ACCOUNTING – TAXATION REPORT IN TERMS OF DEFERRED TAXES ON ASSETS REVALUATION

Paliu – Popa Lucia
Professor Ph.D., "Constantin Brâncuşi" University of Târgu Jiu, Romania
Cosneanu Lavinia
Phd Student, West University of Timisoara, Romania
Popa Marcel
Student, "Constantin Brâncuşi" University of Târgu Jiu, Romania

Abstract

There has always been and will be a relationship between accounting and taxation, and the ongoing discussions are related to intensity, interrelation and generation of reciprocal effects. Profit is the "wealth" achieved by the economic entity, the share of shareholders after paying the income tax, where applicable, which makes the profit have a major influence on the method of determination and thus of the accounting treatment incurred by the income tax depending on the accounting cultures in dispute for supremacy, namely the European accounting culture and the Anglo-Saxon accounting culture. As the users of information in the financial statements seek to assess the performance and profitability of the company in general and, academically, the income tax is the only element raising debates on the relationship between accounting and taxation, we deemed it useful to conduct a study on the accounting – taxation report in terms of deferred taxes related to assets revaluation. The record of deferred tax amount for each type of temporary difference results in elimination of tax effects from accounting, with the aim of revealing the real earnings of the economic entity and not its fiscal side, all of which is a step in disconnecting the taxation accounting.

Keywords: *income tax, deferred tax, tax reassessment, IAS, temporary differences.*

JEL Classification: *M40, M41, M48, M49*

1. Introduction

The financial statements, which are actually a synthesis core of accounting information are the most common method regarding management communication and the least expensive one, but in the context of the trend on European and international level to ensure a common agreed framework for the preparation and presentation of financial statements, a new formula of the accounting and taxation report must be accepted, both in the connection and disconnection relationships. The reason I chose to tackle the accounting – taxation report in terms of deferred taxes regarding asset revaluation resulted from the great importance held by the *accounting information on deferred tax* in the business of the economic entity, as failure to account taxes by the deferred tax method causes fluctuation in net profit compared to the temporary differences, and this leads to greater weight in predicting both profit and cash flow. This article deals with the issue of accounting – taxation report in terms of deferred taxes on asset revaluation, namely the emergence and evolution of deferred taxes due to non-recording of asset revaluation for tax purposes.

2. Connection and disconnection in the accounting – taxation report

The accounting – **taxation** connection involves linking the two fields without having an interconditioning relationship; accounting is the main knowledge base of the taxation. Referring to the **accounting** – **taxation** disconnection we may say that it derives from the differences between the accounting rules and principles and the tax ones. Once these differences are found, the required reintegrations and deductions are performed between the accounting and tax values. Given these considerations, two sets of results are calculated for taxation of the profit: accounting result and tax result.

A large number of accounting professionals often complain that accounting principles are not observed by taxation and accounting is subject to taxation, some even argue that *"total disconnection of taxation from accounting" is required.* Thus, there is the question of their reconciliation, and most accounting standards currently used in the world provide certain methods in this regard, conventionally referred to as current (payable) tax method and deferred tax method. Specifically, this reconciliation is achieved through the ***deferred tax***. Thus, *the deferred tax expense*, revealing the difference between the accounting and tax result, as the second component of income tax expense, i.e. *payable tax expense*, is an *attribute of accounting* and through its record the tax effects are eliminated from accounting, in order to reveal the outcome of the economic entity in terms of the real standing and not in terms of tax. Looking from this perspective, when we pronounce the word ***"tax"***, regardless of its nature, the first perception considers

taxation and the liability to pay a sum of money to the state. But over time, due to the development of business relations and hence the emergence of groups of economic entities as a result of cross-border relations, a growing need arose regarding the tax accounting treatment and, in particular, **income tax**, due to the multiple implications attached. [2]

Also, due to its economic approaches and being subject to both the accounting and tax regulations, income tax creates debate in the specialized literature, and the ***connection between accounting and taxation*** itself is treated through it. [3, 4, 8, 10]

