

VARIOUS CONCEPTS TO ACCOUNT FOR INCOME TAXES IN GENERAL PURPOSE FINANCIAL STATEMENTS

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Introduction

This paper deals with at least the following three problems:

1. Determination of the amount of taxes on income;
2. Objectives of financial statements;
3. Presentation of taxes on income in financial statements.

It is good practice to define the starting points before starting. Without trying to present balanced interpretations the following descriptions are given:

Income taxes: legal levies related to income or loss of an enterprise in a period, for which compensations in return are not or hardly visible. No difference is made in taxes on profit and loss of a company and profit and loss of an individual. Differences in taxation between various legal entities are not being dealt with.

(General purpose) Financial statements: the statements presenting a view of the financial position and of the results in the course of the business of an individual or a company (both hereinafter called: enterprise). The general purpose of these statements is to provide such information that a sound judgement can be formed on the financial position and result of the enterprise: the size and composition of the enterprise's assets, liabilities and net worth (shareholders' equity), changes in financial position and income and expenses. This information is made up for all kinds of users and purposes and not for special purposes only.

Concepts to account for: the method used to account for certain financial quantities (in this case income taxes), including determination of the amounts and presentation of such amounts in financial statements. In other words and restricted to taxes: the way in which taxes are presented (as assets, liabilities, losses and profits) as elements of the financial position of the enterprise.

It is appropriate to restrict the problem to taxes on profits or losses of enterprises, generated in the course of business. Taxes on other income of individuals, such as salaries, rent, interest, dividends etc. are not being dealt with.

Different accounting principles or practices exist in different countries. Further, many interpretations are possible. Therefore various concepts to account for income taxes in financial statements are considered to be acceptable. These concepts can vary from

- calculating taxes on income at actual rate on the reported (commercial) income or loss (hereinafter called: result)
- to
- income taxes actually paid or payable for the accounting period on the base of income or loss as determined in accordance with rules established by taxing authorities (hereinafter called: tax base).

The purpose of financial statements differs from the purpose of statements on which the amount of tax is determined. Financial statements should enable to

form an opinion on the financial position and the results. Tax statements are basis for levying taxes. Further, contrary to the influence of the enterprise on its results for a period, after fixation of the tax base, the enterprise cannot influence the tax payable.

Taxes on income suggest a relationship between the result, the current tax rate and the amount of taxes payable. As long as the result as presented in the financial statements for a period, is the only and direct tax base of the same period, there is little or no problem. But as soon as the rules established by taxing authorities (as tools of economic policy) cause differences between result on one side and the tax base on the other side, major questions arise which will be dealt with in this paper.

All kinds of differences, changes and special rulings occur. A brief summary of the problems encountered, comprises:

- the matching principle for results and taxes on income
- timing differences
- permanent differences
- valuation for tax purposes: additional depreciation and amortization
- tax free reserves
- current cost accounting; adjustment of general purchasing prices
- tax incentives, investment grants etc.
- loss carry forward and loss carry back
- changes in tax rates
- taxes on distributed and undistributed profits
- consolidation of results of parent company and subsidiaries
- taxation of (unremitted) earnings of subsidiaries
- treatment of income generated abroad
- total income or separate types of income as basis of taxation; capital gains
- net of tax method
- taxes relating to extraordinary profits and losses
- exemption from taxation for certain enterprises
- presentation of income taxes in financial statements
- discounted deferred tax liabilities.

Connected with taxation are problems with respect to shifting the burden of taxes, compensating, avoiding and/or postponing of taxes.

Income taxes and result of the enterprise

The major problem comprises the question: should the amounts of taxes on income be presented in financial statements on the base of allocation of tax under the matching principle or as tax actually payable? Directly connected with this question is the determination of the amount of income taxes on the result as presented in financial statements versus income tax calculated in accordance with rules established by taxing authorities, which rules differ from accounting principles applied in preparing the financial statements.

If income tax is considered to be related to the results of an enterprise, the allocation method seems to be preferable because in the long run results and taxes will match. If tax is considered being the direct liability for the year under review,

the tax payable method seems to be correct. In this latter case income tax is considered to be an appropriation of profits. The allocation method implies that tax is considered to be a cost incurred in the generation of the results of the enterprise and then an accrual or deferral method is compulsory. Allocation of tax is made when there is a direct relationship between income of the period and the tax reported in the financial statements.

The deferral and the accrual (or liability) method differ. The latter accrues income taxes to be paid on pretax accounting income. The tax effects of timing differences are regarded as liabilities for taxes payable in the future or as assets, being advance payments of taxes for future periods. These liabilities and assets are adjusted for changes in tax rates. The deferral method defers effects of timing differences and allocates the differences to income tax expense of future periods when the timing differences reverse. These differences are determined on the basis of the tax rates in effect at the time the timing differences originate and are not adjusted for subsequent changes in tax rates. The main difference between both methods is caused by changes in tax rates.

It appears that in many countries there is an obligation to or a preference for presenting income taxes on the allocation method (matching principle).

Because income taxes always have a certain relationship to the results of the enterprise, a further investigation of the reconciliation between results (profits or losses) and the tax base is necessary.

