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Accounting for income taxes, an interpretation of APB opinion no. 11;

Donald J. Bevis

Raymond E. Perry

American Institute of Certified Public Accountants. Accounting Principles Board

ACCOUNTING FOR INCOME TAXES Bevis and Perry AICPA

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INTRODUCTION

Historical Development

The issuance of Accounting Principles Board Opinion No. 11, *Accounting for Income Taxes*, represents the culmination of many years of study and consideration. The Opinion is the most complete and authoritative statement ever issued on the subject. In many respects, it is a codification of practices followed by many companies in the past, although these practices were not necessarily expressed in official pronouncements.

The principal problems in accounting for income taxes arise from transactions that affect the determination of net income for financial accounting purposes in one reporting period and the computation of taxable income in a different reporting period. The practice of interperiod allocation of income taxes has evolved for more than twenty-five years, particularly since the enactment of the United States Internal Revenue Code of 1954 which permitted the use of accelerated depreciation methods for tax purposes. As would be expected when an accounting procedure develops over a long period of time, various approaches to allocation have been followed by different companies. The objective of the Opinion is to provide guidelines to cover the recognition and presentation of income taxes in financial statements.

After several years of research by Professor Homer A. Black, with the assistance of the Accounting Research Division of the American Institute of Certified Public Accountants, Accounting Research Study No. 9, *Interperiod Allocation of Corporate Income Taxes*, was published in May 1966. Concurrent with publication of the Study, a subcommittee of the Accounting Principles Board began consideration of the subject.

The subcommittee presented a point outline of the substantive issues involved for consideration by the Board before drafting the Opinion. Numerous discussions were held within the Board, with extensive consideration by the subcommittee between Board meetings.

In the summer of 1967, the subcommittee held informal meetings with more than twenty industry associations, user groups, and government agencies.

Subsequently, a public exposure draft of the Opinion was distributed to members of the AICPA, listed companies, and others. Approximately 1,000 letters of comment were received and considered by the Board. A substantial number of the letters objected to a proposed requirement that realized investment credits be deferred and amortized over the life of the related property. As a result and in order to permit further study, particularly of transition problems, the Board deleted that section from the proposed Opinion. Accordingly, APB Opinions No. 2 and No. 4, dealing with the "*Investment Credit*", continue in effect.

APB Opinion No. 11 was issued in December 1967, effective for fiscal periods beginning after December 31, 1967. The conclusions significantly modify the views previously expressed by the predecessor Committee on Accounting Procedure and by the Board and vary in some important respects from the recommendations of Accounting Research Study No. 9.

Subjects Included in the Opinion

The Opinion reaffirms the general concept that "income taxes are an expense of business enterprises earning income subject to tax." By definition, income taxes include taxes based on income determined under provisions of the United States Internal Revenue Code and foreign, state and other taxes (including franchise taxes) based on income.[1]

The major subjects covered by the Opinion are (1) interperiod allocation of income tax expense because of timing differences, (2) accounting for operating loss carrybacks and carryforwards, and (3) financial statement presentation of income taxes, including allocation within a period (intraperiod allocation).

The Board also reaffirmed its conclusion, expressed in APB Opinion No. 10, *Omnibus Opinion—1966* (paragraph 6), that deferred taxes

[1] In some situations (such as for the State of California), application of the Opinion requires the current accrual of certain taxes measured by income in the years the income is earned, even though the taxes constitute a fee for the privilege of doing business in a succeeding period and are payable in that period.

should not be accounted for on a discounted basis pending further study of the broader aspects of discounting as it is related to financial accounting in general.

APB Opinion No. 11, as in the case of all other Opinions of the Board, is not intended to apply to immaterial items.

Exclusions from the Opinion

As mentioned previously, accounting for investment credits continues to be governed by APB Opinions No. 2 and No. 4. However, in applying APB Opinion No. 11, consideration should be given to the effect of investment credits in certain situations not covered in those Opinions, as discussed in this article.

APB Opinion No. 11 applies to all other aspects of accounting for income taxes and to all industry situations except as specifically indicated.

The Opinion does not apply to regulated industries in those circumstances where the standards described in the Addendum to APB Opinion No. 2 are met. That Addendum states that there may be differences in the application of generally accepted accounting principles to regulated industries because of the effect of the rate-making process and that different treatments, therefore, may be necessary in order to achieve an appropriate matching of expenses and revenues.

The Board deferred consideration of the special problems of allocation of income taxes in interim statements and among components of a business enterprise pending resolution of the broader problems of recognition and allocation of all revenues and expenses in these situations.

Further study is being given to the question of recognition of taxes on undistributed earnings of subsidiaries; accordingly, the provisions of Accounting Research Bulletin No. 51 (paragraph 16) continue to govern in this area.

Four specialized industry situations having tax consequences somewhat similar to those for timing differences have been excluded pending further study. Each of these situations has certain unique aspects which create problems in the measurement and recognition of their tax consequences. The exclusions are—(1) intangible development costs in the oil and gas industry, (2) "general reserves" of stock savings and loan associations, (3) amounts designated as "policyholders' surplus" by stock life insurance companies, and (4) deposits in statutory reserve funds by United States steamship companies. The Opinion is, however, applicable to these industries in all other respects including timing differences.

INTERPERIOD TAX ALLOCATION

Objective

The Opinion adopted the comprehensive allocation concept which requires interperiod allocation of income taxes in the case of all material timing differences, both recurring and nonrecurring. The objective of interperiod allocation of income taxes is to match the income tax expense reported in an income statement for a specific period with the revenues and other expenses reported for that period. Stated another way, reported income tax expense should represent the tax effects or tax consequences of the revenues and expenses included in income before income taxes (which is referred to in the Opinion as "pretax accounting income").

The Board rejected the partial allocation viewpoint which generally would require interperiod allocation only for nonrecurring differences. Under prior pronouncements of the Committee on Accounting Procedure, interperiod allocation was required for nonrecurring differences and for some but not all recurring differences.[2] Practice had been mixed with regard to types of recurring differences where allocation was not specifically required under prior pronouncements.

Alternative Methods Considered by the APB

The Opinion adopted the deferred method of applying tax allocation and rejected the alternatives—the liability and the net of tax methods.[3] The three methods are discussed in detail in Accounting Research Study No. 9 and are summarized in the Opinion. Each of the three methods was considered by the Accounting Principles Board in its deliberations.

Generally, the same amount of net income would be reported under

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[2] ARB No. 43, Chapter 10, Section B, *Taxes: Income Taxes,* paragraph 1, stated that "The section does not apply where there is a presumption that particular differences between the tax return and the income statement will recur regularly over a comparatively long period of time."

[3] Prior pronouncements permitted the use of any of the three methods—deferred, liability or net of tax. For example, see ARB No. 43, Chapter 9, Section C, *Depreciation: Emergency Facilities—Depreciation, Amortization and Income Taxes* (paragraphs 11-13); ARB No. 44 (Revised), *Declining-balance Depreciation* (paragraphs 4, 5, 7 and 10); ARB No. 51, *Consolidated Financial Statements* (paragraph 17); APB Opinion No. 5, *Reporting of Leases in Financial Statements of Lessee* (paragraph 21); and APB Opinion No. 6, *Status of Accounting Research Bulletins* (paragraph 23).

each of the three tax allocation methods if tax rates never changed or no new taxes were imposed. The effect on net income of changes in tax rates or the imposition of new taxes, however, will vary depending upon which of the three methods is used. Also, the net of tax method may yield different net income amounts when depreciation or amortization expense is capitalized or included in inventories and treated as a cost of future periods. Financial statement presentation varies depending upon the method used.

The deferred method of allocation ". . . is a procedure whereby the tax effects of current timing differences are deferred currently and allocated to income tax expense of future periods when the timing differences reverse. The deferred method emphasizes the tax effects of timing differences on income of the period in which the differences originate. The deferred taxes are determined on the basis of the tax rates in effect at the time the timing differences originate[4] and are not adjusted for subsequent changes in tax rates or to reflect the imposition of new taxes." The tax effects of transactions which reduce taxes currently payable (or create a refund of taxes because of a loss carryback) are treated as deferred tax credits; the tax effects of transactions which increase taxes currently payable (or reduce the amount of a refund of taxes because of a loss carryback) are treated as deferred tax charges. Such deferred credits and charges are amortized to income tax expense in future years as the original timing differences reverse and enter into the determination of pretax accounting income.

Advocates of the liability method consider income tax expense for a period to represent the taxes paid or to be paid on the components of pretax accounting income. Differences between tax expense for accounting purposes and taxes currently payable, which result from timing differences, are viewed as either liabilities for taxes payable in the future, or assets for prepaid taxes. Under the liability method, taxes are computed at the rates in effect or expected to be in effect when the components of pretax accounting income are reported in an income tax return. Adjustments of the liability or prepaid accounts are made whenever tax rates change or new taxes are imposed.

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[4]The Revenue and Expenditure Control Act of 1968, which became law on June 28, 1968, imposes a 10% income tax surcharge retroactive to January 1, 1968 for corporations. The surcharge should be considered for financial accounting purposes under the Opinion as a change in tax rates effective as of that date even though it may be only a temporary change. Accordingly, the tax effects of timing differences originating in a taxable period subject to the surcharge should be computed as if the law had actually been in effect on January 1, 1968.

The advocates of the net of tax method consider that tax allocation (determined by either the deferred or liability methods) should give explicit recognition to the fact that taxability and tax deductibility are factors in the valuation of assets and liabilities and the related revenues and expenses. Under the net of tax method, deferred tax accounts are not presented separately in the balance sheet, but instead are shown as reductions of the related assets and liabilities. Also, some advocates of the net of tax method would follow a similar procedure in the income statement and show the income statement effects of tax allocation as adjustments to the related revenue and expense accounts.

Under either the deferred or the liability methods, it is possible to determine from the financial statements the effects of tax allocation; this is not possible under the net of tax method without extensive additional disclosures.

The deferred method is considered to be preferable to the liability method because, although deferred tax charges and deferred tax credits are similar in some respects to receivables and payables, they do not represent receivables and payables in the usual sense. Also, the deferred method has the practical advantage that it neither requires assumptions as to future tax rates or the imposition of new taxes, nor does it require adjustments of balance sheet deferred tax accounts when tax rates change or new taxes are imposed.

In substance, the deferred method, being income statement oriented, measures the tax cost or tax benefit of a timing difference on the basis of the tax rates in effect at the time the difference originates. The liability method, being balance sheet oriented, relates the cost or benefit to the amount actually payable or expected to be payable. For example, assume that a company owns one building and adopts accelerated depreciation for tax purposes and straightline depreciation for accounting purposes. Under the deferred method, the tax effects would be equal to the reduction or increase in income taxes payable attributable to the difference between depreciation claimed for tax purposes and the amount recognized for accounting purposes. Under the liability method, the tax effects would be based on the taxes expected to be payable over the period in which the property will be held. Conceivably, such tax effects could be computed at "capital gains" rates if there was an intention to dispose of the property at a later date and it was apparent that a capital gain would result.

Deferred taxes relating to an originating timing difference are computed, under the deferred method, as the difference in income taxes payable that would result from (a) including the effect of the timing difference in the calculation of income taxes payable and (b) excluding the effect of the timing difference from such calculation.

The deferred method may be applied to each individual transaction or similar transactions may be grouped. When similar transactions are grouped, either (1) originating differences and reversing differences may each be considered separately, or (2) the originating and reversing differences may be combined.

Differences between pretax accounting income and taxable income may be either "timing differences" which require interperiod tax allocation or "permanent differences" which do not require interperiod tax allocation. The distinction between timing differences and permanent differences can best be explained by considering the technical definitions included in the Opinion together with specific examples.

Timing Differences

Timing differences are defined as—

> "Differences between the periods in which transactions affect taxable income and the periods in which they enter into the determination of pretax accounting income. Timing differences originate in one period and reverse or 'turn around' in one or more subsequent periods. Some timing differences reduce income taxes that would otherwise be payable currently; others increase income taxes that would otherwise be payable currently."

When timing differences occur, the income tax currently payable as shown on the income tax return for a period may not be the appropriate amount of income tax expense to match with the pretax accounting income for the period. In order to obtain proper matching, it is usually necessary to report as income tax expense an amount that is more or less than income taxes currently payable. In substance, the Opinion requires the recognition of the tax effects as income tax expense in the same periods as the related transactions are recognized in the determination of net income for financial accounting purposes. The cumulative effects of timing differences at any date appear in the balance sheet as deferred taxes—either deferred charges or deferred credits.

Transactions which give rise to timing differences are classified into four categories—(1) revenues or gains taxed *after* accrual for accounting purposes, (2) expenses or losses deducted for tax purposes *after* accrual for accounting purposes, (3) revenues or gains taxed *before* accrual for accounting purposes, and (4) expenses or losses deducted for tax purposes *before* accrual for accounting purposes.

For example, the gross profit on installment sales is customarily recognized for accounting purposes at the time of sale. However, under certain circumstances, it is possible to defer the inclusion of gross profit in taxable income until subsequent periods when the receivables arising from the installment sales are collected. Thus, in the period of sale, an originating timing difference occurs because gross profit is included in accounting income, but not in taxable income. In subsequent periods, a reverse timing difference occurs when the installment accounts receivable are collected and gross profit is recognized in the tax returns but not in the accounts.

A simplified illustration of an originating timing difference is presented below. The illustration assumes that a company has sold merchandise on the installment basis for the first time and recognizes the gross profit thereon for accounting purposes at the time of sale but elects the installment method for tax purposes.

Year 1

Pretax accounting income	$1,000,000
Gross margin on uncollected installment sales at end of year	200,000
Taxable income	$ 800,000
Taxes estimated to be payable (assuming a 48% rate less surtax exemption)	$ 377,500
Charge equivalent to reduction in income taxes arising from installment method of reporting for tax purposes (excess of 48% of $1,000,000, less $6,500, over $377,500; or 48% of $200,000)	96,000
Income tax expense as shown in income statement	$ 473,500

A deferred tax is amortized when the reverse timing difference takes place. Thus, in the case of installment sales, as the installment receivables are collected, and the gross profit is recognized for tax purposes, income tax expense is reduced by the amortization of the deferred tax credits previously recorded.

Continuing the preceding illustration, the amortization of deferred taxes related to the reverse timing difference appears as follows:

Year 2

Pretax accounting income	$1,000,000
Gross margin on prior year's sales collected during the current year	200,000
Taxable income	$1,200,000
Taxes estimated to be payable (assuming a 48% rate less surtax exemption plus 10% surcharge)	$ 626,450
Amortzation of deferred taxes set up in prior year (credit)	(96,000)
Income tax expense as shown in income statement	$ 530,450

These illustrations show the effect of a timing difference arising from the use of the installment method for tax purposes and the effect of a change in the tax rate.

