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### IMPACT OF REPORTING OF DEFERRED TAX ON SUSTAINABLE DEVELOPMENT OF A COUNTRY: CASE OF CZECH REPUBLIC<sup>1</sup>

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**Abstract.** Achievement of high quality of accounting information in financial statements requires thorough adherence to generally accepted accounting principles. In connection with deferred tax, this concerns especially the prudence principle and the going concern principle. The deferred tax also has an impact on fiscal sustainability in any given country. The aim of this contribution is to evaluate how information about deferred tax is reported by small and medium sized enterprises in Czech Republic and evaluate quality of such reporting. The research was conducted in the form of a questionnaire survey concerning recognition of deferred tax among accounting units which prepare their financial statements according to IFRS or according to Czech accounting standards. The entities that stated in the questionnaire that they recognize deferred tax were further analysed in more detail. The survey revealed that the standard does not take into consideration that small and medium-sized enterprises would not have to account for deferred tax. The research clearly showed the unwillingness of accounting entities to recognize deferred tax voluntarily.

**Keywords:** financial statements; sustainable development; small and medium-sized enterprises (SMEs); deferred tax; deferred tax liability; deferred tax asset; sustainability; Czech Accounting Standards

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## 1. Introduction

Companies listed in the commercial register are obligated to release their financial statements, which are a fundamental source of information for the decision-making processes of other entities who are in any connection with such entity. According to Dumitru (2012) and Paseková et al. (2017) accounting information should be collected and presented in such a way so as to be able to respond both to the requirements of given entity for its future use by the company and also to respond to informational needs of its partners and other users of financial statements. In a way, the quality of the information offered by the financial statements becomes a purpose in itself and it should bring an added value to the financial reporting frame of a country, help sustain

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the financial system itself and support economic growth of a country. Certain transactions recorded in accounting are strongly influenced also by legal regulations of given, especially by tax laws. Historically the tax laws in Czech Republic are tightly connected with the accounting and are significantly influencing accounting and accounting principles themselves.

Due to the diverging concepts of accounting approach and tax legislation in the area of expenses and revenues, there are significant differences between calculated accounting profit and the tax profit which is a base for income tax calculation.

The presented contribution focuses on the problem of recognition of deferred tax in small and medium-sized companies. It is precisely these businesses that are not obliged to account for deferred tax under Czech accounting law. The aim of conducted research was thus to ascertain whether small and medium-sized enterprises reflect deferred tax in their accounting and to get some indication supporting a hypothesis that if businesses are not obliged to account for deferred tax and recognize it, they do not do so, or only in a very limited way by a low number of companies.

Furthermore, the aim of this research is to see and confirm how the reporting of deferred tax it done by the companies which do not have to report it but they do it anyway, because the deferred tax has an impact on fiscal sustainability of a country. This impact is not as significant as for other, more typical taxes. But from the principle of deferred tax, it is clear that it can provide information about increase or decrease of income tax collection in the future and by doing this to contribute to forecasting of the future tax collection with respect to future cash-flows and thus contribute to better fiscal sustainability. That is why it can be said that deferred tax is one of the tools for application of the prudence principle, one of generally accepted accounting principles. A good tax system should bring sufficient revenues to the state treasury (Šimelytė Antanavičienė 2013; Luzgina 2017; Dobrovič et al. 2016; Giriūnienė, Giriūnas 2017), and should not deteriorate activity of a SME (Włodarczyk et al. 2017; Bikas et al. 2017; Jankelová et al. 2018; Illmeyer et al. 2017; Paseková et al. 2017).

The questionnaire survey method was used for data collection. The acquired data was then further analysed. The text that follows is divided into five chapters. In the first chapter the attention is focused on research of related literature, which is aimed on the information about deferred tax, the calculation methods, usage of deferred tax for earnings management and also the obligation of small and medium-sized enterprises to account for deferred tax. This chapter is followed by a chapter devoted to research methodology. The next chapter is then concerned with the acquired results and it is followed by a summary of the fundamental insights and the conclusions of our research.

