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Accounting for Income Taxes

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Accounting for Income Taxes

Submitted in Partial Fulfillment of the Requirements for Graduation with Honors to the Department of Accounting, Business Administration, and Economics at Carroll College, Helena, Montana.

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April 3, 1992
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I would like to dedicate this thesis to Charles Mandeville who passed away this year. Thank you for your time, caring, sense of humor and especially for making class enjoyable. You, Mr. Mandeville, are the reason I stayed in the accounting program, I guess I have a little German in me too.
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ABSTRACT

Deferred taxes began with the idea that each accounting period should be allocated an amount of income tax expense that relates to the income shown on the income statement (Rosenfield and Dent, 1983, p. 44). The difference between income taxes displayed on an enterprise’s books and taxes paid to the Internal Revenue Service (IRS) due to timing differences is a basic explanation of deferred taxes. However, the simplified definition neither accurately describes deferred taxes nor explains how deferred taxes originate.

The purpose of this thesis is to inform the reader about the controversy in accounting for deferred taxes from the inception of accounting for deferred taxes under the Accounting Principles Board (ABP) 1967 Opinion No. 11, Accounting for Income Taxes, to the adoption of the Financial Accounting Standards Board’s (FASB) Statement of Financial Accounting Standards (SFAS) No. 96 by the same name. SFAS No. 96 was conceived due to the introduction of the conceptual framework.

I will begin with a broad overview of financial accounting policies and practices and then, through the use of a particular example, explain the different methods of measuring deferred taxes and the methods of allocating deferred taxes to the balance sheet. I will show how the use of the liability method, required by SFAS No. 96, more accurately depicts the economic reality of deferred taxes, but due to the complexities behind accounting for deferred taxes and the controversy in applying SFAS No. 96. The statement has been delayed several times creating a period of non-comparability of financial statements for use to investors and creditors and a wide diversity in practice of accounting for deferred taxes.
INTRODUCTION

The FASB is the "official private sector charged with the responsibility of establishing and improving Generally Accepted Accounting Principles in the United States" (Williams et al., 1989, p. 15). Since FASB superseded the APB in 1973, one of its major projects has been creating a conceptual framework. The theory behind the conceptual framework was to "develop an authoritative, coherent structure of objectives and broad fundamentals of financial accounting...[which] will be the basis for developing new financial accounting standards and eliminating inconsistencies that exist in current standards" (Williams et al., 1989, p. 24).

The conceptual framework mandates the use of the asset/liability method, which emphasizes the balance sheet where assets and liabilities are presented instead of the income statement. "The FASB pronouncement that best illustrates the shift from an income statement to a balance sheet focus is Statement No. 96 Accounting for Income Taxes. This statement changes accounting for income taxes from the deferred method, which has an income statement focus, to the liability method, which is much more balance sheet driven" (Sever and Boisclair, 1990, p. 37).
When accounting for income taxes, one must decide if taxes are an expense or a distribution of income. Several arguments exist for a distribution of income theory. First, expenses are incurred to attain a specific benefit or to generate revenue. Income taxes are not an expense under this definition because they are not paid to obtain a specific benefit or to generate revenue (Beresford et al, 1983, p. 25). Furthermore, expenses are incurred during regular business and exist whether or not a profit is made. However, income taxes occur only if taxable income exists. Income taxes therefore cannot be an expense because the amount is determined by income; thus, they are a distribution of income.

On the other hand, proponents of income as an expense claim that

income tax involves a commitment and subsequent payment of cash not available for dividends or other purpose...income taxes are a cost of doing business, as are wages, salaries, and raw materials. They believe income taxes are subject to managerial control, reduction and administration, just as other costs are...they contend that the nature of the tax by itself should not change the view that it is an expense (Beresford et al, 1983, p.26).

Since income taxes are considered an expense and not a distribution of income in authoritative accounting pronouncements, we will assume that they are an expense in this paper.

Deferred taxes are a balance sheet item which represents either a future tax obligation or benefit to an enterprise due to temporary differences. These differences occur when revenues and expenses
are reported in financial statement pretax income either earlier or later than they are included in taxable income reported to the IRS. Depreciation is the most widely encountered temporary difference (Stepp, 1985, p. 99). The difference exists because depreciation for accounting purposes is used to allocate the cost of the asset over its useful life. However, the IRS allows for a faster write-off to encourage capital spending (Beresford et al., 1983, p. 134). For instance, BOB, Inc. buys equipment for $500,000 on January 1, 1990. BOB will depreciate the equipment on its books using the straight line method over the ten-year useful life of the asset. On the other hand, BOB will use the Accelerated Cost Recovery System (ACRS) for income tax purposes. On December 31, of the next five years, BOB will depreciate $50,000 on his books. However, depreciation for ACRS purposes designed by the IRS is as follows for BOB’s equipment, which is classified as five-year equipment:

<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>20%</td>
</tr>
<tr>
<td>Year 2</td>
<td>37%</td>
</tr>
<tr>
<td>Year 3</td>
<td>19%</td>
</tr>
<tr>
<td>Year 4</td>
<td>12%</td>
</tr>
<tr>
<td>Year 5</td>
<td>12%</td>
</tr>
</tbody>
</table>

The depreciation will reduce taxable income by a greater amount than the books in the first five years, but less in later years. Since FASB requires accounting for deferred taxes, the options available to them, their choices and reasons why are what follows.
Chapter 1
THE CONCEPTUAL FRAMEWORK

The conceptual framework changes the major financial statement from the income statement, which represents an enterprise’s revenues and expenses over a period of time, to the balance sheet, which represents an enterprise’s financial position at a particular point in time. This asset/liability approach emphasizes the balance sheet where assets and liabilities are located and then explains revenues and expenses through these accounts. In accounting for deferred taxes, the asset/liability method focuses on those assets and liabilities that have a tax basis different from the financial reporting basis (Parks, 1988, p. 25).

As FASB attempts to bring coherence to financial reporting and accounting principles through the conceptual framework and to create more consistency in accounting standards, changes occur in the display of the financial reports and also affects the bottom line.

With more items appearing, the display of the balance sheet is changed (Sever and Boisclair, 1990, p. 37). Since the conceptual framework was implemented, several pronouncements have been adopted that require the balance sheet presentation to be much more detailed (Sever and Boisclair, 1990, p. 137). The statement that best illustrates this switch is SFAS No. 96, Accounting for Income Taxes.
This statement changes accounting for income taxes from the deferred method to the liability method (Sever and Boisclair, 1990, p. 37).

The switch to emphasizing the balance sheet makes the income statement more volatile. This situation is true especially in the area of taxes because SFAS No. 96 requires that a change in tax rates must be immediately recognized (Sever and Boisclair, 1990, p. 37). This recognition requires that the tax asset or liability be remeasured with the new rate and the change placed on the income statement. The result is that the income statement not only reflects events occurring from operations, but also changes in various balance sheet accounts that are unrelated to the operations of the enterprise (Sever and Boisclair, 1990, p. 37). The increased volatility will make explaining the income statement in footnote disclosures more difficult and more necessary for management and investors to be able to interpret the report (Sever and Boisclair, 1990, p. 37).

Only three of the concepts statements relate to the accounting for deferred income taxes. Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises* states that the objective of financial accounting is to provide information about the economic resources of an enterprise and claims to those resources, to provide information useful in assessing the amounts, timing, and uncertainty of prospective net cash flows, to provide information on factors that may affect liquidity and solvency, and to provide information about how an enterprise obtains and spends cash (Nair and Weygandt, 1981, p. 98). The focus of the financial statements are geared toward external users to help with investment and credit decisions.
Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information* identifies two major objectives of financial reporting statements: relevance, that is, information reported, should help users make predictions about an enterprise’s future, and reliability, that is, information reported should accurately represent what it purports to represent.

