**CLEAN UP THE BALANCE SHEET:**

**GET RID OF DEFERRED TAXES**

***Anthony H. Catanach Jr. and J. Edward Ketz***

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Deferred tax assets and deferred tax liabilities remain bizarre and frequently misunderstood members of the financial statement community. Whatever they may be, it is doubtful that the former are assets, or that the latter are liabilities. Likewise, to measure income tax expense as a function of financial reporting income is peculiar because Congress and the IRS assess income taxes on an idiosyncratic number called taxable income, NOT some financial reporting number.

We previously discussed how the FASB has systematically distorted liability accounting by allowing corporations to hide lease obligations of an artificial construct it calls *operating leases*. See [Is A Lease Accounting Breakthrough in the Offing?](http://blogs.smeal.psu.edu/grumpyoldaccountants/archives/699) By allowing business entities to hide their lease obligations, GAAP became CRAP (cleverly rigged accounting ploys). We also have commented on the continued abuse of available-for-sale securities accounting, and how it too has GAAP eliding into CRAP. See [GAAP is Crap: The Case of JP Morgan](http://blogs.smeal.psu.edu/grumpyoldaccountants/archives/694). Maybe the FASB wanted to atone for such balance sheet faux pas by actually adding something to liabilities, and it chose deferred income taxes. In this case, GAAP becomes UNREAL (unreliable really equivocal accounting liabilities). Tired of the acronyms and initialisms yet?

The first reason why the notion of deferred tax liabilities is silly was eloquently enunciated by nationally recognized University of Chicago [Professor Sidney Davidson](http://www.chicagobooth.edu/news/2007-09-18_davidson.aspx), in a famous 1958 article in *The Accounting Review* (yes, only two Grumpy Old Accountants would remember this gem). In “Accelerated Depreciation and the Allocation of Income Taxes,” Professor Davidson explained that a growing firm that uses an accelerated form of depreciation will never pay back the deferred income tax liabilities that it records. Instead, the deferred tax liability will grow and grow, and at some point dominate the right hand side of the balance sheet. Only under certain conditions involving declining growth rates would the firm actually pay off this “liability.” It’s hard to classify something as a liability if it is never paid, isn’t it?

A second reason (and related) reason that deferred tax liabilities are “suspect” concerns the definition of liabilities, something that current standard-setters seem to overlook. The FASB defines liabilities as:

*Probable future sacrifices of economic benefits arising from present obligations of an enterprise to transfer assets or provide services to other entities in the future as a result of past transactions or events* (Concept Statement No. 6).

And since we are politically correct, the IASB employs a similar definition. Still not convinced, then just look at how deferred tax liabilities are defined in most accounting texts.

*Deferred tax liabilities represent the increase in taxes payable in future years as a result of taxable temporary differences existing at the end of the current year.*

Nothing really there about payment of resources…just a discussion about temporary differences.

Let’s look at an example. Suppose a business enterprise uses accelerated depreciation for tax purposes and straight-line for financial reporting and that depreciation for tax purposes amounts to $320,000 and for financial purposes $200,000. This creates a book/tax difference of $120,000 and, if we assume a tax rate of 25%, also a deferred tax expense and liability of $30,000. But what is the nature of this $30,000?

This $30,000 is not necessarily a probable future sacrifice—the sacrifice being the future taxes paid to the U.S. and other governments. It is a probable sacrifice only if the entity generates sufficient taxable income that the depreciation does not shield. This income stream may or may not actually occur.

And even if it were a probable future sacrifice, there is a much bigger problem. This future “sacrifice” is not a present obligation of the firm. This incremental tax becomes a “present obligation” only when the next tax year rolls around. Taxes are statutory requirements that arise only in the year they are imposed. They are not obligations in prior years.

Still not convinced? Deferred tax liabilities are not a result of past transactions between the tax authority and the taxpayer. We clearly have a transaction when the taxpayer purchased the plant or equipment, and we also have past tax transactions. But, these transactions themselves do not give rise to future tax payments. It is future transactions between the firm and the government that will lead to future tax payments.

Also, if deferred taxes were in fact liabilities, one would expect them to be discounted, something Professor Hugo Nurnberg pointed out in 1972 (“Discounting Deferred Tax Liabilities,” also in *The Accounting Review*). All long-term obligations are measured at the present value of their future cash flows, including mortgages, bonds and long-term notes payable. Perhaps the FASB does not require discounting of deferred tax liabilities because it knows that fundamentally the numbers used in computing deferred tax liabilities are not real cash outflows. If they were, discounting would be meaningful; as they aren’t cash outflows, discounting only compounds this horror.