## **2. The inspiration of Czech accounting legislation by International accounting standards in the area of deferred tax (the historical perspective)**

Deferred tax is covered by International accounting standard no. 12 (IAS 12-Income Taxes). As stated in the introduction of this standard, its aim is to prescribe an approach to accounting solutions for income tax calculations from accounting profit. The fundamental question is how to account for current and future tax consequences of accounting transaction. In its development, the standard gradually went through various methods of calculating the deferred tax. In the beginning the deferral method was used (1979-1996); the standard then switched to the liability method by using the nominal approach. Use of this approach was permitted until 2000. The current amendment forbids this method and prescribes a calculation using the balance sheet method. Analysis of individual items is conducted from the perspective of the balance sheet and no longer from the profit and loss statement point of view. However, the evolution process of this standard has not yet ended. In March 2009 a new proposal for the revision of the standard was presented in response to remarks created by the initiative for the convergence of IFRS and US GAAP which started in 2002. The goal of this process was a convergence of IAS 12 standard with FAS 109 Accounting of Income Tax and minimization of their reciprocal differences. (Baštincová and Tužinský, 2011).

The standard defines basic terms which are interconnected and generate deferred tax. These are especially temporary differences which can be taxable in the future (taxable temporary differences) and the result thereof is a deferred tax liability, or contrariwise, temporary differences deductible in the future (deductible temporary differences), the result of which is a deferred tax asset. The standard requires accounting units to account for deferred tax in the same way as they would for transactions which elicit this tax. Therefore, in transactions which are accounted for nominally, deferred tax is also accounted for nominally, whereas in transactions which are recorded directly in to the equity, deferred tax is likewise accounted for directly in equity (International Accounting Standards Board).

Czech accounting legislation underwent a similar evolution in the past. Deferred tax first appeared in the measures of the Ministry of Finance which amended accounting classifications and accounting methods in connection with the accounting reform at the beginning of the 1990s. In the beginning there was a very limited circle of accounting units which were obliged to account for deferred tax (only companies that were part of a group) as was also the case for titles from which deferred tax was calculated (It was calculated only from differences between accounting and tax depreciation). Accounting for deferred tax was based on the liability method of the nominal approach. Regardless of the prudence principle, there was an obligation to account for both deferred tax liability and deferred tax asset.

For accounting in Czech Republic, the beginning of the new century was connected with a comprehensive amendment of accounting principles, which has also affected the deferred tax. The amendment of Accounting act from 2004 required accounting units to keep accounts so that the financial statements compiled on the basis of them may provide a fair and true view of the accounting entity's financial situation (Section 7 Act No. 563/1991 Coll., on Accounting). Deferred tax represents one of the areas which helps fulfil this obligation. Part of this requirement is also to respect the prudence principle, which was likewise implemented directly into the Act. According to these act accounting units are to include only profits which were gained and, contrariwise, to take into account all foreseeable risks and possible losses which concern assets and liabilities known to them until the moment the financial statement is compiled in their financial statements (Section 25, para. 3 Act no. 563/1991 Coll., on Accounting). From this rule it is logical that if it is a known fact to an accounting unit that temporary differences have arisen between accounting and tax regulations which would result in a higher tax payable in the future, they should create a fund from disposable profit from a regular period for coverage thereof (deferred tax liability). On the other hand, if there is to be a lower payable tax in the future as a result of temporary differences, it will contrariwise be possible to increase disposable profit from a regular period by a sum which the accounting unit will be able to recover through savings on payable tax (deferred tax asset). (Decree No. 500/2002 Coll., Czech Accounting Standard No. 3). Due to a fact that the starting point of the Czech national amendment in the area of deferred tax was the IAS 12 international accounting standards, the differences between the Czech amendment and this standard are not in any way significant.

### **3. The information capability of deferred tax**

According to Istudor et al. (2011), recognition of deferred tax enables better information capability of financial statements. Financial statements then reflect both really accounted for costs and the cost for deferred tax, which gives a rise to approach which is far closer to reality. Deferred tax helps to distribute taxes to several accounting periods (Geyer, 2014).