Concepts Statement No. 6, *Elements of Financial Statements of Business Enterprises*, which supersedes Concepts Statement No. 3 with the same name, defines the basic elements on financial statements. According to Concepts Statement No. 6, an item should appear on the balance sheet or income statement only if it qualifies as an asset or liability, a revenue or expense, can be recognized, and can be measured or estimated in a dollar value with a reasonable degree of accuracy. According to Concepts Statement No. 6, liabilities are defined as “probable future sacrifices of economic benefit obtained or controlled by a particular entity as a result of a past transaction or event” and assets are defined as “probable future economic benefits obtained or controlled by a particular entity as a result of past transactions” (Read and Bartsch, 1991, p. 15).

FASB has restructured the requirements for accounting for income taxes based on the criteria set forth in the conceptual framework.
Revenues and expenses that are reported in financial statement pretax income either earlier or later than they are included in taxable income reported to the IRS create temporary differences (Discussion Memorandum, 1983, p. 1). These differences are called timing differences, and APB Opinion No. 11 defines them as a difference "between the periods in which transactions affect taxable income and the periods in which they enter into the determination of pretax accounting income" (Exposure Draft, 1986, p. 6). If they reduce taxable income in one period, then they will reduce financial reporting income in another, and the cumulative effect will be the same (Discussion Memorandum, 1983, p. 1). SFAS No. 96 expands timing differences to include tax credits, changes due to inflation and business combinations.

All timing differences fall into essentially three classes. The first is where the reversal is not dependent on future events, and either origination or reversal takes place within a single discrete period. One of these differences is gross profit on installment sales. To facilitate the collection of taxes, the government allows this kind of difference to be accounted for tax wise on a cash inflow basis
The theory behind the IRS rule is that it is easier to collect taxes in the period that the enterprise actually receives the cash rather than when it acknowledge the revenue, but does not have the cash on hand.

The most common kind of reversal is one which is not dependent on future events, but both origination and reversal take place over several periods.

The final class of timing difference is one in which the reversal depends on future events. However, predicting the period of reversal may be difficult and estimates of the reversal may change over time. These qualities are especially true on depreciation and warranty liability (Stepp, 1985, p. 106). The government allows accelerated depreciation, higher tax deductions, in the first years of ownership of an asset in order to advance economic goals. Accelerated depreciation gives incentives to make capital investments (Discussion Memorandum, 1983, p. 1). The following are the types of timing differences which have to be accounted for:

1. Revenues or gains are taxable after they are recognized in financial income (Exposure Draft, 1986, p. 4). These are timing differences due to installment sales when the financial accounting income recognizes all the revenue from the sale at the time of the sale, but taxable income is not recognized until cash is received, often over several periods. The related income tax expense must be included in both the current taxes payable and deferred taxes payable until the sales are collected and the deferral reverses (Giles, 1976, p. 11).
2. Expenses or losses are deductible after they are recognized in financial income (Exposure Draft, 1986, p. 4). A warranty liability is an example of this type of timing difference. An expense for expected warranty obligations is recognized in the financial statements at the time of the sale, but the deduction is not recognized in taxable income until a payment is made.

3. Revenues or gains are taxable before they are recognized in financial income (Exposure Draft, 1986, p. 4). An example of this timing difference is the sale of subscriptions. The receipt of cash is recognized immediately as taxable income, but financial income cannot be recognized until the services have been rendered and the income earned. For tax purposes, the future services will not be included in taxable income in future years.

4. Expenses or losses are deductible before they are recognized in financial income (Exposure Draft, 1986, p. 4). Depreciation of an asset is an example of this type of timing difference. Tax laws allow a faster depreciation method than is often taken for financial accounting income. Accounting theory mandates that the cost of the asset be allocated over the useful life of the asset through depreciation. However, the government allows a faster depreciation rate as an economic incentive for capital spending. Since the asset cannot be depreciated below its cost either for tax reporting or financial reporting, the difference between the two methods is temporary and will “catch-up” in future years. The result is lower taxes in the first year of ownership but additional taxes in later years.
Statement of Financial Accounting Standards No. 96 goes beyond timing differences to require the recognition of temporary differences. Temporary differences include all timing differences and the following additional differences.

1. A reduction in the tax basis of depreciable assets because of tax credits (Exposure Draft, 1986, p. 4).

2. An increase in the tax basis of assets because of indexing for inflation (Exposure Draft, 1986, p. 4). The tax laws may require an adjustment to the carrying value (cost less depreciation) of the asset for the effects of inflation. This adjusted basis will be the basis that future tax deductions from depreciation or taxable gain or loss will be computed. However, financial accounting will not adjust the basis of the asset for inflation and its basis will be less than the remaining tax basis. This difference will result in tax deductible amounts in future years (Exposure Draft, 1986 p. 5).

3. Business combinations that are accounted for under the purchase method (Exposure Draft, 1986, p. 5). There may be differences between the tax basis of assets and liabilities assumed and the values that are recorded on the books. These differences will result in future taxable or deductible amounts when they are recognized and the reported amounts of the assets or liabilities are recovered or settled (Exposure Draft, 1986, p. 5).

Before the inception of the conceptual framework, there were various ways to handle timing differences and various ways to classify the results on the balance sheet. The practice was based on APB Opinion No. 11, *Accounting for Income Taxes*. FASB has attempted to create a uniform way to account for temporary
differences in SFAS No. 96 by following the theory of the conceptual framework. In the exposure draft of the proposed Statement No. 96, the FASB plans to require that

A liability or asset shall be recognized for the deferred tax consequences of all temporary differences, that is, the amount of taxes payable or refundable in future years as a result of the deferred tax consequences of events recognized in financial statements in the current or preceding years. The measurement of a deferred tax liability or asset shall assume that the only taxable or deductible amounts in future years are the result of temporary differences at the end of the current year (Exposure Draft, 1986, p. 6).

Because the term “temporary difference” is not referred to in most sources, this paper will concentrate on the “timing difference” portion of temporary differences.
Chapter 3
FLOW THROUGH METHOD

The flow through method says that tax expense for the year equals taxes payable for the year and no taxes are deferred (Beresford et al., 1984, p. 73). Advocates of the flow through method claim that taxes arise from taxable events—the collection of revenue—and should not be recognized until that point. Further, “it is argued that income taxes are a composite effect of governmental fiscal and policy objectives and, thus, are not functionally related to financial reporting income of companies” (Beresford et al., 1983, p. 20). The flow through method is the easiest to apply and the record keeping requirements are minimal (Beresford et al., 1984, p. 74). Another argument for requiring the flow through method is that “income tax depends only on taxable income, and accounting shouldn’t attempt to relate it to financial reporting income which doesn’t affect the amount of tax” (Beresford et al., 1984, p. 74). In their opinion, deferred taxes depend on the future which cannot be predicted (Beresford et al., 1983, p. 20). Finally, proponents of the flow through method argue that deferred taxes are used to “smooth” income and make it more predictable; however, they claim that the income is now “artificial” and obscures the results of management’s
efforts to minimize taxes and that this obscurity is "more confusing than enlightening and is too complex to be practical" (Beresford et al., 1983, p. 21).

