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# Theoretical and Practical Aspects of Deferred Taxes in IFRS

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**Abstract:** Accounting rules of any country usually differ from the norms of tax legislation, which can lead to difficulties in determining and accounting for deferred taxes. This article examines the causes of temporary differences in accounting for company's assets under IFRS and provides examples of calculation of deferred taxes. The study authors concluded that: deferred taxes can hide their real financial position of the company; it is always difficult to recognize deferred taxes due to different reasons of their occurrence; some countries use different from the IFRS rules for accounting for deferred taxes. Thus, the calculation of deferred taxes is an important issue of accounting. Taking into account the problems of their calculation and distribution, this topic is an interesting topic for further research in order to explore possible solutions to the existing problems and recognition of IFRS for Russian and foreign companies.

**Key words:**Income of the company % Income tax % Taxable temporary differences % Deferred tax assets % Deferred tax liabilities

## INTRODUCTION

Currently, one of the most important problems faced by the companies is the proper and adequate evaluation of their business activities, the flexibility to manage their current financial statement and the implementation of the effective planning for future activities based on real figures. This is necessary for the survival of the companies in a competitive environment and ensuring their financial stability.

Nowadays, more and more companies refer to the international standards of accounting and reporting. This is a result of international integration, increasing foreign economic relations between countries and their involvement in international capital markets. Companies, which operate on international markets, must provide their foreign partners reliable and publicly available data on the activities of the company. The information provided by the company must also be understandable in order to attract foreign investors and creditors. The most common way to solve this problem is a preparation of financial statements in accordance with International Financial Reporting Standards (IFRS) which are currently used by many leading countries [1].

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The rules of tax legislation of a particular country usually differ from the corresponding rules of the adopted standards of accounting for calculating income. Sovirtually, every accounting system includes a standard which is created to explain the differences that arise between the estimated income tax according to the accounting system and the tax which is really calculated and paid to the budget of the state in the same period [1]. An example of such standard is IFRS IAS 12 "Income Taxes." This standard defines the deferred tax as the amount of tax to be paid in future periods. Simply put, the deferred tax is a tax that will be paid in the future. Under IFRS deferred taxes arise from taxable temporary differences. According to IAS 12, temporary differences can be defined as the differences between the carrying amount of an asset or liability in the financial statement and its tax base i.e. the amount in which an asset or liability is estimated for the calculation of income tax by the competent tax authorities. The deferred taxes in the financial statements show the obligation of income tax that the company needs to pay in the future.

The deferred taxes are important for several major reasons. First of all, deferred taxes help to provide more accurate calculation of accrual earnings as well as a more accurate measure of equity position [2]. Secondly, deferred taxes moderate earnings by increasing the tax liability in “good” years and decreasing the tax liability in “bad” years [3]. Thus, it is very important to show a true financial picture of the company each year. However, the calculation of deferred taxes is complicated and can cause some problems.

Income, which is recorded in the company’s profit and loss statement, usually is different from the taxable income, because the requirements for recognition of income and expense items under accounting standards differ from those under tax law [4]. This happens in different situations such as accounting for depreciation, the cost of construction contracts, lease, when the company receives an advance payment for services, etc. The result of the difference in accounting and tax income is a deferred tax.

The world's first standards of accounting for deferred tax, ARB N 11 (in the U.S.), SSAP 15 (in the UK) and IAS 12, required to keep records on the basis of permanent and timing differences [5]. Timing differences are income and expenses which periods for accounting and tax purposes are different (for example, in the case of application of different rates of depreciation for tax and accounting purposes). These differences arise in the process of income or expense recognition in the financial statement and are redeemed in the process of their recognition for tax purposes and vice versa [6]. The example of these differences could be tax deductions for the cost of fixed asset which is received before or after the recognition of the cost of this asset. Permanent differences arise when the income or expense is recognized only in the financial statement or only for tax purposes [5]. An example of permanent differences can be the expenses in the form of fines, penalties and other sanctions listed in the budget as well as certain tax charges which do not have corresponding amount in the financial statement.

According to FRS 19, the method of recognition of deferred taxes on the basis of permanent and timing differences remained in the UK. In the US, for example, this approaches changed significantly and these changes are reflected in the FAS 109. This method with relatively small amendments was also reflected in IAS 12. These standards refused to recognize the deferred taxes on the basis of permanent and timing differences. Instead, they introduced the concept of temporary differences, which is the difference between the carrying amount of an asset or liability and its tax value (in terms ofIFRS - tax base, US GAAP - tax basis) [5]. Concept of temporary differences considers differences between accounting and tax law from the perspective of the balance sheet, while the concept of timing differences-from the perspective of the profit and loss statement. This is what has determined the names of the methods of accounting for deferred taxes: balance sheet method and income statement method.