The pilot version of IAS 12 enabled accounting entities to choose whether they would use, whilst calculating deferred tax, the deferral method or the liability method. At the time, emphasis was placed especially on information presented in the profit and loss statement, and standard therefore preferred the deferral method over the liability method. According to Janoušková (2007), the deferral method ensured better adherence to the principle of assigning expenses to revenues with which they are connected objectively and in correct time frame, and thereby led to a more precise quantification of the economic result than by using the liability method. In certain cases, transactions connected with the creation of deferred tax are accounted directly against equity. According to Müllerová and Vančurová (2006) deferred tax has to be accounted for like this, for the rule applies that deferred tax is accounted for in the same way as the transaction which elicited it.

Poterba et al. (2011) further states that the majority of companies recognize a deferred tax liability rather than a deferred tax asset. Depreciation is then indeed the greatest source of temporary differences. According to Dhaliwal (2013) it is possible on the basis of the dispersal of deferred tax assets to assess whether a given business will make adequate profits in the future. Financial Accounting Standard Board (FASB) indicates that supplementary information on a deferred tax asset or liability should be stated in an appendix to the financial statement (Philips et al., 2003). Graham et al. (2012) add that it is precisely notes on deferred tax in the appendix and the harmonization of the tax and accounting profit/loss that can provide users of the financial statement with information on the viability of a given company.

Lev and Nissim (2004) further document the positive relationship between the future growth of the economic result and the proportion of the taxable economic result and the accounting profit/loss. A change from accelerated to linear depreciation increases deferred tax and increases the economic result (Lev and Nissim, 2002). According to Lev and Nissim (2002), similar accounting procedures which have an impact on deferred tax are thoroughly standard and reduce the ability of deferred tax to provide information on the quality of business activity.

Philips et al. (2003) state that a deferred tax expense provides information on earnings management prior to taxation. Murdoch et al. (2015) add that using deferred tax can improve forecasts of income tax payments in comparison with using only current income tax. Profit is an important base for various indicators of financial analysis. According to Müllerová (2005), by correctly accounting for deferred tax, the accounting entity can acquire more realistic values of these financial indicators and avoid the distortion thereof caused by overestimation of disposable profit. In addition, improved comparability with sectorial indicator values or values acquired from the data of competing businesses is achieved. Also Colley et al. (2012) report the influence of deferred tax on financial indicators, especially debt-to-equity ratio.

#### **4. Deferred tax in small and medium-sized enterprises**

The small and medium-sized enterprise sector plays an irreplaceable role in any developed economy (Kozubíková et al., 2015) and are at present the centre of attention of theoretical research within the European Union (Belás et al. 2015; Benešová et al. 2018) state that quality business environment creates favourable conditions for the development of SMEs as they represent an important part of the national economic system. Not only economic criteria but also social, educational, cultural, and other factors are playing an important role in this process (Ključnikov et al. 2016, Smekalova et al. 2014, Dobeš et al. 2017; Abbas 2018).

According to data from the Ministry of Industry and Trade of Czech Republic, small and medium-sized enterprises represent more than 1 million economic subjects; they account for 61.52 % of employment and 54.57 % of accounting added value. The proportion of these businesses in the total number of active entrepreneurial subjects is 99.83 %. Support of small and medium-sized entrepreneurship is currently connected with the requirement of reducing the administrative burden for these businesses, which has an impact also on the area of accounting and financial reporting. One of these reliefs is the possibility to compile a simplified financial statement, which entails a condensed financial statement and simpler Notes. In contrast to this, there is no doubt that there is the unified European Union market, which requires uniform legal norms and standardization also in the area of financial reporting for small and medium-sized enterprises. (Ministry of Industry and Trade)

Decree No. 500/2002 Coll. states in Section 59 which accounting entities are obliged to account for deferred tax. Obligated to do so are mainly those companies which form a consolidated group due to unified accounting rules for compilation of a consolidated financial statement. Then there are accounting entities which compile a full financial statement: these include all joint-stock companies. Then from the remainder of trade corporations, those which are obliged by law to have their financial statements verified by an auditor (see Section 20 Act No. 563/1991 Coll. on accounting). Other accounting entities can (but do not have to) account for deferred tax and recognize it voluntarily. It therefore stems that small and medium-sized enterprises are obliged to account from deferred tax only to a limited extent.