However, reported net earnings under the flow through method would cause net earnings on the income statement to be highly volatile because tax expense would fluctuate with taxes payable (Beresford et al., 1984, p. 74). This fluctuation would be particularly volatile with relatively small companies whose income tends to fluctuate between tax brackets. Furthermore, opponents of the flow through method argue that "the tax recognized would erroneously bear no relation to the pretax income shown in the financial statements" (Beresford et al., 1983, p. 21). Opponents of the flow through method claim that lack of deferred taxes does not accurately reflect future cash flow (Beresford et al., 1983, p. 22).

For example, when an installment sale occurs, future cash flows from this sale are reduced by the amount of taxes that will be paid on that income. The flow through method does not accurately reflect this situation because tax income is based on cash received and will be taxed when the cash is collected. Financial statement income is based on the accrual method, and the entire income from the sale will be reflected on the date of the sale. The difference in the income year to year is not shown in the flow through method and, therefore, has been rejected by FASB.

Since the flow through method is not seriously being considered by the Board, this paper will not consider it further.
Chapter 4
METHODS OF ALLOCATION

Interperiod income tax allocation is based on the theory that individual transactions and events have tax consequences that should be recognized when the transaction or event affects taxable income (Beresford et al., 1983, p. 11). However, as a result of rules set forth by the IRS, some transactions or events incur timing differences. The cumulative effect of these timing differences results in the same total amount of taxes being paid, just at a later period of time (Beresford et al., 1983, p. 11). The amount of the tax effect that is not immediately expensed is recorded on the balance sheet as an obligation or benefit which will reverse in the future (Beresford et al., 1983, p. 13). There are three methods of interperiod income tax allocation: the deferred method, the liability method, and the net-of-tax method.

Deferred Method of Interperiod Income Tax Allocation

The APB “concluded that the deferred method of tax allocation should be followed since it provides the most useful and practical approach to interperiod tax allocation and the presentation of income taxes in financial statements” (Discussion Memorandum,
The deferred method focuses on the income statement and matching revenues with expenses in the same period (Discussion Memorandum, 1983, p. 16).

Under the deferred method, deferred taxes are calculated using the tax rate enacted for the period the timing difference originates and is netted against the reversing differences, which one calculated using the tax rate in effect at the time the difference originated (Beresford et al. 1983, p. 54 and Discussion Memorandum, 1983, p. 16). The amount of the timing difference that is accumulated on the balance sheet is the difference between the income taxes computed for the IRS and on the books. The deferred tax account is not adjusted for subsequent changes in tax rates or to reflect the imposition of new taxes (Nair and Weygandt, 1981, p. 92). Originally, APB considered the deferred method to be the most useful and practical approach to accounting for timing differences (Beresford et al., 1983, p. 59). The non-adjustment of the deferred tax account was favored because the deferred tax account then would not "distort the relationship between tax expense and the pretax accounting income" (Beresford et al., 1983, p. 59).

In our example of BOB, Inc., the additional tax expense recognized for the period would be the same as the deferred taxes column below. The depreciation difference amount would reverse starting in year six, lowering tax expense for those years.
Because the tax rate changes, the entire tax liability accrued will not reverse, and an $11,100 balance will remain in the deferred tax account after the equipment has been fully depreciated.

Another benefit of the deferred method is that it is the least costly method because it does not require accounting for changes in the tax rates (Beresford et al, 1983, p. 74). The deferred method’s principle objective is to “spread the tax cost or benefit of originating timing differences over the periods in which the differences reverse” (Beresford et al, 1983, p. 54). This method focuses on past cash flows (Stepp, 1985, p. 99); therefore, there is no need to make assumptions about those items in the future (Beresford et al, 1983, p. 59).

On the other hand, the deferred method emphasizes the tax expense on the income statement which does not follow the conceptual framework’s asset/liability method. This focus makes it difficult for investors and creditors to interpret the deferred tax account on the balance sheet (Hogan, 1991, p. 6). In addition,
changes in the tax rate will affect deferred taxes, sometimes dramatically, and this consequence will not be shown in the deferred tax balance under the deferred method. “When tax rates change, a residual deferred tax balance...is not ‘cleared out’ under the aggregate net change method until all timing differences reverse, this residual may become permanently lodged in the deferred tax accounts” (Robbins, 1986, p. 37). Furthermore, the theory behind APB’s requirement of the deferred method was that it would zero out in the long run when actual tax payments caught up with the accrued liability. However, inflation, changing tax rates and the need for more sophisticated costly equipment destroyed that theory because replacing equipment with new more expensive equipment creates a higher tax write off at the beginning (Business Week, 1983, p. 134). Because of the growing deferred tax balance and the conceptual framework, FASB has found the deferred method to be unacceptable. For these reasons, in addition to the difficulty in interpreting the deferred tax account, FASB has decided that the deferred method does not accurately portray economic reality.

**Liability Method of Interperiod Income Tax Allocation**

Under the liability method of interperiod income tax allocation, deferred taxes are calculated using the tax rate that is expected to be in effect when the timing difference reverses (Beresford et al., 1983, p. 54). If the future tax rates cannot be predicted, then the current tax rate is used and the balance in the deferred tax account is adjusted when the future tax rate becomes known (Beresford et al., 1983, p. 54). The liability that is accrued more closely represents a predicted future cash outlay than under the
deferred method (Discussion Memorandum, 1983, p. 11). The accrual on the balance sheet reflects the definition of a liability based on Concepts Statement No. 6 as a "probable future sacrifice" (Discussion Memorandum, 1983, p. 12), which is what a deferred tax account should represent to be useful in determining cash outflows, liquidity and solvency. Furthermore, adjusting the deferred tax balance to reflect changing tax rates more closely represents the expected future cash outflow than using the current tax rate in effect (Rayburn, 1987, p. 48). A change in the tax rate will change the amount an enterprise owes to the government.

The liability method also more accurately follows the conceptual framework. It is balance sheet oriented and "its principle objective is to accrue the total tax that will actually be assessed on timing differences when reversed" (Beresford et al., 1983, p. 54). Under the liability method, the deferred tax account will not continue to grow and distort the tax liability to financial statement users. The liability method generates more understandable results on the balance sheet because it focuses on what has occurred or will occur on a company's tax return (Beresford and Neary, 1986, p. 10).

However, the use of the liability method requires estimating future tax rates. FASB has altered the requirements of SFAS No. 96 to require the modified liability method. Under this method, only the known future tax rates are used to determine the enterprise's deferred tax liability. While the modified liability method continues more accurately to display the tax liability on the balance sheet, it alleviates the necessity to predict future tax rates. Another argument against the liability method is that changes in the tax rate or tax laws
could result in a tax expense on the income statement that does not relate to operations (Beresford et al., 1983, p. 129). This matter could be explained through disclosures, but that would add a time consuming burden on preparers of financial statements. Finally, the liability method would require an increase in record keeping to determine reversal dates (Beresford and Neary, 1986, p. 10). The benefits of understanding the deferred tax account, however, would outweigh the additional record keeping costs for many companies.

In our example of BOB, Inc., the change in tax rate would have a significant effect on the deferred tax balance, which would not be recognized if the deferred method were used.

BOB, Inc. would expense and accrue the amount in year one that is expected to be paid when the difference reverses starting in year six. When the asset is fully depreciated, the balance in the accrued liability will be zero.

