The Economic Function of Deferred Taxes

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By

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CONTENTS

LIST OF ABBREVIATIONS AND BRANDS

IAS 12	International Accounting Standards 12 Income Taxes,
IAS	International Accounting Standards,
IFRS	International Financial Reporting Standards,
IASC	International Accounting Standards Committee
IASCF	International Accounting Standards Committee Foundation,
IASB	International Accounting Standards Board, IASB,
SIC	Standing Interpretations Committee
IFRIC	International Financial Reporting Interpretation Committee,
IFRS	Interpretations Committee Interpretations Committee of International Financial Reporting Standards
HCDT	Harumová Coefficient Deferred Taxes
DT	Deferred Taxes
DT_A	Deferred Tax Assets
DT_L	Deferred Tax Liability
BV	Book Value
TV	Tax Value
DB	Debit
CR	Credit
BV_A	Book Value of Assets
TB_A	Tax Bases of Assets
TB_L	Tax Bases of Liability
BV_L	Book Value of Liability
TV_L	Tax Value of Liability
TD	Temporary Difference
TD_A	Temporary Difference of Assets
TD_L	Temporary Difference of Liability
TB	Tax Basis
BV_N	Net Book Value
TV_R	Tax Residual Value
TR_C	Current Tax rate
TR_{PP}	Tax rate for the Previous Period
TR_{NP}	Tax rate for next period
T_A	Tax Assets
T_L	Tax Liabilities
TT_D	Taxable Temporary Difference

DT_D	Deductible Temporary Difference
DT_{NB}	New Balance Reflected of Deferred Taxes
DT_{OB}	The original Balance of Deferred Taxes
TR_O	The original Tax Rate
TR_N	The new Tax Rate
LD	Linear Depreciation
CA	Cost of an Asset
N_{LD}	Number of years in the Linear Depreciation in Depreciation Group
AD_1	Accelerated Depreciation in the first year
C_1	Coefficient Assigned the first year Depreciation period
$AD_{2\text{-}n}$	Accelerated Depreciation in the second and subsequent years
C_2	Coefficient Assigned the subsequent years Depreciation period
NBV_{PP}	Net book Value of Property at the end of the previous period
n	Number of years for which the Property was Depreciated
IRV	Increased Residual Value
PV	Present Value of expected future revenue, expenditure
CF_n	Cash Flow in individual periods
n	Maturity period of long-term receivables, payables
$1/(1 + i)^n$	Discount Factor
i	Discount Rate
PV_{LC}	Present Value of long-term claims
PV_{SC}	Present Value of short-term claims
P_M	Percentage of the valuation difference for the Month
VD_M	Valuation Difference to the beginning of the Month
IVD_M	Increase the Valuation difference for the Month
ISS	Initial state of Stocks
VPS_M	Volume of purchased Stocks for a Month
VDA_M	Valuation difference attributable to the used Material
AC_M	Actual Consumption for the reference Month
CV_N	Nominal value of Claims
VL_N	Nominal value of Liabilities
PV_{LL}	Present Value of long-term liabilities
PV_{SL}	Present Value of short-term liabilities
S	Securities

INTRODUCTION

Accounting for deferred taxes is difficult and is often discussed in accounting. The issue of income taxes in accounting is encountered in the form of taxes payable, and deferred taxes. The calculation of the amount of tax due, and the rules for its removal, are fully subordinated to tax legislation. Deferred taxes are indeed only a matter of accounting, but the calculation must be based on the relevant tax regulations. The transformation of the accounting profit to the tax base is implemented through imputables items or deductibles. As a result, there arises a situation where the tax base is either higher or lower than the accounting profit or loss. Categories of deferred taxes are accounted in the current year, taking into account how they will look with this modification in the future. Thus, deferred income taxes are one of the instruments that affect compliance with the basic requirement of accounting and the true and fair view of the business activities and results. They are an important tool for correct presentation of tax expenses, and also the result of economy in financial statements.

Deferred tax is an accounting category that forms the part of tax expense and affects the reported amounts of profit after tax. It does not affect the current income tax expense in the current period stated in the tax return; the tax authority does not apply. Accounting for deferred income tax represents the assignment of costs incurred as a result of the obligation to pay income tax for the correct accounting period, as well as revenue generated as a result of entitlement to a reduction of income tax for the correct accounting period. Through the recognition of deferred tax, there mainly applies the precautionary principle in the identification and presentation of income. The transformation of profit or loss - identified in accounting for income tax base, under the Act on Income Tax - is calculated on differences in costs and expenses that are expensed, but the Act on Income Tax does not recognize them. This creates two kinds of differences: a) Permanent differences - which represent an expense or income in the books recognized, but for tax purposes are unrecognized at the time of book keeping or later periods, and b) temporary differences - which represent an expense or income in the books recognized, but for tax purposes will be recognized in later periods.

Temporary differences between the carrying value of assets, and the book value of liabilities and their tax value, are known as the taxable temporary differences and deductible temporary differences. For taxable temporary differences, we charge for deferred tax liabilities; deductible temporary differences are charged on deferred tax assets.