This is preceded by the question what is profit or loss? Inasfar as connected with accounting for income taxes, when determining the result of an enterprise, the following questions should be answered:

- Are income and expenses determined on a historical basis?
- What is the influence of „holding gains” (successive price fluctuations) or „capital gains”?
- Should profit or loss be determined on the base of simultaneous differences between income and expenses?
- What is the consequence of investing in monetary or non monetary items and what does it mean if such investments are financed by owners or by debts?
- Is there an influence of appropriation of profits on profit itself? (are certain items part of determining profit or appropriation of profit)?

The answers to these questions have influence on the amount presented as result of the enterprise and therefore on taxes on income presented in financial statements.

Because many countries have different concepts to determine results, comparison of concepts to account for income taxes is for that reason already almost impossible. This problem is enlarged because of a wide range of deviations in the existing rules to calculate the tax base in relation to the result of the enterprise. The differences therefore originate from two main sources: different concepts for determining results in financial statements and different tax rules. It is impossible to deal with all kinds of concepts in determining income and also impossible to present a review of (technical) tax matters of various countries. Therefore attention is given to certain generally accepted accounting principles and generally acknowledged problems, which also gives the opportunity to present a brief survey of features as mentioned in the national papers.

Differences between results in financial statements and the tax base

The result, as shown in financial statements is calculated on bases which differ in various countries. However, it may be assumed that the result pretends to present the profit or loss of an enterprise, generated in the course of business. The differences in accounting practices are not being dealt with: the result is considered to be acceptable under the circumstances in which the financial statements are presented.

When the tax is not computed on the basis of accounting principles for the preparation of general purpose financial statements, the tax actually payable differs from the tax eventually payable on the base of the result. If the tax actually payable is included in the financial statements, there is no provision made for the tax on the difference between result and tax base. It appears that the user of these financial statements should at least have knowledge of this difference, especially when it is a timing difference.

A permanent difference will never have an effect on future financial statements. A timing difference will have an adverse effect on future statements because the tax on the difference, not shown now, will occur in the period the timing difference reverses. Disclosure of timing differences is useful for measuring (future) net income and for the actual financial position: a liability or a right exists with respect to future payment or refund of tax, connected with recent result, which is temporarily not included in taxable income.

This is a strong point in favour of the matching principle. It leads to financial statements, presenting a fair view of (details of) the total financial position and of (composition of) the net result of the period. This net result is - taking into account rules for appropriation of results - at the disposal of those entitled to the proceeds of the enterprise. Even if taxes are considered being an appropriation of income, rather than a cost, the unavoidable nature of income taxes will be expressed by disclosing the total burden as connected with the result of the period.

The differences originate from tax regulations and from different objectives of financial statements and of tax bases.

Differences originating from tax regulations

Various items can differ for tax and commercial purposes. In most countries these are:

- depreciation on fixed assets
- amortization of intangible assets
- valuation of stocks
- tax free reserves
- tax incentives
- loss carry back and loss carry forward
- total income or separate types of income as tax base.

A very wide range of possibilities exists in various countries. Because of different purposes of economic policy of the countries, there is no common practice in determining the tax base. The more economic circumstances differ in the countries, the more differences between result and tax base may occur. Especially in periods of (anticipated) recession, boom and inflation, special rules are made for treating items in a modified way for tax reasons. Measures to cope with re-

cession are a.o. allowing accelerated depreciation, investment grants, investment allowances and tax free reserves.

It is a largely spread discussion point whether depreciation on current cost of fixed assets and allowing tax free reserves for „holding gains” on certain assets, is a proper way to determine and tax real results and thus cope with inflation. In this respect methods of general purchasing price accounting are also presented. (These problems are also dealt with by study group 1: accounting for changes in the value of money.)

It may be concluded that the historical cost basis is used internationally. Only in a few countries certain allowances are granted for tax purposes such as tax free reserves for price increases of base stocks and tax free reserves for gains on sales of fixed assets. It also occurs that revaluation of certain assets is granted.

The differences in items for tax and commercial purposes can have the intention to postpone tax (accelerated depreciation), to reduce tax or to exempt from tax (investment tax credits, not to be offset in the future). If the deferment of tax will be offset by or is offsetting corresponding differences in other periods, there is a temporary or timing difference. The tax base of the current period is thus influenced by or will influence items of other financial years. If the recent tax reduction will not be offset we may conclude to a permanent difference, comparable to a reduction of actual tax rates.

The timing differences create most problems for the accounting of taxes in general purpose financial statements, in particular when the financial statements should be made up on the base of the matching principle: income and related expenses should be matched when determining the result of a period.

Permanent differences can have as a consequence that the matching principle is met (the result of the period includes the tax actually and eventually payable) and that also the taxes payable method is valid (presenting only tax expenses).