<table>
<thead>
<tr>
<th>Year</th>
<th>Depreciation on Books</th>
<th>Depreciation for Taxes</th>
<th>Difference</th>
<th>Tax Rate</th>
<th>Deferred Taxes</th>
<th>Accrued Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$50,000</td>
<td>$100,000</td>
<td>$50,000</td>
<td>40%</td>
<td>$17,000</td>
<td>$17,000</td>
</tr>
<tr>
<td>Year 2</td>
<td>50,000</td>
<td>185,000</td>
<td>135,000</td>
<td>40%</td>
<td>45,900</td>
<td>62,900</td>
</tr>
<tr>
<td>Year 3</td>
<td>50,000</td>
<td>95,000</td>
<td>45,000</td>
<td>34%</td>
<td>15,300</td>
<td>78,200</td>
</tr>
<tr>
<td>Year 4</td>
<td>50,000</td>
<td>60,000</td>
<td>10,000</td>
<td>34%</td>
<td>3,400</td>
<td>81,600</td>
</tr>
<tr>
<td>Year 5</td>
<td>50,000</td>
<td>60,000</td>
<td>0</td>
<td>34%</td>
<td>3,400</td>
<td>85,000</td>
</tr>
<tr>
<td>Year 6</td>
<td>50,000</td>
<td>0</td>
<td>(50,000)</td>
<td>34%</td>
<td>(17,000)</td>
<td>68,000</td>
</tr>
<tr>
<td>Year 7</td>
<td>50,000</td>
<td>0</td>
<td>(50,000)</td>
<td>34%</td>
<td>(17,000)</td>
<td>51,000</td>
</tr>
<tr>
<td>Year 8</td>
<td>50,000</td>
<td>0</td>
<td>(50,000)</td>
<td>34%</td>
<td>(17,000)</td>
<td>34,000</td>
</tr>
<tr>
<td>Year 9</td>
<td>50,000</td>
<td>0</td>
<td>(50,000)</td>
<td>34%</td>
<td>(17,000)</td>
<td>17,000</td>
</tr>
<tr>
<td>Year 10</td>
<td>50,000</td>
<td>0</td>
<td>(50,000)</td>
<td>34%</td>
<td>(17,000)</td>
<td>0</td>
</tr>
</tbody>
</table>

$100,000 $100,000 $0 $0
If the tax rate for year six when the difference reverses is not known in year one, then the $20,000 liability would be accrued on the balance sheet at the end of year one. The deferred tax account would be adjusted at the beginning of year three, or when the tax rate for year six becomes known. The $11,100 adjustment will flow through to the income statement, making reported earnings more volatile and less predictable while increasing the interpretability of the deferred tax liability on the balance sheet. According to Concepts Statement No. 6, the liability, after the adjustment, would represent the amount the enterprise plans to pay in the future. Moreover, the use of the liability method would increase the predictability of future cash out flows for taxes as Concepts Statement No. 2 prescribes.

Net-of-Tax Method of Interperiod Income Tax Allocation

The net-of-tax method is used in addition to either the deferred method or the liability method. The result of the deferred tax effect of a timing difference is not carried as an asset or a liability, but as a valuation allowance to the asset or liability to which they pertain (Discussion Memorandum, 1983, p. 13). The valuation allowance either increases or decreases the carrying amount of the asset or liability based on whether the deferred tax reduces or increases taxes in that period (Discussion Memorandum, 1983, p. 13). In our example of BOB, Inc., the deferred tax amount would increase the depreciation taken on the books to reflect $100,000 of depreciation taken in the first year.

One benefit of the net-of-tax method is that there is no need to argue whether or not deferred taxes are an asset or liability based on
the definitions in the conceptual framework. In addition, classifying
the deferred tax with the appropriate asset or liability shows the
economic consequences of the deferred tax as it relates to the
enterprise (Beresford et al. 1983, p. 62). There is also no need to
choose either comprehensive or partial allocation methods
(Beresford et al. 1983, p. 62). Furthermore, the net-of-tax method
is balance sheet oriented, so it follows the theory of the asset/liability
method in the conceptual framework (Beresford et al. 1983, p. 61).

The use of the net of tax method, however, still requires either
the deferred method or the liability method be used (Beresford et al.
1983, p. 62). Therefore, it must be decided whether or not the
easier to apply less record keeping requirements of the deferred
method outweighs the easily interpreted deferred tax account which
more accurately reflects economic reality of taxes of the liability
method. Furthermore, the use of the net of tax method
oversimplifies the relationship of depreciable assets to taxes
(Beresford et al. 1983, p. 62). Opponents of the net-of-tax method
argue that the use of a valuation allowance erroneously reports an
asset or liability on its tax basis and that same asset would be valued
differently by nontaxable enterprises (Beresford et al. 1983, p. 62).
In addition, the depreciation allowance would not represent the
useful life of the asset as it is supposed to do. Finally, critics also
claim that using the net of tax method would complicate the
accounting for deferred taxes (Beresford et al. 1983, p. 63). The tax
effects of timing differences would be hidden in the valuation
accounts, making it difficult for investors and creditors to predict
future cash outflows. Only through complex disclosures could the
valuation accounts be explained, which makes the net-of-tax method more costly and time consuming for the information provided (Beresford et al., 1983, p. 63).
Chapter 5
METHODS OF MEASUREMENT

Interperiod income tax allocation can be measured either partially or comprehensively.

**Partial Allocation Method**

Partial allocation is based on the theory that deferred taxes should be determined for transactions and events that will cause a tax to be paid or received based on the definition of assets and liabilities in the conceptual framework. Under partial allocation, deferred taxes would be recognized only for those differences that are reasonably expected to reverse (Beresford et al., 1983, p. 31). To the extent that deferred taxes are expected to increase due to predicted reversals not occurring, a payment is not expected to be made and no deferred taxes would be provided (Beresford et al., 1984, p. 74). Therefore, “deferred taxes wouldn’t be provided for reversals of timing differences expected to be replaced by new, originating differences from similar transactions” (Stepp, 1985, p. 98).

The use of the partial allocation method results in a number of benefits. Proponents argue that since partial allocation “allows management to consider budgets, forecasts and planning in deciding whether deferred taxes should be provided in the accounts” and
“because it is cash-flow oriented,” it more accurately reflects economic conditions and is a better indicator of liquidity and solvency than the comprehensive method covered below (Beresford et al., 1984, p. 40 and p. 74). In addition, partial allocation would reduce the deferred tax liability account on the balance sheet to more accurately reflect future tax payments. Advocates of partial allocation argue that “the tax effect of originating differences offsets or eliminates the tax effect of reversing differences, resulting in no tax payment” (Discussion Memorandum, 1983, p. 25). “The partial allocation approach is based on offsetting timing differences for groups of similar transactions or events” (Discussion Memorandum, 1983, p. 25). The theory is that transactions in future periods will equal or exceed the timing differences of reversals from recurring transactions and, therefore, a liability for those timing differences should not be accrued (Discussion Memorandum, 1983, p. 25). Another argument for partial allocation is based on the idea that a timing difference is an interest free loan given by the government as an incentive for capital expenditures -- investment in long-term depreciable assets -- and the government does not plan to collect these taxes. Therefore, the tax liability should not be accrued as a future probable sacrifice (Discussion Memorandum, 1983, p. 26).

