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DEFERRED TAXES IN THE CONTEXT OF THE UNIT PROBLEM

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This article examines the theory underlying the current accounting and reporting standards for deferred taxes and concludes that using the flow-through accounting approach is a better fit for reporting this financial statement item than the asset-liability approach currently required by the Financial Accounting Standards Board (FASB). We propose that the underlying issue in accounting for deferred taxes is the unit problem as presented by Carl Devine. To obtain a perspective on the magnitude and behavior of the deferred tax account balances reported by firms, we observe approximately 2,100 firms in 20 industries over a ten-year period (1997-2006). Most firms appear to postpone deferred tax reversals by utilizing tax planning strategies, allowing them to defer indefinitely the requirement to pay tax on earlier timing differences. Therefore, net deferred tax liability balances can be thought of as possible or remote contingencies rather than probable liabilities. To illustrate the financial consequences of using the approach where the tax expense is equal to the statutory tax liability instead of the expense reported under the current rules, we compute the change in the debt-to-equity (DTE) ratios of the firms in the sample by eliminating the net deferred tax balances from liabilities and adding them to equities.

Keywords: Deferred taxes, the unit problem, flow-through method, asset-liability method.

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