In a typical case where installment sales occur each year, there would be both originating differences and reversing differences each year. Accordingly, the increase or decrease in the deferred tax credit balance would be the combination of the tax effects from originating differences and the tax effects of reversing differences. Thus, income tax expense appearing in the financial statements might be higher or lower than taxes currently payable.

It should be noted that at least two periods are affected by each initial timing difference—the period in which the difference originates and a subsequent period (or periods) when the initial difference reverses.

Another example of a relatively simple kind of recurring timing difference is a provision for product warranty expenses which originates in one period and reverses in one or more future periods. The provision is recorded for accounting purposes during the period when the warrantied products are sold. However, an income tax deduction is not allowed until the period when expenditures under the warranty are made. For the period when the timing difference originates, warranty expense for accounting purposes exceeds warranty expense for tax purposes; and, consequently, taxable income is greater than pretax accounting income and income taxes payable are greater than income tax expense for accounting purposes. In effect, a portion of the income taxes are prepaid. During a subsequent period a reverse timing difference occurs when expenditures under the warranty are made. In the period of reversal, warranty expense for tax purposes exceeds warranty expense for accounting purposes; consequently, taxable income and income taxes are reduced.

In the not uncommon situation where the warranty period runs for more than one year, the reverse timing differences occur in part during each year of the warranty period. Under these circumstances, the total of the reverse timing differences for several periods will be equal to the original timing difference occurring during the period when the warrantied products were sold. In many cases it will be impracticable to relate recurring originating timing differences to the reverse timing differences because of the number of transactions involved. This problem becomes particularly important when the tax rates applied to originating differences change from period to period. In these cases an arbitrary assumption as to reversal may be necessary. Application of either first-in, first-out, or averaging techniques would be appropriate in these situations.

A more complex example of timing difference occurs when an accelerated method of depreciation is used for tax purposes, while the straight-line method is used for accounting purposes. In such cases, the depreciation accounting following the purchase of a unit of depreciable property results in originating timing differences each period for a number of periods during which tax depreciation exceeds accounting depreciation. In later periods reverse timing differences occur as accounting depreciation exceeds tax depreciation. The reversal period is, of course, known. Even for this type of timing difference, however, an arbitrary flow assumption—either first-in, first-out or averaging—may be necessary in order to relate specific reverse timing differences to specific originating timing differences. The problems of specific identification of reverse timing differences with originating timing differences become further complicated if not impossible, if a composite rate of depreciation is used for a group of assets, the individual units of which have different life cycles.

Permanent Differences

Permanent differences are defined as—

> "Differences between taxable income and pretax accounting income arising from transactions that, under applicable tax laws and regulations, will not be offset by corresponding differences or 'turn around' in other periods."

Timing differences involve both an originating difference and, subsequently, a reverse difference. Differences between accounting and taxable income, however, are permanent if an originating difference is *never* followed by a reverse difference. Interperiod tax allocation should not be applied to permanent differences because the amount of income tax payable is the proper income tax expense to match with the revenues and other expenses reported for the period in which the differences occur.

Permanent differences may arise under the tax law because specified revenues are exempt from taxation or specified expenses are not deductible. Examples of exempt revenues are life insurance proceeds and interest on municipal obligations. Examples of non-deductible expenses are premiums paid on officers' life insurance and fines. Amortization of goodwill recorded for accounting purposes gives rise to a permanent difference if it is not deductible for tax purposes.

Permanent differences also arise if items enter into the determination of taxable income but are never recognized in determining accounting income. Examples are the excess of statutory depletion over cost depletion and the special deduction for certain dividends received which are recognized for tax purposes but not for accounting purposes.

A permanent difference also results if different bases of carrying property for accounting purposes and for tax purposes produce amounts for depreciation or amortization different for tax purposes than for accounting purposes. Also, gains or losses for tax purposes upon dispositions of such property may differ from those recognized for accounting purposes. Different bases for property frequently result from write-downs of assets in a reorganization. Different bases may also occur from business combinations accounted for as purchases and treated as tax-free exchanges or from business combinations accounted for as poolings of interests and treated as taxable exchanges. Similarly, in the case of a donation of property, accounting expense could be recorded on the basis of the net carrying amount of the property whereas the tax deduction would be for the fair value on the date of gift.

Nonqualified stock option plans may result in permanent differences. Compensation should be recorded in the accounts at the date of grant equal to the difference between the option price and the fair value of the optioned stock at that date; the deduction for tax purposes, if any, cannot be taken until the option is exercised. The difference between the fair value at date of grant and the option price constitutes a timing difference and tax allocation procedures should be applied. This difference reverses when the option is exercised or expires. The deduction for tax purposes at the time of exercise is based upon the fair value of the stock at that time. Any difference between the fair value at that time and the fair value at date of grant should under one theory be treated as an adjustment of compensation; however, inasmuch as current practice does not require the recognition of this element of compensation, it should be treated, in principle, in the year the option is exercised as a permanent difference because it is never followed by a reversing difference.[5]

Likewise, qualified stock option plans may give rise to permanent differences. Under these plans there are certain restrictions as to the sale of the stock. If the restrictions are not met, the employee may have taxable income and the corporation may have a tax deduction.[5]

In summary, tax benefits or tax costs related to transactions affecting income for a period should be reflected in the income statement for that period. If there are no timing differences affecting income for a period, the income statement will show only the taxes estimated to be payable for the period as income tax expense; any tax benefits or tax costs related to permanent differences occurring in the period pertain to that period.

Computation of Deferred Taxes

The Opinion requires that "The tax effect of a timing difference should be measured by the differential between income taxes computed with and without inclusion of the transaction creating the difference between taxable income and pretax accounting income." In computing such differentials, "taxable income" is defined as "the excess of revenues over deductions or the excess of deductions over revenues to be reported for income tax purposes for a period" except that "deductions" do not include loss carrybacks or loss carryforwards. Accordingly, in theory, a separate computation is required for each originating timing difference in order to determine what the tax would have been both with and without including the timing difference. In practice, the same result will often be obtained if the current tax rate is simply applied to the amount of the timing difference. In some cases, however, the same result will not be obtained by use of the "short-cut" approach. Differences may result from the effect of the investment credit or a foreign tax credit, the existence of an operating loss for the period, or the fact that an operating loss would be incurred if a timing difference is excluded.

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[5]In practice the tax effects of these transactions are generally treated as adjustments of capital inasmuch as they are associated with the issuance of the stock and not with the measurement of income.

Two alternative approaches to the computation of the tax effects of timing differences are set forth in paragraph 37 of the Opinion, which states:

> "In computing the tax effects referred to in paragraph 36, timing differences may be considered individually or similar timing differences may be grouped. The net change in deferred taxes for a period for a group of similar timing differences may be determined on the basis of either (a) a combination of amounts representing the tax effects arising from timing differences originating in the period at the current tax rates and reversals of tax effects arising from timing differences originating in prior periods at the applicable tax rates reflected in the accounts as of the beginning of the period; or (b) if the applicable deferred taxes have been provided in accordance with this Opinion on the cumulative timing differences as of the beginning of the period, the amount representing the tax effects at the current tax rates of the net change during the period in the cumulative timing differences."

Similar timing differences refer to individual timing differences which arise from the same kinds of transactions. For example, all differences between accounting depreciation and tax depreciation may be grouped together as similar differences even though they may relate to many individual assets acquired during various years. Also, differences between accounting and taxable income arising from deferral for tax purposes of gross margin on installment sales may be grouped together as similar differences even though they may represent many individual sales occurring over a number of different periods. However, depreciation timing differences should not be combined with gross margin timing differences.

For convenience, the method of computation set forth in (a) in the preceding quotation is referred to as the "gross change method", because, for each group of similar timing differences, separate computations are made for the tax effects of originating differences based on current tax rates and for the tax effects of reversing differences at the applicable tax rates reflected in the accounts at the beginning of the period. The method of computation described under (b) is referred to as the "net change method", because a single computation is made at the current tax rates for the net cumulative effect of both originating and reversing differences occurring during a period relating to a particular group of similar timing differences.

For each kind of "similar" differences, a company may choose to compute deferred taxes either on individual transactions or for groups of transactions and in the latter case by either the gross change or net change methods. Once chosen, the same method should be consistently employed for the specific kind of similar differences. If the method of computation is changed, a consistency exception will be required in the auditor's report where the effect is material.

Under all three methods of computation (individual transaction, gross change, or net change) the tax effect is based on a differential calculation.[6] Under either the individual transaction or the gross change methods the reversal of tax effects of timing differences originating prior to the effective date of the Opinion may be recognized only if the applicable deferred taxes had been provided for in accordance with the Opinion either in the prior periods, or retroactively as of the effective date of the Opinion. The net change method may be employed only if the deferred taxes applicable to the net cumulative differences of prior periods were provided in those periods or retroactively as of the effective date of the Opinion.

The provisions discussed in the preceding paragraphs were included in the Opinion so that a company that was not applying interperiod tax allocation for any particular kind of timing difference prior to the effective date of the Opinion could not use the tax effects of the reversal of that difference to offset deferred taxes required to be recognized for current originating timing differences.

For example, assume that research and development expenditures are capitalized when incurred and amortized in subsequent periods for accounting purposes, but are deducted when incurred for tax purposes, and that no provision has been made in the past for the applicable deferred taxes. After the effective date of the Opinion, deferred tax credits (equivalent to the tax benefits received) must be provided by a charge against income with respect to any expenditures which are capitalized for accounting purposes but are claimed as tax deductions in the period of expenditure. However, as these costs which were capitalized prior to the effective date of the Opinion are amortized during periods *after* the effective date, the tax effects of such reverse timing differences may not be considered as a reduction of the provision for deferred taxes required for differences originating *after* the effective date.

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[6] The calculation should take into consideration all taxes based on income—United States, foreign, state and local. As a practical matter, where companies are subject to a number of jurisdictions which have income taxes, the rates to be used in the calculation are often determined by increasing the United States income tax rate by a percent equivalent to the effect of the taxes imposed by the other jurisdictions.

Illustrations of the procedures followed in computing deferred taxes comparing the gross change method with the net change method are presented in Exhibits I and Ia. They are not intended as typical illustrations but rather to illustrate some of the complications that may be encountered in practice. The illustrations also demonstrate that the current provision for deferred taxes is not necessarily the amount obtained by applying the current statutory tax rate to the amounts of the timing differences.

Amortization of Deferred Taxes

The amortization of deferred taxes upon reversal of nonrecurring timing differences usually presents no special problems. If the entire reverse timing difference occurs during one period subsequent to the period of origination, the entire deferred tax set up at the time of origination is amortized to income tax expense during the period of reversal. If the timing difference reverses over two or more periods, the deferred tax recognized at the time of origination is amortized in each of the subsequent periods of reversal in proportion to the amount of the reverse timing difference in each period relative to the total original timing difference.

Sometimes when the gross change method of computing deferred taxes is employed for recurring timing differences, it may be possible to associate specific reverse timing differences with specific originating timing difference. Under such circumstances, the amortization of deferred taxes is similar to that previously described for nonrecurring timing differences. There are instances of recurring timing differences, however, in which it is not possible to associate a specific reverse difference with a specific originating difference. Often in such circumstances the total deferred tax account applicable to the particular type of, or group of similar, timing differences has been accumulated over a number of years at varying rates. It is appropriate in such circumstances to amortize a portion of the aggregate deferred tax balance at the beginning of the period by use of either the first-in, first-out flow assumption or the average rate assumption.

Under the first-in, first-out assumption, the earliest additions to the deferred tax account are amortized first. Application of the first-in, first-out assumption requires a record of amounts of deferred taxes by year of addition. Under the average rate assumption, the amount of deferred tax amortized is determined by applying the ratio of aggregate deferred taxes to aggregate timing differences at the beginning of the period, to the amount of the reverse timing difference during the period. The practice

EXHIBIT I

COMPUTATION OF DEFERRED TAXES UNDER ALTERNATIVE APPROACHES FOR TWO KINDS OF TIMING DIFFERENCES

Assumptions

1. All prior deferred taxes are at an average rate of 48%
2. Current period tax rate is 48% less surtax exemption of \$6 and plus 10% surcharge
3. Current period investment credit is \$0

	Gross Change Method	*Net Change Method*
	(thousands of dollars)	
Computation of taxable income		
Pretax accounting income	\$500	\$500
Timing differences from use of accelerated depreciation for tax purposes and straightline depreciation for accounting purposes:		
Originating—tax depreciation in excess of accounting depreciation	(500)	
Reversing—accounting depreciation in excess of tax depreciation	100	
Net change		(400)
Timing differences from use of installment method for tax purposes and accrual method for accounting purposes:		
Originating—gross margin on current period sales uncollected at end of period	(300)	
Reversing—gross margin on prior period sales collected during current period	400	
Net change		100
Taxable income	\$200	\$200
Computation of tax estimated to be currently payable		
48% rate	\$ 96	\$ 96
Surtax exemption	(6)	(6)
10% surcharge	9	9
	\$ 99	\$ 99

	Gross Change Method	Net Change Method
	(thousands of dollars)	
Computation of deferred tax on depreciation timing difference		
Taxable income	$200	$200
Originating or net change in depreciation timing differences	500	400
Adjusted taxable income—"without" timing differences	$700	$600
Tax on adjusted taxable income	$363 (a)	$310 (a)
Tax currently payable	99	99
Differential equivalent to tax effects of timing differences to be added to deferred tax credit	$264	$211
Computation of deferred tax on deferred gross margin timing differences		
Taxable income	$200	$200
Originating or net change in gross margin timing differences	300	(100)
Adjusted taxable income—"without" timing differences	$500	$100
Tax on adjusted taxable income	$257 (a)	$ 46 (a)
Tax currently payable	99	99
Differential equivalent to tax effects of timing differences to be added to (or deducted from) deferred tax credit	$158	$(53)
Summary of changes in deferred tax credit balance		
Additions to deferred credits arising from originating differences:		
Depreciation	$264	
Deferred gross margin	158	
Arising from increase in cumulative depreciation differences		$211
Amortization of deferred credits arising from reversing differences:		
Depreciation—(48% of $100)	(48)	
Deferred gross margin—(48% of $400)	(192)	
Net amortization arising from reduction in cumulative deferred gross margin		(53)
Net Increase	$182 (b)	$158 (b)

Notes:

(a) 48% of adjusted taxable income ("without" timing difference), less surtax exemption of $6 and plus 10% surcharge.

