ACCOUNTING TREATMENT OF DEFERRED INCOME TAXES ACCORDING TO THE REQUIREMENTS OF THE ROMANIAN ACCOUNTING REGULATIONS

Bunget Ovidiu-Constantin

West University of Timişoara, Faculty of Economics and Business Administration, Timişoara, 16, J. H. Pestalozzi Blvd., Phone: +40 (740) 250.934, ovidiu.bunget@abaconsulting.ro

Dumitrescu Alin-Constantin

West University of Timişoara, Faculty of Economics and Business Administration, Timişoara, 16, J. H. Pestalozzi Blvd., Phone: +40 (740) 250.955, alin.dumitrescu@abaconsulting.ro

Abstract: Known as a debatable topic, the relationship between accounting and taxation still represents a field of convergence and divergence, of tolerance and intolerance. Therefore, the Romanian accountant is in permanent pursuit of quality accounting information and its impact on taxation. Currently, a great importance is granted to accounting judgements, and this is magnified by the fact that most fiscal contributions are based on accounting information. Deferred income taxes reconcile accounting profits with income taxes pursuant to the impact of temporary differences between the book value and tax value of assets and liabilities disclosed in the financial statements.

Key words: deferred income taxes, reserves, provisions, accounting.

The adoption of Order of the Minister of Public Finance no. 94/2001 for the harmonization of Romanian financial reporting with the requirements of the 4th Directive of the European Union and of the International Accounting Standards[298] (OMFP 94) accelerated the reorganization of Romanian accounting, based on the International Accounting Standards (subsequently, International Financial Reporting Standards – IFRS).

International Accounting Standard IAS 12 – Income Taxes (*IAS 12*) is known as a difficult regulation in respect to the practical application of its provisions in Romania, especially regarding the recognition of deferred income taxes. Therefore, it is still subject to many actual accounting debates. *OMFP 94* does not explicitly refer to income taxes[299]. Practically, it accepts *in integrum* the application of *IAS 12 – Income Taxes*. We should highlight here the efforts of the Romanian accounting legislators to approve „solutions"[300] regarding the application of legal provisions referring to deferred income taxes, and to grant some current practices the rank of accounting law source, but also the efforts of professional bodies, respectively the Body of Romanian Chartered and Certified Accountants.

Deferred income taxes reconcile accounting profits with income taxes pursuant to the impact of temporary differences between the book value and tax value of assets and liabilities disclosed in the financial statements. Based on the previous assertions we can conclude the following:

The *assessment* of deferred income taxes is based on balance sheet information (known as the „balance sheet method" or the method of variable carry forwards) and not on the income statement. When the book value of assets is smaller than the tax basis, respectively the book value of liabilities is higher than the tax basis we obtain a *deductible temporary difference,* which generally generates receivables for deferred income taxes. When the book value of assets is higher than the tax basis, respectively when the book value of liabilities is smaller than the tax basis we obtain a *taxable temporary difference*, which generally generates payables for deferred income taxes. Although not from the beginning, *OMFP 94* has created the conditions for the appropriate application of the requirements of *IAS 12,* by introducing in the chart the

[298] Romania's Official Gazette, Part I, no. 85/ 20 February 2001

[299] Bunget Ovidiu Constantin – *Contabilitatea românească: între reformă şi convergenţă*, Economica Printing House, Bucharest, 2005, p. 295

[300] Decision of the Minister of Public Finance no. 9/2003 for approval of certain solutions regarding the application of legal provisions regarding income taxes, together with the accounting regulations harmonised with the European Directives and with the International Accounting Standards, Romania's Official Gazette no. 171 bis/2003

following accounts regarding deferred income taxes: *6912 - Expenses with deferred income taxes*, *791 - Revenues from deferred income taxes*, *4412 - Deferred income tax*.

Temporary differences represent the essential element of the variable carry forwards method (the previous version of *IAS 12* allowed the recognition of deferred income taxes based on two methods: fixed carry forwards and variable carry forwards; however, they were based on the income statement and are currently prohibited).