Temporary or timing differences exist when results are adjusted to determine the tax base. Tax regulations may allow to charge the tax base for extra depreciation on fixed assets in the year these assets were acquired or in a limited number of years, compared with the normal period of depreciation. This implies that tax actually payable in the first year(s) is lower than tax based on the result, in which normal depreciation is included. In the years following the accelerated depreciation period, the tax base and therefore the tax actually payable will be higher than tax based on the results. In the whole period of depreciation total tax will be based on the total of the results of this period (if tax rates do not change and no losses or compensation of losses occur). The same situation exists when tax free reserves are allowed in one period and added to the tax base in another period. Further temporary facilities occur for valuation of stocks and other assets. These adjustments of results for tax purposes all lead to postponing tax from one to another period. This also occurs when tax incentives are offset by tax on future results.

The same situation exists when certain expenses of the reporting period are recognized for tax purposes in future periods or when income of future reporting periods is recognized for tax purposes in an earlier period. These will cause actual tax in excess of tax computed at the current rate on the result and future benefits because of offsetting these differences. This leads to a claim on future tax benefits (future tax payable will be less than normal tax rates on future results). This claim

will generally only be collected if future profits occur. Including these claims in the financial statements is subject to similar conditions as claims from future compensation of tax losses. Liabilities from timing differences because of postponing tax payable will be offset in future periods because automatically taxable income is generated. Only future tax losses, to be compensated with the timing differences, may prevent the payment of tax on the timing differences.

Permanent differences create a momentary tax effect without any future offsetting. They have the same character as lower tax rates or exemption from tax: net result is higher than it would have been without the tax effect and no adverse reaction will follow in determining future results. This may lead to the conclusion that permanent differences create result of the period in which they occur and only disclosure of their special effect is required. That disclosure could be by calculating income tax in the financial statements without taking into account the permanent difference (i.e. normal income tax is based on the result) and showing separately in the financial statements the (permanent) difference. Other opinions are that the tax effect on the permanent difference should be taken into account in the complete period the connected items are used (e.g. investment allowance during the useful lifetime of the assets).

The foregoing shows that most of the differences between results and tax bases originate from determining income and expenses in different ways. In determining costs for a certain period, expenses, depreciation and amortization and valuation of assets and liabilities are frequently treated in different ways. Tax authorities may allow to include costs connected with the use of assets in an earlier period than (generally accepted) accounting principles allow and thus the tax burden for the period is less than it would have been in normal circumstances. These allowances vary widely: accelerated depreciation on fixed assets may differ from a 100 percent depreciation in the year of the purchase of the asset to a limited extra percentage during the first few years in which the asset is brought into use. Sometimes it is not allowed to amortize intangible assets for tax purposes. In other cases purchased goodwill etc. may be amortized in a certain period. There are also great differences in the valuation of other assets (such as stocks), although valuation at cost or market (under the f.i.f.o. concept) is widely spread. Within this concept certain countries allow l.i.f.o. for tax purposes or a base stock method at historical (unchanged) cost.

The same effect may be achieved by allowing certain parts of income to be excluded from taxes by building up tax free reserves. Many times these reserves imply capital gains arising from the sale of fixed assets. These gains may be exempt from taxes to encourage industrial investment. This exemption is sometimes connected with the period of time the asset has been held. It also appears that the exemption from tax is for a limited period; the gain should then be used as the initial depreciation on the replacement of the asset already sold.

The accelerated depreciation and amortization, facilities in valuing other assets and tax free reserves create in principle temporary or timing differences. Also the deduction of capital gains on the sale of an asset from the purchase price of its replacement creates a temporary effect, even if this procedure may be repeated many times. Sometime - perhaps at the end of the existence of the enterprise - compensation follows (tax will have to be paid). This is in contrary to permanent differences. These permanent differences only occur when the tax consequence

is final, to be compared with changing tax rates.

Tax incentives are allowed to assist capital investment or investment in certain areas. The incentives include total or partial exemption from tax, government grants etc. Depending on the result of the tax incentives timing differences or permanent differences may occur.

In various countries tax regulations allow special treatment of other parts of the results of enterprises than already dealt with. Certain gains on sales of fixed assets may be taxed at different rates. Income from subsidiaries is sometimes not taxed in the parent company, either before or after distribution to the parent. Distributed and undistributed income are sometimes taxed at different rates, or refunds of income tax are granted after the distribution of the profit. Further, income generated abroad, might be treated differently from national income. Certain types of enterprises are sometimes taxed at other than normal rates or are even exempt from taxation.

These special treatments disturb the general relation between results in general purpose financial statements and income taxes. The accounting for such items is closely connected with that for other temporary or timing differences and permanent differences. Most of the tax regulations mentioned here will cause permanent differences: the special treatment will have a final nature. Only if the differences will be offset in future periods (under changing circumstances) timing differences will occur. For permanent differences there may be the problem to determine the period(s) in which the difference will be accounted for.

The total lifetime of an enterprise is divided into periods (tax years, financial years). Generally speaking, the total difference between the value of the enterprise at the end of its lifetime and at the beginning thereof shows the total result, not taking into account capital paid-in and dividends etc. Income tax, if intended to participate in the (total) income, should then be equal to the tax computed at the tax rate applied to the result of the whole period. (Problems with respect to changes in the purchase power of the currency not included.) Dividing the total period into tax years etc. leads to timing differences when certain tax years show losses. If these losses are fully compensated by profits and carry forward (and/or carry back) is possible for an indefinite period, the total tax is again connected with total result. Two problems arise:

1. how should tax of a financial year be calculated if compensation of losses of other years has been effectuated.
2. when should compensation of the loss of one year be shown if actual compensation might take place in another year.