(b) The difference between the net increase in the deferred tax credit balance of $182 under the gross change method and $158 under the net change method, or $24 (in effect 4.8% of $500, the aggregate amount of reversing timing differences) represents the effect of using (1) under the gross change method the current tax rate for originating differences and the effective prior period rates for reversing differences and (2) under the net change method the current tax rate for the cumulative net effect of both originating and reversing differences.

EXHIBIT Ia

COMPUTATION OF DEFERRED TAXES UNDER ALTERNATIVE APPROACHES FOR TWO KINDS OF TIMING DIFFERENCES

Assumptions

Same as Exhibit I, except current period investment credit is $50.

	Gross Change Method	*Net Change Method*
	(thousands of dollars)	
Computation of taxable income		
Same as Exhibit I		
Computation of tax estimated to be currently payable		
48% rate	$ 96	$ 96
Surtax exemption	(6)	(6)
10% surcharge	9	9
Allowable investment credit	(50)	(50)
	$ 49	$ 49
Computation of deferred tax on depreciation timing difference		
Taxable income	200	$200
Originating or net change in depreciation timing differences	500	400
Adjusted taxable income—"without" timing differences	$700	$600
Tax on adjusted taxable income	$313 (a)	$260 (a)
Tax currently payable	49	49
Differential equivalent to tax effects of timing differences to be added to deferred tax credit	$264	$211

	Gross Change Method	Net Change Method
	(thousands of dollars)	
Computation of deferred tax on deferred gross margin timing differences		
Taxable income	$200	$200
Originating or net change in gross margin timing differences	300	(100)
Adjusted taxable income—"without" timing differences	$500	$100
Tax on adjusted taxable income	$207 (a)	$ 10 (b)
Tax currently payable	49	49
Differential equivalent to tax effects of timing differences to be added to (or deducted from) deferred tax credit	158	$(39)
Summary of changes in deferred tax credit balance		
Additions to deferred credits arising from originating differences:		
Depreciation	$264	
Deferred gross margin	158	
Arising from increase in cumulative depreciation differences		$211
Amortization of deferred credits arising from reversing differences:		
Depreciation—(48% of $100)	(48)	
Deferred gross margin—(48% of $400)	(192)	
Net amortization arising from reduction in cumulative deferred gross margin		(39)
Net increase	$182	$172 (c)

Notes:

(a) 48% of adjusted taxable income ("without" timing difference), less surtax exemption of $6, plus 10% surcharge and less allowable investment credit of $50.

(b) 48% of adjusted taxable income ("without" timing difference), less surtax exemption of $6, plus 10% surcharge and less maximum investment credit of $36 ($25 plus 50% of the difference between $46 and $25).

(c) The difference between the net increase in the deferred tax credit balance under the net change method of $158 in Exhibit I and $172 in Exhibit Ia, or $14, arises from the influence of the investment credit. It should be noted that under the gross change method the full investment credit of $50 is utilized in all of the computations "with and without inclusion of the transaction creating the difference between taxable income and pretax accounting income." Under the net change method the utilization of the investment credit is limited to $36 in the computation of the tax effects of deferred gross margin timing differences whereas $50 is utilized in the computation of depreciation timing differences. (See section on "Investment Credit Carrybacks and Carryforwards.")

adopted for amortization of deferred taxes, where specific identification is not possible, should be consistently followed; otherwise, if the effect is material a consistency exception will be required in the auditor's report.

Amortization procedures are different when the net change method of computing deferred taxes is employed. Under the net change method no amortization of deferred taxes is recorded for periods in which the aggregate timing differences increase. In each period in which the aggregate timing differences decrease, deferred taxes are amortized. Such amortization is computed as the difference between income tax on taxable income and income tax on taxable income less the reduction in aggregate timing differences. The amortization of deferred taxes, however, cannot exceed the amounts previously provided. In a period when reversal of all timing differences of a particular type occurs, the entire related deferred tax account should be amortized regardless of the amount determined under the differential computation. For example, a company that has been using the installment method of accounting for gross margin on installment sales for tax purposes may decide to abandon the installment method by selling all installment receivables. The entire amount of deferred tax credits relative to installment sales which was carried over from the preceding period should then be amortized.

OPERATING LOSSES

Tax benefits are usually available when operating losses are incurred. Such benefits are obtained either (a) from refunds of taxes paid in prior profitable years—by carryback of losses, or (b) as reductions of taxes otherwise payable in future profitable years—by carryforward of losses.[7] The basic accounting concept of matching revenues and expenses suggests that it is appropriate to record the tax benefit from an operating loss in the income statement of the loss year.

Loss Carrybacks

Refunds of taxes paid in prior years arising from carrybacks of operating losses should be recognized during the loss year. This is required

[7]This section is also applicable to other unused deductions and credits that may be carried backward or forward in determining taxable income (for example, capital losses, contribution carryovers and foreign tax credits).

to achieve proper matching inasmuch as current realization of the refund is assured. The refunds should be reflected in the balance sheet as current assets.

An illustration of the presentation of an operating loss carryback, assuming that pretax accounting income and taxable income are identical, follows.

Loss before refundable income taxes	$1,000,000
Refund of prior years' income taxes arising from carryback of operating loss	485,000
Net loss	$ 515,000

(Note: The refund should be computed at the amount actually refundable regardless of current tax rates.)

A loss carryback may occur at a time when net deferred tax credits exist. Under these circumstances "appropriate adjustments of existing net deferred tax credits may also be necessary in the loss period." The tax effects of the loss carryback included in the income statement should be based on income (loss) reported for accounting purposes rather than for tax purposes, the objective being to reflect in income the carryback refund which would exist if there were no timing differences. The difference between this amount and the amount currently refundable should be added to or deducted from the appropriate balance sheet deferred tax account. This is accomplished by recomputing the net deferred tax amounts for the carryback periods and the current period on a cumulative basis. Such computation is illustrated in Exhibit II.

Loss Carryforwards—Conflict of Concepts

The procedures applied to loss carryforwards differ from those applied to loss carrybacks. The existence of a carryforward means that a company has incurred operating losses which exhausted benefits available from carrybacks and which can be realized only as a carryforward. Usually a company in a carryforward position is experiencing financial difficulties so serious that doubt exists as to future realization of the carryforward. In such cases a company may not have shown profits in any recent year—or in its entire history. The recording of the tax benefit of a loss carryforward during the loss year under such circumstances would be contrary to the accounting concept that revenues or gains should not be recognized if realization is doubtful.

EXHIBIT II

APPLICATION OF LOSS CARRYBACK AGAINST EXISTING DEFERRED TAX CREDITS

	Income (Loss) Before Income Taxes		*Income Tax Expense (Credit)*			*Cumulative Net Deferred Tax Credits*
Year	*Accounting*	*Taxable*	*Current*	*Deferred*	*Total*	
1	$ 15,000	$ 5,000	$ 2,500	$ 5,000	$ 7,500	$ 5,000
2	15,000	5,000	2,500	5,000	7,500	10,000
3	15,000	5,000	2,500	5,000	7,500	15,000
4	15,000	5,000	2,500	5,000	7,500	20,000
5	(35,000)	(45,000)	(7,500) (A)	(10,000) (B)	(17,500)	10,000 (C)
6	5,000	15,000	—0— (A)	2,500 (D)	2,500	12,500

Assumptions:

1. 50% tax rate for all years.
2. Surtax exemptions and investment credits ignored.

Notes:

(A) Taxes paid in years 2, 3 and 4 aggregating $7,500 become refundable as a result of the carryback of the loss from year 5. No tax is payable in year 6 because of the loss carryforward from year 5.

(B) For years 2 through 5 cumulative accounting income is $10,000, which at a 50% rate requires a deferred tax credit of $5,000. Accordingly a reduction in deferred tax credits of $10,000 is required. In effect, a loss carryforward has been recognized to that extent. (See section on "Recognition of Carryforwards as Offset to Deferred Tax Credits.")

(C) The cumulative deferred tax credit at end of year 5 consists of $5,000 from year 1 plus $5,000 for years 2 through 5.

(D) Represents the tax benefit ($2,500) of the loss carryforward to year 6 previously recognized in year 5.

The Opinion takes the position, relative to loss carryforwards, that the realization concept should take precedence over the matching concept. Therefore, loss carryforward benefits usually should be recognized only when realized through subsequent profitable operations. However, the Opinion also states that the future tax benefit of a loss carryforward should be recorded as an asset during the loss year in those cases where realization is *assured beyond any reasonable doubt.*

In the usual case of a loss carryforward—where realization is *not* assured beyond any reasonable doubt—tax benefits can be recognized *only* during subsequent years *as they are realized.* Thus, even though in a period subsequent to the loss year the future realization of a carryforward becomes assured beyond any reasonable doubt, it is not permissible under the Opinion to recognize the future tax benefit until it is actually realized.

When a loss carryforward is realized and recognized subsequent to the loss period, income statement presentation is a problem. Under the matching concept, the benefit applies to the loss period and not to the period of realization; this suggests retroactive adjustment of the loss period. However the criteria set forth in APB Opinion No. 9, *Reporting the Results of Operations*, greatly restrict prior period adjustments. One criterion essential to a prior period adjustment is that such adjustment not be "attributable to economic events occurring subsequent to the date of the financial statements for the prior period." Since the realization of the tax benefit from the operating loss results from subsequent profitable operations, it is clear that it does not meet this test. Therefore, it is not appropriate to adjust the loss period retroactively.

In order to keep within the criteria of APB Opinion No. 9, it is necessary to include the tax benefit from a loss carryforward in the income statement of the year of realization. However, because it seemed illogical to consider such a credit to be a part of ordinary income, the Board decided that such tax benefits should be presented as extraordinary credits in the year of realization.

A loss carryforward benefit recognized in the year realized could be presented as shown in Exhibit III.

EXHIBIT III

RECOGNITION OF LOSS CARRYFORWARD BENEFIT IN YEAR REALIZED

Income before income taxes and extraordinary items		$1,000,000
Income tax expense:		
Currently payable	$200,000	
Tax effect of loss carryforward	300,000	500,000
Income before extraordinary items		$ 500,000
Extraordinary items:		
Reduction of income taxes arising from carry-forward of prior years' operating losses	$300,000	
Loss on major devaluation of foreign currency (less applicable income tax of $100,000)	(100,000)	200,000
Net income		$ 700,000

Assumptions:

1. 50% tax rate for all years.
2. Surtax exemptions and investment credits ignored.

Assurance Beyond Any Reasonable Doubt

The Opinion provides that the future tax benefit of a loss carryforward should be recognized as an asset during the loss period if realization is "assured beyond any reasonable doubt." Consequently, the meaning of the phrase "assured beyond any reasonable doubt" is quite important. It was the Board's intention that recognition of future tax benefits of carryforwards should be restricted to unusual cases.

The Opinion cites, by way of example, circumstances under which carryforwards may be recognized during the loss year as follows:

> "Realization of the tax benefit of a loss carryforward would appear to be assured beyond any reasonable doubt when both of the following conditions exist: (a) the loss results from an identifiable, isolated and nonrecurring cause and the company either has been continuously profitable over a long period or has suffered occasional losses which were more than offset by taxable income in subsequent years, and (b) future taxable income is virtually certain to be large enough to offset the loss carryforward and will occur soon enough to provide realization during the carryforward period."

The use of the words "identifiable, isolated, and nonrecurring" in the above quotation was intended to rule out recognition of loss carryforwards resulting from generally unsuccessful business operations of an entity. Thus, operating losses resulting because of depressed economic conditions or because of changes in consumer preferences or in technology do not give rise to a situation where a future tax benefit may be recognized. Loss carryforwards resulting from the introduction of products or services which have not achieved sufficient acceptance to produce profits do not qualify for recognition prior to realization. Such non-recognition of loss carryforwards applies both to companies in existence for many years that have moved into a new area of business and to newly-formed companies in the developmental stage.

Examples of the kinds of situations giving rise to loss carryforwards that may qualify for recognition during the loss period are:

(1) Losses resulting from the expropriation of a foreign subsidiary, or from the abandonment of one of several operations where the continuing operations are and have been profitable and are virtually certain to be profitable enough to offset the loss carryforwards, and

(2) Losses of one or more subsidiaries of a profitable parent company where the carryforward will be made available as an offset against

other taxable income by filing a consolidated income tax return, or by claiming a bad debt deduction, or by some other means. On the other hand, it would not be appropriate to record a loss carryforward of a subsidiary company even though the parent and other subsidiaries are profitable if there are no specific plans to obtain the tax benefit from the loss.

In those rare cases where operating loss carryforwards are expected to be realized beyond any reasonable doubt as offsets against future taxable income, the potential tax benefits should be reflected in the balance sheet as assets, and should be classified as current or noncurrent depending on the extent to which realization is expected to occur within the current operating cycle.

Recognition of Carryforwards as Offsets to Deferred Tax Credits

It may happen that an operating loss carryforward arises at a time when net deferred tax credits exist because of prior timing differences. Even though the realization of an operating loss carryforward is not assured beyond any reasonable doubt, it may be necessary if net deferred tax credits exist to recognize a portion or all of the loss carryforward as an offset to such net deferred tax credits. The Opinion provides that, in such situations:

> "net tax credits should be eliminated to the extent of the lower of (a) the tax effect of the loss carryforward, or (b) the amortization of the net deferred tax credits that would otherwise have occurred during the carryforward period. If the loss carryforward is realized in whole or in part in periods subsequent to the loss period, the amounts eliminated from the deferred tax credit accounts should be reinstated (at the then current tax rates) on a cumulative basis as, and to the extent that, the tax benefit of the loss carryforward is realized."

The limiting factor in the amount of loss carryforward that may be recognized by way of offset against net deferred tax credits is indicated in clause (b) of the preceding quotation.

The justification for recognizing loss carryforwards as an offset to deferred tax credits is that it would be unrealistic to require recognition of deferred tax credits while at the same time denying recognition of deferred tax charges, in the form of a loss carryforward. This follows because both the deferred credits and the deferred charges will reverse during the same future accounting periods. However, net deferred credits which will not be amortized until after the expiration of the loss carryforward period cannot be offset by loss carryforwards.

If both current and non-current net deferred tax credits exist when the future benefit of a loss carryforward is recognized as an offset, such benefit should be allocated between current and non-current deferred tax credits on a proportional basis.