## 5. Methodology

The data for the survey was acquired by a questionnaire survey. Students who visited small and medium-sized enterprises in the Czech Republic for this purpose took part in the study data collection. The selection of visited companies was left to the students but the number of employees was required to not exceed 250. The number of employees was the only criteria applied to distinguish the small and medium enterprises. The students contacted the heads of accounting department. Respondents' replies described the situation at the current interviewing time. A total of 418 questionnaires were obtained. In each completed survey, the students stated the name of the business and the contact person. The origin of the data was randomly verified in roughly thirty businesses by the contact person via telephone and no issues were identified during verification process.

The questionnaire contained six questions. The first question ascertained whether deferred tax was recognized in the business. If the reply was negative, the respondents stated the reason for non-recognition. Other questions were aimed only at those respondents who answered positively to the first question. Replies to the questions provided information as to whether they recognize deferred tax as a deferred tax asset or a deferred tax liability. In the case of recognition of a deferred tax asset, the respondents stated why they decided to do so. Other questions then ascertained the reasons for recognizing deferred tax, what titles enter into the calculation of deferred tax and whether they elaborate the information on deferred tax in an appendix. The first two questions divided the respondents into three groups. The first group included respondents which do not recognize deferred tax; in the other group there are respondents which recognize deferred tax as a deferred tax liability (DTL); and finally, the third group comprises of respondents which recognize deferred tax as a deferred tax asset (DTA).

The financial statements of firms which were stated in the questionnaire that they recognized deferred tax were further analysed. We used quantitative methods to analyse the quality of presented information about deferred tax. We assessed whether the information stated in the financial statement is adequate from the perspective of its users. The following categories were used after this assessment: excellent supplementary information, supplementary information with partial shortcomings and inadequate supplementary information.

## 6. Empirical results and discussion

The results gained by questionnaire survey will be summarized in the first part of our paper. Questionnaires acquired from 418 businesses were analysed. Deferred tax is not recognized in approximately half (210 firms) of businesses; and among the other half of businesses which recognize deferred tax, approximately two thirds (136 firms) are those which recognize it as a deferred tax liability and one third of them (72 firms) as a tax deferred asset. Accounting entities which did not recognize deferred tax were asked questions which were intended to justify this fact, which is shown by the following figure (Figure 1). Respondents could state their own answer and not only choose from prepared ones.

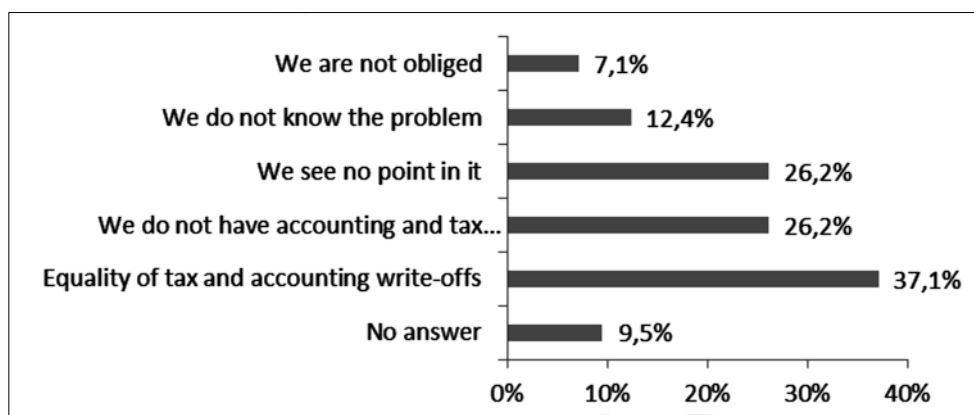


Fig. 1. Relative representation of reasons for not recognizing deferred tax

Source: Authors' results

Most respondents give objective reasons to justify non-recognition of deferred tax. Most frequently it is the non-existence of temporary and accounting differences (in small businesses, accounting and tax depreciation are equal; as a rule, neither adjusting items nor provisions are accounted). Another reason is the non-comprehension of the significance of deferred tax and the conviction stemming therefrom that its recognition makes no sense. Ignorance of the problem is a markedly less frequent substantiation, and a relatively small part of the respondents refer to the fact that they are not obliged to recognize deferred, furthermore, reasons for reporting of deferred tax asset were tested in case company reports it as such.