(An additional problem is connected with change of tax rates between the year of the loss and the year of compensation thereof.)

Compensation of losses of a period can be effectuated in previous and/or in future years. Normally only compensation with prior years' results and tax bases (carry back) gives certainty with respect to actual refund of taxes. Unless future tax bases are known and show profits covering the available tax losses, utilization of carry forward of tax losses is uncertain. In most cases this uncertainty prevents the inclusion of the future tax saving in financial statements (concept of prudence). An exception on this rule is that deferred taxes may be considered as an asset in the period of the loss if the loss is of an extraordinary non-recurring nature and the enterprise has been profitable in the past and will be profitable in future

periods.

Compensation of losses of one period in another period creates additional problems when the tax rate in the period of the loss differs from the tax rate in the period of the compensation. If a deferred tax saving has been included in the financial statements, adjustment of the deferral is generally required if the financial statements are intended to present the fair view of the financial position. If the effect of the compensation of the loss is only shown in the period the loss is used as a deduction from the tax base, the actual tax rate is automatically included.

In some countries there is no limit to the period in which losses can be carried forward. In many countries the period of compensating tax losses in future years is limited in time (e.g. from two to ten years; a more or less general period is five years). It also occurs that the period of compensation is different in the total existence of the enterprise: losses of the initial years of an enterprise may be carried forward for an indefinite period and further losses for a limited period. It is not widely spread that losses may be carried back to preceding years. In that case a tax loss of a year creates a refund of tax paid for preceding years.

Differences originating from objectives of financial statements as compared with those of tax bases

Differences between results in financial statements and the tax base are not only connected with special tax rules but also with the objectives of general purpose financial statements. The concept of this paper does not include a basic dealing with objectives of financial statements. However, it is impossible to exclude the following aspects completely.

Financial statements should at least present a fair view of the financial position of an enterprise at a certain date and of the results for the period then ended. Users of these financial statements have different purposes. However, the basic concepts in use for the general purpose financial statements mostly have in common that the enterprise is considered to be on a going concern basis, that the accrual basis should be applied (matching income and expenses) and that prudence requires not to recognize income before it is actually made and to recognize loss when it is predictable. Within these concepts an important question is whether the concept of the going concern is possible on the basis of historical costs or whether current value accounting should be applied for determining results and the value of assets and liabilities. Regardless of the financial structure of the enterprise there is a rapidly growing acknowledgment that in the time of important price alterations financial statements based on historical cost may not meet the objectives and even may endanger the going concern concept.

This has led to various adjustments of the historical cost concept. The best known thereof are general purchase price accounting and current value (replacement cost) accounting. Although many other considerations may be given, these methods intend to meet the needs of maintaining purchase power of shareholders' equity and/or calculate profit as the difference between income and current costs.

When such methods are applied to financial statements, and tax authorities maintain the historical cost concept, results on one side and the tax base on the other side will show considerable differences. Tax actually payable on tax base

will then also differ considerably of tax based on result (as calculated on g.p.a. or on current value accounting).

The objectives of financial statements as basis of levying taxes differ from those for general purposes. Tax authorities need a more or less uniform tax base in which a view of the financial position and of the results of the enterprise are at the most of secondary importance. Because of various reasons (e.g. simplicity of historical cost, seldom application of current cost accounting and uncertainties with respect to what profit really is) tax bases are generally based on historical cost. Only in few countries (parts of) results caused by price increases are eliminated for tax purposes.

Most of the differences will occur in (depreciation on) fixed assets and in inventories and thus in cost of sales. Income and expenses are recognized on other quantities than the tax base does. Inflation accounting will often lead to lower results than historical cost accounting.

When we restrict to depreciation and inventories, without the influence of monetary assets and liabilities, an example shows the influence. Suppose an annual increase of prices of 10 percent on fixed assets and inventories, equal for replacement cost and for general purchase prices. With unchanging quantities of inventories (periodic repurchasing), and subsequent replacement of fixed assets, both cost of sales and depreciation will be lower in historical cost accounting than as current cost. Actual differences will depend on the course of price increases and actual replacement of inventories. A simplified example is:

<i>Year 1</i>	<i>Historical cost</i>	<i>Current cost</i>
Fixed assets, basis for depreciation	100,000	110,000
Inventories	50,000	52,500
Revaluation reserve		16,000
	<hr/>	<hr/>
Sales	100,000	100,000
Cost of sales	<u>(70,000)</u>	<u>(73,500)</u>
Gross profit	30,000	26,500
Expenses	(20,000)	(20,000)
Depreciation	<u>(5,000)</u>	<u>(5,500)</u>
Profit before taxes	5,000	1,000
Income tax	<u>(2,500)</u>	<u>(2,500)</u>
Net profit (loss)	2,500	(1,500)
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<i>Year 2</i>		
Fixed assets, basis for depreciation	100,000	121,000
Inventories	55,000	57,750
Revaluation reserve		31,100
	<hr/>	<hr/>
Sales	110,000	110,000
Cost of sales	<u>(77,000)</u>	<u>(80,850)</u>
Gross profit	33,000	29,150
Expenses	(22,000)	(22,000)
Depreciation	<u>(5,000)</u>	<u>(6,050)</u>
Profit before taxes	6,000	1,100
Income tax	<u>(3,000)</u>	<u>(3,000)</u>
Net profit (loss)	3,000	(1,900)
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In circumstances as in the above example, current value accounting, if not accepted for tax purposes, leads to higher taxes actually payable than the tax based solely on the results. Because of the permanent nature of the difference, it could be included in the financial statements as a deduction of profit although other practices are possible: the tax on differences between result and tax base could be deducted from the revaluation reserve in the balance sheet without disclosure in the statement of income.

