

COMPARISON OF DEFERRED TAX MATERIALITY REPORTING IN ACCORDANCE WITH CONTINENTAL AND ANGLO-SAXON REPORTING SYSTEM

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Abstract

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The paper is concerned with the influence of a financial reporting system on a deferred tax reporting. The continental and Anglo-Saxon reporting systems are compared. The materiality of the deferred tax item is used as a means for evaluation of the impact of deferred tax reporting. The category of deferred income tax is assessed on a sample of companies operating in the chemical industry (NACE 20.1) and reporting in accordance with the Czech accounting legislation (representative of continental reporting system) in the time series from 2005 to 2015. The results are compared with the results of author's previous study concerning the reporting of deferred tax according to IFRS (representative of Anglo-Saxon reporting system).

Keywords: the category of deferred income tax, Czech Republic, the materiality level, Continental and Anglo-Saxon reporting systems

INTRODUCTION

The aim of the research is to prove if the deferred tax category is significant item in financial statements. The assessment of significance deferred tax category is important for the influence of earnings management on financial position of companies.

Theoretical background

The deferred tax arises due to the differences between taxation and accounting rules, due to book-tax differences. The issue of book-tax differences is related with three economics areas, namely accounting for income taxes, earnings management and capital market anomalies. In the quantification of the impacts of the deferred tax on fiscal position of companies, it is necessary to research the connection or disconnection between the taxation and accounting rules in respective country. The objectives of the financial reporting and taxation are quite different and both are depending

on local circumstances. While the aim of financial reporting is concentrated on fair reporting to users of financial information (i.e., financial results must not be overestimated), the aim of taxation is to collect the taxes (i.e. to ensure the revenue for the state budget). A high number of studies concerning the relationship between taxation and financial reporting (e.g. Walton, 1992, Nobes, Parker, 2010, Douppnik, Salter, 1995, Hoogendoorn, 1996, Lamb, Nobes, Roberts, 1998, Blake, Fortes, Amat, Akerfeldt, 1998, Aisbitt, 2002 – Nordic countries) can be found. The relationship between taxation and financial reporting in the conditions of the Czech Republic was measured by Nerudová (2009). Due to these facts, the reported profit or loss differs from the income tax base in a majority of states. The majority of studies deals with the relationship of tax and accounting rules for the income measurement. The most significant studies were carried out by Lamb, Nobes, Roberts (1998), Holland (1998), Freedman, MacDonald (2007), Eberhartinger, Klostermann (2007).

The level of difference between a profit or loss and a tax base is dependent on a relationship between the tax system and the financial reporting system used in a particular country. There are two significant financial reporting systems (continental and Anglo-Saxon). These systems differ in the main features. The Anglo-Saxon system is based on the consistent application of the fair view principle and satisfaction of the information needs of external users. The corporate accounting standards are typically set by independent accounting standards setters (Financial Accounting Standards Board – FASB, International Accounting Standards Board IASB). The accounting standards are approved by functional financial markets (IFRS, US GAAP). Accounting treatments are intended to insure uniformity of companies' financial statements and accounting methods, similar activities may be treated very differently for tax purposes. The financial reporting is quite independent on the tax rules. The continental system of financial reporting is significantly influenced by the tax legislation. The information needs of government, tax authorities are the main objectives of the financial reporting. Despite the fact that the book-tax differences (BTDs) arise in both systems, it is supposed that the BTDs are lower in the continental system.

There are two types of BTDs – permanent and temporary. Permanent differences' effect (in the form of reduction or increase of taxable income comparing with reported income) is definitive. Temporary differences give rise to an accounting category called deferred tax. The deferred tax reflects the fact that the tax and rules for financial reporting in most countries differ.

Various approaches to the level of deferred taxes recognition are used in individual reporting systems (depending on special criteria – size, type of entity, financial reporting system used). These are ignoring of deferred taxes through their partial recognition to full expression. Each of these approaches has a different effect on the financial statements and consequently provides a different information base for decision making of many users of these statements.

Non-recognition of deferred tax approach does not provide information applicable for a correct estimation of future tax payments, due to absence of insight into the future tax savings and tax payments. This approach does not consider business transactions which are recognized in that period when they are recognized by tax authorities, which may be before or after the period when the event itself is recognized in the financial statements. It does not record the relationship between accounting income and income tax expense in the income statement and it leads to distortions in the net profit after tax.

The treatments for deferred tax reporting (for companies obliged for deferred tax reporting) do not differ significantly in particular financial

reporting systems, while the income tax rules could be significantly different in particular countries.

