc depr)	40,000	40,000	40,000
Tax depreciation	60,000	20,000	10,000
Income before tax	0	40,000	50,000
Income tax	**0**	**20,000**	**25,000**

We will proceed to calculate as per request above:

Liability Method

Year	1	2	3
Income Statement			
Sales	100,000	100,000	100,000
Cost of Sales (exc depr)	40,000	40,000	40,000
Depreciation	30,000	30,000	30,000
Income before tax	30,000	30,000	30,000
Income tax	0	20,000	25,000
Net Income	30,000	10,000	5,000
Balance Sheet			
Cash / (other assets)	70,000	130,000	170,000
Fixed Assets	60,000	30,000	0
Total Assets	130,000	160,000	170,000
Taxes payable	0	20,000	25,000
Equity	130,000	140,000	145,000
Total Liability & Equity	130,000	160,000	170,000

Deferred Tax Method

Year	1	2	3
Income Statement			
Sales	100,000	100,000	100,000
Cost of Sales (exc depr)	40,000	40,000	40,000
Depreciation	30,000	30,000	30,000
Income before tax	30,000	30,000	30,000
Income tax - Deferred	15,000	(5,000)	(10,000)
- Current	0	20,000	25,000
Net Income	15,000	15,000	15,000
Balance Sheet			
Cash / (other assets)	70,000	130,000	170,000
Fixed Assets	60,000	30,000	0
Total Assets	130,000	160,000	170,000
Taxes payable	0	20,000	25,000
Deferred tax	15,000	10,000	0
Equity	115,000	130,000	145,000
Total Liability & Equity	130,000	160,000	170,000

Now let take a look at the outcome of this example. In both answers the entity ends up with 170,000 in cash, a tax liability of 25,000 and equity of 145,000. Revenues, cost of sales and depreciation are the same. As a practical matter so is the total tax expense and the net income of 45,000 each respectively.

So what's the big deal. Both method get the same answer. True, but only in total. Look back carefully at income per year.

Year	1	2	3
Sales	100,000	100,000	100,000
Net Income (Liab)	30,000	10,000	5,000
Net Income (Defr)	15,000	15,000	15,000
Equity (Liab)	130,000	140,000	145,000
Equity (Defr)	115,000	130,000	145,000

Which entity is better managed? Which entity has better cash flow or is worth more? Entity following the liability would have a better reputation in year one when its reported earning is twice that of the entity using the deferred tax method. But in year three the investors may look to the accountant to find out why things are really going badly? Are they? Or is it just that the accounting has mislead people about the true operations of the company.

The liability method substitutes a cash flow concept in reporting income taxes. That method is inconsistent with all of the other conventions used in presenting the financial statements. Revenues, which are still uncollected, are included in income, as are costs, in the form of account payable, which have yet to be paid. Why should taxes, which are due in a future period, be treated any differently?

DEFERRED TAX METHOD

Generally there are many difference in the treatment of revenues and expenses in the determination of income in accordance with GAAP and the calculation of income for the determination of an income tax liability. As we have demonstrated above, ultimately there is no difference in total tax expense over the life of the entity, but there may be significant differences in the accounting period to which the expense is allocated.

Deferred tax accounting is a method of allocating the total tax expense for a business entity among accounting periods during the life of the entity. It is predicated upon a theoretical matching of costs with revenue. It result in recognition of taxes which will be due at some time in the future in the determination of current income, not just the actual tax liability for the year.

There are two recognized methods for calculating deferred taxes, the deferred credit method and the liability method. The selection of the method

to be used has no impact on the calculation of the provision for deferred income taxes except when there is a change in the tax rate.

In general the deferred credit method focuses on the income statement and the liability method on the balance sheet. Under the deferred credit method, the provision for deferred income taxes is calculated at the tax rate in effect in the each year during the life of the entity. Any shortfall caused by an increase in rate is recognized only when the accumulated deferred tax credit is depleted. Any overprovision resulting from a decrease in rates is to be recognized only in the year in which all difference between financial and tax reporting has been eliminated. The accounting for differences can be either on an item by item (gross) basis or on an aggregate (net) basis. Under this methodology the deferred tax credit may not always be equal to the estimated future tax liability resulting from future reversal of timing difference.