Now let’s turn our attention to deferred tax assets, another monstrosity. The FASB defines assets as:

*Probable future economic benefits obtained or controlled by a particular enterprise as a result of past transactions or events* (Concept Statement No. 6).

And again, the IASB’s definition is again quite similar. Let’s contrast this asset definition with how deferred tax assets are defined:

*Deferred tax assets represent the increase in taxes refundable (or saved) in future years as a result of deductible temporary differences existing at the end of the current year.*

Again, nothing here about the receipt of resources, just more on temporary differences.

Another example is in order. Suppose a firm has estimated warranty expense of $1 million for financial reporting purposes, but tax expense is zero because nobody has filed a warranty claim by fiscal year-end. The FASB asserts that the company has a deferred tax asset of $250,000 (assuming again the tax rate is 25%) because the amount represents future deductions against future taxes.

However, these “tax assets” are not future economic benefits yet if for no other reason, than the government’s tax laws can change. Even if they were, they are not the result of any past transactions or events. Nobody has made a warranty claim. All we have is an adjusting journal entry that the entity made with itself. It has not contracted or exchanged anything involving these warranties. And, as before, not requiring any discounting is again telling—there is no discounting because there is no event and no cash inflow.

Additionally, a company must write down the supposed value of the deferred tax asset if it is more likely than not that it will not realize some of the asset (i.e., the company will not generate sufficient taxable income to be able to use future deductions). If this “asset” were real, where is the market valuation (mark-to-market model)? As firms cannot reliably conduct such a valuation (e.g., a Level 3 estimate per FAS 157), the presumed valuation process rings hollow.

Probably the most illogical aspect of deferred taxes of all occurs on the income statement. Companies generally report income tax expense immediately after income before taxes. This close proximity gives the reader the idea that there is a relationship between the two, but of course, there is no association. The actual amounts owed to the IRS are computed on taxable income, not on the financial reporting earnings before taxes.

Expenses are supposed to be sacrifices incurred during the operating activities of the entity. While the current taxes payable portion of income tax expense is indeed a sacrifice, the deferred portion is clearly not a sacrifice of any resources of the firm. Indeed, business enterprises manage their taxes so as to minimize the sacrifices they make.

So, why haven’t corporations objected too much to deferred income tax accounting? Clearly, wiping these liabilities off the books would improve long-term solvency ratios. Maybe they like the fact that this accounting gives the public the perception that businesses are paying significantly more taxes than they actually do. Wal-Mart, for example, reports income tax expense of $7.9 billion on pretax income of $24.4 billion, a tax rate of 33 percent. It also discloses that it actually paid $5.9 billion to government agencies, a difference of $2 billion. This accounting treatment might be important rhetorically to corporations in debates about whether corporate America pays its fair share (e.g., Duhigg and Kocieniewski, “[How Apple Sidesteps Billions in Taxes,” *New York Times*](http://www.nytimes.com/2012/04/29/business/apples-tax-strategy-aims-at-low-tax-states-and-nations.html?pagewanted=all)), assuming the public confuses income tax expense with income taxes paid. Given the complexity of the issues we have outlined about, is there any doubt that they do?

Analysts and researchers (and Grumpy Old Accountants) have an easy time dealing with the problem of deferred income taxes, as the misinformation is in plain view. We just eliminate the phony assets and liabilities from the balance sheet, and recast income tax expense to the current tax liability portion. Nevertheless, the FASB still should eliminate these deferred accounts and clean up the balance sheet, especially if they are serious about principles-based accounting. It makes the financial statements more representationally faithful, a key qualitative characteristic per FASB Concept Statement No.8. And the IASB should follow suit. Would you call this reverse conceptual condorsement?

And the benefits don’t end there. Auditors could spend less time auditing the income tax accrual, corporations could reduce tax accounting staff that spend hours accumulating temporary difference data, text publishers could eliminate a voluminous chapter from accounting texts (and reduce costs), educators could spend more time teaching meaningful accounting topics (e.g., the statement of cash flows), and students could stop memorizing one more set of useless accounting rules.

Just a thought…

*This essay reflects the opinion of the authors and not necessarily the opinions of The Pennsylvania State University, The American College, or Villanova University.*