Deferred tax assets and liabilities are measured using tax rates that have been expected to apply in the period in which the deferred tax asset balance, or deferred tax liability, is applied. They are usually accounted as an expense, i.e., to affect profit or loss, or, are settled directly with equity without affecting the income.

This publication deals with the issue of deferred taxes in the theoretical and practical level. In addition to the historical development of deferred taxes - whether in terms of national or international rules - it presents the reasons for their introduction, and their function, in the presentation of the assets and liabilities of an entity in the financial statements concerned. In addition to accounting and tax aspects, the publication also examines financial aspects of deferred taxes and their economic function in a company.

In practical terms, the publication explores selected titles leading to the creation of deferred taxes and the calculation of individual cases. The economic function of deferred taxes, in the publication examined by the application of deferred taxes, is shown as deferred taxes (deferred tax liabilities and deferred tax assets) to adjust for taxes payable by a uniform tax expense (current and deferred tax together).

CHAPTER ONE

HISTORY OF ACCOUNTING FOR DEFERRED TAXES

From an historical point of view, the existence of deferred taxes can be justified as a tool for compliance with certain accounting rules and principles, which should lead to a true and fair presentation for assets and liabilities in the financial statements. According to R. Farkas (2010), for accounting and the preparation of financial statements, there exist certain principles. It should be noted that the terminology of the Accounting Act is unclear in the use of expressions. In accordance with the accounting principles and accounting policies, it uses terms such as, 'principles', 'methods', 'processes', and the like. The basic assumption of accounting in the Slovak Republic defines the Accounting Act; it formulates accounting as a set of obligations that entities must meet. The basic prerequisites of accounting, according to A. Šlosárová (2006), are:

a) The definition of an entity,
b) measurement using a monetary unit,
c) the fiscal year,
d) the verifiability of accounts.

The Accounting Act imposes an obligation respecting the rights of the general accounting principles in accounting and preparing financial statements as reported by B. Soukupová (2004). Accounting and processing, says J. Svobodová (2008), are governed by generally accepted accounting principles. Below mentioned general accounting policies are essential in management and bookkeeping only in terms of above mentioned functions, which should perform accounting. Generally accepted accounting principles, according to K. Máziková (2006), are principles that are required in order to adhere to the entities within accounting and the preparing of financial statements.

Examples include: Principles for achieving a true and fair view; the principle of balance sheet continuity; the accrual principle; the principle of stability of methods; the principle of continuity of the continuation of an accounting entity in its activities; the prohibition of the compensation of verifiability principle; and, the principle of prudence. A. Šlosárová (2015) further complements these generally accepted accounting principles with the following: Priority of substance against the form; valuation principles; substantive and temporal allocation of costs to revenues; and, the principle of explaining (clarifying, illumination) values. According to R. Farkaš (2010), the principles are equivalent, except the principle of true and fair view. The principle of a true and fair view is superior and overrides all other principles. According to the Accounting Act, if an entity determines that the accounting principles and methods used in the accounting period are incompatible with the true and fair presentation of facts, preparation of financial statements is required in order to give a true and fair view of reality. Accounting methods are the methods and procedures used by entities to ensure compliance with accounting principles.

The accounting entity must respect each accounting principle, and it chooses a method, which ensures compliance. The choice of accounting methods is limited by the legislation, as stated by A. Šlosárová (2015) and J. Strählová (2009), and they add that, although the Accounting Act sets out the principles for proper accounting more closely, it does not specify the method of accounting to be used, which makes it possible to select the individual entrepreneurial method of accounting. Therefore, an accounting entity must have developed its own internal guidelines, which also include the determination of the manner, in which it manages the accounting. The accounting entity must use in the accounting period the same accounting policies and accounting principles, according to B. Soukupová (2004). If an accounting entity changes the existing accounting policies and methods during the accounting period, the new accounting principles and methods must be used from the first day of the accounting period. If an accounting entity determines that the accounting principles and methods used in the accounting period are incompatible with the true and fair presentation of the facts, it is required to prepare further financial statements to give a true and fair view. The entity is obliged to present information about, and the justification for, any changes in the accounting policies and accounting principles in the notes adhered to its financial statements. The effect of change in accounting principles and methods, according to R. Farkaš (2010), recognized in the financial statements, does not show through profit or loss of the current accounting period, but shows retrospectively through retained earnings.

According to A. Šlosárová (2015), the purposeful activity associated with application management of thought-processes, methods and forms of balancing accounting entity, in compliance with the general rules and the basic assumptions of accounting, is referred to as ‘balance sheet policy’. In the Slovak Republic, to the legislation gradually get accounting principles and methods contained in IAS/IFRS, as they are principles generally accepted in the market economy, says B. Soukupová et al. (2008). According to R. Šlosar (2010), the US GAAP contains an extensive set of accepted assumptions, accounting principles and methods, and recommended practices and best practices of accounting and financial reporting, which is based on common law. As reported D. Saxunová (2008):

– *Accounting should be based on assumptions* (assumption of accounting entity; the assumption of the unrestricted period of the event, i.e., assumption of continuality; the assumption of a monetary (monetary) unit; and, the assumption of a time unit, or periodicity assumption),
– *Accounting should be based on principles* (the historical cost; the realization principle; the accruals counterpart principle; and, the principle of completeness),
– *Limitations in accounting* (cost-benefit relationship, materiality, prudence, practical practices).