As the loss carryforward benefit is realized, the net deferred credits eliminated to give recognition to the carryforward, as well as credits related to originating timing differences of the loss year, should be reinstated at the then current rates (i.e., at the rates at which the loss carryforward is realized) before recognition is given to the realization of any remaining loss carryforwards. At the same time amortization of such deferred credits that would otherwise have occurred should also be recognized.

The interaction of net deferred tax credits and loss carryforwards is illustrated in Exhibit IV.

Deferred Tax Charges Existing When Loss Carryforward Arises

A company may incur operating losses sufficient to put it in a loss carryforward position at the same time that unamortized net deferred tax charges exist. To the extent the deferred charges arose in the three preceding profitable years, they would normally be eliminated through carryback of losses. However, balances prior to that period may still remain. If the realization of the tax benefit of the carryforward is not assured beyond any reasonable doubt, the question arises as to the propriety of continuing to carry the remaining deferred tax charges. In these situations unamortized net deferred tax charges represent the tax effects of additional expenses not recognized for tax purposes but recognized for accounting purposes. Therefore, if it is not appropriate to recognize the effect of the tax loss carryforward in the year of loss, it may not be appropriate to recognize or to continue to carry as deferred charges the tax effects of the additional expenses recognized for accounting purposes. Accordingly, in the situations cited the net deferred tax charges should be evaluated as to realizability in the same manner as are other assets.

In other situations companies may incur losses which, because of the nature of the timing differences, are larger for accounting purposes than the amounts carried forward for tax purposes and there is no assurance of future realization of the carryforward benefit. No recognition is given to the tax effects (deferred tax charges) of the timing differences (additional accounting loss carryforwards) inasmuch as the tax effects would be zero under the "with" and "without" computations. Therefore, when these timing differences reverse, the tax benefits realized will not be offset by amortization of deferred charges which would otherwise have been provided. Accordingly, in these situations the tax benefits realized from these timing differences (additional accounting loss carryforwards) should be included in the income statement as extraordinary credits (see Exhibit V) in the same manner as benefits obtained upon future realization of tax loss carryforwards (see Exhibit III).

Loss Carryforwards Arising Prior to Quasi-Reorganization

A company which goes through a quasi-reorganization (including for this purpose the application of a deficit in retained earnings to contributed capital) is likely to be in a loss carryforward position. The proper accounting for the future tax benefit of such loss carryforwards poses a question because the losses occurred prior to quasi-reorganization, but the tax benefit from the carryforward is available as an offset against taxable income after quasi-reorganization. Normally, it would be inappropriate to recognize the potential future tax benefits from the carryforward at the date of the quasi-reorganization because realization would not be assured beyond any reasonable doubt. Also, the deficit from operations prior to the quasi-reorganization is written off to contributed capital; in effect a new enterprise is said to have been established.

When a tax benefit is realized from such loss carryforwards, the Opinion provides that such benefits should be added to contributed capital because the benefits are attributable to the loss periods prior to the quasi-reorganization. Thus, the benefits are treated as a part of the capital of the new enterprise.

In some instances, losses may also occur subsequent to the quasi-reorganization and the question may arise as to whether realization of the loss carryforwards applies to losses incurred prior or subsequent to quasi-reorganization. Under the tax law the earliest loss carryforward must be utilized first. For accounting purposes the tax benefits from loss carryforwards should be allocated between losses before and after the quasi-reorganization in the same manner that they are available under the tax laws.

The above requirements apply to the tax effects of loss carryforwards realized after the effective date of APB Opinion No. 11 even though the related quasi-reorganization occurred prior to the effective date.

The concepts described in the preceding paragraphs relative to quasi-reorganizations apply equally to reorganizations under the bankruptcy laws where a deficit is written off to capital.

EXHIBIT IV

EXAMPLE OF LOSS CARRYFORWARD RECOGNIZED AS OFFSET TO NET DEFERRED TAX CREDITS

(All amounts in thousands of dollars)

	Income before income taxes		Depreciation		Income tax expense (1)			Cumulative net deferred tax credits
Year	Accounting	Taxable	Accounting	Tax	Current (2)	Deferred (F)	Total	
1	$ 15,000	$ 5,000	$ 10,000	$ 20,000	$ 2,500	$ 5,000	$ 7,500	$ 5,000
2	15,000	5,000	10,000	20,000	2,500	5,000	7,500	10,000
3	15,000	5,000	10,000	20,000	2,500	5,000	7,500	15,000
4	15,000	5,000	10,000	20,000	2,500	5,000	7,500	20,000
5	(54,000) (3)	(64,000) (3)	10,000	20,000	(7,500) (A)	(15,000) (B) (2,000) (C)	(24,500)	3,000
6	2,000	6,000	10,000	6,000	—	(2,000) 3,000	1,000 (D)	4,000
7	2,000	6,000	10,000	6,000	—	(2,000) 3,000	1,000 (D)	5,000
8	2,000	6,000	10,000	6,000	—	(2,000) 3,000	1,000 (D)	6,000
9	2,000	6,000	10,000	6,000	—	(2,000) 3,000	1,000 (D)	7,000
10	5,000	9,000	10,000	6,000	—	(2,000) 4,500	2,500 (D)	9,500
11	10,000	16,000	10,000	4,000	8,000	(1,900) (E)	6,100	7,000
12	10,000	16,000	10,000	4,000	8,000	(1,900) (E)	6,100	5,700
13	10,000	16,000	10,000	4,000	8,000	(1,900) (E)	6,100	3,800
14	10,000	16,000	10,000	4,000	8,000	(1,900) (E)	6,100	1,900
15	10,000	16,000	10,000	4,000	8,000	(1,900) (E)	6,100	—
	$ 69,000	$ 69,000	$150,000	$150,000	$ 42,500	$ —	$ 42,500	$ —

ADDITIONAL ASSUMPTIONS:

(1) 50% tax rate for all years and surtax exemptions and investment credits ignored.

(2) Equal to amount payable (or refundable) each year.

(3) Loss carryforward of $9,000 on accounting and $49,000 on tax basis is **not** assured beyond any reasonable doubt.

Notes:

(A) Refund of taxes paid in years 2-4 available because of loss carryback.

(B) Adjustment of deferred credit from timing difference recognized in years 2-4 (carryback period) in accordance with paragraph 44 of Opinion. No deferred credit is required for year 5 since tax refund computed with timing difference is same as refund computed without timing difference.

(C) The tax benefit of the loss carryforward that may be recognized is the lower of (1) the tax effect of carryforward for accounting purposes of $4,500 (computed as 50% of $9,000); or (2) the amortization of remaining deferred tax credits that would otherwise occur during the carryforward period of $2,000 (computed as $20,000—timing difference reversing in years 6-10—divided by $50,000—aggregate timing difference at end of year 5—or 40% applied to $5,000 deferred credit from year 1). The $2,000 limitation prevails.

(D) During each of the years 6 through 10, amortization of deferred tax credits on a cumulative basis of $2,000 is recognized on the basis of 50% of $4,000 reverse timing differences. In each of these years, deferred credits are restored to the extent of realization of the loss carryforward equal to tax that would otherwise be currently payable in year 6 through 9 of $3,000 each year, and in year 10 of $4,500. Full benefit of carryforward is added to deferred credits because aggregate net deferred credits never exceed amounts that would have been recorded if there had been no operating loss.

(E) The accumulated deferred tax at the end of year 10 is $9,500 which must be amortized equally during each of the years 11 through 15 since timing differences reverse in equal annual amounts of $6,000 during those years.

(F) The average rate assumption has been used in the amortization of deferred tax credits upon reversal of the depreciation timing differences. A first-in, first-out assumption could have been applied. (See section on "Amortization of Deferred Taxes.")

EXHIBIT V

RECOGNITION OF ADDITIONAL ACCOUNTING LOSS CARRYFORWARD BENEFIT IN YEAR REALIZED

Income before income taxes and extraordinary items		$1,000,000
Income tax expense:		
Currently payable	$200,000	
Tax effect of losses (or expenses) deducted from income for accounting purposes in prior loss periods, but for tax purposes in current period	300,000	500,000
Income before extraordinary items		$ 500,000
Extraordinary items:		
Reduction of income taxes arising from deduction of prior years' accounting losses (or expenses)	$300,000	
Loss on major devaluation of foreign currency (less applicable income tax of $100,000)	(100,000)	200,000
Net Income		$ 700,000

Assumptions:

1. 50% tax rate for all years.
2. Surtax exemptions and investment credits ignored.

Purchased Loss Carryforwards

Occasionally when a corporation acquires another business in a transaction accounted for as a purchase, one of the assets acquired is the future tax benefit of a loss carryforward. Such future tax benefit should be recorded as an asset at the date of purchase only if its realization is assured beyond any reasonable doubt. In the normal case, however, where such assurance does not exist, the tax benefits of such a loss carryforward "... should be recognized only when the tax benefits are actually realized and should be recorded as retroactive adjustments of the purchase transactions ...".

This is based on the concept that accounting for the acquisition of a business as a purchase requires the allocation of the purchase price to the assets acquired. When a loss carryforward exists it may be considered as an important part of the assets acquired. It is likely that in arriving at the purchase price the parties assigned some value to the loss carryforward. Therefore, when the purchase price is being allocated, the future tax benefit of the carryforward should, in theory, be recorded as a receivable. However, inasmuch as it may not be recorded as a receivable unless its recovery is assured beyond any reasonable doubt, the effect of not recognizing it at the date of the purchase may be to increase the goodwill or reduce the "negative goodwill" that would otherwise be recognized.

Therefore, if and when a tax benefit is realized from the purchased loss carryforward, a retroactive adjustment of the purchase transaction is required. This would normally be accomplished by an adjustment of goodwill or "negative goodwill". In some cases adjustment of tangible assets and depreciation may also be required. Such accounting treatment should be applied to tax benefits realized after the effective date of the Opinion even though the related purchase occurred before the effective date.

INVESTMENT CREDIT CARRYBACKS AND CARRYFORWARDS

APB Opinion No. 2 states: "The amount of a carryback of unused investment credit may be set up as an asset (a claim for refund of income taxes) and be added to the allowable investment credit in accounting for the effect of the credit in the year in which the property is placed in service. A carryforward of unused investment credit should ordinarily be reflected only in the year in which the amount becomes 'allowable', in which case the unused amount would not appear as an asset." APB Opinion No.

4 made no change in this conclusion. Both Opinions remain in effect without modification by APB Opinion No. 11.

APB Opinion No. 2 required that the "deferral" method should be followed in accounting for investment credits; APB Opinion No. 4 stated that the "flow-through" method was also acceptable. This method is now predominant in practice. Under the "deferral" method investment credits actually realized, including those realized through carryback or carryforward, are deferred and amortized over the productive life of the acquired property.

Under the "flow-through" method investment credits generally are treated as reductions of income tax expense of the year in which the credits are actually realized. Practice does not treat the realization of investment credit carryforwards as extraordinary items in the year of realization, as is required for operating loss carryforwards under APB Opinion No. 11.

As discussed in the section on "Computation of Deferred Taxes," the effect of the investment credit must also be recognized in computing deferred taxes for timing differences originating in the current period. This occurs because deferred taxes are computed as the differential in taxes (giving effect to investment credits) arising from including and excluding the timing difference.

If tax allocation results in net deferred credits the differential calculations will recognize as income for financial accounting purposes, through a reduction in the deferred tax provisions, that portion of available investment credits that would have been allowable had taxes payable been based on pretax accounting income. In effect investment credit carryforwards are being recognized as offsets against net deferred tax credits in a manner similar to that followed for operating loss carryforwards. The carryforwards utilized should be limited to the lower of (a) the amount of the carryforward benefit or (b) the amortization of the net deferred credits that would otherwise have occurred during the carryforward period. The total amount of investment credits that may be reflected in these computations is limited to the amount actually available (either currently or as a carryforward).

As the investment credit carryforward benefits are realized, reductions of net deferred credits resulting from application of unused investment credits should be reinstated at the then current rates (i.e., at the rates at which the investment credit carryforwards are realized) before recognition is given to the realization of any remaining investment credits. At the same time amortization of such deferred credits that would otherwise have occurred should also be recognized.

If allocation results in a net deferred charge an opposite effect should be obtained—a portion of the investment credit actually realized will be deducted from the deferred charge and omitted from income of the current period for financial accounting purposes.

EXHIBIT VI

EXAMPLE OF EFFECT OF INVESTMENT CREDIT WHEN TAXABLE INCOME IS ZERO (thousands of dollars)

Assumed Facts		
Pretax accounting income		$500
Additional depreciation for tax purposes		500
Taxable income		$ -0-
Available investment credits		$100
Tax rate		52.8% (less surtax exemption)
Deferred tax computation		
Tax on taxable income		$ -0-
Tax on taxable income without timing difference:		
52.8% of $500 less surtax exemption		$257
Less investment credits (maximum—$25 plus 50% of tax in excess of $25 or $141) limited to $100		100
		$157
Differential equal to deferred tax credit		$157
Financial statement presentation		
Income before income taxes		$500
Income tax expense:		
Currently payable	$ -0-	
Deferred	157	157
Net income		$343

(Note: If more than one kind of timing difference is involved and the available investment credits are less than the maximum based on pretax accounting income, then the available credits should be applied in proportion to the amounts of the respective timing differences.)

EXHIBIT VII

ILLUSTRATION OF DEFERRED TAX COMPUTATION WHEN INVESTMENT CREDIT CARRYFORWARD EXISTS (thousands of dollars)

Assumptions:		
Pretax accounting income		$1,000
Excess depreciation (assuming no cumulative timing differences from prior years exist)		500
Taxable income		$ 500
Available investment credits		$ 400
Deferred taxes:		
Taxable income with timing difference		$ 500
Tax thereon:		
52.8% less surtax exemption		$ 257
Investment credits ($25 plus 50% of tax in excess of $25)		141
Tax payable		$ 116
Taxable income without timing difference		$1,000
Tax thereon:		
52.8% less surtax exemption		$ 521
Investment credits ($25 plus 50% of tax in excess of $25)		$ 273
Tax		$ 248
Differential equal to deferred tax credits		$ 132
Investment credits:		
Available		$ 400
Realized		141
Carryforward		$ 259
Investment credit benefit received in computation of deferred taxes:		
Deferred taxes without considering investment credits ($521 less $257)	$264	
Deferred taxes as computed above	132	$ 132
Investment credit carryforward to future years		$ 127
Summary:		
Income before income taxes		$1,000
Income tax expense:		
Currently payable (after giving effect to investment credits realized of $141)	$116	
Deferred taxes	132	248
Net income		$ 752

FINANCIAL STATEMENT PRESENTATION

Allocation Within a Period

APB Opinion No. 11 requires income tax expense for any period to be allocated among income before extraordinary items, extraordinary items, adjustments of prior periods (or of the opening balance of retained earnings), and direct entries to other stockholders' equity accounts. The amount of income tax expense for the period allocated to income before extraordinary items is computed as the amount of income tax expense (after giving effect to related investment credits) that would have been determined by excluding from pretax accounting income all transactions that are not included in the determination of income before extraordinary items. The difference between income tax expense allocated to income before extraordinary items and the total income tax expense for the period (after giving effect to investment credits) is then allocated among the extraordinary items (and to adjustments of prior periods and direct entries to stockholders' equity accounts).