The tax authorities often consider all increases of prices to be part of the tax base. The enterprise does not and could then include these differences in (shareholders') equity (revaluation reserve). The various ways of treating these items are not being dealt with in this paper.

The differences originating from objectives of financial statements compared with those of tax bases, lead to permanent differences as long as one of both objectives is not changed into the other. When such changes are not known at the time the financial statements are prepared the differences should be treated as permanent differences: the income tax actually payable is determining. Allocation method and taxes payable method will lead to the same result. To be considered is whether the part of the income tax, connected with increase of prices, should be charged to income or to the revaluation itself.

Accounting for income taxes in general purpose financial statements

Various concepts

Mostly financial statements comprise at least the balance sheet, the income statement (profit and loss statement) and the explanatory notes to these statements. Details of the financial statements differ in various countries. Sometimes details of items and disclosure of bases underlying the valuation of assets and liabilities and the determination of the result are presented in balance sheet and income statement and sometimes in the notes. To eliminate the great variety in these practices we refer to the financial statements taken as a whole. The accounting for income taxes may thus be limited to dealing with income taxes as part of the financial position at a certain date and of determining net income for the period then ended.

The scope of financial statements (including accounting for income taxes in financial statements) is to present a fair view of the financial position and of the results of an enterprise. The accounting principles, practices and methods should lead to and enable the fair view which is aimed at. Users of the statements should find all true information which is possible within the scope of financial statements. This does not include all purposes. Financial statements do not indicate the total value of the enterprise as needed for selling or purchasing the enterprise. General purpose financial statements (should) present a view of the financial position and of the results of the specific enterprise in the course of its existence and under its specific circumstances. Consequences of liquidation, purchase, cooperation with other enterprises and future developments are normally not included in general purpose financial statements. Their use is therefore limited.

Within this limited use it is generally accepted that income taxes are included in financial statements as a deduction from income and as far as not yet paid in the period - as a liability. There is quite a difference in the attitude of those

who consider income taxes to be an appropriation of income and those who consider income taxes to be a cost. The nature of taxes will let no freedom to determine the appropriation of income in as far as income tax payable for the period is concerned: this part of net income before taxes is irrevocably to be set apart for the treasury or other authorities. Therefore, even in the attitude of income taxes being an appropriation of income, disclosure of the total amount payable for the period seems inevitable. In this case it is not important if the amount payable has actually been paid at the end of the period; the balance of the amount payable and the amount paid is then also to be disclosed, as a compulsory profit sharing (dividend) not yet distributed.

If income tax is considered to be a cost incurred in the generation of the result of the enterprise, inclusion in the financial statements of at least the amount payable for the period is required. In most countries income and expenses in financial statements are determined on the accrual basis under which income and related expenses should match (in the same period).

Under both concepts disclosure of the tax position with respect to temporary or timing differences could be made by disclosure in the notes. This can depend on the materiality of the differences and of the view with respect to what financial statements, taken as a whole, should include. Consideration should be given to the required level of information in financial statements, below which the statements no longer present the position for which they are intended. Not including important assets and/or liabilities in the balance sheet may mislead the user. A strong point in this respect is that the financial position has already been influenced by actions before balance sheet date. In other words: because of the results of past periods (and special tax regulations) taxes will have to be paid in the future. If such liabilities are not shown in the balance sheet, also the future burden will not match with the results then made (and shown).

This leads to the conclusion that tax liabilities, whether or not immediately payable, should be dealt with like other liabilities: to be included in the balance sheet. An exception will then be made when it is reasonably to be expected that actual payment on the liability will not occur, e.g. when future tax losses are foreseen, to be compensated with the amounts on which the tax liability is based. In all other cases liabilities should be maintained, like all those liabilities of which realization (payment) is expected. The general consequence will then also be that the amount of the liability is charged to income. However, if a part of the tax base is not included in the result but directly entered into (shareholders') equity, a direct charge to the equity is often made.

Permanent differences are not offset by reverse actions in the future. They have a final influence on net results. Therefore there is no reason to reflect any future obligation or right in the balance sheet, except when the amount of the difference of tax is not included in the period in which it occurred. In certain countries it is acceptable to include tax advantages or disadvantages in results of the successive periods in which a related asset or liability is used. An example is the tax credit related to purchases of certain fixed assets: this tax advantage, to be effectuated in one or a few years, is then included in the results (lower tax) of the periods in which of the useful lives of these assets. In other countries these tax advantages have to be shown in the year(s) they actually appear.