This implies principles and limits, which are used in the development and application of standards that regulate normal accounting procedures and characterize, in due course, the current environment for reporting of financial information, as stated by Šuranová, Z. (2007). Between US GAAP and IAS/IFRS, there exists - according to Škorecová, E. (2010) - certain symbiosis and complementarity, despite the fact that different teams of accountants have been created in different countries. Since 2002, the makers of the two systems, by mutual agreement, have pursued convergence (alignment) of both renowned multinational sets of accounting standards, which should lead to a point in time where they become fully compatible and comparable.

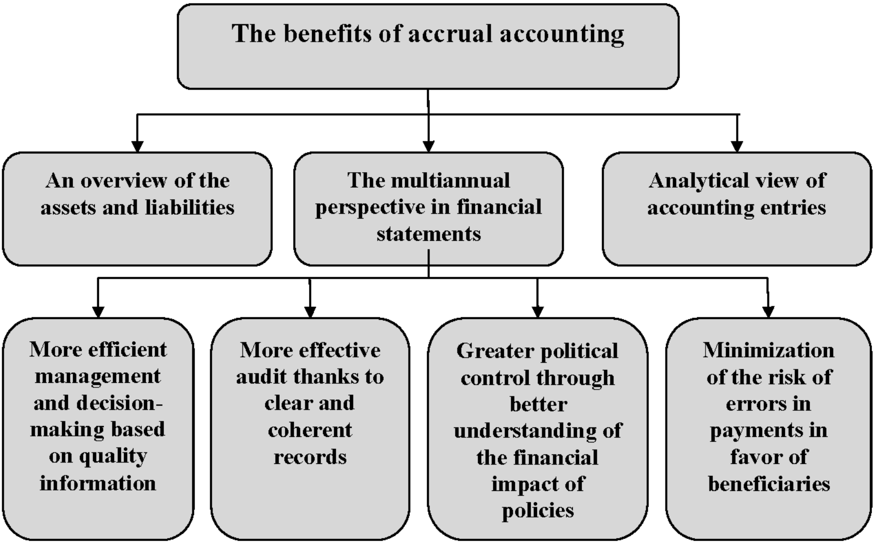
1.1 The reasons for the introduction of deferred taxes

Calculation, accounting and reporting of deferred taxes is an area that is relatively difficult in accounting, and therefore the system is not always accepted by accounting entities with enthusiasm. It expects a relatively good understanding of accounting theory and tax rules, as well as an understanding of the nature of transactions that deferred tax cause. If anyone asks whether the accounting and reporting of deferred taxes has any practical significance, it is possible this publication will convince him/her. Promotion of the accounting rules, on the definition of deferred taxes, may be justified in reference to the need for compliance with generally accepted accounting principles. The most important principles and rules underlying the incidence of deferred taxes may be included in the accrual principle and the precautionary principle, the principle of conservation of the proceeds, and the principle of objectiveness of financial analysis.

1.1.1 Accruals principle as the basic principle for deferred taxes

Accrual principle is the rule for expenses and revenues in the period concerned, in which they are earned and incurred; meaning the costs incurred and income recognized in the accounting period, to which they relate. This principle is applied on a monthly (annual) basis; costs and revenues are therefore calculated in a month in which they are earned or incurred, regardless of whether within the monthly (annual) statements we have, or we do not have, an accounting document - accrual basis. It is an accounting system based on the "origin of the case". In applying the accrual basis, assets, liabilities, own resources, costs and revenues are accounted and presented in the financial statements, when they fulfill the definitions contained in the relevant accounting law. Accrual basis is used in financial accounting by recording revenue when received, and recording expenses in the period in which they occur, regardless of any received or paid cash. Accrual basis, as one of the pillars of double-entry accounting principles, forms the basis of all costs and revenues in the accounting period in which they are incurred, regardless of the date of payment or collection, or settlement date. Accrual principle is emphasized by the independence of the accounting period, which is important in arriving at the profit or loss for the current period and which does not take into account the results of operations in other periods. Accrual basis contributes to the financial statements on the basis that it has to be true and fair, leading to a true and fair view of facts on the management of the company. Accrual accounting is best explained by comparison with more traditional cash accounting. The advantages of the accrual approach are shown in figure 1 - 1.

Fig. 1 - 1 Benefits of accrual accounting



Source: Modernizing of the EU accountancy. Guide to the EU's new financial reporting. The European Commission.

In cash accounting, transactions are recorded only in the case of acceptation, or payment of cash. Cash accounting (as opposed to accrual) does not distinguish between the purchase of assets and the payment of expenses - both are simply 'payments'. In accrual accounting, transactions are recognized when they occur. As an example can be introduced the purchase invoices sent in December, which will be also reported in this year, although the payment should be carried out during next year. The costs of such an invoice would be included in the period to which they are earned or incurred.