The deferred tax liability method calculated the provision for current tax the same as the "with" calculation used in the deferred tax credit methodology. However, the provision for the deferred tax provision is different in that it is necessary to schedule out the reversal of the cumulative timing differences at the end of the accounting period and apply the future tax rate to the difference reversing in each year. Under the liability method the provision for deferred tax thus reflects the impact of a change in rates at the time such change in rates, even prospective, becomes known. The liability for deferred income taxes is always the product of the reversal of all timing difference taxed at the rate expected to be in effect in the year in which the timing difference reverse.

Some generalizations may be made:

- Over the life of the entity the actual tax liability will be the same under either method. In calculating, we should not anticipating future income or losses from operations, only the differences themselves.
- Theoretically deferred tax debits may result from the computation, but these debits must be evaluated as to their realization. In general such deferred tax debits should be written off currently as they will very rarely meet the criteria for realization under current accounting rules.

Let's now back to the same example but change the facts as follows.

Year	1	2	3
Sales	100,000	100,000	100,000
Cost of Sales (exc depr)	40,000	40,000	40,000
Book depreciation	30,000	30,000	30,000
Tax depreciation	60,000	20,000	10,000
Tax rate	50%	25%	25%
Capital invested	100,000		
Purchase of PP& E	90,000		

Answer:

Using Deferred Tax Credit Method	Year		
Income Statement	1	2	3
Sales	100,000	100,000	100,000
Cost of Sales (exc depr)	40,000	40,000	40,000
Depreciation	30,000	30,000	30,000
Income before tax	30,000	30,000	30,000
Income tax - Deferred	15,000	(2,500)	(12,500)
- Current	0	10,000	12,500
Net Income	15,000	22,500	30,000
Balance Sheet			
Cash / (other assets)	70,000	130,000	180,000
Fixed Assets	60,000	30,000	0
Total Assets	130,000	160,000	180,000
Taxes payable	0	10,000	12,500
Deferred tax	15,000	12,500	0
Equity	115,000	137,500	167,500
Total Liability & Equity	130,000	160,000	180,000

Deferred Tax Liability Method			
Year	1	2	3
Income Statement			
Sales	100,000	100,000	100,000
Cost of Sales (exc depr)	40,000	40,000	40,000
Depreciation	30,000	30,000	30,000
Income before tax	30,000	30,000	30,000
Income tax - Deferred	15,000	(5,000)	(10,000)
- Current	0	10,000	12,500
Net Income	15,000	25,000	27,500
Balance Sheet			
Cash / (other assets)	70,000	130,000	180,000
Fixed Assets	60,000	30,000	0
Total Assets	130,000	160,000	180,000
Taxes payable	0	10,000	12,500
Deferred tax	15,000	10,000	0
Equity	115,000	140,000	167,500
Total Liability & Equity	130,000	160,000	180,000

Again there are difference in the reported income:

Net Income (def credit)	15,000	22,500	30,000
Net Income (def liability)	15,000	25,000	27,500
Net Income (liability) *	30,000	20,000	17,500

* (From above with adjustment in the tax rate).

The difference is the result of not reflecting the effect of the reduction in tax rate until such time as the timing differences or the related credit are depleted. It would work similarly by deferring the additional expense until the third year if we had increase rather than decreased the rate.

Both method result in considerably different reported income when compared with the Liability method which recognizes the "benefit" of the deferral of the taxes as income in year one and charges the reversal to years two & three.

In practical situations there would likely be many timing difference all working together to complicate the issue and very frequently having offsetting effects.

DIFFERENCES

The need to account for deferred taxes results from differences in the period in which certain items are reflected in the determination of income for financial reporting and tax purposes. In additions some items, which are appropriately reflected in income during an accounting period, may never be reportable for income tax purposes. And visa versa.

Permanent differences. Items, which are included in the computation of income for either book or tax purposes, but not in both, are permanent differences. Some of the more common items include expenses such as benefits in kind which are financial expenses but are not allowable deductions for tax purposes, revaluations which may not be proper book expenses but are deductible for tax purposes, tax exempt income and other similar items.

Timing differences. Items, which included in the determination of both financial and taxable income but in different period, are referred to as timing differences. Common items, which are timing differences, include depreciation, pension liabilities and payments, lease arrangements. The length of time between the inclusion in financial and tax income is not relevant, only the determination as to the ultimate inclusion of the item in the determination of both financial and taxable income.

We should note that permanent differences are considered in the calculation of taxable income regardless of the method of calculating income tax expenses. That is they are considering in the computation taxable income currently and the cost or the benefit is reported in income currently. Or in other words the existence of deferred tax accounting is caused by timing differences. Or while calculating the deferred tax, we need to identify

all the timing differences and should not need to look further for permanent differences.