The topic of deferred tax is a subject of IAS 12 in the IFRS and ASC 740 in the US GAAP in the case of Anglo-Saxon reporting system. According to the IAS 12 temporary differences are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base. The tax base of an asset or a liability is the amount attributed to that asset or liability for tax purposes. The reporting of deferred tax represents an instrument for distributable profit or loss regulation in a form of an accrual or a deferral, when in a period of lower payable income tax, the company postpones the part of the reported profit in a form of deferred tax liability. In a period of higher payable income tax, the company increases the reported profit by creation of deferred tax asset or by use of deferred tax liability.

There is a similar treatment for deferred tax reporting in the CAL, it is the Czech Accounting Standard No. 003 Deferred Tax. The CAL is a representative of continental financial reporting system, similarly as Germany, France, Austria, and Spain.

According to Schnader, Noga (2013), there is one more reason for reporting of the differences between firm's book income and its taxable income. It is a questionable reason. The questionable reasons are based on an intentional manipulation with financial statements, tax evasion, etc. However in the situation the most effective firm management is expected to take advantage of legal tax planning techniques, the unusually large differences between book and taxable income can potentially indicate the company uses illegal options for decrease its tax base or increase a profit for external users of financial statements. There are many studies concerning this issue (Desai, 2003, Manzon, Plesko, 2002, Plesko, 2004, Phillips, Pincus, Rego, 2003, Landry, Chlala, 2005, Hanlon, Hoopes, Schroff, 2014, Chi, Pincus, Teoh, 2014, Noga, Schnader, 2013, Laux, 2013, Blaylock, Shevlin, Wilson, 2012, Donohoe, McGill, 2011, Haskins, Simko, 2011, Colley et al, 2012, Crabtree, Maher, 2009, Weber 2009, Shackelford, Slemrod and Sallee, 2009 Jackson, 2015). The majority of them was carried out using the data of corporations incorporated in the USA listed on the US Stock Exchange. The dataset usually covers period after 1994. It is clear that the conclusions are very similar. The studies approved a relation between book and tax reporting and firms' incentives to engage in earnings management activities, and an increase in the risk of the non-achievement of planned goals. For example, there is the study of Landry and Chlala (2005), they synthesize available sources considered this issue of differences between book and taxable income and concluded that the BTD is an indicator of certain trends and discrepancies, and of a risk of failure to achieve sufficient income in the future. Further analysis of earnings quality is demanded. It

is possible only with the reconciliation of accounting and taxable income, combined with other methods of analysis such as the relationship between accounting income and cash flow from operations. Also Hanlon (2005) found that the companies with unusually large temporary BTDs have less persistent accruals and earnings. She found that investors interpreting large positive BTDs as a “red flag” and reducing their expectation of future earnings persistence.

Leach and Newsome (2007) and Rosner (2003) found that companies, which manage their earnings by BTDs have greater probability of bankruptcy. The changes in firm BTDs could be a reason of changes in income caused by the management activity.

The conclusions of study of Weber (2009) demonstrate that unusually large BTDs are underestimated by market itself and therefore credit rating agencies should incorporate this indicator into their calculations of rating.

Shackelford, Slemrod and Sallee, 2009 in their study researched the relation between accounting earnings and cash flow and the impact of BTDs on these indicators. Based on the conclusion they formalized the idea that the attractiveness of some investment decisions is enhanced because they provide managers with discretion over the timing of taxable income and/or book income.

Chi, Pincus and Teoh (2013) found evidence that investors misprice information contained in BTDs, measured as ratio of taxable income to book income.

The topic of temporary component of book-tax differences was examined in many studies, namely Philips *et al.*, 2003; Hanlon, 2005; Blaylock *et al.*, 2012, Philips *et al.* (2003) assessed if the usefulness of deferred tax expense in detecting earnings management. They provided the evidence that deferred tax expenses generally be useful for total accruals and abnormal accruals. For examined this hypothesis they use two Jones-type models in detecting earnings management to avoid an earnings decline and to avoid a loss.

Blaylock *et al.* (2012) examined book-tax differences as a signal of earnings persistence. They find that there are multiple potential sources of book-tax differences. Then they examined the differing implications of large positive book-tax differences for earnings and accruals persistence depending on the source of those book-tax differences. They illustrated the importance of the source of the book-tax differences.