1.1.2 The principle of prudence and fair presentation in accounting

The principle of prudence is that it should not be considered uncertain, even if the expected benefits, and, on the other hand, they need to be considered as possible, even if uncertain losses. Basically, accounting entities should not overestimate profits. The unrecognized deferred income tax of an accounting entity also infringes on the principle of caution when reporting profit, because unrecognized deferred income tax may adversely manifest itself in relation to the equity principle entity. These facts must be based on a going concern entity; otherwise, it would not make sense to charge for deferred income tax (Janoušková, 2007).

Deferred tax liability is recognized on account of costs, thus reducing the available profit, which could be distributed to shareholders or owners. This principle is particularly important in the case of accounting for deferred tax assets. Deferred tax assets may be charged only in the event that, in the future, there will be a sufficient tax base so a deferred tax asset can be applied. If the entity is sure about the sufficiently large tax base, and certain deferred tax assets are recognized, it can then divide more disposable income.

The principle of true and fair view, regarding the subject of accounting in the financial statements, means that the entity is required to charge so that the financial statements present a true and fair view of the facts that are the subject of the accounting, and the financial position of the entity. The view in the financial statements is true if the contents of the financial statement items corresponds to the reality and is in accordance with appropriate accounting principles, and methods. The display in the financial statements is true if they are prepared using accounting principles and methods that lead to a fair presentation of the financial statements.

1.1.3 The principle of preserving the essence of property enterprise

The essence of property includes the effective date of the valuation of property components that may, or may not, be recognized in the balance sheet of the company. After an initial measurement, the historical cost of the assets and liabilities are subsequently measured at fair value and are further re-measured every year against the current fair value. Some specific transactions - for example, the merger of another company or part thereof - are required to measure asset or liability at fair value even at its initial recognition. The revaluation of assets and liabilities are differences between the book and tax values that lead to accounting for deferred taxes. Titles included in the calculation of deferred taxes will probably increase in the future. In the process of the further convergence of national accounting standards with international standards, it will form the possibility of the revaluation of certain balance sheet items at fair value that are not accepted by tax rules. Income tax affects the profit after tax, i.e., profit (loss), which is also intended for distribution to owners (partners, shareholders); a share of profits or dividends (Baštincová, 2007). The essence of property, and the survival of businesses, could be jeopardized if the existing temporary differences were in the form of a reflected deferred tax liability; the General Assembly would divide the entire available profit.

1.1.4 The principle of objectiveness of financial analysis

Financial analysis, by construction of formulas for calculation of various financial ratios (profitability indicators, in particular), is based on profit after tax (net profit). Failure to take into account deferred income tax could then create the effect of distortion in the process of comparing the performance of companies due to the over, or understatement, of net income (Tužinský, 2010). Distributable profits are one of the data used to calculate the number of financial indicators, especially for the calculation of profitability indicators. These indicators are often used to compare performance between undertakings, and therefore it is necessary to objectify disposable earnings to avoid skewing of results of comparative analysis. For example, an indicator return on equity (ROE) reflects the equity return, i.e., economic results achieved on deposited funds owners. When calculating return on equity, it is necessary to consider whether to include in the calculation the shareholders' equity in the total amount, or to make certain adjustments (reduction); the calculated values of the indicator are not distorted.

The equity of the company is liable to contain multiple items that are on the accounts of class 4 and properly accounted in accordance with applicable accounting procedures, denouncing not directly about the real owners deposit, as it is more a specific adjustment to the carrying value (revaluation, correction of errors of previous periods, etc.). Equity needs to be adjusted for certain effects that reasonably reflect the real amount of own deposits. Adjustments may relate, for example, to items such as: Sections balance of the subscribed equity impact of the deferred tax asset recorded as expenses, which improve the reported results of operations and, hence, the equity valuation of intangible assets, for example, valuable rights, goodwill, etc., that the risk of overstatement is also unduly increasing the equity. Information on the valuation of individual items of assets and liabilities, grounds and equipment revaluation titles - accounting for deferred tax assets and the like - can be found in the notes of the financial statements. This supporting information can be used to assess the calculation of the indicator and the inclusion, or exclusion, of certain items of equity value.

Investors, when deciding on placing their free funds, shall be decided on the basis of assessment of the profitability indicators, and other indicators of financial analysis. The predictive value of these indicators can be distorted if the deferred tax will not be charged. The importance of accounting for deferred taxes, in this case, is indicated in the following example:

Example 1 - 1
Company A has its data listed, before accounting to the balance sheet, in Table 1 – 1

Tab. 1 - 1 Data of A before accounting for deferred taxes (in EUR)

Fixed assets	7000	Equity	5000
Current assets	3000	Profit	500
		Liabilities	4500
Total assets	**10000**	**Total liabilities**	**10000**

Source: Author's work

If we calculated the return on equity, we could proceed according to the following formula:

$$profitability\,of\ A = \frac{\text{Profit}}{\text{Equity}} = \frac{500}{5000} = 10\ \%$$

Return on equity before accounting for deferred taxes is 10%. The Table 1 - 2 lists the data for the comparison of the company, and after the calculation of deferred taxes in the amount of 250 Euro (deferred tax liability).