If exclusion of extraordinary losses from a net loss for a period results in income before extraordinary items, an appropriate provision should be made for the income tax expense that would have been applicable to such income. This imputed tax provision should then be reversed by application against the extraordinary loss.

If exclusion of extraordinary items from pretax accounting income results in a loss before extraordinary items, a credit tax provision should be allocated to such loss. The credit would be equivalent to the tax that would be refundable from an operating loss carryback equal to the loss before extraordinary items. The sum of such credit tax provision and total income tax expense for the period should then be allocated among the items excluded from pretax accounting income in the determination of the loss before extraordinary items. Often the income tax expense allocated to the extraordinary items will differ from the tax that normally would be associated with such items, as illustrated in the example on next page.

If there is more than one item of revenue and expense included in extraordinary items, adjustments of prior periods and direct entries to stockholders' equity accounts, it is necessary to allocate the total income tax effects applicable to them among the individual items. The tax effect applicable to each individual item should be determined as the differential

Loss before income taxes and extraordinary capital gain	$(200,000)
Income tax credit (assuming a 50% rate)	100,000
Loss before extraordinary credit	$(100,000)
Extraordinary long-term capital gain of $600,000, less applicable income tax of $250,000[8]	350,000
Net income	250,000

in income taxes resulting from including and excluding the specific item and should be determined in the same manner as for a timing difference. The amount of income tax expense allocated to all excluded items should then be allocated to the individual items on the basis of the proportion that the tax effect of each item bears to the aggregate tax effects.

In certain unusual cases, an item recognized in the determination of taxable income may not enter into the reporting of results of operations but, instead, for accounting purposes represents a capital transaction which is reflected by a direct entry in a stockholders' equity account. In such cases, the tax effect of such an item should be related to the transaction affecting the stockholders' equity account and not considered to be an increase or decrease of income tax expense for the period. An example of such a direct entry to stockholders' equity accounts arises in connection with that portion of a loan loss reserve of a bank which is recorded in the accounts and is deducted for tax purposes but is in excess of allowances required for accounting purposes and is, therefore, treated as appropriated surplus.

When a transaction is includable in the determination of taxable income for a period but is treated as a prior period adjustment for accounting purposes, the tax effects should be allocated to such prior periods. When a change in accounting method is made by retroactive restatement of prior years' operations, the applicable income tax expense should be determined on the basis of the applicable rates for those prior periods.

[8]The amount of $250,000 represents the sum of 25% of $600,000, or $150,000 (the alternative tax), plus $100,000, the tax credit attributable to the carryback of the loss from operations under the "with" and "without" computations. This $100,000 tax credit is, in effect, lost inasmuch as the alternative tax computation available because of the long-term capital gain does not provide for any recognition of the loss from operations.

Income Statement Presentation

All taxes based on income, including foreign, state and local, should be reflected in income tax expense in the income statement.

The components of income tax expense for the period should be disclosed separately. This disclosure of components may be done either on the income statement or in a note. The components of income tax expense that must be disclosed separately for the period, allocated among income before extraordinary items, extraordinary items, adjustments of prior periods (or of the opening balance of retained earnings) and direct entries to other stockholders' equity accounts, are as follows:

(a) Taxes estimated to be payable,

(b) Tax effects of timing differences,

(c) Tax effects of investment credits (whether on the deferral method or the flow-through method) and

(d) Tax effects of operating losses.

An example of income statement presentation of income tax expense follows:

	1968	*1967*
Income before income taxes	$800,000	$700,000
United States, foreign and state income taxes (Note A)	300,000	350,000
Net income	$500,000	$350,000

Note A — Income tax expense differs from amounts currently payable because certain revenues and expenses are reported in the income statement in periods which differ from those in which they are subject to taxation. The principal differences in timing between the income statement and taxable income involve (a) depreciation expenses recorded under the straightline method in the income statement and by accelerated methods for tax purposes and (b) provision for product warranties recorded in the income statement as warrantied products are sold but deducted for tax purposes when services under the warranties are performed. The differences between income tax expense and taxes currently payable are reflected in deferred tax accounts in the balance sheet. Income tax expense consists of the following:

	1968	*1967*
Currently payable before giving effect to investment credits	$ 550	$ 350
Investment credits realized	(175)	(50)
Deferred — net	(75)	50
	$ 300	$ 350

Balance Sheet Presentation

The Opinions of the Board require that income tax accounts be presented in the balance sheet so as to provide separate classification of the following elements:

(a) Taxes estimated to be currently payable,
(b) Net amount of current deferred charges and current deferred credits relating to timing differences,
(c) Net amount of noncurrent deferred charges and noncurrent deferred credits relating to timing differences,
(d) Refundable taxes arising from carrybacks of operating losses, investment credits and similar items,
(e) Future tax benefits of carryforwards of operating losses and similar items (in those unusual cases where they have been recognized because realization is assured beyond any reasonable doubt) and
(f) Deferred investment credits (applicable when the deferral method of accounting for investment credits is employed).

The distinction between current and noncurrent deferred taxes due to timing differences is based on the classification of the asset or liability related to each specific timing difference. For example, deferred taxes arising from timing differences in depreciation expense are classified with noncurrent liabilities because the related depreciable assets are noncurrent. On the other hand, if installment receivables are included in current assets, the deferred tax credits arising from the use of installment method for tax purposes are classified with current liabilities.

The Board considered the possibility of presenting current deferred tax charges separately from current deferred tax credits, with similar separation of noncurrent deferred tax charges from noncurrent deferred tax credits. However, the Board concluded that allowing the netting of deferred charges and credits achieved a simpler presentation while allowing the reader of the financial statement to determine the effect on the balance sheet of interperiod tax allocation. It was considered necessary, however, to separate the net current deferred taxes from the net noncurrent deferred taxes in order to conform with accepted principles for determining working capital.

General Disclosures

In addition to the presentation of components of income tax presented in the income statement and in the balance sheet, APB Opinion No. 11 requires the following general disclosures:

"(a) Amounts of any operating loss carryforwards not recognized in the loss period, together with expiration dates (indicating separately amounts which, upon recognition, would be credited to deferred tax accounts);

(b) Significant amounts of any other unused deductions or credits, together with expiration dates; and

(c) Reasons for significant variations in the customary relationships between income tax expense and pretax accounting income, if they are not otherwise apparent from the financial statements or from the nature of the entity's business.

The Board recommends that the nature of significant differences between pretax accounting income and taxable income be disclosed."

In addition, APB Opinions Nos. 2 and 4 require disclosure of the method adopted (deferral or flow-through) in accounting for investment credits and the amounts of unused carryforwards, together with expiration dates. These requirements are consistent with the disclosure requirements cited above in APB Opinion No. 11.

TRANSITIONAL PROBLEMS

APB Opinion No. 11 was effective for fiscal periods that began after December 31, 1967. Retroactive application was not mandatory but was encouraged. The obvious advantage of applying the Opinion retroactively was to achieve complete comparability among all reported periods—both then and in the future.

If a company did not elect to apply the Opinion retroactively, it was nevertheless necessary to make changes in presentation of deferred taxes that related to periods prior to the effective date. For example, a company that was, prior to the effective date, presenting deferred tax accounts as direct reductions of related assets and liabilities—"net of tax" presentation—was required to change the presentation of balance sheets at the end of fiscal periods beginning after December 31, 1967. This was required even though the amounts of deferred taxes carried over from prior years had not been recomputed to conform to the provisions of the Opinion.

The net of tax presentation is also prohibited in income statements for periods subject to the Opinion. When comparative income statements are presented which include years beginning both before and after the effective date of the Opinion, it is not required that "net of tax presentation" be eliminated from the former income statements but it would certainly be highly desirable even though the amounts of deferred taxes are not recomputed.

Deferred tax accounts relating to timing differences may be computed either on the basis of individual transactions or, with respect to similar timing differences, under the "gross change" or "net change" methods. Irrespective of which basis or method is elected, no recognition (beyond systematic amortization of previously recorded deferred taxes) can be given in the computation of the current deferred tax provision to the reversal of tax effects arising from timing differences originating prior to the effective date of the Opinion unless the applicable deferred taxes have been provided for in accordance with the Opinion, either during the periods in which the timing differences originated or, retroactively, as of the effective date of the Opinion. The method or methods adopted should be consistently applied. If the methods are changed, disclosure of a change in accounting is necessary.

There are cases in which a company, prior to the effective date of the Opinion, did not apply interperiod tax allocation procedures for significant timing differences in accordance with the Opinion, but was required to do so subsequent to the effective date. It should be noted that under such circumstances if the provisions of the Opinion were not applied retroactively, there may be a significant lack of comparability among income statements for a number of years. This will occur because it will be necessary to recognize deferred taxes for timing differences that originate subsequent to the effective date of the Opinion, whereas it will not be permissible to reflect in the provision for deferred taxes the tax effects of similar timing differences that reverse during the same period. The effect of this procedure will be to place the accounts of the company on a full allocation basis gradually over a period of time. The period of time required for full allocation to be achieved and the significance of the lack of comparability will depend on the "rollover period" of the timing differences involved, and their materiality.

An example of a possible extreme lack of comparability could occur in the case where a company has not been providing deferred taxes relating to provisions for product warranty costs where the warranty period is relatively short, say two or three years. In such a case, during the first few years following the effective date of the Opinion, the provision (credit) for deferred taxes in the income statement will vary widely (decreasing in amount) even though there is no change in tax rates or in the ending amount of the warranty reserve. Such lack of comparability, assuming it is significant, requires explanation in a note to the financial statements. It is obvious that under these circumstances retroactive application would be highly desirable.

Some companies adopted tax allocation procedures for depreciation timing differences at the effective date of Accounting Research Bulletin No. 44 (Revised) on a prospective basis and did not retroactively provide deferred taxes for accumulated timing differences at that date. Such companies should consider the advisability of providing such deferred taxes retroactively on the basis provided in APB Opinion No. 11.

If a company decides to give retroactive effect to the Opinion, the computations of deferred taxes relating to timing differences for prior periods should be based on the provisions of the Opinion and should be applied to all material items of those prior periods. It is unacceptable to compute such deferred taxes under the "liability" approach, which has been rejected in the Opinion, even though the liability approach would have been acceptable if it had been followed in prior years. On the other hand, where deferred taxes have been provided in prior years under the liability method, recomputation under the deferred method should be required only when the differences are material.

The Board recognized that it was not practicable to discuss in APB Opinion No. 11 all of the problems that could arise in the application of the principles stated in the Opinion. Likewise it was not practicable in this article to indicate or suggest solutions to some existing problems or to anticipate solutions to new problems. Further experience in the implementation of the Opinion will undoubtedly lead to new or different treatments.

APB Opinion No. 11: Accounting for Income Taxes

AICPA Accounting Principles Board

Contents

Contents—continued

INTRODUCTION

1. This Opinion sets forth the Board's conclusions on some aspects of accounting for income taxes. These conclusions include significant modifications of views previously expressed by the Committee on Accounting Procedure and by the Board. Accordingly, this Opinion supersedes the following Accounting Research Bulletins (ARBs) and Opinions of the Accounting Principles Board (APBs):

a. ARB No. 43, Chapter 10, Section B, *Taxes: Income Taxes.*
b. Letter of April 15, 1959, addressed to the members of the Institute by the Committee on Accounting Procedure interpreting ARB 44 (Revised).
c. APB Opinion No. 6, *Status of Accounting Research Bulletins* (paragraphs 21 and 23).

2. This Opinion also amends the following ARBs and APBs insofar as they relate to accounting for income taxes:

a. ARB No. 43, Chapter 9, Section C, *Depreciation: Emergency Facilities — Depreciation, Amortization and Income Taxes* (paragraphs 11-13).
b. ARB No. 43, Chapter 11, Section B, *Government Contracts: Renegotiation* (paragraph 8).
c. ARB No. 43, Chapter 15, *Unamortized Discount, Issue Cost, and Redemption Premium on Bonds Refunded* (paragraph 11).
d. ARB No. 44 (Revised), *Declining-balance Depreciation* (paragraphs 4, 5, 7 and 10).
e. ARB No. 51, *Consolidated Financial Statements* (paragraph 17).
f. APB Opinion No. 1, *New Depreciation Guidelines and Rules* (paragraphs 1, 5, and 6).
g. APB Opinion No. 5, *Reporting of Leases in Financial Statements of Lessee* (paragraph 21).

3. *Discounting.* The Board's Opinion on "Tax Allocation Accounts — Discounting," as expressed in APB Opinion No. 10, *Omnibus Opinion — 1966* (paragraph 6), continues in effect pending further study of the broader aspects of discounting as it is related to financial accounting in general.

4. *Investment Credits.* The Board is continuing its study on accounting for "Investment Credits" and intends to issue a new Opinion on the subject as soon as possible. In the meantime APB Opinion No. 2, *Accounting for the "Investment Credit,"* and APB Opinion No. 4 (Amending No. 2), *Accounting for the "Investment Credit,"* remain in effect.

5. Certain aspects of tax allocation, including illustrations of procedures and an extended discussion of alternative approaches to allocation, are presented in Accounting Research Study No. 9, *Interperiod Allocation of Corporate Income Taxes*, by Homer A. Black, published by the American Institute of Certified Public Accountants in 1966.[1] The Board has considered the Study and the comments received on it. The conclusions in this Opinion vary in some important respects from those reached in the Study.

APPLICABILITY

6. This Opinion applies to financial statements which purport to present financial position and results of operations in conformity with generally accepted accounting principles. It does not apply (a) to regulated industries in those circumstances where the standards described in the Addendum (which remains in effect) to APB Opinion No. 2 are met and (b) to special areas requiring further study as specifically indicated in paragraphs 38-41 of this Opinion. The Board has deferred consideration of the special problems of allocation of income taxes in interim financial statements and among components of a business enterprise pending further study and the issuance of Opinions on the applicability of generally accepted accounting principles to these statements.