Deductible temporary differences means that the company will have to affect its current results with amounts representing recoverable income tax for current balance sheet items, due to the fact that, up to now, it paid more income taxes, and in the future, for

4412 Deferred income taxes = *791 Revenues from deferred income taxes*

the same balance sheet items, it will pay less (current) income taxes and the income tax receivables will be reversed.

6912 Expenses with deferred income taxes = *4412 Deferred income tax*

Active deferred taxes should be recognised under special precautions. In fact, they represent a future tax deduction and the expressed supposition is valid only if the company achieves sufficient future taxable profits in order to allow the ascertained deduction. We mention below the following situations:

- the company holds sufficient passive deferred taxes vis-à-vis the tax authority;
- the company expects to hold sufficient future profits vis-à-vis the tax authority, from other sources than those from passive deferred taxes;
- the company's fiscal facilities allow the procurement of sufficient future taxable profits necessary for recovering/cancelling active deferred taxes;

Taxable temporary differences means that, in the future, when it will obtain economic benefits (when the value of assets or liabilities is recovered), the company will have to pay amounts, which once represented current income taxes. Therefore, out of prudence reasons, the company should initially recognise the liabilities with deferred income taxes,

6912 Expenses with deferred income taxes = *4412 Deferred income tax*

and at that future date, it should reverse the liabilities with deferred income taxes, because it should have had realised taxable profits for which it will pay current income taxes.

4412 Deferred income taxes = *791 Revenues from deferred income taxes*

We would like to highlight, that income taxes are generated *only* by temporary differences and not by final differences (permanent)[301]. The latest are subject to fiscal and accounting judgements within a definite financial year. They are not „carried forward" to future periods (i.e. protocol expenses, outages, fines and penalties, daily allowance, etc.).

On the other hand, due to accounting and fiscal treatments applied in different ways and in different financial years, there are also situations resulting in temporary differences for other items included in the yearly financial statements, such as:

- expenses with interests and unfavourable exchange rate differences related to the financial year, which do not comply with the requirements regarding full deductibility of that financial year, and which are fiscally carried forward to the next financial years;
- fixed assets disclosed in the balance sheet, which did not benefit of the additional fiscal amortization of 20% or of other amortization regimes not recognised by the tax legislation;
- capitalization of provisions for restoration of damaged land or for environment rehabilitation, which are deductible expenses under the tax law; from the accounting point of view, these provisions are capitalised, and therefore they will be expensed in tranches, by means of amortization;

[301] Mihai Ristea (coordinator) – *Contabilitatea finciară a întreprinderii*, Universitara Printing House, Bucharest, 2004, p. 480

– revenues and expenses related to hire purchases are taxable, respectively deductible during the duration of the contract, and accounting entries are recognised when delivered;
– tangible and intangible assets with a different working life than the normal technical working lives are fiscally recognised (Law no. 15/1994 regarding amortization of capital included in tangible and intangible assets, republished, with subsequent amendments);
– costs recognised as expenses in accounting, which fiscally are considered assets; they will be recognised as deductible expenses in tranches, according to law;

The assessment of deferred income taxes coincides with the assessment of the yearly financial statements. The deferred income tax is calculated by weighing the temporary difference with the valid income tax rate or with the income tax rate to be in force at the date when the asset will be realised or the debt will be paid, based on the legislation in force at the date of the preparation of the financial statements or on the legislation to be in force, but for which exists a reasonable level of certainty at the date of the financial statements (the transition from 25% to 16% starting with 2005 is a good example in this respect).

In the yearly financial statements, the balance of account *4412 Deferred income tax* reflects the nature of the deferred income tax (payable or recoverable) in the future, for the items presented in the financial statements and which have allocated temporary differences.