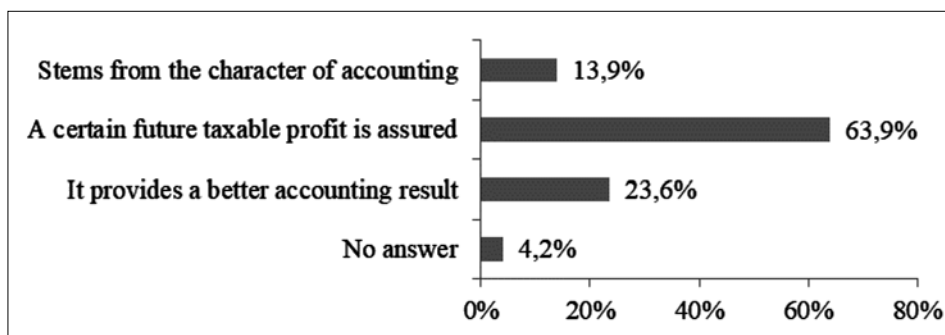


Fig. 2. Relative representation of reasons for not reporting deferred tax as deferred tax offset

Source: Authors' results

For a dominant number of respondents, the reason for recognition of deferred taxes as deferred tax assets is the guarantee of generating future taxable profit. Only less than a quarter of monitored respondents use this method because it provides more accurate accounting results. Others consider this accounting procedure as the natural consequence of the reporting system. Less than a twentieth of monitored respondents did not justify the given choice.

The relative representation of titles entering into calculation of deferred tax is illustrated in Figure 3. The difference between accounting and tax depreciation enter the calculation of deferred tax in more than 80% of businesses. Similarly, to the formation of accounting provisions, the formation of accounting adjusting items is utilized in deferred tax calculation by approximately 40 % of businesses. Approximately one fifth of businesses stated the title of transferred tax losses. Overestimation, fines and penalties, unsettled social and health insurance and retrospective tax assessment of liabilities is stated by less than 3% of businesses cases.

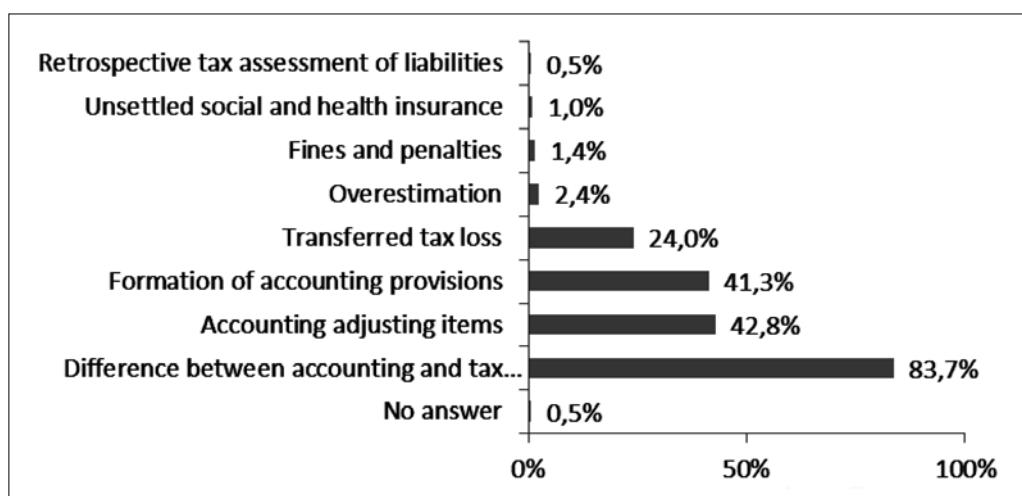
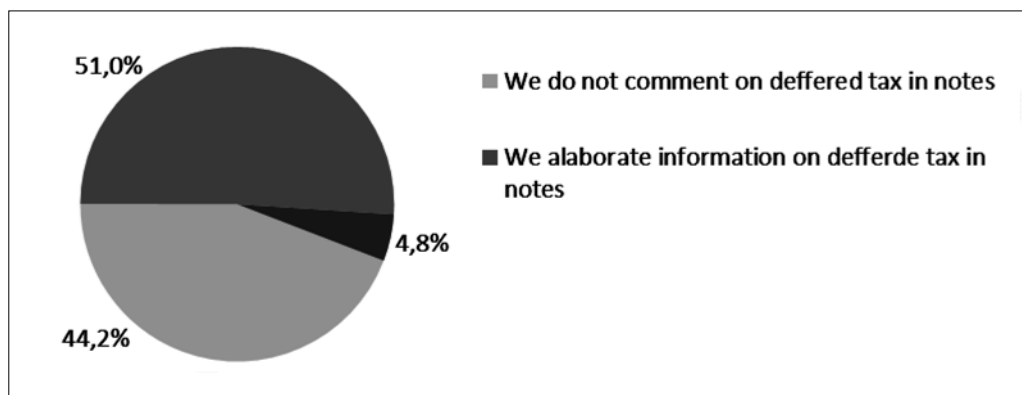