7. The Board emphasizes that this Opinion, as in the case of all other Opinions, is not intended to apply to immaterial items.

SUMMARY OF PROBLEMS

8. The principal problems in accounting for income taxes arise from the fact that some transactions[2] affect the determination of net income for financial accounting purposes in one reporting period and the computation of taxable income and income taxes payable in a different reporting period. The amount of income taxes determined to be payable for a period does not, therefore, necessarily represent the appropriate income tax expense applicable to transactions recognized for financial accounting purposes in that period. A major problem is, therefore, the measurement

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1 Accounting Research Studies are not statements of this Board, or of the Institute, but are published for the purpose of stimulating discussion on important accounting issues.

2 The term *transactions* refers to all transactions and other events requiring accounting recognition. As used in this Opinion, it relates either to individual events or to groups of similar events.

of the tax effects of such transactions and the extent to which the tax effects should be included in income tax expense in the same periods in which the transactions affect pretax accounting income.

9. The United States Internal Revenue Code permits a "net operating loss" of one period to be deducted in determining taxable income of other periods. This leads to the question of whether the tax effects of an operating loss should be recognized for financial accounting purposes in the period of loss or in the periods of reduction of taxable income.

10. Certain items includable in taxable income receive special treatment for financial accounting purposes, even though the items are reported in the same period in which they are reported for tax purposes. A question exists, therefore, as to whether the tax effects attributable to extraordinary items, adjustments of prior periods (or of the opening balance of retained earnings), and direct entries to other stockholders' equity accounts should be associated with the particular items for financial reporting purposes.[3]

11. Guidelines are needed for balance sheet and income statement presentation of the tax effects of timing differences, operating losses and similar items.

SUMMARY OF CONCLUSIONS

12. The Board's conclusions on some of the problems in accounting for income taxes are summarized as follows:

a. Interperiod tax allocation is an integral part of the determination of income tax expense, and income tax expense should include the tax effects of revenue and expense transactions included in the determination of pretax accounting income.
b. Interperiod tax allocation procedures should follow the deferred method,[4] both in the manner in which tax effects are initially recognized and in the manner in which deferred taxes are amortized in future periods.
c. The tax effects of operating loss carry*backs* should be allocated to the loss periods. The tax effects of operating loss carry*forwards*[5] usually should not be recognized until the periods of realization.

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[3] See APB Opinion No. 9, *Reporting the Results of Operations.*

[4] See paragraph 19.

[5] The term "loss carry*forwards*" is used in this Opinion to mean "loss carryovers" as referred to in the United States Internal Revenue Code.

d. Tax allocation within a period should be applied to obtain fair presentation of the various components of results of operations.

e. Financial statement presentations of income tax expense and related deferred taxes should disclose (1) the composition of income tax expense as between amounts currently payable and amounts representing tax effects allocable to the period and (2) the classification of deferred taxes into a net current amount and a net noncurrent amount.

DEFINITIONS AND CONCEPTS

13. Terminology relating to the accounting for income taxes is varied; some terms have been used with different meanings. Definitions of certain terms used in this Opinion are therefore necessary.

a. *Income taxes.* Taxes based on income determined under provisions of the United States Internal Revenue Code and foreign, state and other taxes (including franchise taxes) based on income.

b. *Income tax expense.* The amount of income taxes (whether or not currently payable or refundable) allocable to a period in the determination of net income.

c. *Pretax accounting income.* Income or loss for a period, exclusive of related income tax expense.

d. *Taxable income.* The excess of revenues over deductions or the excess of deductions over revenues to be reported for income tax purposes for a period.[6]

e. *Timing differences.* Differences between the periods in which transactions affect taxable income and the periods in which they enter into the determination of pretax accounting income. Timing differences originate in one period and reverse or "turn around" in one or more subsequent periods. Some timing differences reduce income taxes that would otherwise be payable currently; others increase income taxes that would otherwise be payable currently.

f. *Permanent differences.* Differences between taxable income and pretax accounting income arising from transactions that, under applicable tax laws and regulations, will not be offset by corresponding differences or "turn around" in other periods.[7]

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[6] For the purposes of this definition "deductions" do not include reductions in taxable income arising from net operating loss carry*backs* or carry*forwards*.

[7] See paragraph 33.

g. *Tax effects.* Differentials in income taxes of a period attributable to (1) revenue or expense transactions which enter into the determination of pretax accounting income in one period and into the determination of taxable income in another period, (2) deductions or credits that may be carried backward or forward for income tax purposes and (3) adjustments of prior periods (or of the opening balance of retained earnings) and direct entries to other stockholders' equity accounts which enter into the determination of taxable income in a period but which do not enter into the determination of pretax accounting income of that period. A permanent difference does not result in a "tax effect" as that term is used in this Opinion.

h. *Deferred taxes.* Tax effects which are deferred for allocation to income tax expense of future periods.

i. *Interperiod tax allocation.* The process of apportioning income taxes among periods.

j. *Tax allocation within a period.* The process of apportioning income tax expense applicable to a given period betwen income before extraordinary items and extraordinary items, and of associating the income tax effects of adjustments of prior periods (or of the opening balance of retained earnings) and direct entries to other stockholders' equity accounts with these items.

14. Certain general concepts and assumptions are recognized by the Board to be relevant in considering the problems of accounting for income taxes.

a. The operations of an entity subject to income taxes are expected to continue on a going concern basis, in the absence of evidence to the contrary, and income taxes are expected to continue to be assessed in the future.

b. Income taxes are an expense of business enterprises earning income subject to tax.

c. Accounting for income tax expense requires measurement and identification with the appropriate time period and therefore involves accrual, deferral and estimation concepts in the same manner as these concepts are applied in the measurement and time period identification of other expenses.

d. Matching is one of the basic processes of income determination; esentially it is a process of determining relationships between costs (including reductions of costs) and (1) specific revenues or (2) specific accounting periods. Expenses of the current period consist of those costs which are identified with the revenues of the current period and those costs which are identified with the current period on some basis other than revenue. Costs identifiable with future revenues or otherwise identifiable with future periods should be deferred to those future periods. When a cost cannot be related to future revenues or to future periods on some basis other than revenues, or it cannot reasonably be expected to be recovered from future revenues, it becomes, by necessity, an expense of the current period (or of a prior period).

TIMING DIFFERENCES

DISCUSSION

Nature of Timing Differences

15. Four types of transactions are identifiable which give rise to timing differences; that is, differences between the periods in which the transactions affect taxable income and the periods in which they enter into the determination of pretax accounting income.[8] Each timing difference originates in one period and reverses in one or more subsequent periods.

a. Revenues or gains are included in taxable income later than they are included in pretax accounting income. For example, gross profits on installment sales are recognized for accounting purposes in the period of sale but are reported for tax purposes in the period the installments are collected.

b. Expenses or losses are deducted in determining taxable income later than they are deducted in determining pretax accounting income. For example, estimated costs of guarantees and of product warranty contracts are recognized for accounting purposes in the current period but are reported for tax purposes in the period paid or in which the liability becomes fixed.

c. Revenues or gains are included in taxable income earlier than they are included in pretax accounting income. For example, rents collected in advance are reported for tax purposes in the period in which they are received but are deferred for accounting purposes until later periods when they are earned.

d. Expenses or losses are deducted in determining taxable income earlier than they are deducted in determining pretax accounting

[8] Accounting Research Study No. 9, *Interperiod Allocation of Corporate Income Taxes,* page 2-3 and 8-10.

income. For example, depreciation is reported on an accelerated basis for tax purposes but is reported on a straight-line basis for accounting purposes.

Additional examples of each type of timing difference are presented in Appendix A to this Opinion.

16. The timing differences of revenue and expense transactions entering into the determination of pretax accounting income create problems in the measurement of income tax expense for a period, since the income taxes payable for a period are not always determined by the same revenue and expense transactions used to determine pretax accounting income for the period. The amount of income taxes determined to be payable for a period does not, therefore, necessarily represent the appropriate income tax expense applicable to transactions recognized for financial accounting purposes in that period.

17. Interperiod tax allocation procedures have been developed to account for the tax effects of transactions which involve timing differences. Interperiod allocation of income taxes results in the recognition of tax effects in the same periods in which the related transactions are recognized in the determination of pretax accounting income.

Differing Viewpoints

18. Interpretations of the nature of timing differences are diverse, with the result that three basic methods of interperiod allocation of income taxes have developed and been adopted in practice. The three concepts and their applications are described and evaluated in Chapters 2, 3 and 4 of *Accounting Research Study No. 9*. A brief description of each method follows.

19. Interperiod tax allocation under the *deferred method* is a procedure whereby the tax effects of current timing differences are deferred currently and allocated to income tax expense of future periods when the timing differences reverse. The deferred method emphasizes the tax effects of timing differences on income of the period in which the differences originate. The deferred taxes are determined on the basis of the tax rates in effect at the time the timing differences originate and are not adjusted for subsequent changes in tax rates or to reflect the imposition of new taxes. The tax effects of transactions which reduce taxes currently payable are treated as deferred credits; the tax effects of transactions which increase taxes currently payable are treated as deferred charges. Amortization of these deferred taxes to income tax expense in future periods is based upon

the nature of the transactions producing the tax effects and upon the manner in which these transactions enter into the determination of pretax accounting income in relation to taxable income.

20. Interperiod tax allocation under the *liability method* is a procedure whereby the income taxes expected to be paid on pretax accounting income are accrued currently. The taxes on components of pretax accounting income may be computed at different rates, depending upon the period in which the components were, or are expected to be, included in taxable income. The difference between income tax expense and income taxes payable in the periods in which the timing differences originate are either liabilities for taxes payable in the future or assets for prepaid taxes. The estimated amounts of future tax liabilities and prepaid taxes are computed at the tax rates expected to be in effect in the periods in which the timing differences reverse. Under the liability method the initial computations are considered to be tentative and are subject to future adjustment if tax rates change or new taxes are imposed.

21. Interperiod tax allocation under the *net of tax method* is a procedure whereby the tax effects (determined by either the deferred or liability methods) of timing differences are recognized in the valuation of assets and liabilities and the related revenues and expenses. The tax effects are applied to reduce specific assets or liabilities on the basis that tax deductibility or taxability are factors in their valuation.

22. In addition to the different methods of applying interperiod tax allocation, differing views exist as to the extent to which interperiod tax allocation should be applied in practice.

23. Some transactions result in differences between pretax accounting income and taxable income which are permanent[9] because under applicable tax laws and regulations the current differences will not be offset by corresponding differences in later periods. Other transactions, however, result in differences between pretax accounting income and taxable income which reverse or turn around in later periods; these differences are classified broadly as timing differences. The tax effects of certain timing differences often are offset in the reversal or turnaround period by the tax effects of similar differences originating in that period. Some view these differences as essentially the same as permanent differences because, in effect, the periods of reversal are indefinitely postponed. Others believe that differences which originate in a period and differences which reverse in the same period are distinguishable phases of separate timing differences and should be considered separately.

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[9] See Paragraph 33.

24. In determining the accounting recognition of the tax effects of timing differences, the first question is whether there should be any tax allocation. One view holds that interperiod tax allocation is never appropriate. Under this concept, income tax expense of a period equals income taxes payable for that period. This concept is based on the presumption that income tax expense of a period should be measured by the amount determined to be payable for that period by applying the laws and regulations of the governmental unit, and that the amount requires no adjustment or allocation. This concept has not been used widely in practice and is not supported presently to any significant extent.

25. The predominant view holds that interperiod tax allocation is appropriate. However, two alternative concepts exist as to the extent to which it should be applied: partial allocation and comprehensive allocation.

Partial Allocation

26. Under partial allocation the general presumption is that income tax expense of a period for financial accounting purposes should be the tax payable for the period. Holders of this view believe that when recurring differences between taxable income and pretax accounting income give rise to an indefinite postponement of an amount of tax payments or to continuing tax reductions, tax allocation is not required for these differences. They believe that amounts not reasonably expected to be payable to, or recoverable from, a government as taxes should not affect net income. They point out in particular that the application of tax allocation procedures to tax payments or recoveries which are postponed indefinitely involves contingencies which are at best remote and thus, in their opinion, may result in an overstatement or understatement of expenses with consequent effects on net income. An example of a recurring difference not requiring tax allocation under this view is the difference that arises when a company having a relatively stable or growing investment in depreciable assets uses straight-line depreciation in determining pretax accounting income but an accelerated method in determining taxable income. If tax allocation is applied by a company with large capital investments coupled with growth in depreciable assets (accentuated in periods of inflation) the resulting understatement of net income from using tax allocation is magnified.

27. Holders of the view expressed in paragraph 26 believe that the only exceptions to the general presumption stated therein should be those

instances in which specific nonrecurring differences between taxable income and pretax accounting income would lead to a material misstatement of income tax expense and net income. If such nonrecurring differences occur, income tax expense of a period for financial accounting purposes should be increased (or decreased) by income tax on differences between taxable income and pretax accounting income provided the amount of the increase (or decrease) can be reasonably expected to be paid as income tax (or recovered as a reduction of income taxes) within a relatively short period not exceeding, say, five years. An example would be an isolated installment sale of a productive facility in which the gross profit is reported for financial accounting purposes at the date of sale and for tax purposes when later collected. Thus, tax allocation is applicable only when the amounts are reasonably certain to affect the flow of resources used to pay taxes in the near future.

28. Holders of this view state that comprehensive tax allocation, as opposed to partial allocation, relies on the so-called "revolving" account approach which seems to suggest that there is a similarity between deferred tax accruals and other balance sheet items, like accounts payable, where the individual items within an account turn over regularly although the account balance remains constant or grows. For these other items, the turnover reflects actual, specific transactions—goods are received, liabilities are recorded and payments are subsequently made. For deferred tax accruals on the other hand, no such transactions occur—the amounts are not owed to anyone; there is no specific date on which they become payable, if ever; and the amounts are at best vague estimates depending on future tax rates and many other uncertain factors. Those who favor partial allocation suggest that accounting deals with actual events, and that those who would depart from the fact of the tax payment should show that the modification will increase the usefulness of the reports to management, investors or other users. To do this requires a demonstration that the current lower (or higher) tax payments will result in higher (or lower) cash outflows for taxes within a span of time that is of significant interest to readers of the financial statements.