However, opponents of partial allocation disagree with the reasoning for partial allocation. They argue that the deferred tax account should not be based on predicted future events, but should “reflect events and circumstances as they exist” (Beresford et al., 1983, p. 35). Furthermore, net income is likely to be highly volatile and less predictive under partial allocation due to changes in the tax
rates, economic condition, or planned future events not occurring (Beresford et al. 1984, p. 74). This unpredictability goes against the conceptual framework Statement No. 2’s requirement that reporting be relevant, which includes having a predictive value. Another major criticism of partial allocation is the probability of diverse applications. “It places a lot of reliance on management’s judgment, and it can result in diverse reporting for identical facts and circumstances” (Beresford et al. 1984, p. 74). This difference would affect the comparability of financial statements among companies (Discussion Memorandum, 1983, p. 26).

**Comprehensive Allocation Method**

The objective of comprehensive allocation is to recognize tax consequences of transactions in the same period as those transactions are included in financial reporting income (Discussion Memorandum, 1983, p. 23). It is based on the view that all timing differences have tax effects that make tax expense either higher or lower for that period and should be included in determining deferred taxes on the balance sheet. Comprehensive allocation is when “tax expense for a year equals taxes payable for the year plus effects of all timing differences” (Beresford et al. 1984, p. 73).

Advocates of comprehensive allocation feel that it is more consistent in matching the tax expense liability with the event that occurred than either the flow through method or the partial allocation method (Beresford et al. 1984, p. 73). Concepts Statement No. 6 defines assets and liabilities as resulting from past transactions and comprehensive allocation recognizes the tax effects of timing differences from transactions that have occurred as prescribed by the
conceptual framework. In addition, because there is little reliance on management's judgment in applying rules, net income tends to be less volatile under comprehensive allocation than the former method (Beresford et al. 1984, p. 73). Therefore, net income is more predictive following Concepts Statement No. 2's definition of relevance. Also, "some claim that comprehensive allocation, by substantially eliminating the need for judgment, improves the integrity of reported profits" (Beresford et al. 1983, p. 36).

Furthermore, the deferred tax account has the effect of "smoothing" the reported earnings. Comprehensive allocation is based entirely on past transactions and is, therefore, more attractive than partial allocation and its assumption of future events. The advocates of comprehensive allocation argue that comparability between companies is more accurate. Another benefit is that comprehensive allocation "more fairly reports a company's capitalization" because it recognizes the entire amount of the government interest free loan on the balance sheet (Beresford et al. 1983, p. 36 and p. 37).

On the other hand, opponents of comprehensive allocation argue that the deferred tax account continues to grow and the amount will never be paid to the government. These high amounts imply that in the future there will be a high cash outflow that in reality will never occur. This representation of a non-reality is not useful to financial statement users who attempt to predict future cash outflows (Beresford et al. 1984, p. 73). Therefore, the deferred tax account is irrelevant as it does not portray an economic reality (Beresford et al, 1984, p. 74). The argument that comprehensive allocation results in a more "thorough and consistent association in the matching of
revenues and expenses” comes under attack by Robert Sprause, a member of the Financial Accounting Standards Board, who states that matching is “too often an attractive but empty slogan rather than a meaningful concept one can look to for guidance” (Nair and Weygandt, 1981, p. 94). In addition, comprehensive allocation will cause the deferred tax account to fluctuate when there is either a change in the tax rate or in the estimates of which the reversal will occur (Stepp, 1985, p. 106).
Chapter 6
ACCOUNTING PRINCIPLES BOARD OPINION NO. 11

APB Opinion No. 11 was issued in 1967 and requires a comprehensive interperiod income tax allocation using the deferred method (Discussion Memorandum, 1983, p. 3). To account for deferred taxes under APB Opinion No. 11, a deferred tax charge account for future taxes payable and a deferred tax credit account for future benefits are used. These accounts are neither an asset nor a liability, but are netted and classified to offset the asset and liability account with which the deferred tax corresponds. This classification makes the deferred tax either a current or non-current amount based on the related asset and not when the tax will benefit or become due (Beresford et al., 1983, p. 121). If the deferred tax charge or credit is not related to a specific asset or liability, then FASB Statement No. 37 requires that the charge or credit be classified based on when they are expected to reverse (Beresford et al., 1983, p. 141).

APB Opinion No. 11 allows two approaches to the use of the deferred method: the gross change approach or the net change approach. The gross change approach determines the accumulated gross change in the deferred tax accounts by multiplying the tax rate in effect at the time each difference originates and using that same difference when it reverses. Under the net change approach, similar
items are grouped on the balance sheet with reversing differences deducted from originating differences before the current tax rate is applied to the net amount. Under the net change approach, originating and reversing items are aggregated before applying the current year's tax rates. The flow assumptions for timing differences are not vital (Hogan, 1991, p. 6). Part of the amount of the tax expense recognized in each year is deferred under both approaches (Hogan, 1991, p. 5).

After the issuance of ABP Opinion No. 11, additional pronouncements were issued to interpret the requirements, address matters not covered, amend rules provided, or attempt to clarify the intended application of the concepts set forth. In 1969, APB issued an interpretation of APB Opinion No. 11 which explains the requirements for APB Opinion No. 11. Although this is not an authoritative pronouncement, it has been widely used in applying the requirements of APB Opinion No. 11 (Beresford et al. 1983, p. 140). The APB issued several additional opinions, interpretations, and statements after Opinion 11, which clarify accounting for deferred taxes in special circumstances.

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<td>Interpretation No. 32</td>
<td>Application of Percentage Limitations in Recognizing</td>
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These additional statements and interpretations resulted in a deferred tax accounting requirement that is "extremely difficult to comprehend and apply, making it conducive to varying interpretations and, hence, to wide diversity in practice" (Beresford et al., 1983, p. 3). This diversity in practice makes comparability among enterprises impractical and also makes analyzing the deferred tax account nearly impossible. These additional statements, opinions, and interpretations support the idea that even after 25 years, APB Opinion No. 11 is troublesome; there are still many misunderstandings about how to apply the opinion (Levy, 1981, p. 97). In their article "Let's Fix Deferred Taxes," R.D. Nair and J.J. Weygandt claim that the pronouncements on accounting for deferred income taxes in special situations are "inconsistent with the concepts underlying the treatment of deferred taxes in APB Opinion No. 11 and will lead only to confusion and misunderstanding" (Nair and Weygandt, 1981, p. 90). They further claim that this confusion stems from the fact that APB Opinion No. 11 "lacks a sound conceptual basis" (Nair and Weygandt, 1981, p. 90).

Moreover, small enterprises find that applying APB Opinion No. 11 and all its extras are too costly in relation to the benefits they receive (Beresford et al., 1983, p. 3) and many do not fulfill all the requirements necessary because of this cost (Nair and Weygandt, 1981, p. 90).

Additionally, the difficulty in understanding the deferred tax account and this classification of deferred taxes does not enable the
user to easily predict future cash flows as prescribed by Concepts Statement No. 2. “The problem with the deferred method is interpretability of the balance in the deferred tax account” (Hogan, 1991, p. 6). Under APB No. 11, the current portion of deferred taxes relates to assets and liabilities in the current section of the balance sheet (Nair and Weygandt, 1981, p. 92). Likewise, the non-current portion of deferred taxes relates to those assets and liabilities classified as non-current in the balance sheet. In our example, the entire deferred tax amount would be classified as non-current as the asset is grouped with the long-term non-current assets. This classification is true even though the amount of the benefit or obligation for the year following the current one provides a current benefit or obligation and should be classified that way according to the conceptual framework.