Lev and Nissim (2004) were the first who investigated the association between the ratio of tax-to-book income to predict earnings growth and abnormal stock returns to explain the earnings-price ratio in the period before and after the implementation of Statement of Financial Accounting Standards (SFAS) No. 109 in 1993. They dealt with both temporary and permanent BTDs as well as tax accruals, such as changes in the tax valuation allowance. They also find that the tax

fundamental is strongly related to contemporaneous earnings-price ratios and weakly related to stock returns. That can indicate improvement in investor's perceptions of the involvement of the tax information for future earnings during the time.

Also it is worth to mention the study of Hanlon (2014) that is dealing with the relation between tax enforcement and financial reporting quality. They find that the government, because it has tax claim on firm's profits is actually the largest minority shareholder in almost corporations. There is the evidence that higher tax enforcement by the tax authority has a positive correlation with the quality of financial reporting.

It is difficult to find similar studies carried out for European firms. There are only studies of Gordon, Joos (2004), Bohušová, Svoboda (2005), Chluděk (2011), and Vučković-Milutinović, Lukić (2013).

The study carried out by Vučković-Milutinović, Lukić (2013) deals with the 20 largest non-financial companies and 20 banks in Serbia. The research uses financial statements data for the period 2009 – 2010. The research examines the materiality of DTA and DTL. The conclusions of study of Bohušová, Svoboda (2005) have shown the materiality of the deferred tax category in the Czech Republic – the median of deferred tax/total income tax ratio is 15.21% resp. 7.4% in the researched samples. As the most complex, the research of Chluděk (2011) can be considered.

MATERIALS AND METHODS

The paper is concerned with the materiality of deferred tax category in the financial reporting of the Czech non-financial companies obliged for deferred tax reporting and preparing financial statements according to the CAL and the impact of the deferred tax reporting on the level of distributable profit or loss.

The study is built on conclusion of previous study made by author (Habanec, 2016). That study dealt with the materiality of the deferred tax category in financial statements prepared according to the IFRS. The dataset covers the financial statements of the publicly traded companies operating in the chemical industry in the Czech Republic (NACE 20.1). The financial statements are covering period starting in 2005 up to 2015. The year 2005 is the first year of obligatory application of IFRS for publicly traded companies within the EU. Companies making business in chemical industry has lot of obligations arises in applying IFRS principles (e.g. revaluation on fair value, restoring items of property, plant and equipment, etc.), that's the reason why chemical industry have been choosen.

The analysis utilizes the publicly available financial statements and their notes data of companies operating in the chemical industry (NACE 20.1). The system of the Czech Ministry of Finance (ARES) was used for their identification. The number of 11 companies was identified. Companies which did not present their financial

statements in a suitable, and did not present all the information during the researched period were excluded. The researched sample consists of 6 companies (Colorlak, a.s.; DEZA, a.s.; Lach-Ner, s.r.o.; Linde gas, a.s.; Lovochemie, a.s.; Silon, s.r.o.) and covers the series from 2005 to 2015. The dataset includes 66 firm-years.

The calculation of the materiality was based on gross profit and total assets. The International standards of audit (hereinafter ISA) 320 – Materiality methodology was used for the materiality definition. Due to the fact that neither ISA 320, nor IFRS set any quantitative criteria for materiality calculation, the study of McKee, Eilifsen (2000) granted by the Norwegian Research Council was used for setting quantitative criteria of materiality. According to this study, there are four possible approaches to materiality quantification (Single rules, Variable of size rules, Blend of averaging methods and Formula methods).

The materiality level for the P/L statement items was computed as a percentage of gross profit. For balance sheet items materiality level was computed by single rule:

$$\text{Materiality level} = \text{total assets} * 0.05 \quad (1)$$

$$\text{Materiality level} = \text{gross profit} * 0.05 \quad (2)$$

If the balance sheet items and profit and loss statement items were interrelated the lower of the both amounts is considered. The materiality level is defined in USD according to the Norwegian Research Council, the criteria were converted to the approximate amount in the CZK. The criteria for materiality level were set in the following way.

- 2 to 5 % of gross profit if it is less than 500,000 CZK,
- 1 to 2 % of gross profit if it is between 500,000–25,000,000 CZK,

- ½ to 1% of gross profit if it is between 25,000,000–2,500,000,000 CZK,
- ½ % of gross profit if it is over 2,500,000,000 CZK.

The results are compared with results of the previous study carried out in this issue (Habanec, 2016).

RESULTS

The Variable of size rules for the deferred tax (expense, income) reported in the profit and loss statement and the single rule for the deferred tax asset or liability reported in the statement of financial position for setting the materiality level. The following tables describe the level of the deferred tax materiality in researched companies.