Comprehensive Allocation

29. Under comprehensive allocation, income tax expense for a period includes the tax effects of transactions entering into the determination of pretax accounting income for the period even though some transactions may affect the determination of taxes payable in a different period. This

view recognizes that the amount of income taxes payable for a given period does not necessarily measure the appropriate income tax expense related to transactions for that period. Under this view, income tax expense encompasses any accrual, deferral or estimation necessary to adjust the amount of income taxes payable for the period to measure the tax effects of those transactions included in pretax accounting income for that period. Those supporting comprehensive allocation believe that the tax effects of initial timing differences should be recognized and that the tax effects should be matched with or allocated to those periods in which the initial differences reverse. The fact that when the initial differences reverse other initial differences may offset any effect on the amount of taxable income does not, in their opinion, nullify the fact of the reversal. The offsetting relationships do not mean that the tax effects of the differences cannot be recognized and measured. Those supporting comprehensive allocation state that the makeup of the balances of certain deferred tax amounts "revolve" as the related differences reverse and are replaced by similar differences. These initial differences do reverse, and the tax effects thereof can be identified as readily as can those of other timing differences. While new differences may have an offsetting effect, this does not alter the fact of the reversal; without the reversal there would be different tax consequences. Accounting principles cannot be predicated on reliance that offsets will continue. Those supporting comprehensive allocation conclude that the fact that the tax effects of two transactions happen to go in opposite directions does not invalidate the necessity of recognizing separately the tax effects of the transactions as they occur.

30. Under comprehensive allocation, material tax effects are given recognition in the determination of income tax expense, and the tax effects are related to the periods in which the transactions enter into the determination of pretax accounting income. The tax effects so determined are allocated to the future periods in which the differences between pretax accounting income and taxable income reverse. Those supporting this view believe that comprehensive allocation is necessary in order to associate the tax effects with the related transactions. Only by the timely recognition of such tax effects is it possible to associate the tax effects of transactions with those transactions as they enter into the determination of net income. The need exists to recognize the tax effects of initial differences because only by doing so will the income tax expense in the periods of initial differences include the tax effects of transactions of those periods.

31. Those who support comprehensive allocation believe that the partial allocation concept in stressing cash outlays represents a departure

from the accrual basis of accounting. Comprehensive allocation, in their view, results in a more thorough and consistent association in the matching of revenues and expenses, one of the basic processes of income determination.

32. These differences in viewpoint become most significant with respect to the tax effects of transactions of a recurring nature—for example, depreciation of machinery and equipment using the straight-line method for financial accounting purposes and an accelerated method for income tax purposes. Under partial allocation the tax effects of these timing differences would not be recognized under many circumstances; under comprehensive allocation the tax effects would be recognized beginning in the periods of the initial timing differences. Under partial allocation, the tax effects of these timing differences would not be recognized so long as it is assumed that similar timing differences would arise in the future creating tax effects at least equal to the reversing tax effects of the previous timing differences. Thus, under partial allocation, so long as the amount of deferred taxes is estimated to remain fixed or to increase, no need exists to recognize the tax effects of the initial differences because they probably will not "reverse" in the foreseeable future. Under comprehensive allocation tax effects are recognized as they occur.

Permanent Differences

33. Some differences between taxable income and pretax accounting income are generally referred to as permanent differences. Permanent differences arise from statutory provisions under which specified revenues are exempt from taxation and specified expenses are not allowable as deductions in determining taxable income. (Examples are interest received on municipal obligations and premiums paid on officers' life insurance.) Other permanent differences arise from items entering into the determination of taxable income which are not components of pretax accounting income in any period. (Examples are the special deduction for certain dividends received and the excess of statutory depletion over cost depletion.)

OPINION

34. The Board has considered the various concepts of accounting for income taxes and has concluded that comprehensive interperiod tax allo-

cation is an integral part of the determination of income tax expense. Therefore, income tax expense should include the tax effects of revenue and expense transactions included in the determination of pretax accounting income. The tax effects of those transactions which enter into the determination of pretax accounting income either earlier or later than they become determinants of taxable income should be recognized in the periods in which the differences between pretax accounting income and taxable income arise and in the periods in which the differences reverse. Since permanent differences do not affect other periods, interperiod tax allocation is not appropriate to account for such differences.

35. The Board has concluded that the deferred method[10] 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.

36. The tax effect of a timing difference should be measured by the differential between income taxes computed with and without inclusion of the transaction creating the difference between taxable income and pretax accounting income. The resulting income tax expense for the period includes the tax effects of transactions entering into the determination of results of operations for the period. The resulting deferred tax amounts reflect the tax effects which will reverse in future periods. The measurement of income tax expense becomes thereby a consistent and integral part of the process of matching revenues and expenses in the determination of results of operations.

37. In computing the tax effects referred to in paragraph 36, timing differences may be considered individually or similar timing differences may be grouped. The net change in deferred taxes for a period for a group of similar timing differences may be determined on the basis of either (a) a combination of amounts representing the tax effects arising from timing differences originating in the period at the current tax rates and reversals of tax effects arising from timing differences originating in prior periods at the applicable tax rates reflected in the accounts as of the beginning of the period; or (b) if the applicable deferred taxes have been provided in accordance with this Opinion on the cumulative timing differences as of the beginning of the period, the amount representing the tax effects at the current tax rates of the net change during the period in the cumulative timing differences. If timing differences are considered individually, or if similar timing differences are grouped, no recognition should

[10] See paragraph 19.

be given to the reversal of tax effects arising from timing differences originating prior to the effective date of this Opinion unless the applicable deferred taxes have been provided for in accordance with this Opinion, either during the periods in which the timing differences originated or, retroactively, as of the effective date of this Opinion. The method or methods adopted should be consistently applied.

Special Areas Requiring Further Study

38. A number of other transactions have tax consequences somewhat similar to those discussed for timing differences. These transactions result in differences between taxable income and pretax accounting income in a period and, therefore, create a situation in which tax allocation procedures may be applicable in the determination of results of operations. These transactions are also characterized by the fact that the tax consequences of the initial differences between taxable income and pretax accounting income may not reverse until an indefinite future period, or conceivably some may never reverse. In addition, each of these transactions has certain unique aspects which create problems in the measurement and recognition of their tax consequences. These special areas are:

a. Undistributed earnings of subsidiaries.
b. Intangible development costs in the oil and gas industry.
c. "General reserves" of stock savings and loan associations.
d. Amounts designated as "policyholders' surplus" by stock life insurance companies.
e. Deposits in statutory reserve funds by United States steamship companies.

39. Paragraph 16 of ARB No. 51, *Consolidated Financial Statements*, states that:

> "When separate income tax returns are filed, income taxes usually are incurred when earnings of subsidiaries are transferred to the parent. Where it is reasonable to assume that a part or all of the undistributed earnings of a subsidiary will be transferred to the parent in a taxable distribution, provision for related income taxes should be made on an estimated basis at the time the earnings are included in consolidated income, unless these taxes are immaterial in amount when effect is given, for example, to dividend-received deductions or foreign tax credits. There is no need to provide for income tax to the parent company in cases where the income has been, or there is evi-

dence that it will be, permanently invested by the subsidiaries, or where the only likely distribution would be in the form of a tax-free liquidation."

The Board has decided to defer any modification of the above position until the accounting research study on accounting for intercorporate investments is completed and an Opinion is issued on that subject.

40. Intangible development costs in the oil and gas industry are commonly deducted in the determination of taxable income in the period in which the costs are incurred. Usually the costs are capitalized for financial accounting purposes and are amortized over the productive periods of the related wells. A question exists as to whether the tax effects of the current deduction of these costs for tax purposes should be deferred and amortized over the productive periods of the wells to which the costs relate. Other items have a similar, or opposite, effect because of the interaction with "percentage" depletion for income tax purposes. The Board has decided to defer any conclusion on these questions until the accounting research study on extractive industries is completed and an Opinion is issued on that subject.

41. The "general reserves" of stock savings and loan associations, amounts designated as "policyholders' surplus" by stock life insurance companies and deposits in statutory reserve funds by United States steamship companies each have certain unique aspects concerning the events or conditions which may lead to reversal of the initial tax consequences. The Board has decided to defer any conclusion as to whether interperiod tax allocation should be required in these special areas, pending further study and consideration with a view to issuing Opinions on these areas at a later date.

OPERATING LOSSES

DISCUSSION

42. An operating loss arises when, in the determination of taxable income, deductions exceed revenues. Under applicable tax laws and regulations, operating losses of a period may be carried backward or forward for a definite period of time to be applied as a reduction in computing taxable income, if any, in those periods. When an operating loss is so applied, pretax accounting income and taxable income (after deducting the operating loss carry*back* or carry*forward*) will differ for the period to which the loss is applied.

43. If operating losses are carried backward to earlier periods under provisions of the tax law, the tax effects of the loss carry*backs* are included in the results of operations of the loss period, since realization is assured. If operating losses are carried forward under provisions of the tax law, the tax effects usually are not recognized in the accounts until the periods of realization, since realization of the benefits of the loss carry*forwards* generally is not assured in the loss periods. The only exception to that practice occurs in unusual circumstances when realization is assured beyond any reasonable doubt in the loss periods. Under an alternative view, however, the tax effects of loss carry*forwards* would be recognized in the loss periods unless specific reasons exist to question their realization.

OPINION

44. The tax effects of any realizable loss carry*backs* should be recognized in the determination of net income (loss) of the loss periods. The tax loss gives rise to a refund (or claim for refund) of past taxes, which is both measurable and currently realizable; therefore the tax effect of the loss is properly recognizable in the determination of net income (loss) for the loss period. Appropriate adjustments of existing net deferred tax credits may also be necessary in the loss period.

45. The tax effects of loss carry*forwards* also relate to the determination of net income (loss) of the loss periods. However, a significant question generally exists as to realization of the tax effects of the carry*forwards*, since realization is dependent upon future taxable income. Accordingly, the Board has concluded that the tax benefits of loss carry*forwards* should not be recognized until they are actually realized, except in unusual circumstances when realization is *assured beyond any reasonable doubt* at the time the loss carry*forwards* arise. When the tax benefits of loss carry*forwards* are not recognized until realized in full or in part in subsequent periods, the tax benefits should be reported in the results of operations of those periods as extraordinary items.[11]

46. In those rare cases in which realization of the tax benefits of loss carry*forwards* is assured beyond any reasonable doubt, the potential benefits should be associated with the periods of loss and should be recognized in the determination of results of operations for those periods. Realization is considered to be assured beyond any reasonable doubt when conditions such as those set forth in paragraph 47 are present. (Also see paragraph 48.) The amount of the asset (and the tax effect on results

[11] See APB Opinion No. 9, *Reporting the Results of Operations.*

of operations) recognized in the loss period should be computed at the rates expected[12] to be in effect at the time of realization. If the applicable tax rates change from those used to measure the tax effect at the time of recognition, the effect of the rate change should be accounted for in the period of the change as an adjustment of the asset account and of income tax expense.

47. Realization of the tax benefit of a loss carry*forward* would appear to be assured beyond any reasonable doubt when both of the following conditions exist: (a) the loss results from an identifiable, isolated and nonrecurring cause and the company either has been continuously profitable over a long period or has suffered occasional losses which were more than offset by taxable income in subsequent years, and (b) future taxable income is virtually certain to be large enough to offset the loss carry*forward* and will occur soon enough to provide realization during the carry*forward* period.

48. Net deferred tax credits arising from timing differences may exist at the time loss carry*forwards* arise. In the usual case when the tax effect of a loss carry*forward* is not recognized in the loss period, adjustments of the existing net deferred tax credits may be necessary in that period or in subsequent periods. In this situation net deferred tax credits should be eliminated to the extent of the lower of (a) the tax effect of the loss carry*forward*, or (b) the amortization of the net deferred tax credits that would otherwise have occurred during the carry*forward* period. If the loss carry*forward* is realized in whole or in part in periods subsequent to the loss period, the amounts eliminated from the deferred tax credit accounts should be reinstated (at the then current tax rates) on a cumulative basis as, and to the extent that, the tax benefit of the loss carry*forward* is realized. In the unusual situation in which the tax effect of a loss carry*forward* is recognized as an asset in the loss year,[13] the deferred tax credit accounts would be amortized in future periods as indicated in paragraph 19.

49. The tax effects of loss carry*forwards* of purchased subsidiaries (if not recognized by the subsidiary prior to purchase) should be recognized as assets at the date of purchase only if realization is assured beyond any reasonable doubt. Otherwise they should be recognized only when the tax benefits are actually realized and should be recorded as retro-

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[12] The rates referred to here are those rates which, at the time the loss carry*forward* benefit is recognized for financial accounting purposes, have been enacted to apply to appropriate future periods.

[13] See paragraph 46.

active adjustments[14] of the purchase transactions and treated in accordance with the procedures described in paragraphs 7 and 8 of ARB No. 51, *Consolidated Financial Statements.* Retroactive adjustments of results of operations for the periods subsequent to purchase may also be necessary if the balance sheet items affected have been subject to amortization in those periods.

50. Tax effects of loss carry*forwards* arising prior to a quasi-reorganization (including for this purpose the application of a deficit in retained earnings to contributed capital) should, if not previously recognized, be recorded as assets at the date of the quasi-reorganization only if realization is assured beyond any reasonable doubt. If not previously recognized and the benefits are actually realized at a later date, the tax effects should be added to contributed capital because the benefits are attributable to the loss periods prior to the quasi-reorganization.

TAX ALLOCATION WITHIN A PERIOD

DISCUSSION

51. The need for tax allocation within a period arises because items included in the determination of taxable income may be presented for accounting purposes as (a) extraordinary items, (b) adjustments of prior periods (or of the opening balance of retained earnings) or (c) as direct entries to other stockholders' equity accounts.

OPINION

52. The Board has concluded that tax allocation within a period should be applied to obtain an appropriate relationship between income tax expense and (a) income before extraordinary items, (b) extraordinary items, (c) adjustments of prior periods (or of the opening balance of retained earnings) and (d) direct entries to other stockholders' equity accounts. The income tax expense attributable to income before extraordinary items is computed by determining the income tax expense related to revenue and expense transactions entering into the determination of such income, without giving effect to the tax consequences of the items excluded from the determination of income before extraordinary items. The income tax expense attributable to other items is determined by the tax consequences of transactions involving these items. If an operating loss exists before extraordinary items, the tax consequences of such loss should be associated with the loss.