Using the net change approach when reversing timing differences allows an enterprise to use either the tax rate currently in effect or the tax rate in effect at the time of the deferral (Discussion Memorandum, 1983, p. 16). This further adds to the complexity of interpreting the balance in the deferred tax account and can cause the balance to increase. “Under the old rules, the emphasis was on the current tax expense shown on the income statement. Deferred taxes were an almost balancing amount placed on the credit side of the balance sheet” (Sheehy and Shlett, 1991, p. 50). Because of this “balancing effect,” it is difficult to interpret the results in the deferred tax account. The information is neither relevant or reliable as defined by Concepts Statement No. 2.
Some believe that “the authoritative literature issued since Opinion No. 11 has significantly eroded the broad concepts adopted in it and has only added to the controversy over present accounting for income taxes” (Beresford *et al.*, 1983 p. 3). Dennis R. Beresford, the chairman of FASB, states that “most of the present accounting requirements on this subject [deferred taxes] are contained in Opinion No. 11, which was issued by the Accounting Principles Board in 1967. The requirements of Opinion No. 11 were controversial 20 years ago, and they still are controversial” (Liebtag, 1987, p. 80). Many feel that the issuance of APB Opinion 11 did not help the accounting for deferred taxes, but increased the controversy (Nair and Weygandt, 1981, p. 87). Furthermore, with the issuance of Concepts Statement No. 3 (superseded by No. 6) the definition of deferred taxes from APB Opinion No. 11 does not “fit” the definitions of balance sheet items as adopted by FASB (Nair and Weygandt, 1981, p. 87).

Another argument against the deferred method is that, “although the deferred method produces an appropriate current period tax expense, it doesn’t deal with changes in tax rates and other events that affect the deferred tax accounts in the balance sheet” (Parks, 1988, p. 25). Finally, because of the use of the deferred method, deferred tax accounts are considerably higher than what the corporation expects to reverse in the future. Some critics blame comprehensive allocation for this continually growing account that lends to the non-interpretability of the tax account (Beresford *et al.*, 1983, p. 4).
APB Opinion No. 11, together with its related interpretations and additional statements, resulted in a group of complex rules and requirements that are difficult to comprehend, costly to apply, and nearly impossible to interpret. For these reasons, and because APB Opinion No. 11 does not fit with the definitions in the conceptual framework, FASB has taken time to reconsider the issue of deferred tax accounting. What they chose and how it affects a corporation are discussed in the following pages.
Chapter 7  
STATEMENT OF FINANCIAL ACCOUNTING  
STANDARDS NO. 96  

FASB's Statement No. 96, "Accounting for Income Taxes," was originally issued in 1987 (Williams, 1992, p. i). It requires comprehensive allocation using the liability method. Under Statement No. 96, deferred taxes would have their own account on the balance sheet and not be a valuation allowance to a specific account. The deferred tax accounts would be classified as an asset or a liability based on the definitions in the conceptual framework. SFAS No. 96 requires that all temporary differences be scheduled according to their probable reversal date. This scheduling is to help determine of the non-current and current total deferred tax asset or liability and to enable the application of the appropriate tax rate in each year. Under Statement No. 96, the tax benefit or obligation expected to be received or paid during the current period (within one year) would be classified as current deferred taxes and the remaining amount would be classified as non-current (Nair and Weygandt, 1981, p. 102). The current deferred tax account would consist of short-term timing differences, which include installment sales and the current portion of long-term timing differences.
term timing differences would be associated with depreciation and exploration costs for oil and gas companies, which are costs that reverse over many years. In our example of BOB, Inc., the amount of the depreciation tax benefit or obligation available the following year would be classified as current, and the remainder would be non-current.

The fundamental changes in accounting for deferred taxes call for a change in record keeping for an enterprise (Hogan, 1991, p. 5). Applying SFAS No. 96 requires that the deferred tax amount be based on applicable income tax regulations (Parks, 1988, p. 32). Essentially, in order to compute the deferred tax balance, a hypothetical tax return needs to be prepared for each year that differences reverse (Hogan, 1991, p. 6). The preparation of hypothetical tax returns makes the emphasis from originating and reversing differences that have already taken place, to expected future timing differences (Hogan, 1991, p. 6).

Using the liability method can be very beneficial. The amount of deferred taxes on the balance sheet is more precise (Sheehy and Shlett, 1991, p. 50). Application of SFAS No. 96, with its emphasis on the balance sheet, makes the deferred tax account more meaningful and easier to interpret (Parks, 1988, p. 24). The dual classification of non-current and current deferred taxes helps financial statement users predict future cash flows (Nair and Weygandt, 1981, p. 102) and evaluate an enterprise’s liquidity and solvency as financial statements should do according to Concepts Statement No. 1. Furthermore, “adjustments to the deferred tax account must be made when tax law changes are made by congress”
A change in the enacted tax rate could have a significant effect on the deferred tax account of a corporation. In our example, from results in Chapter 4, BOB, Inc. will have $11,100 of taxes that will not have to be paid due to a change in the tax rate. Since enterprises have many assets whose deferred depreciation is affected by tax rates, the difference between what the books show as a liability and what will actually be paid could be highly significant. SFAS No. 96 has attempted to reduce this difference by requiring a change in the deferred tax account balance when tax rates change. The result is a deferred tax account balance that more meaningfully reflects what is expected to be paid in the future.

The statement on deferred taxes has been highly criticized since its adoption. Many claim that it is too complicated. Although it adds information for investors and creditors, it adds length and complexity to the disclosures (Sheehy and Shlett, 1991, p. 53). In addition, the switching of a portion from non-current to current each year could have a negative impact on ratios used by creditors, making loans for businesses more difficult (Sheehy and Shlett, 1991, p. 53). Furthermore, the requirement of classifying the deferred tax by the year which it reverses will be only an estimation, lowering the reliability of the financial statements (Derieux, 1990, p. 89). The new standards create a greater degree in volatility of reported earnings on the income statement (Parks, 1988, p. 24). SFAS No. 96 makes the record keeping and decision making more complex (Parks, 1988, p. 24). Additional tax planning strategies will need to be implemented to minimize deferred liabilities and maximize assets, because corporations currently want to recognize the maximum
amount of tax benefits associated with future tax deductions (Parks, 1988, p. 34).

In response to the complaints about the complexity of SFAS No. 96, FASB acknowledges that applying the new standard may indeed be complex, but "that complexity is mostly attributable to the tax law and must be dealt with regardless of accounting requirements" (Parks, 1988, p. 32). However, FASB did delay the required adoption date because of the opinion that "...the result [of SFAS No. 96] was a standard that was far more complicated than its predecessor and certainly more difficult to understand, implement and explain" (Derieux, 1990, p. 89).
Chapter 8
DISCOUNTING

Based on the economic world today of increasing costs and interest rates, a dollar is worth more now than it will be worth in the future. Present value is determined by discounting the amount of the liability or asset by an interest rate factor to determine what the actual future sacrifice or benefit will be worth when paid or received (Beresford et al., 1983, p. 82). Without discounting, deferred taxes are recorded at the absolute amount payable in the future (Beresford et al., 1983, p. 82). With discounting, they are recorded at an amount less than the total with the difference representing the interest (Beresford et al., 1983, p. 82). At first it would seem as though the deferred tax amount should be discounted due to the time value of money and increasing interest rates. The implementation of discounting deferred taxes would require the prediction of timing difference reversals, the selection of the appropriate discount rate, and the determination of the appropriate method to schedule timing difference reversals (Rayburn, 1987, p. 44).