If we consider that the interests of shareholders versus state are diametrically opposed, then the results of the two sides will be different as well (accounting result versus tax result). Thus on the one hand, management is required to consider the tax effects in business decisions, [6] and in terms of liabilities to be paid to the state budget, the task of achieving the 3 L: least, latest, legal, highly debated in the literature. IRS, on the other hand, seeks to get bigger sums to the state budget, so from the perspective of the state, only one L (legal) would be equivalent to those of the accounting; the other two items change into: more and faster. [1]

Fekete et al. have conducted an empirical study about the connection between the accounting and taxation at the level of economic entities listed on the Bucharest Stock Exchange, based on grouping those entities according to their size (BigE - large economic entities, SME - small and medium business entities, μE - very small economic entities). The result set based on Pearson's coefficient - E (p) - was that a strong relationship between accounting and taxation exist in the base of the pyramid (very small economic entities), and this relationship diminishes gradually to the top of the pyramid (entities small and medium economic or large economic entities).

This group is summarized in Figure no.1. [5]

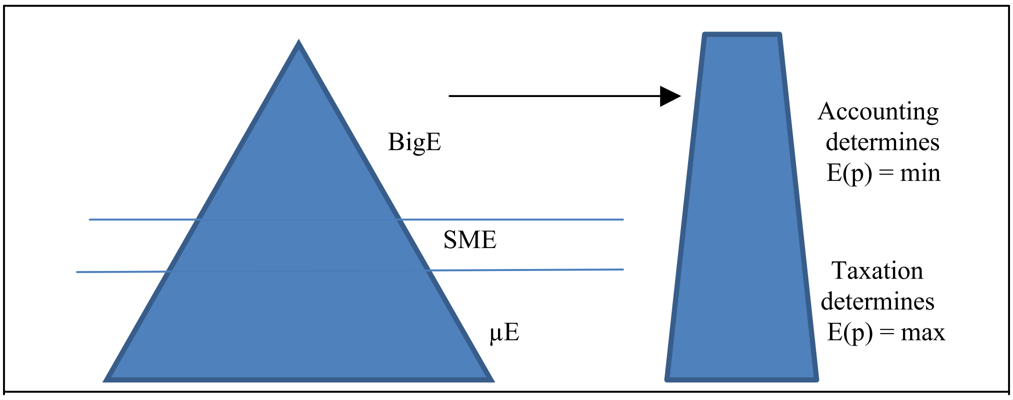

Figure No.1 **The economic entities` pyramid in terms of size according to the relationship between taxation versus accounting**

3. Emergence and evolution of deferred taxes due to revaluation of fixed assets

Since the goal of financial statements is to provide information about the financial position, financial performance and cash flows of an economic unit, useful for a wide range of users in making economic decisions, *special attention* should be given to *deferred taxes arising from revaluation of tangible assets* of the entity, whereas today it is not possible to properly judge the performance of an economic entity based on the financial statements unless we have detailed knowledge of such elements.

Since the primary goal of *accounting* is to provide true and fair view of the financial statements (currently under the new conceptual framework of the International Accounting Standards Board [IASB], which is the most accurate representation) through its principles, it has, in fact *an overwhelming influence on the result*, and in order to achieve its two goals (accurate presentation versus shareholding – state relationship), through the international bodies IASB and the Accounting Standards Board of the US [FASB], accounting developed the accounting reference frames International Accounting Standard [IAS] 12 "Income tax" and the Report on the Observance of Standards and Codes [SFAS] 109, both with the same major goal: income tax accounting. [1]

Furthermore, the IASB provides for the revaluation of fixed assets in standards such as: IAS 16 "Property, Plant and Equipment", IAS 38 "Intangible Assets", IAS 39 "Financial Instruments: Recognition and Measurement" and IAS 40 "Investment Property". [9]

A goal in the analysis of accounting - taxation report in terms of deferred taxes on asset revaluation was the sequential study of depreciation recorded in the accounts which, moreover, is different from that used in calculating taxable income; thus either *deductible temporary differences*, or *taxable temporary differences* emerge which in turn, generate deferred tax assets or deferred tax liabilities.