Fig. 3. Relative representation of titles entering into the calculation of deferred tax

Source: Authors' results

It stemmed from the questionnaire that approximately half of the businesses which recognize deferred tax provide information on this tax and, as the case may be, on its structure in an appendix, the second half do not.

A deferred tax liability or asset represents resulting amount into which several titles may enter during its calculation as shown in Figure 3. In that case, Section 39 Para. 5 Ordinance No. 5/2002 Coll. lays down that accounting entities are to specify in a breakdown the deferred tax liability or asset and state the titles from which the resulting amount is comprised. The following figure shows how businesses which recognize deferred tax comply with this obligation.



**Fig. 4.** Relative representation of businesses in groups according to whether they provide further information on deferred tax in an appendix

*Source:* Authors' results

The primary goal of financial reporting is that the financial statement gives a true and fair view of assets, liabilities, the financial situation and the economic result, regardless of the business size. Generally accepted accounting principles serve towards fulfilling this requirement. One of them is the prudence principle, the consistent application of which enables keeping with other general accounting principle, that being the assurance of the uninterrupted continuance of the business in the foreseeable future. These requirements are the content of the accounting directive of the European Parliament and Council 2013/34/ES from 26 June 2013 on annual financial statements and consolidated financial statements. Likewise, the amendment of the accounting act which takes effect as of 1. 1. 2016 respects these regulations. It is precisely deferred tax that is one of the tools which helps to fulfil the caution principle and the going concern principle.

The actual recording and reporting of deferred tax assets or liabilities is performed in several steps. The first is the ascertainment as to whether the accounting entity is obliged to account for deferred tax. If the law does not directly impose this obligation on the accounting entity, it has to decide whether this will improve the information capability of its financial statements and whether they should compile them fully with the connected recognition of deferred tax or not. The results of the questionnaire survey clearly show the unwillingness of accounting entities to recognize deferred tax voluntarily.

The second step is the identification of temporary differences, from which title of deferred tax arises. According to accounting regulations which are in effect, deferred tax is calculated from all temporary differences. Besides the difference between the accounting and tax net book value of depreciated property caused by varying accounting and tax depreciation, other temporary differences also have to be taken into consideration. Adjusting items, provisions, contractual penalties from delays and other titles could be examples. In view of the fact that deferred tax is not a novelty in Czech accounting, accounting entities have, as a rule, been adequately acquainted with the main titles leading to the formation of deferred tax.