Presentation in financial statements

Temporary or timing differences - as defined before - generate a tax liability, often referred to as a deferred tax. Inclusion in accounts payable in the balance sheet then is obvious. Depending on the period in which payment (setting off) is expected, classification in short term or in long term liabilities is to be considered. In many countries a period up to one year means short term and from one year on classification as long term takes place.

However, several considerations give rise to not classifying deferred tax as accounts payable. One of these is the fact that it may occur that tax authorities are preferential creditors: if necessary payment of taxes can be forced before some other debts may be paid. This is a reason for classification of deferred taxes in the balance sheet, separate from accounts payable.

Another consideration is that deferred taxes are only payable after fulfilment of certain conditions, such as the generation of future taxable profits (not offset by losses). Further uncertainties may exist with respect to the actual date of offsetting the conditions on which the deferred tax is based. It is also uncertain which tax rate actually will exist at that time. Problems with respect to the valuation of a liability are no motive for complete by neglecting this liability. Like in other uncertain events, a reasonable evaluation of all known circumstances can lead to a fair presentation. The uncertainties are sometimes expressed by classification of deferred taxes in the balance sheet as a „provision”. (Provisions include liabilities of which uncertainties exist with respect to exact date and amount of payment, such as happens with pension liabilities.)

On the „right side” of the balance sheet a division is possible between risk-bearing capital and non-risk-bearing items. Although in the long run all liabilities are risk-bearing, the classification intends to show the amount of capital, bearing first risks. In other words: risk-bearing capital will only be refunded after (full) payment of all other liabilities. The nature of tax as participating in the results of enterprises comprehends that no tax is actually due when there is no positive tax base. In case of tax losses even a refund might take place. This simultaneous participation of tax authorities and owners of capital in (tax) losses, is a point for classification deferred taxes as risk-bearing capital.

Presentation of tax consequences of tax losses differs in many countries, mostly because of different rules for compensation of tax losses. A major difference exists between the situation in which the effectuation of the compensation is beyond any doubt and the situation in which uncertain events have to be fulfilled, e.g. future profits have to be generated. The first case exists when unquestionable tax rules grant compensation of the loss of the period with profits of prior periods. If no uncertainties exist with respect to the tax bases of the relevant years, the refund of tax is an assured asset or a reduction of a liability. Inclusion in the balance sheet and in the income statement of the period the loss incurred is fairly general practice.

If realization of the compensation is depending on future uncertain events, the expected fulfilling of these events is determining: the tax saving in future periods is contingent on the appearance of a positive tax base in future periods. The potential tax saving is generally not included in the result in the period of the loss. If there are circumstances as already referred to (loss results from non recurring cause, profitability over a long period, future taxable income reasonably assured)

the tax saving related to the loss is sometimes included in the determination of result in the period of the loss. Classification in the balance sheet as a receivable with disclosure of the contingent nature is mostly inevitable.

It appears that tax losses may be offset against existing liabilities as reflected in a deferred tax liability. Then the tax savings on the loss can be realized without the appearance of taxable profits in the future. The loss carry forward will be offset against the future reversals of the timing differences. The conditions to be met should be the matching of amounts and periods of loss carry forward and timing differences and the tax rates involved. This offsetting of tax losses against deferred tax liabilities is often disclosed in the financial statements.

Deferred taxes will be reallocated when the timing differences reverse: the deferred taxes become actually payable or receivable. Many times reclassification is made of the deferrals to amounts currently payable or receivable. Special consideration can be given to credit balances of deferred taxes related to revaluation of assets, not recognized for tax purposes. If the deferred tax on the revaluation has been deducted from the direct credit to equity, it occurs that future higher actual tax amounts are reported as a cost and added to equity.

Prepayments of income taxes and taxes recoverable when paying income taxes are deducted from the gross amount of the liability for the period. In general the balance of the liability for the period is shown in one item.

In financial statements taken as a whole reflection of certain parts of income taxes is sometimes not only and completely made in the balance sheet (and income statement) but partly in the notes. Disclosure of deferred tax assets and liabilities etc. is then more or less an information in addition to the financial position as presented in the balance sheet. Although the financial statements taken as a whole give the required information, the different treatment in balance sheet and notes may cause misunderstanding.

Income taxes are generally included in the income statement before net income is determined. Net income available to those entitled to the results of the enterprise is decreased by the amount claimed by tax authorities. If income taxes also relate to other income than from the ordinary operations of the enterprise, or if income taxes differ for certain parts of income, these taxes are sometimes presented separately from income from the ordinary operations.

Under net of tax presentation tax effects of timing differences are recognized as a reduction of the related assets or liabilities and of the related income and expenses. These compensations combine two relationships: one with respect to the original item (e.g. cost of fixed assets) and one with respect to the tax effects of timing differences (e.g. tax benefit because of deducting accelerated depreciation). This may lead to misleading information by presenting the balance of the compensations.