In accordance with IFRS (IAS) 12 "Income Taxes", a so-called "comprehensive balance sheet method" of accounting for income taxes is usually used [6]. Its essence is that the book value of the assets or liabilities of the company is compared to their tax bases. The process of this comparison reveals temporary differences between the carrying amount and tax base of assets and liabilities, which are recognized as deferred tax liabilities (DTLs) and deferred tax assets (DTAs) [7]. The carrying amount of an asset or liability is the amount at which the asset or liability is reflected in the balance sheet while a tax base of an asset or liability is the amount at which the asset or liability is recognized for tax purposes [8]. Thus, for purposes of calculating the temporary differences, IFRS requires to create a so-called tax balance [5]. The meaning of a concept of temporary differences is that deferred taxes seek to deal

with the mismatch between the tax payable based on taxable profit and theta expense based on pre-tax accounting profit [2].

The identified temporary differences are divided into deductible and taxable. Deductible differences result a reduction of tax payments in future periods, which leads to the formation of a deferred tax assets (DTAs). In contrast, taxable differences form a deferred tax liabilities (DTLs) which will increase the income tax in the future i.e. create a taxable amounts [7]. It is important to clearly define DTAs and DTLs because it will be problematic to identify errors after recognition. Taxable temporary difference occurs when the carrying amount of an asset exceeds its tax base or when the carrying value of the liability is less than its tax base. Deductible temporary difference appears when the carrying amount of the asset is less than its tax base and the carrying value of the liability is greater than its tax base [5]. IFRS introduces a number of exceptions to the general rule of recognition, where the temporary differences do not lead to the formation of deferred taxes. In particular, it is a recognition of goodwill, recognition of assets and liabilities for transactions which are not taxable as well as individual situations e.g. in case of investments in subsidiaries of the company [2]. The recognition of deferred tax in such cases is the subject of serious disputes and the main reason why for example the UK refuses to use the concept of temporary differences and balance sheet method of accounting [9]. Instead, the UK uses the method based on profit and loss statement when calculating the differences arising from recognition of income or expense for accounting and tax purposes [10].

As mentioned above, the determination of deferred tax can be done in three ways: by deferral method, by the obligations, which arise under profit and loss statement and the balance sheet method. The concept of deferred tax was not used in Russia until recent time. There is still no definition of deferred tax in the current tax law. However, this does not mean that Russian companies as well as foreign organizations that operate in Russia, does not face the issues of deferred taxes.

As stated before, differences in the tax law and accounting arise from differences in the purposes pursued by each of the jurisdictions. Accounting legislation requires the formation of the financial statements, which would show the picture of the real financial situation of the company, while tax legislation pursues fiscal functions of collecting tax payments and very often the restrictions are imposed in the part of expenses [3].

Differences between the accounting and tax law arise mainly from differences in the initial measurement of assets and liabilities, discrepancy of time (speed) of the recognition of income and expenses [11]. As already mentioned, the most significant differences in the rules of accounting and taxation are observed in the assets accounting.

The non-current assets with a limited economic life need to be depreciated. However, in tax accounting, capital allowances of non-current assets can take place [8].When the depreciation charged in the year-end differ from the stated capital allowances, the carrying amount of the asset would differ from its tax base, which will lead to temporary differences.

For example, there is an asset which was acquired in year 1 for $10000. The company is using a straight line depreciation over five years, which gives a depreciation charge of$2000 each year. As mentioned before, deferred tax assets or liabilities arise from temporary differences which result in tax payable in the future. Companies pay income taxes based on the taxable profits. The tax authorities can make some adjustments when determining those profits. For example, depreciation is considered a not tax deductible expense for taxation purposes. However, the tax relief is granted in the form of capital allowances. Consequently, in order to calculate taxable profits, the depreciation should be added back and the capital allowances should be deducted.

Let’s assume that the company was granted the following capital allowances:

The total accumulated depreciation and capital allowances must be equal to the cost of the asset, which is $10000. Now, the temporary differences can be calculated as the difference between the carrying amount of an asset and its tax base (Table 1).

In years 1 and 2 the company has received a tax relief, because the capital allowances are bigger than the depreciation expense, which is good for cash flow because it defers the payment of tax. However, this tax

Table 1: The taxbenefitsfor the years of the assets

| | Capital allowances ($) |
|---|---|
| Year 1 | 3700 |
| Year 2 | 2500 |
| Year 3 | 1500 |
| Year 4 | 1300 |
| Year 5 | 1000 |
| Total | 10000 |

must be paid in the future, because those differences are only temporary. Hence, in years 3, 4 and 5, the company will be charged an additional tax, because the capital allowances are smaller than the depreciation charged.

In year 1, the taxable temporary difference is $1700, which will lead to tax being paid in the future. The expected tax payable is recorded as a tax liability by crediting in the Statement of Financial Position and debiting the tax expense in the Income Statement [8]. If the tax rate is 30%, then in year 1 the DTL of $510 (30%*$1700) will arise. Accordingly, the DTL in year 2 will be $660 (30%*$2200). Taking into account theDTL and tax expense of $510, which was recorded in year 1, the DTL to be recorded in year2 is crediting the liability and debiting the tax expense by $150 ($660-$510).