It is clear from the results of the questionnaire survey that the number of accounting entities that recognized a deferred tax liability dominates. This is given both by caution in the case of deferred tax assets and the fact

that a deferred tax liability usually arises from the title of dissimilar tax and accounting depreciation, which is the most frequent and most significant title, and its influence often dominates over titles leading to the formation of deferred tax liabilities. These results are identical also to those of Poterba et al. (2011). Accounting units are obliged to provide details on deferred tax (both a liability and an asset) in an appendix to the financial statement. In the event of non-recognition of deferred tax assets due to prudence, the accounting entity should not forget to substantiate this fact. It should, among others, state the amount of non-recognized deferred tax assets and a breakdown of the titles which caused the formation of partial deferred tax assets and liabilities. It stemmed from the questionnaire survey that half of the interviewed accounting entities do not state any information on deferred tax in an appendix.

We statistically tested Hypothesis 0: Number of entities which comment on their deferred tax in their financial statements and those who do not is independent to the fact whether they calculated deferred tax as a deferred tax asset or liability. Alternative hypothesis presumed dependence of both factors. Using of  $\chi^2$  test resulted in p-value of 0,44 ( $>> 0.05$ ). This results leads to acceptance of Hypothesis 0. Thus no statistically significant relation between the way of reporting of deferred tax and the way how companies comment on it in notes was proven. Approximately a third of companies recognize deferred tax as a deferred tax asset. In accordance with the prudence principle, these firms have to expect that they will report a profit in the future adequately high enough to be able to apply this deferred tax asset in the future. According to the results of Belás, Bilan, Demjan and Sipko (2015), however, there is yet a large measure of uncertainty among Czech and Slovak entrepreneurs in connection with the preservation of their business activity given the consequences of the global financial crisis. The aim of the survey was to verify the hypothesis that if businesses are not obliged to account for deferred tax and recognize it, they do not do so, or only in very limited numbers and range. The results of the survey confirmed this hypothesis, and also pointed towards the reasons why this is so.

## Conclusions

The accounting act obliges accounting entities to keep accounts so that the financial statement compiled on the basis thereof may provide a fair and true image of the subject of the accounting of the accounting entity's financial situation (see Section 7 Para. 1 Act No. 563/1991 Coll.). Accounting for deferred tax is among the tools which enable the fulfilment of this required accounting principle. The fact that Decree No. 500/2002 Coll., as an accompanying regulation to this act, enables the majority of small and medium-sized enterprises not to account for deferred tax and not to recognize it is indeed a certain reduction of administrative burden for these businesses, although it is a contravention of the above-mentioned principles laid down by the law.

Increasing harmonization in an increasingly connected world cannot be halted. Discussion as to whether small and medium-sized businesses require thorough harmonization has been underway since the beginning of the new millennia. Objections from the sides of opponents of harmonization of financial reporting for these businesses (with the reason they are not businesses of international scale) are gradually weakening in the connected and globalizing world. Foreign investors, for whom the ability to orient themselves in business financial statements is fundamental, operate also with small and medium-sized businesses.

In 2009, the International Accounting Standards Board (IASB) published the Standard for Small and Medium-sized Enterprises, which stems from full IFRS, although it was modified for the needs of smaller entrepreneurial subjects. Although the Czech Republic has not yet implemented it (which cannot be ruled out in the future), it is an important fact that the standard does not take into consideration that small and medium-sized enterprises would not have to account for deferred tax.

The global economic environment requires the comparability and reliability of accounting information serving towards decision-making and management. US GAAP and IFRS are among the main harmonizing directions. The ever-growing harmonization of accounting standards will also have a growing influence on Czech accounting standards. This could provide a competitive advantage to firms which are already preparing for this situation (Šteker, 2012).



Company creates disposable source for covering of higher tax payable which will arise in the future by reporting deferred tax liability and disables the possibility of dispersing of this source. On the contrary reporting deferred tax asset which in its creation causes increase in disposable profit available for distribution should be approached with caution and only when it is certain that resources will be available to cover future higher tax payments. Accounting for deferred tax thus in the end can contribute to improved informational situation about expected future increase or decrease of tax collection from income tax, to improvement of predictions of such tax collection and by doing this also to better fiscal stability.

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