Disclosure in the income statement of tax effects of timing differences and of permanent differences is - if not already required - many times helpful in interpreting the composition of the result. A deferral method of accounting for timing differences can automatically lead to such a disclosure. Under the tax payable method these timing differences are not included in the income statement; sometimes additional information is included in the notes. The tax effect of permanent differences, if included directly in income taxes in the income statement, may prevent comparability of net results of successive periods. This also occurs

when tax losses are offset against result of the period and no deferred tax saving had been taken up in the balance sheets of previous periods.

Presentation of income taxes in the income statement can vary from inclusion of one item (as a cost or as an appropriation of result) to a detailed information on the various components of the income tax for the period.

These components can be:

- tax paid in and for the period
- tax for the period, payable in future periods
- deferred tax to be offset against future events
- deferred tax from prior periods, offset against events of this period
- change of tax rates:
 - of deferred taxes from prior periods
 - of accrued taxes
- tax effects of a permanent nature:
 - based on events of this period
 - originating from other periods
- tax effects from compensation of losses:
 - of losses of this period and carried back
 - of losses of this period to be carried forward
 - of losses from other periods, compensated in this period
- differences between valuation of tax liabilities as included in the balance sheet of prior periods and the valuation in the balance sheet of this period or the amount paid
- different tax on separate types of income
- exemption from taxation
- tax effects of income earned abroad
- tax effects on distribution or not distribution of income (parent company and/or subsidiaries)
- taxes connected with consolidation of results of enterprises; fiscal unity.

The (amounts of the) components of total income tax as included in the income statement of the period depend on the concept applied to account for income taxes in the financial statements. A brief summary of the components revealed is:

- Tax paid for the period is the minimum to be included in the income statement. Applying the matching principle leads to a broader interpretation.
- Tax for the period, payable in future periods is a normal liability, not to be treated in a way different from other liabilities, even if deferment of payment has been granted.
- Deferred tax to be offset against future events has been dealt with above; compliance of the matching principle is determining for occurrence of this component.
- Deferred tax not included in the balance sheet of prior periods will cause a tax effect in the current income statement when the circumstances reverse.
- A change of tax rates of deferred taxes from prior periods, included in the balance sheets of prior periods will have an effect on the income statement of this period depending on the deferral or the accrual method. Under the deferral method the change of the tax rate as compared with the rate at the

time the deferral was made, will only occur in the period when the timing differences reverse. Under the accrual method any change in tax rate as compared with the rate at the time the accrual was made, will effect the income statement (or eventually directly a reserve) of the period the change in the accrual is known.

- Tax effects of a permanent nature, originating from the current period, can have influence on the income tax to be deducted from the result of the period. The effect can be taken in full or be spread over certain periods. In the latter case other periods will be influenced than the one from which the tax effect originates. Certain interpretations of the matching principle and/or certain rulings may cause a different treatment.
- Tax effects from compensation of losses of the current period will mostly effect the result of this period if the compensation has actually been effectuated (refund of taxes, carry back). If compensation is anticipated of losses of the current period in future periods, or if a refund of income taxes already paid is to be expected in the future, the benefit will - under certain circumstances - be included in the result of the period of the loss. In many other cases the benefit of compensation of tax losses will occur in the period of actual compensation of the loss. Disclosure of these tax savings and of amounts and availability of loss carry forward is often made.
- If other than nominal values are applied in valuation of tax liabilities, the proceeding of time will lead to eliminating this other valuation. Many times these differences are caused by discounting the liability. The difference may also influence interest in the income statement.
- Different taxes or different tax rates can be applicable to separate types of income. These can include capital gains, extraordinary profits and losses and certain expenses. Disclosure of the tax effect of the different treatment is sometimes made.
- Exemption from taxation occurs for certain enterprises or parts of enterprises for a limited or for an indefinite period. Especially in combined or consolidated income statements, a separate treatment is appropriate of the tax effects on the entities included.
- Many times income earned abroad is treated in another way than other income. The foreign income is sometimes exempt from local income tax, sometimes different tax rates or tax credits are allowed. The tax effect of this specific treatment can be a component of total income taxes.
- Tax rates can differ for distributed and undistributed results of an enterprise. Many times distributed profits are taxed at a lower rate because the recipient of dividends etc. will be taxed again. The lower rates are for example only applicable after actual distribution of income, regardless of the period in which the income has been generated. Also it appears that lower rates are applicable on income which is (will be) distributed within a certain period. Based on these rulings and the actual circumstances the tax effect of distributed income may influence several periods.
- In some countries (consolidated) results of all enterprises owned by another enterprise will be taxed. It also occurs that the parent can request to consider the total of parent company and (fully owned) subsidiaries as one entity for tax purposes. The tax authorities then only recognize the consolidated posi-

tion of the group; legal composition and legal entities within the group are neglected. When fixed tax rates exist, not depending on the total result this fiscal unity may be advantageous as certain entities within the group having tax losses can offset these losses against taxable income of other entities in the same period. The combination of the results can have influence on the income tax to be included in the financial statements of the individual entities. Different treatments occur: the total tax is included only in the financial statements of the parent (even if results of the subsidiaries are not completely included in the result of the parent), or total tax effects are divided over all the subsidiaries as if each of those would have been taxed separately.

The attitude of considering income taxes as an appropriation of result can cause that no income tax at all is mentioned in the income statement. Then income taxes are treated like dividends and mentioned only if the total appropriation of income is disclosed.