In some countries, taxable profit or tax loss in the current period can be affected due to revaluation or other treatment of value of an asset at the fair value at that time, in which case the tax base is adjusted and there is no temporary difference. There are, however, other countries where the taxable profit or tax loss is not affected and, consequently, the tax base is not adjusted. In the latter case, in the future, by recovery of the book value, taxable economic benefits will be generated for the entity and the amount that will be deducted for tax purposes will differ from the value thereof. Thus, the difference between the book value of the revalued asset and its tax base is a *temporary difference* and gives rise to *deferred tax assets or liabilities*. The same goes if the asset is not transferred; its value is recovered through its use, in this case taxable income is generated which exceeds the tax depreciation in future periods. [9] Thus we need to distinguish between *accounting and tax revaluation*: while the *accounting revaluation* is carried out by persons entitled to bring an asset's net book value to the fair value from the time of revaluation, thereby giving a true picture of the company's assets, *tax revaluation* is carried out as required by law and is recognized by the tax authorities. The difference found between the fair value and the book value is the "revaluation reserve" which is part of equity, without affecting the profit or loss.

If the accounting revaluation made has no correlation with the fiscal one, the taxable income of the period in which it occurs will not be affected, and the tax base of the asset is not adjusted. Through the practical example presented in the article, we will reveal the emergence and evolution of deferred taxes due to non-recording of asset revaluation for tax purposes. Thus, we will briefly review the ***accounting*** – ***taxation report*** in terms of ***deferred taxes on revaluation of fixed assets*** because when depreciation recorded in accounting differs from that used in calculating taxable income, such deferred taxes can arise. In this situation, deductible temporary differences or taxable temporary differences arise, which in turn generate deferred tax assets or deferred tax liabilities.

Thus, the differences arising between the income tax expense recorded in accounting and the income tax determined on the basis of tax rules generate debts or deferred tax assets.

Example: At the end of financial year N, an economic entity purchases machinery at the purchase cost of RON 60,000, with a normal useful life of six years. The linear depreciation method is recognized in terms of accounting and taxation. At the end of financial year N + 1 the equipment is revaluated and the fair value is RON 65,000, which is not recognized for tax purposes. Considering that the economic entity obtains an accounting result of RON 11,000 in year N+2, RON 12,000 in year N+3, RON 14,000 in year N+4, RON 9,000 in year N+5 and RON 16,000 in year N+6, we will show in Table No. 1 the methodology regarding fixed asset revaluation in terms of using the net book value at the end of financial year **N + 1**.

Table No. 1 **Revaluation on a net basis** RON

Explanation	Situation before revaluation	Situation after revaluation
Gross book value	60,000	65,000
Accumulated depreciation	10,000	10,000
Net book value	50,000	65,000
Revaluation reserve	-	15,000

Because revaluation is not recorded for tax purposes and there is no legal provision requiring the conduct of revaluation at this time, the tax base will be adjusted after the revaluation recognized in the accounts, thus being equal to the net book value before revaluation, RON 50,000. Since the revalued amount of the equipment (RON 65,000) is higher than the tax base, this causes a taxable temporary difference of RON 15,000 and deferred tax liability of RON 2,400. In the five years remaining from the useful life of the equipment, the economic entity will obtain from the use thereof taxable profits of RON 65,000, but will be able to deduct for tax purposes only RON 50,000 as depreciation expenses. Therefore, in the remaining five years, the economic entity will pay tax increased by RON 2,400 than normal in terms of accounting, if the transaction had no tax consequences. The balance sheet of N+1 will record deferred tax liabilities amounting to RON 2,400 but these liabilities will not affect the profit or loss.