Tab. 1 - 2 Company A data and recognition of deferred tax liabilities (in EUR)

Fixed assets	7000	Equity	5000
Current assets	3000	Profit	250
		Liabilities	4750
Total assets	**10000**	**Total liabilities**	**10000**

Source: Author's work

$$profitability\,of\ A = \frac{\text{Profit}}{\text{Equity}} = \frac{250}{5000} = 5\ \%$$

After the recognition of deferred taxes, we may alter the structure of items on the liabilities side. Since deferred taxes represent the tax charges they reduce our results of operations, and tax liabilities increase the total liabilities. If we compare the final profitability of Company A before, and after, the recognition of deferred tax liability, the difference is 5% (10-5).

Example 1 - 2
In another example, we can see the impact of accounting for deferred tax assets. Based on the data in Table 1 - 1, the return on equity before accounting for deferred taxes is 10%. Table 1 - 3 lists a comparison of data for Company A and for recognition of deferred taxes to the amount of 250 Euro (deferred tax asset).

Tab. 1 - 3 Data company and recognition of deferred tax assets (in EUR)

Fixed assets	7000	Equity	5000
Current assets	3250	Profit	750
		Liabilities	4500
Total assets	**10250**	**Total liabilities**	**10250**

Source: Author's work

$$profitability\,of\ A = \frac{\text{Profit}}{\text{Equity}} = \frac{750}{5000} = 15\ \%$$

After the recognition of deferred taxes, we alter the structure of the items on the assets and liabilities. Since deferred taxes from tax income (negative expense) will increase our results of operations, it is leading to increased liability as we increase tax assets total claims on the assets side. Comparing the final profitability of Company A before, and after, the recognition of deferred tax assets; the difference is 10% (15-5).

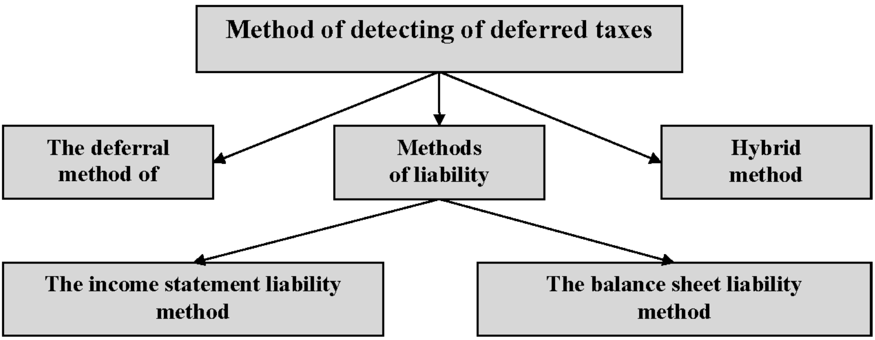
In the example, we can see how we change the items in the balance sheet after the calculation of deferred taxes. Impact on the profitability of the company is evident in accounting for deferred tax liabilities, and the accounting for deferred tax assets. From this, we find that the rate of return on invested capital would be significantly undervalued (or overvalued) if we charged for deferred taxes.

When unrecognized deferred tax liability by the company is distributed more out of distributable profits than it should, it may cause problems in operating activities in the future. When unrecognized deferred tax assets are distributed, the company could divide more from distributable profits to investors; the future can expect lower tax liability due to the reduction of the tax base.

1.1.5 Method of detecting deferred taxes

In professional accounting theory, there are different ways to determine deferred taxes. These methods can differ between each other; mainly from the point of view of temporary differences entering into the calculation of deferred taxes, the tax rate applied, and then the recalculation of deferred taxes of a change in rates.

Fig.1 - 2 Methods for detection of deferred taxes



Source: Author's work

The best known methods for the determination of deferred tax accounting theory include:

- *The deferral method*
- *The liability method of income statement*
- *The balance sheet liability method*
- *The hybrid method*

The deferral method of payment - using this method, revenue and expenses, which are included in the tax base of the current period, will move from the current accounting period to the next. An entity uses, in calculating, the deferred tax rate applicable for the tax period in which the deferred tax is calculated. When changing tax rates, deferred taxes recalculates in subsequent years (Janoušková, 2007, p. 12). The deferred payment method emphasizes the accurate recognition of profit, or loss, in the income statement, and quantifies the extent of such temporary differences influenced by this report. The difference with this method is that when calculating deferred tax, temporary differences multiplied by the tax rate are applicable at the time of these differences. When the temporary differences turn (change), this method of deferred payment, for this approach by the deferred tax, becomes payable and derecognized, using the same tax rate that applied at the time of recognition of temporary differences. In this method, therefore, when changing the tax rate, old balance is recalculated on deferred tax. Deferred tax is captured in the balance sheet amount and is calculated on the basis of the tax rate applicable at the time of the temporary difference, and not on the tax rates that will apply when the tax is payable. This method focuses on the accurate recognition of deferred tax when in profit, but it is not always able to recognize accurately a deferred tax asset, or liability item, in the balance sheet. This does not take into account the change in the tax rate; the deferred tax balance sheet is not the amount that is payable at the time of the rollover (changes) of the temporary difference. In regard to this absence of most of the International Accounting Standards (including IAS and US GAAP), this method is not recommended and, therefore, is not currently used.