Valuation of income taxes in financial statements

Determining for the valuation is the rate of taxes and the period in which actual payment or receipt will occur. Taxes payable in or for the period in which the result has been recognized, normally do not create problems: rate and period are known and nominal value will be used. Exceptions are possible when there are uncertainties with respect to circumstances to be fulfilled before final rates and amounts are fixed.

Further consideration is given to the period of time, elapsing between the moment the tax has been calculated and included in the financial statements, and the moment actual payment is expected.

The uncertainties are sometimes expressed by estimating the rates of future actual payments and the chance of fulfilment of other circumstances.

The implication of the time factor sometimes leads to another than nominal value of tax items in financial statements. If tax liabilities do not bear interest, in some countries these liabilities are discounted. The reasoning then is that the enterprise has a no interest bearing debt, payable in the future, of which the value should include the gain in comparison to normal interest payable on such debts. With an interest rate of 8% and a period of 10 years before actual payment of a debt of 1,000,000, the discounted value will be 463,000. This calculation will be complicated when the future tax effects on the interest used for discounting the debt are considered. In that case the debt should be discounted using an interest rate of normal interest minus income tax thereon.

When evaluating this method of accounting for non interest bearing debts, one should also consider items bearing a lower than (currently) normal interest. Further, assets should be treated like liabilities. A 4% interest bearing debt is only gradually different from a 0% interest bearing debt when 8% interest is normal. Further an interest free loan should then be valued on the same basis as an interest free debt for a comparable period. It may be concluded that discounting of tax liabilities (deferred tax) in general purpose financial statements is only seldom used.

Exceptions are made when related items of tax liabilities are normally valued

at discounted amounts. This happens with certain pension liabilities: the current value of future payments is calculated, taking also into account future interest to be made on (the investment of) the existing liability. If this practice is accepted, the nominal tax effects of the discounted liability will then automatically be a discounted tax item.

This general attitude may differ in circumstances when financial statements are made up for special circumstances, such as valuation of the enterprise when selling the shares or merging with another enterprise. Then, special advantages and circumstances - such as goodwill, generated in the course of the business and a financial position including long term debts without cost of interest - may be taken into account contrary to the behaviour in normal circumstances.

(Parts of) income taxes are subject to unknown conditions and circumstances. These uncertainties may be of such a profound nature that no reasonable evaluation of the outcome is possible. In that case inclusion in the balance sheet and income statement could only be made as a memorandum item (P.M.). Disclosure in the notes with possible minimum and/or maximum implications will then be appropriate.

Special features in the national reports

1. In Austria, France, Ireland and the United Kingdom (U.K.) and the U.S.A. taxable income is based on the result as shown in the financial statements with differences for tax purposes. South Africa determines taxable income not by reference to accounting profit but by a process of gross income less deductions, quite materially inconsistent with the matching concept. The South African National Council of Chartered Accountants recommends to prepare separate statements for income tax purposes, as annual financial statements are not intended to serve the purpose of tax schedules.
Although in most countries results are adjusted for tax rules, a basic relation between tax base and result exists. If completely different rules exist for calculating the tax base as compared with the result, it could lead to the position that the tax is not an income tax as being dealt with in the reports.
2. Divergences between financial income (result) and taxable income (tax base) exist in all five countries. The divergences cause permanent and temporary or timing differences.
3. Austria treats as tax charge in the annual accounts the actual periodic tax expense (unless the equity in the annual accounts exceeds assets less liabilities as calculated for tax purposes). In France more or less the same habit exists, although the author recognizes that this does not respect the accruals concept and that it makes it difficult to compare the results of subsequent financial years. South Africa requires to comply to the concept of matching (and going concern, consistency and prudence). The requirements of matching makes it necessary to create a deferred tax account when there is a deferral of a tax liability or asset. The U.K. recognizes an additional problem in the case that income tax assessments are based on income of a preceding year. The question is still pending whether or not the matching process has to be applied. U.S.A. rulings prescribe comprehensive tax allocation, with disclosure of the

components: taxes to be paid currently, effects of timing differences and effects of operating losses.

4. Losses may be deducted from profits in five or six future years or partly longer. Carry-back is not generally granted. As far as being dealt with, recognizing loss carry-forwards (recording of future tax savings) in advance of realization is not done or rare. Exceptions are made when realization is reasonably assured.
5. In some of the reporting countries taxes on assets not held for sale are lower than normal rates. In France such capital gains should not be distributed.
6. In South Africa and the U.S.A. tax effects are recognized on undistributed earnings of a subsidiary.
7. In general differences between results and tax bases originate from depreciation, consolidation, investment deductions, sale of fixed assets and certain price fluctuations. Special features are:
 - Austria – 25% of taxable profit to be included in an investment reserve.
 - France – some charges are only deductible for tax purposes when actually paid instead of accrued.
 - South Africa – undistributed profits tax is due unless a company pays out dividends in the period beginning six months prior to and ending six months after the end of the financial year.
 - U.K. – shareholders are allowed to credit against their income tax corporation tax imputed to the distribution.
 - U.S.A. – interest on bonds of certain local governments are not included in taxable income.