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[14] See APB Opinion No. 9, *Reporting the Results of Operations.*

OTHER UNUSED DEDUCTIONS AND CREDITS

OPINION

53. The conclusions of this Opinion, including particularly the matters discussed in paragraphs 42-50 on tax reductions resulting from operating losses, also apply to other unused deductions and credits for tax purposes that may be carried backward or forward in determining taxable income (for example, capital losses, contribution carryovers, and foreign tax credits).

FINANCIAL REPORTING

DISCUSSION

Balance Sheet

54. Interperiod tax allocation procedures result in the recognition of several deferred tax accounts. Classification of deferred taxes in the balance sheet has varied in practice, with the accounts reported, alternatively, as follows:

a. *Separate current and noncurrent amounts.* In this form of presentation all balance sheet accounts resulting from income tax allocation are classified into four separate categories—current assets, noncurrent assets, current liabilities and noncurrent liabilities.

b. *Net current and net noncurrent amounts.* In this form of presentation all balance sheet accounts resulting from income tax allocation are classified into two categories—net current amount and net noncurrent amount.

c. *Single amount.* In this form of presentation all balance sheet accounts resulting from income tax allocation are combined in a single amount

d. *Net of tax presentation.* Under this approach each balance sheet tax allocation account (or portions thereof) is reported as an offset to, or a valuation of, the asset or liability that gave rise to the tax effect. Net of tax presentation is an extension of a valuation concept and treats the tax effects as valuation adjustments of the related assets and liabilities.

Income Statement

55. Interperiod tax allocation procedures result in income tax expense generally different from the amount of income tax payable for a period. Three alternative approaches have developed for reporting income tax expense:

a. *Combined amount.* In this presentation income tax expense for the period is reported as a single amount, after adjustment of the amount of income taxes payable for the period for the tax effects of those transactions which had different effects on pretax accounting income and on taxable income. This form of presentation emphasizes that income tax expense for the period is related to those transactions entering into the determination of pretax accounting income.
b. *Combined amount plus disclousure (or two or more separate amounts).* In this presentation the amount of income taxes reported on the tax return is considered significant additional information for users of financial statements. The amount of taxes payable (or the effect of tax allocation for the period) is, therefore, disclosed parenthetically or in a note to the financial statements. Alternatively, income tax expense may be disclosed in the income statement by presenting separate amounts—the taxes payable and the effects of tax allocation.
c. *"Net of tax" presentation.* Under the "net of tax" concept the tax effects recognized under interperiod tax allocation are considered to be valuation adjustments to the assets or liabilities giving rise to the adjustments. For example, depreciation deducted for tax purposes in excess of that recognized for financial accounting purposes is held to reduce the future utility of the related asset because of a loss of a portion of future tax deductibility. Thus, depreciation expense, rather than income tax expense, is adjusted for the tax effect of the difference between the depreciation amount used in the determination of taxable income and that used in the determination of pretax accounting income.

OPINION

Balance Sheet

56. Balance sheet accounts related to tax allocation are of two types:

a. Deferred charges and deferred credits relating to timing differences; and

b. Refunds of past taxes or offsets to future taxes arising from the recognition of tax effects of carry*backs* and carry*forwards* of operating losses and similar items.

57. Deferred charges and deferred credits relating to timing differences represent the cumulative recognition given to their tax effects and as such do not represent receivables or payables in the usual sense. They should be classified in two categories—one for the net current amount and the other for the net noncurrent amount. This presentation is consistent with the customary distinction between current and noncurrent categories and also recognizes the close relationship among the various deferred tax accounts, all of which bear on the determination of income tax expense. The current portions of such deferred charges and credits should be those amounts which relate to assets and liabilities classified as current. Thus, if installment receivables are a current asset, the deferred credits representing the tax effects of uncollected installments sales should be a current item; if an estimated provision for warranties is a current liability, the deferred charge representing the tax effect of such provision should be a current item.

58. Refunds of past taxes or offsets to future taxes arising from recognition of the tax effects of operating loss carry*backs* or carry*forwards* should be classified either as current or noncurrent. The current portion should be determined by the extent to which realization is expected to occur during the current operating cycle as defined in Chapter 3A of ARB No. 43.

59. Deferred taxes represent tax effects recognized in the determination of income tax expense in current and prior periods, and they should, therefore, be excluded from retained earnings or from any other account in the stockholders' equity section of the balance sheet.

Income Statement

60. In reporting the results of operations the components of income tax expense for the period should be disclosed, for example:

a. Taxes estimated to be payable
b. Tax effects of timing differences
c. Tax effects of operating losses.

These amounts should be allocated to (a) income before extraordinary items and (b) extraordinary items and may be presented as separate items in the income statement or, alternatively, as combined amounts with disclosure of the components parenthetically or in a note to the financial statements.

61. When the tax benefit of an operating loss carry*forward* is realized in full or in part in a subsequent period, and has not been previously recognized in the loss period, the tax benefit should be reported as an extraordinary item[15] in the results of operations of the period in which realized.

62. Tax effects attributable to adjustments of prior periods (or of the opening balance of retained earnings) and direct entries to other stockholders' equity accounts should be presented as adjustments of such items with disclosure of the amounts of the tax effects.[15]

General

63. Certain other disclosures should be made in addition to those set forth in paragraphs 56-62:

a. Amounts of any operating loss carry*forwards* not recognized in the loss period, together with expiration dates (indicating separately amounts which, upon recognition, would be credited to deferred tax accounts);
b. Significant amounts of any other unused deductions or credits, together with expiration dates; and
c. Reasons for significant variations in the customary relationships between income tax expense and pretax accounting income, if they are not otherwise apparent from the financial statements or from the nature of the entity's business.

The Board recommends that the nature of significant differences between pretax accounting income and taxable income be disclosed.

64. The "net of tax" form of presentation of the tax effects of timing differences should not be used for financial reporting. The tax effects of transactions entering into the determination of pretax accounting income for one period but affecting the determination of taxable income in a different period should be reported in the income statement as elements of income tax expense and in the balance sheet as deferred taxes and not as elements of valuation of assets or liabilities.

EFFECTIVE DATE

65. This Opinion shall be effective for all fiscal periods that begin after December 31, 1967. However, the Board encourages earlier application of the provisions of this Opinion.

[15] See APB Opinion No. 9, *Reporting the Results of Operations.*

66. Accordingly, the tax allocation procedures set forth in this Opinion should be applied to timing differences occurring after the effective date. (See paragraph 37 for treatment of timing differences originating prior to the effective date.) Balance sheet accounts which arose from interperiod tax allocation and accounts stated on a net of tax basis prior to the effective date of this Opinion should be presented in the manner set forth in this Opinion.

67. The Board recognizes that companies may apply this Opinion retroactively to periods prior to the effective date to obtain comparability in financial presentations for the current and future periods. If the procedures are applied retroactively, they should be applied to all material items of those periods insofar as the recognition of prior period tax effects of timing differences, operating losses and other deductions or credits is concerned. Any adjustments made to give retroactive effect to the conclusions stated in this Opinion should be considered adjustments of prior periods and treated accordingly.[16]

The Opinion entitled "Accounting for Income Taxes" was adopted by the assenting votes of fourteen members of the Board, of whom one, Mr. Halvorson, assented, with qualification. Messrs. Biegler, Crichley, Davidson, Luper, Queenan and Walker dissented.

Mr. Halvorson assents to the publication of the Opinion, but dissents to the first sentence of paragraph 67 which permits retroactive application. He believes that the recommendations for comprehensive allocation should be applied prospectively and that adjustments that may be required because of timing differences not recognized in years prior to the adoption of comprehensive allocation should be accounted for when the future tax effects occur.

Messrs. Biegler, Davidson and Queenan dissent from this Opinion because they do not agree with the conclusion expressed in paragraph 34 that tax allocation should be applied on a comprehensive basis. They believe, instead, that income tax expense should be determined on the basis of partial allocation, as explained in paragraph 26 through 28. They believe that to the extent that comprehensive allocation deviates from accrual of income tax reasonably expected to be paid or recovered, it would result, 1) in accounts carried as assets which have no demonstrable value and which are never expected to be realized, 2) in amounts carried as liabilities which are mere contingencies and 3) in corresponding charges or credits to income for contingent amounts. In their view, comprehensive

[16] See APB Opinion No. 9, *Reporting the Results of Operations.*

allocation shifts the burden of distinguishing between real and contingent costs, assets and liabilities from management and the independent auditor, who are best qualified to make such distinctions, to the users of financial statements.

Messrs. Biegler, Davidson and Queenan further believe that to require classification of deferred taxes as a current asset or current liability, in the circumstances explained in paragraph 57, would contribute to a lack of understanding of working capital, because of the commingling of contingent items with items which are expected to be realized or discharged during the normal operating cycle of a business.

Mr. Queenan also objects to the procedure whereby changes were made in paragraphs 37 and 66 subsequent to the issuance of the ballot draft which, in his opinion, should have had the benefit of open discussion in a Board meeting.

Mr. Luper and Mr. Crichley join in the dissent that has been prepared and submitted by Messrs. Biegler, Davidson and Queenan. In addition, Mr. Luper and Mr. Crichley wish to include the following two paragraphs as additional comments:

Mr. Luper and Mr. Crichley do not concur in paragraph 3 of the Opinion because they believe that it is inappropriate for the Board to issue an Opinion requiring comprehensive tax allocation, which will result in contingent long-term deferred debits and/or credits, without first completing its study and resolving the question of discounting deferred amounts to current value.

Finally, Mr. Luper and Mr. Crichley believe that substantial authoritative support exists for the concept of partial tax allocation, as evidenced by statements of corporate financial executives, independent practicing accountants, and accounting academicians and by the current accounting practices of a significant number of companies. This concept is presently embodied in ARB No. 43, Chapter 10, Section B, which states that tax allocation does not apply where there is a presumption that particular differences between the tax return and the income statement will recur regularly over a comparatively long period of time. Consequently, they believe the prescription of the concept of comprehensive tax allocation is premature until there is greater evidence of the general acceptability of the comprehensive concept.

Mr. Walker believes the so-called comprehensive allocation of material items to be the preferred treatment; however, with the disclosure of the general bases used, it should be permissive to consistently use partial allocation as explained in paragraphs 26 through 28 and the financial presentations described in paragraphs 54 and 55.

NOTES

Opinions present the considered opinion of at least two-thirds of the members of the Accounting Principles Board, reached on a formal vote after examination of the subject matter.

Except as indicated in the succeeding paragraph, the authority of the Opinions rests upon their general acceptability. While it is recognized that general rules may be subject to exception, the burden of justifying departures from Board Opinions must be assumed by those who adopt other practices.

Action of Council of the Institute (Special Bulletin, Disclosure of Departures From Opinions of Accounting Principles Board, *October 1964) provides that:*

a. *"Generally accepted accounting principles" are those principles which have substantial authoritative support.*
b. *Opinions of the Accounting Principles Board constitute "substantial authoritative support".*
c. *"Substantial authoritative support" can exist for accounting principles that differ from Opinions of the Accounting Principles Board.*

The Council action also requires that departures from Board Opinions be disclosed in footnotes to the financial statements or in independent auditors' reports when the effect of the departure on the financial statements is material.

Unless otherwise stated, Opinions of the Board are not intended to be retroactive. They are not intended to be applicable to immaterial items.

APPENDIX A

Examples of Timing Differences

The following examples of timing differences are taken from Accounting Research Study No. 9, *Interperiod Allocation of Corporate Income Taxes*, by Homer A. Black, pages 8-10. They are furnished for illustrative purposes only without implying approval by the Board of the accounting practices described.

(A) *Revenues or gains are taxed after accrued for accounting purposes:*

Profits on installment sales are recorded in accounts at date of sale and reported in tax returns when later collected.

Revenues on long-term contracts are recorded in accounts on percentage-of-completion basis and reported in tax returns on a completed-contract basis.

Revenues from leasing activities is recorded in a lessor's accounts based on the financing method of accounting and exceeds rent less depreciation reported in tax returns in the early years of a lease.

Earnings of foreign subsidiary companies are recognized in accounts currently and included in tax returns when later remitted.

(B) *Expenses or losses are deducted for tax purposes after accrued for accounting purposes:*

Estimated costs of guarantees and product warranty contracts are recorded in accounts at date of sale and deducted in tax returns when later paid.

Expenses for deferred compensation, profit-sharing, bonuses, and vacation and severance pay are recorded in accounts when accrued for the applicable period and deducted in tax returns when later paid.

Expenses for pension costs are recorded in accounts when accrued for the applicable period and deducted in tax returns for later periods when contributed to the pension fund.

Current expenses for self-insurance are recorded in accounts based on consistent computations for the plan and deducted in tax returns when losses are later incurred.

Estimated losses on inventories and purchase commitments are recorded in accounts when reasonably anticipated and deducted in tax returns when later realized.

Estimated losses on disposal of facilities and discontinuing or relocating operations are recorded in accounts when anticipated and determinable and deducted in tax returns when losses or costs are later incurred.

Estimated expenses of settling pending lawsuits and claims are recorded in accounts when reasonably ascertainable and deducted in tax returns when later paid.

Provisions for major repairs and maintenance are accrued in accounts on a systematic basis and deducted in tax returns when later paid.

Depreciation recorded in accounts exceeds that deducted in tax returns in early years because of:

accelerated method of computation for accounting purposes

shorter lives for accounting purposes

Organization costs are written off in accounts as incurred and amortized in tax returns.

(C) *Revenues or gains are taxed before accrued for accounting purposes:*

Rent and royalties are taxed when collected and deferred in accounts to later periods when earned.

Fees, dues, and service contracts are taxed when collected and deferred in accounts to later periods when earned.

Profits on intercompany transactions are taxed when reported in separate returns, and those on assets remaining within the group are eliminated in consolidated financial statements.

Gains on sales of property leased back are taxed at date of sale and deferred in accounts and amortized during the term of lease.

Proceeds of sales of oil payments or ore payments are taxed at date of sale and deferred in accounts and recorded as revenue when produced.

(D) *Expenses or losses are deducted for tax purposes before accrued for accounting purposes:*

Depreciation deducted in tax returns exceeds that recorded in accounts in early years because of:

accelerated method of computation for tax purposes

shorter guideline lives for tax purposes amortization of emergency facilities under certificates of necessity

Unamortized discount, issue cost and redemption premium on bonds refunded are deducted in tax returns and deferred and amortized in accounts.

Research and development costs are deducted in tax returns when incurred and deferred and amortized in accounts.

Interest and taxes during construction are deducted in tax returns when incurred and included in the cost of assets in accounts.

Preoperating expenses are deducted in tax returns when incurred and deferred and amortized in accounts.