Methods of liability – the application of this method of calculation leads to the transfer of liability in order to pay tax in subsequent periods. Unlike the deferral method which will be used the rate applicable at the time, when we will also see the inclusion of a suspense account in the calculation of income tax. Usually, the tax rate at the time of the creation of the balance sheet is not known, so used is rate for the next financial year. The deferred tax is at a rate of change, which is converted in the coming years (Janoušková, 2007, p. 12). Quantification of the deferred tax liability method comprises two approaches. These approaches differ with items that enter into the calculation of deferred taxes. Accordingly, we distinguish:

a) *Result approach* - this approach contains the balance sheet liability method of income statement. By use of result approaches, we deal with disparities between income and expenses in accounting, and tax-deductibles under the relevant tax legislation. By the result approach, we calculate deferred tax timing differences of costs and benefits causing the difference between the tax base and the accounting profit, or loss. The disadvantage of this process is the need for a conversion of the balance of deferred taxes in the balance sheet in line with changes in tax rates. In addition, there are situations when this method *is* used (e.g., in the first year of accounting for deferred tax). This method was used only up to the end of 2002.

b) *The balance sheet approach* - this approach includes a method of liabilities on the balance sheet. By applying the balance sheet approach, we follow temporary differences between the carrying amounts of assets and liabilities in the balance sheet and their tax value (tax base). With the balance sheet approach, we calculate deferred tax on temporary differences arising from the tax bases of balance sheet items (i.e., the difference between their values applied for the purposes of corporation tax, and for accounting purposes). The advantage of this approach is that it is not necessary to recalculate the balance of deferred taxes in the balance sheet, and it can be used even in cases where there are applicable earnings methods (e.g., in the first year of accounting for deferred taxes, or in the case of revaluation of non-monetary deposits or business combinations). In expenses (or in equity), the difference between the opening and closing balances of deferred taxes in the balance sheet must be entered each time (changing its status).

The hybrid method combines the approach of the two previous methods of calculation of deferred tax assets, which are the deferred payment method and method of liabilities. Temporary differences are divided into two groups, and each group is applied to one of the following:

– *The first group* is the costs and revenues that are accounted and disclosed in the accounts, but the tax base will enter in future periods. If the income and expenses recognized in the accounts are not recognized for tax purposes, deferred taxes cannot be quantified with absolute certainty because we do not know all the consequences of these transactions for taxation purposes; they will only be known in the future. In these cases, the method tries to find the best estimation of future deferred tax that applies to temporary differences; tax rates valid at the time of application of deferred tax. So, for these types of temporary differences, within the liability method, we use a deferred tax calculation.

- *The second group* is the costs and benefits that will be reflected in the tax base before they are recognized and recorded in the accounts. If costs and benefits are taxed for the purpose of tax payable before they are recognized as income or expense in the accounts, the deferred tax effect of these transactions is already known. Therefore, the method of deferred payment is applied.

From the above, it is clear that if there is a change in tax rate then this change will affect only a portion of deferred tax and it will be the portion that was calculated on the principle of the liability method. The portion of the deferred tax, in this case, is calculated on the principle of the deferred payment method and is not affected by changing the tax rate because the tax effects of temporary differences are already known in advance. Although this method has some theoretical advantages, it is not used due to the complexity of international accounting standards.

Currently, these methods for the assessment of deferred taxes use the balance sheet liability method, based only on the balance sheet. Under this method, we calculate deferred tax on temporary differences between the book value and tax value (tax base) of each asset and liability in the balance sheet.

1.1.6 Reporting of deferred taxes

The term "reporting" can be characterized as the mechanism of processes procedure monitoring in the enterprise, which should provide, for managers, high-quality information for report processing within all areas of management. The aim of reporting is to create a complex system of information and indicators, which should evaluate not only enterprise development as a whole, but also the development of internal units; thus decided from the point of view enterprise management. On the basis of previous period analysis, reporting creates analyses of management, which results in the processing of reports at various levels of any given enterprise management for external users and obligatory reports. In the past, reporting represented one of a set of subsystems by controlling coordinated enterprise information systems. Within reporting processes from accounting sources, are created reports, statements and statistics with the objective of providing information important for the enterprise management and for its internal units. By its importance, the reporting stands alone as the independent discipline of the enterprise management. It becomes an important tool of management and creation of enterprise strategy, and so helps not only in strategic management, but also in

operative planning; reporting with its information value influences the competitiveness and performance of the enterprise. Reporting can be considered as an “enterprise newscast”, which consists of the creation and distribution of standardized, and also required, sets; also as the automatic enterprise process, which provides (on a regular or occasional basis) required information. Information is the core element for effective enterprise management and rational decision-making regarding to its economic activities. For decision-making, it is necessary to have available information in suitable time and in the correct form, otherwise it is unusable. The precondition of its usability is the existence of the system, which submits information to the particular managerial degree, related to by them managed area, and it filters unnecessary information for the given managerial degree. Regarding the processing of reports in a required structure, there must be available objective information, which is not limited only to classic information from reports of financial accounting.
The aim of reporting is to create the complex system of information *and* indicators, which define the economic activity of the enterprise in an understandable and user-friendly form. Interpretations of required information are formalized by various development levels.