Recognition of deferred income taxes according to the requirements of *OMFP 94* (and *IAS 12*, by default) assumes consideration of the two moments involved [302], respectively:

– application for the first time of accounting regulations harmonised with the 4th Directive of the European Union and with the International Accounting Standards (known in practice as „restatement"); this assumes transition from the previous accounting regulations (Government Decision no. 704/1993 regarding approval of the regulation for the application of Accounting Law or Order of the Finance Minister no. 306/2002 for the approval of simplified accounting regulations, harmonised with the European Directives) to *OMFP 94*;
– actual application of accounting regulations harmonised with the 4th Directive of the European Union and with the International Accounting Standards;

While the second step, theoretically, does not raise any particular problems for accountants, on the other hand, restatement presumes also some reconsiderations of certain accounting problems treated or not treated based on the previous regulations. It is also the case of temporary differences generated both by application of art. 11 (5) of Law no. 414/2002 regarding income tax[303] (valid until 31 December 2003), and by application of art. 24 (12) of Law no. 571/2003 regarding Fiscal Code[304] (after 1 January 2004, until 30 April 2005). The mentioned tax regulations specified that, under certain conditions, companies can benefit from the fiscal facility of recognising an „additional" amortization of 20% out of the fixed assets' input value, at the put in function date. Companies, which used this „facility" and reported according to *OMFP 306,* were allowed to recognise this "additional" amortization also from the accounting point of view (connection accounting-taxation!). However, at the end of the financial year, the realised „income tax savings" should have been „allocated to reserves, by means of account *129 Profit distribution = 1068 Other reserves* / separate analytic"[305]. Subsequent to approval of Law no. 571/2003 regarding Fiscal Code and introduction of the fiscal evidence register for income taxes, the facility of 20% could no longer generate an „additional" accounting amortization expense. However, for profit distribution the legislation maintained the restriction regarding allocation to reserves of realised income tax „savings". We hope that the example below contributes to the understanding of the different approaches and recognitions generated by the application of different accounting regulations.

In October 2003 a company purchased an equipment of 480,000 currency units. The company uses the straight-line method of depreciation over a period of 4 years, according to the provisions of Law no. 15/1994 regarding amortization of capital included in tangible and intangible assets, republished, with

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[302] Emilia Iordache (coordinator) – *Ghid practic de reconciliere contabilitate-fiscalitate*, C.N. Imprimeria Națională S.A. Printing House, Bucharest, 2005, p. 14
[303] Romania's Official Gazette, Part I, no. 456/27 June 2002
[304] Romania's Official Gazette, Part I, no. 927/23 December 2003
[305] Order of the Minister of Public Finance no. 1784/2002 regarding approval of certain measures referring to the closure of the 2002 financial year for juridical persons, which have to prepare yearly financial statements according to Accounting Law no. 82/1991, republished in Romania's Official Gazette, Part I, no. 21/2003, in Appendix at pt. 30

subsequent amendments, and Government Decision no. 964 regarding approval of classification and normal working lives of fixed assets (currently cancelled by Government Decision no. 2139/2004 regarding approval of the Catalogue for classification and normal working lives of fixed assets). The company decided for the additional deduction of 20% out of the input value at the acquisition date, according to art. 11 (5) of Law no. 414/2002 regarding income taxes.

The accounting amortization is of 10,000 currency units/months (480,000 currency units/4 years x 12 months). The fiscal facility consists in an „additional" amortization of 20% out of the input value. At the equipment's put in function date, the facility amounts to 96,000 currency units (480,000 currency units x 20%). Thus, the value of assets to which the monthly fiscal amortization is calculated amounts to 384,000 currency units (480,000 currency units – 96,000 currency units), and the monthly fiscal amortization is of 8,000 currency units (284,000 currency units/48 months).

Considering that the equipment is used during the entire estimated working life, deferred income tax will be calculated as following:

Year	2002	2003	2004	2005	2006
Net book value at year end (accounting basis)	460.000*	340.000	220.000	100.000	-
Fiscal basis (taxable)	368.000**	272.000	176.000	80.000	-
Taxable temporary difference	92.000	68.000	44.000	20.000	-
Total liabilities regarding deferred income taxes	23.000	17.000	7.040	3.200	-
Initial liabilities regarding deferred income taxes	-	23.000	17.000	7.040	-
Adjustment of initial liabilities for deferred income taxes resulted from the decrease of tax rates (25%-16%=9%)	-	-	(6.120)	-	-
Expenses/(revenues) with deferred income taxes from recognition of temporary differences	23.000	(6.000)	(3.840)	(3.840)	(3.200)

* 480.000 – 2 x 10.000 =460.000

* *480.000 – 60.000 – 16.000 = 368.000*

As one can observe, in 2002, when the equipment is put in function, there is a taxable temporary difference, which results in the recognition of a deferred income tax liability in amount of 23,000 currency units.

