UNDERSTANDING THE EFFECTS OF DEFERRED INCOME TAXES ON YOUR OPERATION

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Abstract

Understanding the impact of deferred taxes of any business is vital for management decision-making and monitoring. Standardization facilitates the ability to compute useful and meaningful measures that are comparable to similar businesses. This article explores the issues and computation of deferred taxes on a balance sheet for a farm or ranch as recommended by the Farm Financial Standards Council.

Introduction

When you look at your market value balance sheet, does the equity reflected accurately depict the equity of your operation? Many financial experts and the Farm Financial Standards Council (FFSC) would say no unless your balance sheet includes deferred income taxes. Research has found that most agricultural operations do not compute deferred income taxes on their balance sheet; this article attempts to explain what deferred income taxes are and why it is important to know this item for your operation. *Please note that this article focuses on the balance sheet impact of deferred income taxes, but does not directly address the income statement and earnings impact of deferred income taxes (that discussion would be beyond the scope of this article).*

What are Deferred Income Taxes?

Simply put, deferred income taxes represent an estimate of income taxes that would be due if assets on your balance sheet were sold at their indicated value. In essence, they result from two general types of activities:

- Income taxes due upon the sale of inventories and other assets that are part of your ongoing operation (for example, $100,000 of crop inventory would yield $100,000 of taxable income.)
- Income taxes due upon the sale of capital assets (machinery and equipment, real estate, buildings and improvements, etc.) sold at the value indicated on the balance sheet (this is also sometimes referred to as contingent taxes).

How are Deferred Income Taxes Computed?

There are two main components of deferred income taxes that need to be computed for your operation's balance sheet (three components if you have raised breeding livestock, but we won't go into that discussion here).

The current portion of deferred income taxes relates to taxes associated with the conversion to cash of inventories, receivables, etc. These income taxes may not be due for a long period of time if you continue to maintain year-end inventory at this level. But, since they are "associated" with current assets and the tax would be triggered if those assets were sold, the liability should be shown in the current section of the balance sheet.

In this previous example, inventories are $400,000. From this amount we subtract certain deductible items from the current liabilities section of the balance sheet (accounts payable and accrued interest totaling $80,000). The net of these two numbers ($320,000) is the amount of taxable income that will be generated when the current assets are liquidated and the current liabilities are paid. The amount of taxable income is multiplied by an estimated average tax rate (in this example 30% is being used) and this equals the current portion of deferred income taxes of $96,000.

The noncurrent portion of deferred income taxes is computed in a similar matter except there are generally no deductible liabilities. In this example the market value of machinery and equipment plus real estate ($1,700,000) is subtracted from its tax-basis ($750,000) and the difference ($950,000) is multiplied by the average income tax rate or capital gains tax rate (30% is used here again) to arrive at $285,000.

Why are Deferred Income Taxes Important?

There are four main reasons why deferred taxes are important in truly understanding the financial situation of your operation:

- Provides a more accurate calculation of accrual earnings
- Provides a more accurate measure of your equity position
- Moderates earnings by increasing the tax liability in "good" years and decreasing the tax liability in "bad" years
- When deferred taxes decrease from one balance sheet to the next, a tax reversal is created thereby providing cushion to your operation

The following anecdote shows why deferred taxes are an important component of accurate financial statements. The FFSC has recommended that farmers and ranchers provide a market value balance sheet as part of their financial statements. Because assets are valued at their fair market value, increases in the value of some assets create valuation equity—equity that is not earned (arises as market values exceed the book value of these assets). Therefore as land values increase over time we find that market equity is increasing while the operation simply holds the land. While there is nothing wrong with valuing land at its current fair market value, implicit in the increase in value is a gain on the purchase (i.e., a capital gain). Without accounting for the tax on the capital gain, equity is being overstated.

By adding a deferred tax component to reflect the increase in the value of the real estate, a truer picture of the operation is presented. The financial statements now reflect the equity of the farmer or rancher once the land is sold and income taxes are paid. True, this number is an estimate, but so is depreciation. And, true, most farmers or ranchers won't sell their real estate until they retire. However, an overstatement of equity will occur whenever we allow assets to move freely, without compensating for the increased tax liability on those assets that are increasing in value. Further, it is impossible to predict the future performance of an operation; therefore by showing its true financial picture accurately each year we avoid potential surprises in the unlikely event of a forced sale.

Summary

What are the implications to financial analysis when computing and including deferred income taxes on the financial statements? The first thing to remember is that it's the same operation. Secondly, you might be required to look at your operation both ways (with and without deferred income taxes). Third, as the agricultural industry comes to terms with looking at the impact of deferred income taxes, the typical measures of financial ratios (or benchmarks) we have come to rely on will need to be adjusted. Finally, a key point to keep in mind is that the inclusion of deferred income taxes does not lower your equity—it might lower your reported equity. But, when assets are sold that have unrealized capital gains or income is deferred until next year a tax liability has been created and should be recognized.

An Example

Notice the difference in the two following balance sheets. They are for the same operation—one is simply computed without deferred income taxes, while the other operation has computed deferred income taxes. The difference in equity between these two balance sheets is $381,000.

Assets			
	Without deferred income taxes	With deferred income taxes	
Cash	10,000	10,000	
Inventories	400,000	400,000	= 400,000
Current assets	410,000	410,000	
Machinery	500,000	500,000	= 1,700,000
Land	1,200,000	1,200,000	
Total assets	2,110,000	2,110,000	
Liabilities and Equity			
Accounts payable	50,000	50,000	= 80,000
Accrued interest	30,000	30,000	
Operating note	250,000	250,000	
Current maturity	55,000	55,000	
Current portion deferred taxes	0	96,000	= (400,000 - 80,000) X 30%
Current liabilities	385,000	481,000	
Term debt	375,000	375,000	
Noncurrent portion deferred taxes	0	285,000	= (1,700,000 - 750,000) X 30%
Total liabilities	760,000	1,141,000	
Total equity	1,350,000	969,000	
Total liabilities and equity	2,110,000	2,110,000