When considering discounting, one can identify two options. The first is to implement a “comprehensive recalculation at each balance sheet date using discount rate determined by conditions at
that date or, two, a discount could be established separately for each period of origination and then worked forward using a discount rate assigned” (Stepp, 1985, p. 106). The first option is consistent with the liability method SFAS No. 96 requires. If the liability or modified liability method were chosen, then the scheduling of timing differences would be already mandatory and could easily be used for discounting.

The “choice of interest rate is more difficult, and any rate is likely to be arbitrary” (Nair and Weygandt, 1981, p. 12). Should the enterprise use the investment or borrowing rate when discounting? Should the enterprise use a specific imputed rate or an external rate? And finally, should the enterprise use one rate, or a rate for each item that affects deferred taxes? (Stepp, 1985, p. 102). The American Institute of Certified Public Accountants accounting standards division claims that the use of an imputed interest rate is attractive because “such a rate would provide an approximate discounted amount of the liability and would help users predict future cash flows and evaluate solvency” (Nair and Weygandt, 1981, p. 102).

In our example, discounting the tax benefit and obligation of BOB, Inc, would change the deferred tax account balance. If we use an arbitrary discount rate of 10%, the discounted cash flows would be as illustrated in figure 1 in the chart following the chapter. The tax liability is determined by multiplying the amount of the future taxes payable when the difference reverses by the discount factor. The amount of the accrued tax liability is allocated between interest expense and the tax expense.
In this example, the total amount of interest would be $36,025. As the discount rate increases, the change in the deferred tax account will be more significant.

Proponents of discounting claim that the “present value is clearly a more meaningful measure of the deferred tax liability” (Stepp, 1985, p. 99). Discounting suggests that the time value of money has an important economic effect, and many feel this effect should be recognized in financial statements. The advocates assert that “deferred taxes and taxes currently payable should be reflected differently. That is, the amount of deferred taxes should be smaller as the length of the discount period increases, and the charge to income for $1 of tax currently payable should be higher than the charge to income for $1 of tax payable in the future” (Stepp, 1985, p. 99). Furthermore, discounting more accurately reflects the expected future cash flows of deferring a tax payment making it useful to financial statement users (Rayburn, 1987, p. 48). As
classified by the conceptual framework, deferred tax benefits and obligations are assets and liabilities and should not be treated differently from other assets and liabilities (Beresford et al. 1983, p. 84). APB Opinion No. 23, *Accounting for Income Taxes - Special Areas*, requires that liabilities and assets be recorded at their present value. In addition, other accounting pronouncements require discounting. APB Opinion No. 21, *Accounting on Receivables and Payables*, Statement No. 87, *Accounting for Pensions*, and in Statement No. 98, *Accounting for Leases* also require discounting. Finally, Homer A. Black, a proponent of discounting, takes the view that discounting would unduly complicate deferred tax accounting: "the complications caused by discounting must be considered in relation to the significance of differences between discounted and undiscounted values. That is, complications in and of themselves are never a reason for failure to do something that is correct" (Beresford et al. 1983, p. 84).

On the other hand, APB Opinion No. 10, Omnibus Opinion -- 1966, *Tax Allocation Accounts -- Discounting* concludes that deferred taxes should not be accounted for on a discounted basis (Discussion Memorandum, 1983, p. 20). The nature of deferred tax liabilities, the conceptual difficulties, and the implementation problems in discounting deferred taxes produce compelling arguments for not discounting (Stepp, 1985, p. 108). Although the economic incentive of deferred taxes can be represented by discounting, opponents argue that the government loan is interest free and by not discounting the financial statements reflect this benefit (Stepp, 1985, p. 100). Some argue that discounting would
hide the total tax liability of an enterprise because some of this burden would be reported as interest (Beresford et al., 1983, p. 85). Furthermore, the taxpayer ultimately pays the same total amount to the government regardless of the discount rate (Discussion Memorandum, 1983, p. 20). James O. Stepp says in his article, “Deferred Taxes: The Discounting Controversy” that “when deferred taxes are recorded gross in the balance sheet, the benefit of timing differences is reflected as it is realized as the absence of interest on deferred tax balances. This is the measure of the subsidy that the government has provided and it shouldn't be anticipated by discounting” (Stepp, 1985, p. 100). Interest on deferred taxes is imputed costs and is not incurred like the interest in APB Opinion No. 21. In addition, APB Opinion No. 21 should not apply to deferred taxes because it was intended for fixed sums that are payable at fixed dates, and deferred taxes do not have this nature. Finally, discounting could create serious implementation problems (Stepp, 1985, p. 102).

If the goal of the conceptual framework is to create an authoritative pronouncement which would lead to consistency in accounting standards and principles, it would seem that discounting for deferred taxes should also be required. However, the FASB “concluded that assets and liabilities recognized by the effects of timing differences shall be measured without discounting the future cash flow to arrive at the present value of that cash flow” (Rayburn, 1987, p. 43). The Board's conclusion is based on one of FASB's primary objectives in reconsidering income taxes--simplification. James Stepp concluded in the article, "Deferred Taxes: The
Discounting Controversy, that “It is probable the complexity and increased computations required by discounting, more than the conceptual, that caused the FASB to defer indefinitely its consideration of discounting” (Stepp, 1985, p. 102).
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Chapter 9
EFFECTS ON COMPANIES

The implementation of SFAS No. 96 is very flexible. Due to the delays in its effective date and also because early adoption has been encouraged and accepted by many companies. FASB requires that if early implementation is adopted, all provisions in the statement must be adopted, and any enterprise that has adopted SFAS No. 96 may not revert to accounting for income taxes as provided in APB Opinion No. 11. FASB has chosen not to allow companies to revert after interim or annual statements have been issued because it believes the liability method of SFAS No. 96 is superior to the deferred method.

For adoption, a company may choose to implement the requirements of SFAS No. 96 in the current year, showing the cumulative effect on the income statement, or retroactively, showing the change as a prior period adjustment to retained earnings (Epaves and Smith, 1988, p. 4). This flexibility further complicates the comparison.

Implementing the statement, will cause the financial reporting income of companies with deferred tax liabilities to increase. This increase is due in part to the decrease in the corporate tax rate in
1988 which "allows companies to reduce the tax rate associated with deferred liabilities and thus increase current period earnings" (Parks, 1988, p. 34). Furthermore, "the proposal threatens huge hits to earning over the next few years--hits that have nothing to do with real cash but are only accounting fictions. For IBM the charge could be $1 billion, for Aetna nearly $300 million (Saunders, 1987, p. 74).

Figure 2 on the following page shows the results of a study conducted of the Fortune 500 companies. On the basis of their 1985 financial statements, the effects of implementing SFAS No. 96 are demonstrated as these companies adopt the new standard in 1988-1990. Results show that approximately 25% of America's leading companies could have net income increases at 50% above normal. Furthermore, 11% of these companies could show earnings double the norm.

The biggest book income increases will come to large manufacturers such as General Electric, who "for years have used an array of write-offs to defer taxes" (Gleckman, 1988, p. 22). For instance, "General Electric Company's fourth quarter earnings report typifies the difficulties awaiting investors. GE announced fourth quarter earnings of $868 million, up $138 million over the same period last year. But, the footnotes tell the real story. Included in GE's $868 million reported profit is $400 million from the accounting change, which in turn was used to offset most of the $450 million paper charge that the company took against an anticipated restructuring" (Gleckman, 1988, p. 22).