In year 3 the taxable temporary differences decreased to $1700, which means that the tax to be paid in the future will be $510 (30%*$1700). The DTL needs to be reduces from$660 in year 2 to $510 in year 3 and that is why needs to be debited by $150 ($660-$510). Hence, the tax expense is now credited by $150.

The tax payable in year 4 is $300 (30%*$1000), due to the taxable differences of$1000. The DTL will be reduced from $510 to $300 and debited by $210 ($510-$300), while the tax expense will be credited by $210.

At the end of year 5 the carrying amount of an asset is equal to its tax base that is why there is no taxable temporary differences, which means that the opening DTL of $300 in year 1 needs to be removed and debited while the tax expense of $300 needs to be credited. The results of DTLs are showed in Table 3.

The closing DTLs are recorded in the Statement of Financial Position. IAS 12 is taking a balance sheet approach in calculating the deferred taxes. However, it is also important to see the effects of deferred taxes on the income statement.

Let's assume that the profit of the company before tax for each year is $50000. With a tax rate of 30% it would be logical to expect the tax expense for every year to be $15000.However, we should take into account that income tax is based on taxable profit and not on the accounting profit. First, the taxable profit and tax liabilities should be calculated and then recorded a tax expense.

Table 2: Temporary differences arising during the years of asset's depreciation:

| Year | Carrying amount (cost - depreciation) | Tax base (cost - capital allowances) | Temporary differences |
|---|---|---|---|
| 1 | 8000 (2000) | 6300 (3700) | 1700 |
| 2 | 6000 (2000) | 3800 (2500) | 2200 |
| 3 | 4000 (2000) | 2300 (1500) | 1700 |
| 4 | 2000 (2000) | 1000 (1300) | 1000 |
| 5 | 0 | 0 | 0 |

Table 3: Determination of deferred tax liabilities (DTLs)

| Year | Opening DTL (in the beginning of the year)($) | Increase/Decrease during the year ($) | Closing DTL (in the end of the year) ($) |
|---|---|---|---|
| 1 | 0 | 510 | 510 |
| 2 | 510 | 150 | 660 |
| 3 | 660 | (150) | 510 |
| 4 | 510 | (210) | 300 |
| 5 | 300 | (300) | 0 |

Table 4: Calculation of income tax in result of temporary differences in taxation and accounting

| | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 |
|---|---|---|---|---|---|
| Profit before tax | 50000 | 50000 | 50000 | 50000 | 50000 |
| Depreciation | 2000 | 2000 | 2000 | 2000 | 2000 |
| Capital Allowances | (3700) | (2500) | (1500) | (1300) | (1000) |
| Taxable profit | 48300 | 49500 | 50500 | 50700 | 51000 |
| Tax Liability at 30% | 14490 | 14850 | 15150 | 15210 | 15300 |
| Increase/(decrease) due to deferred tax | 510 | 150 | (150) | (210) | (300) |
| Income Tax | 15000 | 15000 | 15000 | 15000 | 15000 |

As mentioned before, accounting for deferred taxes cause increase or decrease in a tax expense and this need to be taken into account (Table 4).

As we can see from the Table 4, the accounting for deferred taxes based on balance sheet method is ensuring that the matching principle is used, which means that the tax consequences (tax expenses) of an item that are recorded in the financial statements need to be recorded at the same accounting period as the item itself [8].

According to IAS 12, the recognition of deferred taxes on temporary differences, formed as a result of the revaluation of assets, shows the following. Since the value of the assets has increased, the amount of income that these assets can bring in the future has increased too. This future income will be reduced by revaluation of the asset in the accounting and by excluding the cost of revaluation surplus under the tax law. Consequently, the fact of revaluation will cause the company to pay additional income tax. This is why it is important to correctly calculate the deferred taxes because they have an impact on the integrity of the balance sheet and income statement.

However, there are a lot of problems connected to calculation of deferred taxes. First of all, the deferred taxes can obscure the company's real financial situation. For example, accompany can show a deferred tax in the financial statement, but in the future the company may not have enough income to claim a full write-off [12]. Secondly, it is always challenging to recognize the deferred taxes due to the different reasons they arise from. Another problem is that some countries use different accounting rules for deferred taxes than IFRS. In the US, for example, the companies need to offset any deferred taxes that do not materialize, while in IFRS the deferred tax which is not expected to be materialized should not be showed in the company's financial statement [12]. The same is true for the UK, which uses the income statement approach of accounting for deferred taxes instead of balance sheet approach applied by IFRS due to the challenges in recognition of goodwill, investments in subsidiaries, etc '[13-15].

## CONCLUSION

The calculation of deferred taxes is an important issue of accounting. Taking into account the challenges of their calculation and allocation, this topic is an interesting subject for further research in order to investigate the possible solutions for the existing problems and discuss the recognition of the IFRS for Russian and foreign companies.

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