The accounting records shall perform the following:

- cancellation of depreciation recorded until re-evaluation:

2813 „Depreciation of plant, vehicles, animals and plantations"	=	**2133** „Vehicles"	10,000

- reflrevaluation reserve coverage:

2133 „Vehicles"	=	**105** „Revaluation reserves"	15,000

- highlighting the deferred tax liability:

105 „Revaluation reserves"	=	**4412** „Deferred income tax"	2,400

For example, at the end of year N+2, the situation is as follows:

- Accounting depreciation = Revalued amount/5 = 65,000/5 = 13,000 RON;
- Tax depreciation = Tax base/5 = 50,000/5 = 10,000 RON;
- Accounting result = 11,000 RON;
- Tax result = Accounting result + Accounting depreciation – Tax depreciation = 11,000 RON + 13,000 RON – 10,000 RON = 14,000 RON;
- Income tax = 16% * 14,000 RON = 2,240 RON.

Income tax expenses to be recorded in the accounts relate to the accounting result and are worth RON 1,760. The difference between the current income tax (RON 2,240) and income tax expense (RON 1,760) is RON 480 and is the 5th share of the deferred tax liabilities of RON 2,400 that were recorded at the end of N+1. These liabilities are reflected in equal shares during N+2, N+3, N+4, N+5 end N+6.

These liabilities are reflected in equal parts during N+2, N+3, N+4 N+5 and N+6 and the installments are included in current income tax liabilities related to these years.

In the financial year N+2, the following accounting entries shall be made:

- highlighting the depreciation:

6811 „Operating expenses on depreciation of property"	=	**2813** „Depreciation of plant, vehicles, animals and plantations"	13,000

- highlighting current income tax:

691 „Current income tax expense"	=	**4411** „Current income tax"	2,240

- resumption of part of the deferred income tax liability:

4412 „Deferred income tax"	=	**792** „Income tax from deferred income"	480

Table No. 2 shows the centralized situation of data on the resumption of deferred tax liabilities.

Table No. 2 **Resumption of deferred tax liabilities** RON

Year	Accounting depreciation	Tax depreciation	Accounting result	Tax result	Current income tax	Income tax expense	Deferred tax liability resumed
1	2	3	4	5=4+2-3	6=5x16%	7=4x16%	8=6-7
N+2	13,000	10,000	11,000	14,000	2,240	1,760	480
N+3	13,000	10,000	12,000	15,000	2,400	1,920	480
N+4	13,000	10,000	14,000	17,000	2,720	2,240	480
N+5	13,000	10,000	9,000	12,000	1,920	1,440	480
N+6	13,000	10,000	16,000	19,000	3,040	2,560	480

The information provided by accounting should present deferred tax assets and liabilities as non-current receivables, separately from current tax liabilities and receivables.

4. Conclusions

We believe that revaluation is a complex process, frequently found at economic entities where the fixed assets are valued at historical cost and because this cost does not account for the present value of assets, the financial standing and performance reflected in the balance sheet and statement of profit and loss is distorted. On the other hand, in many cases, however, the decision on revaluation of tangible assets may represent an attempt of the entity to increase its equity and artificially increase its self-financing capacity. [7]

Moreover, the motivation to reflect the deferred liabilities and/or receivables in the balance sheet, in an entity's relationship with the state budget, due to the temporary differences arising between the tax basis of assets or liabilities and their book value recorded in the balance sheet is the production of immediate positive effects, such as: reduction of a current liability with taxes to the state budget and prevention of false profit distribution to owners, both resulting in an outflow of resources.

For the purposes of the above, we can say that deferred taxes that arise as a result of non-recording of asset revaluation for tax purposes, and thus the ***existence of accounting depreciation*** and ***tax depreciation*** are an important step in ***eliminating the influence of taxation on accounting*** but often, out of convenience, accountants are tempted to introduce the tax depreciation regulations in accounting. [11]

In this way, all the above, converted into performance requirements related to *deferred taxes*, leads to accurate information to recipients, namely to informational reliability.

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