23.000 6912 Expenses with deferred income taxes = 4412 Deferred income tax 23.000

This amount decreased by resuming it in revenues related to next periods, when the value of the asset (equipment) is gradually recovered by means of amortization, for instance in 2003.

6.000 4412 Deferred income tax = 791 Revenues from deferred income taxes 6.000

At the end of 2004, the changes in the tax provisions generated an adjustment of liabilities regarding deferred income taxes, due to the change of tax rates from 25% to 16%. The total effect was of 9,960 currency units, which we can divide in the effect of the changes in the taxable temporary differences, of 3,840 currency units (68,000 currency units – 44,000 currency units = 22,000 currency units x 16% = 3,840 currency units) and the effect exclusively owed to the change of tax rates, of 68,000 (25%-16%) = 6,120 currency units.

9.960 4412 Deferred income tax = 791 Revenues from deferred income tax 9.960

Assuming that the company switched to OMFP 94 in 2003, it should have restated the financial statements for the financial year ended as of 31 December 2002, when it reported according to OMFP 306, and when the „income tax savings" were recognised as other reserves (# 1068 Other reserves). Practically, this should

have affected own capitals by transferring the „income tax savings” from reserves to liabilities regarding deferred income taxes (an amount of 23,000 currency units).

23.000 1068 Other reserves / separate analytic = 4412 Deferred income tax 23.000

The accounting regulation applicable from 1 January 2006, respectively Order of the Minister of Public Finance no. 1752/2005 regarding approval of accounting regulations harmonised with the European Directives[306] (*OMFP 1752*), gives up the idea of „deferred income tax” and introduces the idea of „provisions for taxes” (*1516 Provisions for taxes*). This account takes over the liabilities regarding deferred income tax. However, *OMFP 1752* proved to be very prudent in respect to receivables for deferred income tax. It no longer contains provisions regarding this economic category, and when the balances of accounts in the trial balance as of 31 December 2005 were transferred to the new chart of accounts, the debit balance of account *4412 Deferred income tax* was allocated to account *1176 Retained earnings resulted from transition to accounting regulations harmonised with the 4th Directive of the European Union*.

The aspects presented above show a fairly interesting development of the approach of passive deferred income tax in Romania. This means that liabilities (the company's current liabilities, resulting from past events; through their settlement the company expects a resources outflow with economic benefits), respectively provisions (debts due or with an uncertain value) are transferred to own capitals (residual interest of shareholders in the company's assets after deducting its liabilities), according to the applied accounting regulation, respectively Order of the Minister of Finance no. 306/2002 regarding approval of simplified accounting regulations harmonised with the European Directives, Order of the Minister of Public Finance no. 94/2001 regarding harmonisation of Romanian accounting regulations with the requirements of the 4th Directive of the European Union and of the International Accounting Standards or Order of the Minister of Public Finance no. 1752/2005 regarding approval of accounting regulations harmonised the European Directives.

Although the 4th Directive of the European Union no. 78/660/EEC regarding yearly accounts of certain types of companies was amended in order to comply with the International Financial Reporting Standards, there are still many problems to be discussed. However, in the near future, the Romanian accounting regulations will „dance” in the spirit of the European regulation, with its performances and imperfections.

In respect to *IAS 12 – Income taxes*, although its application would improve the accurate reporting of expenses/revenues regarding income taxes (i.e. expenses with income taxes are better „correlated” with accounting profits), technically speaking, the functioning mechanism of deferred income tax liabilities is similar to that of provisions for risks and expenses, and, therefore, there should be no significant perception difficulties. However, we recommend granting an increased attention to the economic-financial analysis of financial statements.

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[306] Romania's Official Gazette, Part I, no. 1080 bis/30 November 2005