From the Tabs. I–VI is apparent that for the deferred tax category is significant for majority of companies. Also for almost all reporting firms, the deferred tax category is significant except Colorlak, a.s. Nevertheless it can be said that the deferred tax category is less significant in comparison to companies reporting according to IFRS (average 6.6%). The average deferred tax level in business companies reporting in accordance with the CAL is 4.1%. It is influenced the reporting system applied. The CAL is influenced by the tax system. The book-tax differences, which caused the deferred tax category, are smaller. The Anglo-Saxon accounting system (representing by IFRS) is relatively independent on the income tax legislation, the book-tax differences are higher in comparison to the continental system. The deferred tax category is more significant. These conclusions correspond with author's previous study (Habanec, 2016) where was founded that deferred tax is highly significant accounting category.

CONCLUSION

The category of deferred tax is a specific issue that interconnects the area of accounting and the area of income tax. The main object of this paper was to analyze the significance of the deferred tax category reporting in accordance with Czech accounting legislation and to compare the significant of deferred tax category reporting in accordance with IFRS. There was investigated the sample of six companies namely Colorlak, a.s.; DEZA, a.s.; Lach-Ner, s.r.o.; Linde gas, a.s.; Lovochemie, a.s.; Silon, s.r.o., in the time period 2005–2015. The dataset includes 66 firm-years. The results indicate that the deferred tax category reporting in accordance with Czech national legislate is less significant than deferred tax category reporting in accordance with IFRS. The results were compared with previous study (Habanec, 2016) and confirm expectations state above – deferred tax reporting in accordance with Czech accounting legislate (representing continental accounting system) is less significant than deferred tax category reporting in accordance with IFRS (representing Anglo-Saxon accounting system). Lev and Nissim (2004) and Hanlon (2005) investigate that the tax-base provide information about growth in earnings and the persistence of earnings. In their conclusions the deferred income tax provides information to external users and this conclusion support the conclusion of this paper – the category of deferred income tax is significant in both accounting systems. Poterba (2011) investigate whether the category of deferred income tax may affects behavior and incentives of the company. Because the category of deferred income tax is significant the assumption should be that the behavior and the incentives will be affected by the deferred income tax in both accounting systems. The assumption was confirmed.

Nevertheless the results are based on limited data due to limited amount of publicly traded companies in the Czech Republic.

I: *Colorlink, a.s. Deferred tax materiality (based on variable of size rules and single rules) in thousand CZK*

Year	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	average
Gross profit	22,839	39,014	38,645	22,968	15,236	18,964	11,671	12,437	7,103	29,287	33,384	22,868
DT (P/L)	-24	48	-57	32	8	416	402	702	393	-194	193	224
DT mater. %	N:0.11	N:0.12	N:0.15	N:0.14	N:0.05	Y:2.19	Y:3.44	Y:5.64	Y:5.53	N:0.66	N:0.58	N:0.98
Total assets	461,030	499,116	558,402	637,225	600,622	615,865	661,994	642,003	654,812	689,121	738,219	614,401
DT (BS)	203	251	194	226	233	650	1,411	2,133	2,560	2,312	2,505	1,153
DT mater. %	N:0.04	N:0.05	N:0.03	N:0.04	N:0.04	N:0.11	N:0.21	N:0.33	N:0.39	N:0.34	N:0.34	N:0.19

II: *DEZA, a.s. Deferred tax materiality (based on variable of size rules and single rules) in thousand CZK*

Year	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	average
Gross profit	269,528	294,933	382,587	446,104	67,359	1,075,523	1,089,670	750,623	393,471	434,283	308,710	501,163
DT (P/L)	54,897	13,896	-38,720	-52,031	14,645	24,978	-11,742	-11,651	-7,536	-3,446	13,675	22,474
DT mater. %	Y:20.37	Y:4.71	Y:10.12	Y:11.66	Y:21.8	Y:2.32	Y:1.08	Y:1.55	Y:1.92	N:0.79	Y:4.43	Y:4.48
Total assets	5,283	5,909	6,074	6,831	4,411	4,642	5,217	5,515	5,632	5,469	5,079	5,460
DT (BS)	227,032	240,927	202,207	150,176	164,821	189,799	178,057	166,406	158,870	155,424	169,099	182,074
DT mater. %	Y:4.30	Y:4.08	Y:3.33	Y:2.20	Y:3.74	Y:4.09	Y:3.41	Y:3.02	Y:2.82	Y:2.84	Y:3.33	Y:3.33

III: *Lach-Ner, s.r.o. Deferred tax materiality (based on variable of size rules and single rules) in thousand CZK*