The accounting standards board proposal has not raised objections from management because it will help earnings by
### Percentage Increase in Median and Mean Net Income by Impact Groups

<table>
<thead>
<tr>
<th>Low-Impact Industries</th>
<th>Median</th>
<th>Mean</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fabricated Metal Products</td>
<td>12 19</td>
<td></td>
</tr>
<tr>
<td>Printing and Publishing</td>
<td>17 22</td>
<td></td>
</tr>
<tr>
<td>Chemicals</td>
<td>18 30</td>
<td></td>
</tr>
<tr>
<td>Rubber and Plastics</td>
<td>22 28</td>
<td></td>
</tr>
<tr>
<td>Food and Kindred Products</td>
<td>25 32</td>
<td></td>
</tr>
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</table>

<table>
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<tr>
<th>Moderate-Impact Industries</th>
<th>Median</th>
<th>Mean</th>
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</thead>
<tbody>
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<td>Textile and Apparel</td>
<td>12 53</td>
<td></td>
</tr>
<tr>
<td>Instruments</td>
<td>13 65</td>
<td></td>
</tr>
<tr>
<td>Auto and Transportation</td>
<td>15 49</td>
<td></td>
</tr>
<tr>
<td>Electrical and Electronic</td>
<td>15 62</td>
<td></td>
</tr>
<tr>
<td>Primary Metals</td>
<td>20 65</td>
<td></td>
</tr>
<tr>
<td>Machinery</td>
<td>20 73</td>
<td></td>
</tr>
<tr>
<td>Unclassified</td>
<td>32 63</td>
<td></td>
</tr>
<tr>
<td>Stone Clay and Glass</td>
<td>36 52</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>High-Impact Industries</th>
<th>Median</th>
<th>Mean</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mining</td>
<td>52 115</td>
<td></td>
</tr>
<tr>
<td>Lumber, Wood and Paper</td>
<td>46 183</td>
<td></td>
</tr>
<tr>
<td>Petroleum</td>
<td>68 356</td>
<td></td>
</tr>
</tbody>
</table>

**All Companies**

6 The Woman CPA, April 1988
allowing firms to adjust the deferred taxes already on the books for new, lower tax rates. This move will give a non-cash boost to earnings, at least until congress raises the rates again (Saunders, 1987, p. 76). A change to the flow through method or a partial allocation method would increase reported net earning and reduce reported effective tax rate for most companies (Beresford et al., 1984, p. 74). Also, the new accounting rules will increase earnings on the books, when actual profits are likely to be decreasing (Gleckman, 1988, p. 22).

One of the most difficult requirements for investors is that early adoption of SFAS No. 96 and the continual delays plaguing the statement create a five-year period of non comparability of financial statements for investors. Even comparing financial statements for the same company among different years will be difficult. And, comparing statements among companies will be very tricky (Seidler, 1990, p. 46).

"Some companies implemented SFAS No. 96 early and retroactively. Others implemented SFAS No. 96 on a cumulative catch-up basis...For others the new age is still to come. Some companies still follow APB No. 11. Others have only their toes dipped in the new age as they follow APB No. 11 but disclose the impact as if they had implemented SFAS No. 96.

Thus, companies have a wide variation in the accounting for income taxes as if they actually were operating in different ages (Sheehy and Shlett, 1991, p. 52).
Comparability will be a problem until everyone has adopted uniform rules and, even then, not until these companies gain experience with conforming applications (Sheehy and Shlett, 1991, p. 53).
Chapter 10
DELAYS OF SFAS NO. 96

Deferred taxes is a subject that affects almost all companies and for that reason is one of the most important projects taken on by FASB to date (Beresford et al., 1984, p. 72). The effect it has on companies is also one of the main reasons that the implementation date has been postponed several times. Originally, the effective date for SFAS No. 96, Accounting for Income Taxes, was December 15, 1988 and companies was encouraged to adopt the statement early. Then, implementation was delayed until December 15, 1989 by SFAS No. 100, Accounting for Income Taxes - Deferral of the Effective Date of FASB Statement No. 96, for further consideration by FASB. Statement of Financial Accounting Standards No. 103 delayed the implementation of SFAS No. 96 for an additional two years until December 1991 to “allow time to consider amendment requests” (Sheehy and Shlett, 1991, p. 51). This date also was moved by the issuance of SFAS No. 108, making SFAS No. 96 effective for fiscal years beginning after December 15, 1992, with early adoption still encouraged, while the Board proposes amendments to the statement. If early adoption is taken, the entire statement must be adopted. Even after SFAS No. 96 has been
delayed, if an enterprise adopted the provisions early, it is not
allowed to revert to APB Opinion No. 11 after interim or annual
reports have been issued using the new statement.

Amendments to SFAS No. 96

In June of 1991, FASB issued an exposure draft of a statement
that would replace the delayed SFAS No. 96 and would be effective
for fiscal years ending on or after December 15, 1992. This draft is
a response to the comments that SFAS No. 96 is too complex because
it requires annual scheduling of reversals and it is too restrictive in
not recognizing deferred tax assets that are likely to be realized (HJB
Miller, 1991, p. 2). The basic scope is the same as SFAS No. 96, and
although it is intended to replace the requirements in SFAS No. 96, it
does repeat many of the requirements. The proposed rules are
based on a balance sheet approach and attempt to establish deferred
tax assets and liabilities that meet the definitions of assets and
liabilities as defined in the conceptual framework (Read and Bartsch,
1991, p. 46). In addition, it is also intended to replace many of the

The new statement will simplify the computations required by
SFAS No. 96 and also eliminate some of the inconsistencies (HJB
Miller, 1991, p. 1). Furthermore, it will not be necessary to
schedule reversals of temporary differences and a single tax rate can
be applied to most items (HJB Miller, 1991, p. 1). Under the new
exposure draft, "a deferred tax liability generally would be
recognized for all taxable temporary differences. Deferred tax
assets and liabilities would be measured using the marginal tax rate
expected to apply to the last dollars of taxable income in future years.
(Journal of Accountancy, 1991, p. 19). However, the provision of the exposure draft regarding tax rate is "vague and likely to be troublesome for relatively small companies having income that fluctuates above and below the breaking points on the graduated rate schedule" (HJB Miller, 1991, p. 3).

**Update**


The changes include:

1. the expected marginal tax rate under regular tax rules is applied to temporary differences.

2. a deferred tax asset and related benefit can be recognized, subject to a valuation allowance.

3. the tax expense or benefit is allocated first to income from continuing operations, with any remainder allocated to other components.

4. net deferred liabilities and assets are classified as current or non-current based on the classification of the related asset or liability.

5. temporary differences must be recognized for unremitted earning of domestic subsidiaries.

6. purchase business combinations consummated before adoption of the statement must be restated if possible.
Required adoption of SFAS No. 109 is currently December 15, 1992.
CONCLUSION

Accounting for deferred taxes can be complicated. With the passing of SFAS No. 109, which, one hopes, will not be delayed, perhaps accounting for income taxes can achieve the qualities that FASB hoped for through the conceptual framework. I agree that the liability method is superior to the deferred method. The accrued deferred taxes will be easier to evaluate. Classifying the deferred tax balance based on its characteristics will clarify, when taxes will be due and how much is payable will be more evident. However, FASB needs seriously to consider discounting. Although it is complicated and difficult, it would be more consistent with other accounting pronouncements and display the effects that deferral of payments have on an enterprise.
REFERENCES


Williams, Jan (1992) *Analysis and Explanation of FASB Statement-108 Accounting for Income Taxes - Deferral of the Effective Date of FASB Statement No. 96*. HJB Miller Comprehensive GAAP GUIDE Update

LIST OF ADDITIONAL WORK CONSULTED