Development levels of information displayed in reporting:

1. Table form of interpretation,
2. graphical interpretation of results, display of trends,
3. object display, trends, diagrams, numbers and points,
4. decision-making models in the form of output reports and recommendations,
5. voice interpretation of results and comments to results,
6. dynamic reporting – time activities directly to managers.

To the most important purposes of reports processing, belong:

– Documentation of events (minutes from meetings, control records),
– formation of actions in the enterprise (report, of which consequence is the plan revision),
– control of enterprise performance,
– preparation of decisions.

Reporting functions are based mainly on controlling functions, as reporting was - for a long time - part of this science discipline. Controlling is a method, of which the objective is to increase the effectiveness of

management systems by means of continuous and systematic comparisons of reality and planned conditions pertaining to the business process by the evaluation of found deviations, finding of causes, suggestions of regulations for rectification, or for updating of determined targets. Due to the fact that we consider planning function as information function, and reporting as the basic function of controlling, it is apparent why there appeared the need for making this science discipline independent.
The main functions of reporting for enterprise management are:

- As a tool for the making of decisions by managers on various managerial levels,
- as a tool for top management, used for monitoring the performance of enterprise targets.

Reporting process is the process of introduction of the item, which fulfills the definition of a basic unit of accounting reports, and meets the report-making criteria. Basically, reporting contains the description of the item in a word *and* in numerical form. The item, which meets the criteria of reporting - on the basis of meeting the criteria of balancing - should be reported in the balance sheet, or in the profit or loss account. The last level, of the process of recording the items of final accounts, is their publication. In this phase, the accounting unit itself has to choose the most suitable method for publication pertaining to all circumstances, leading to correct and accurate reporting of all items of the final accounts.

Reporting can be divided into several points of view:

1. The time point of view:
   - retrospective reporting,
   - future-focused reporting.
2. The focus point of view:
   - partial reporting,
   - aggregated reporting.
3. The environment point of view:
   - Reporting evaluating external environment,
   - reporting evaluating internal environment,
   - combined reporting.

By correctly executed reporting, we mean, the enterprise should not be left with any “white space”, or the area, of which results and changes are not monitored or reported. In this way, the management is able to manage the enterprise with the synergic effect towards the fulfillment of all determined objectives. Each reporting should be governed by certain basic rules:

1. Focus on the objective,
2. focus on the problem area,
3. focus on the activity.

Information needs of the management, and of external user groups, divided reports - according to the great number of factors - into several types:

1. According to the obligation of their creation on:

a) Obligatory reports – are created on the basis of relevant legal norms and provisions. To obligatory accounting reports, providing important information in some enterprises, belong, for example:

1. Balance sheet – demonstrates the financial condition of the enterprise,
2. profit and loss account – provides the view on enterprise performance,
3. cash-flow report – displays the cash-flow for evaluated period,
4. equity change report – presents causes of changes in items of equity,
5. notes – provides additional and explanatory information,
6. annual report – summary report on management and enterprise activities.

b) Other reports – provide information mainly for the enterprise management, which can be:

1. A report on management results analysis,
2. a report on cumulated management results,
3. a report on the use of enterprise assets,
4. a report on the financial investments of the enterprise, etc.

The main aim of the reports is in informing about the current management, but also in informing about the prediction of management in the future.

2. According to the purpose of report submitting

a) Standard – these are reports created at regular intervals, with a structure determined in advance, e.g., information on real values, deviations, deviations analysis, and the calculation of expected values at the end of the period, etc. Usually, these reports are submitted monthly, quarterly, or annually, but, if necessary, such reporting can be carried out on a weekly basis, or on a 14-day basis. Considered, should also be the effectiveness of provided services.

b) exceptional – these are reports created on request, which can be exceptional from the point of view of processing a deadline or standard structure, but these reports can also be exceptional reports and analyses, as, for example, in risk analysis of assortment groups, etc., which are not created on a regular, or usual, basis.

3. According to the time point of view

a) Daily reports – are submitted by items of final accounts, which play a significant role in enterprise management;

b) monthly reports – most of accountancy outputs are submitted on a monthly basis, while managers should receive these reports at least during the first week of the following month;

c) quarterly reports – e.g., tax reports on paid tax;

d) annual reports – reports informing about overall enterprise development, e.g., annual reports, which serve for the modification and evaluation of business strategy;

e) exceptional (special) reports – are submitted to the management "only from time to time". These are occasional reports for the evaluation of some concretely occurring situation.

Basic necessities of reports – in the processing of required reports, it is necessary to be based on the purposes and needs for which these reports will serve. For the high level of readability of created reports, it is necessary that they should contain basic necessities, which can be divided into two basic groups on the basis of certain characteristic features:

1. *Formal necessities of reports should contain mainly:*
   – the report title,
   – the purpose of report creation,
   – the date of report compilation,
   – the date of report issue/creation,
   – the stating of the person responsible for the report.
2. *Content necessities of reports should contain mainly:*
   – The report content focus,
   – the system of including, or dividing, data into particular units (items),
   – the units, with determination of basic data (data in €, foreign currency, data in thousands of €, etc.),
   – the link on internal directives of the company (reporting system should be governed by in-house directive).