In order to easier understand the situation, please study carefully the chart as attached on attachment 1

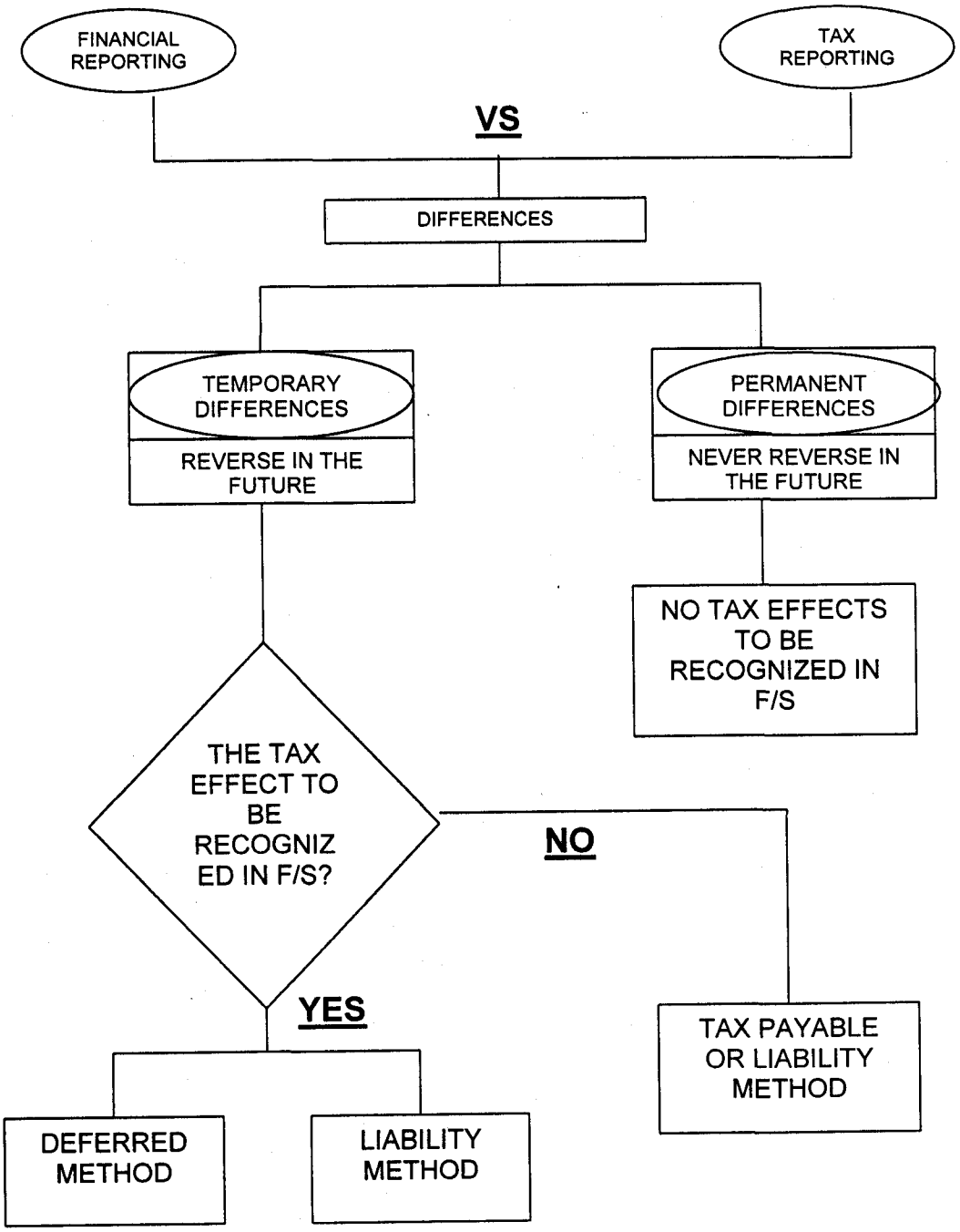
CONCLUSION

Either Tax Payable (Liability) method or Deferred tax method will give the same result in total over the life of entity, but there may be significant differences in the accounting period to which the expense is allocated. Tax payable method may give an entity a higher net income in first years which true needed by some entity during their first years of operation.

However the use of Deferred Tax method may help the entity in managing cash flow by considering tax future effect of items classified as timing differences when calculating the actual income tax. This method is also considered consistent with all of the other conventions used in presenting the financial statement.

Attachment 1

Accounting For Income Taxes



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