Year	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	average
Gross profit	5,415	2,551	-1,309	2,818	2,605	8,567	6,901	6,562	6,725	15,961	15,869	6,844
DT (P/L)	25	575	1,432	569	597	580	72	1,472	-523	1,860	714	765
DT mater. %	N:0.46	Y:22.54	Y:109.40	Y:20.19	Y:22.92	Y:6.77	N:1.04	Y:22.43	Y:7.78	Y:11.65	Y:4.50	Y:11.18
Total assets	67,527	62,222	6,583	61,650	58,334	93,546	113,360	131,337	130,425	135,250	143,597	91,257
DT (BS)	195	7,661	6,229	5,660	5,063	4,482	4,410	2,939	3,462	1,602	888	3,872
DT mater. %	N:0.29	Y:12.31	Y:94.62	Y:9.18	Y:8.68	Y:4.79	Y:3.89	Y:2.24	Y:2.65	Y:1.18	Y:0.62	N: 4.24

IV: Linde gas, a.s. Deferred tax materiality (based on variable of size rules and single rules) in million CZK

Year	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	average
Gross profit	1,010	1,030	1,183	1,358	1,106	1,256	1,400	1,365	1,513	1,533	1,507	1,296
DT (P/L)	24,258	34,727	17,661	7,118	272	3,735	1,001	8,247	3,859	1,521	46,845	13,568
DT mater. %	Y; 2.40	Y; 3.37	Y; 1.49	N; 0.52	N; 0.02	N; 0.30	N; 0.07	N; 0.60	N; 0.26	N; 0.10	Y; 3.11	Y; 1.05
Total assets	6,839	6,562	6,465	5,450	5,284	5,574	5,294	5,458	5,573	5,538	5,658	5,790
DT Amount (BS)	98,036	63,309	44,922	52,524	52,252	48,517	47,516	39,269	47,776	44,801	80,734	56,376
DT mater. %	Y; 1.43	Y; 0.96	Y; 0.69	Y; 0.96	Y; 0.99	Y; 0.87	Y; 0.90	Y; 0.72	Y; 0.86	Y; 0.81	Y; 1.43	Y; 0.97

V: Lovochemie, a.s. Deferred tax materiality (based on variable of size rules and single rules) in million CZK

Year	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	average
Gross profit	157,760	138,383	91,528	658,022	200,105	205,946	492,292	685,549	326,777	406,004	373,862	339,657
DT (P/L)	15,980	22,538	2,481	20,371	6,952	6,540	7,230	3,071	6,635	3,484	45,030	12,756
DT mater. %	Y; 10.13	Y; 16.29	Y; 2.71	Y; 3.1	Y; 3.47	Y; 3.18	Y; 1.47	N; 0.45	Y; 2.03	N; 0.86	Y; 12.04	Y; 3.76
Total assets	2,829	3,157	3,060	3,318	2,908	2,911	3,889	3,664	4,025	4,281	5,146	3,563
DT Amount (BS)	60,824	83,380	83,729	61,647	67,481	72,916	78,891	81,962	75,327	78,811	123,841	78,983
DT mater. %	Y; 2.15	Y; 2.64	Y; 2.74	Y; 1.86	Y; 2.32	Y; 2.51	Y; 2.03	Y; 2.24	Y; 1.87	Y; 1.84	Y; 2.41	Y; 2.22

VI: Silon, a.s. Deferred tax materiality (based on variable of size rules and single rules) in million CZK

Year	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	average
Gross profit	45,134	83,454	132,375	15,432	72,316	34,248	93,963	53,491	52,315	161,140	206,543	86,401
DT (P/L)	5,121	19,277	7,685	253	4,407	687	2,841	2,680	5,749	8,473	9,552	6,066
DT mater. %	Y; 11.35	Y; 23.10	Y; 5.81	N; 1.64	Y; 6.09	Y; 2.01	Y; 3.02	Y; 5.01	Y; 10.99	Y; 5.26	Y; 4.62	Y; 7.02
Total assets	852	912	1,933	1,920	1,708	1,737	1,739	1,736	1,593	1,475	1,674	1,571
DT (BS)	15,837	34,664	42,350	42,603	47,010	46,323	49,164	46,484	52,233	41,275	31,723	40,879
DT mater. %	Y; 1.86	Y; 3.80	Y; 2.19	Y; 2.22	Y; 2.75	Y; 2.67	Y; 2.83	Y; 2.68	Y; 3.28	Y; 2.80	Y; 1.89	Y; 2.60

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