Self-reporting relationship – includes the agreement on trustworthiness, which represents the reporting of information on sale, licensing, details on accepted cash or register of costs by supplier, customer, distribution, license and employee relationships. According to experience of KPMG, at least 70% of self-reporting reports are untrue. Reasons for this arise from errors, misunderstandings, occasionally fraud, but, in the end, there are always consequences.

Reporting by Exception – manager should focus only on exceptional results (good or bad) in order to be alleviated from routine information on “normal”. It is an exceptional intervention of managers by occasional deviations of real data from determined standards, which - in European literature - is known under the term “Management by Exception”.

Reporting of the enterprise individual final accounts – the basic task of the individual final accounts is the presentation of facts about the enterprise, which are the subject of accountancy for internal and external users. After the conclusion of the accounting period (also tax period), entrepreneurs create accounting and tax reports, of whose obligation to create such reports arises from accounting and tax legislation. The tax return (as the tax report) is not part of the final accounts, however, the obligation to put paid and deferred taxes into accounts is created already before the compilation of the final accounts. Users of accounting information also require objective and comparable information on the international level. One of the conditions of such comparability is also the reporting of deferred taxes. The basis of final accounts is to find out to the determined day the condition of property and debts of accounting unit valuated in monetary units, and in the formulary structure to express the management result, and to the date of final accounts to present the cash-flow of accounting period. From the tax point of view, we will focus on property reporting (claims against the tax office) and debts (liabilities against the tax office) in the balance sheet, and the reporting of costs and profits (decreasing of costs) in the profit and loss account, after taking into account paid and deferred taxes.

Transfer differences between the accounting values of the property and its tax base can, in some cases, arise already by establishing of the accounting unit, which regarding to its establishing creates the equity, without regards on the fact, whether it creates the equity on obligatory (legal) basis, or on voluntary basis. By establishing the accounting unit - of which equity is created from the deposits of partners (except the deposit of the enterprise, or of its part, into the equity of a newly-established accounting unit) - transfer differences can appear only between the accounting property value and its tax base, i.e., there will not appear transfer differences between the accounting value of liabilities and the tax base. Part 2, of this work, deals with selected titles leading to the formation of deferred taxes. The basic objective of the correct final accounts is to provide information about financial position, financial performance and cash-flows of the accounting unit for the needs of the wider circle of users by adoption of economic decisions.

Reporting of enterprise consolidated final accounts – consolidated final accounts are the final accounts created on the basis of the individual final accounts of linked enterprises from the point of view of the capital; they are the final accounts for the consolidated complex unit (group of enterprises). The obligation for the creation of consolidated final accounts, for enterprises within the Slovak Republic, is governed by the Accountancy Act. The consolidated final accounts are understood as the final accounts, which provide information about the consolidated complex unit, and are compiled according to methods, and rules, determined by particular provisions (IAS, IFRS).

In the consolidated final accounts are reported the referred income tax, by formation of goodwill. Both paid and referred income taxes are an independent unit in the final accounts and are reported in the balance sheet; they can have an active or passive character. Paid income tax is reported in the profit and loss account as the cost item; reporting of deferred income tax in the profit and loss account, as the cost item, depends on whether carrying into accounts of deferred income tax was carried out in the form of results, or in the form of the balance sheet. Paid and deferred tax has its own place in the notes, within which it is necessary to add information related to paid and deferred income tax and their mutual relationship.

1.2 Historical development of adjustments for deferred taxes

Deferred income tax is generally the accounting tool that objectifies profit after income tax. It relates mainly to a different view of the amount of the income tax in the sum, in the current accounting and the tax period in accounting and in accordance with the Act on Income Tax.
Deferred income tax reflects the part of the cost of the income tax that arises from the obligation to pay income tax in the future; it is assigned to the accounting period on an accrual basis. The purpose of accounting for deferred tax is to assign tax expense (deferred tax) in order to correct the accounting period on an accrual basis. If any expense, or revenue, affects income in a particular financial year, the tax will be effective in subsequent periods; assigned to this expenditure (income) and deferred tax. Its accounting is applied to the precautionary principle in determining income.

The display of all factors affecting the accounting profit or loss is the fulfillment of the requirements that the financial statements present by the true and fair view of the entity's management. Deferred taxes are by nature one of the most complex areas of accounting. It requires a great deal of subjective assessment, especially in the deferred tax asset.

1.2.1 The emergence of standards for accounting for deferred taxes

The idea of deferred taxes, and the need for their application in the double-entry accounting, originated in the United States, when the professional accounting organization called the "American Institute of Certified Public Accountants", in 1967, declared the principled standpoint for the implementation of deferred taxes in accounting practices. The historical development of deferred taxes is associated with the adoption of the international accounting standard IAS 12 Income Taxes.

The original standard (approved in 1979, and valid until 1998) requires an entity, accounting for deferred tax, using either the deferral method of payment, or the liability method, which is known as a method commitments on delivery approaches (timing concept). The standard has undergone several modifications and currently is under negotiation for