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# Accounting for income taxes; Opinions of the Accounting Principles Board 11; APB Opinion 11

American Institute of Certified Public Accountants. Accounting Principles Board

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OPINIONS OF THE ACCOUNTING PRINCIPLES BOARD

DECEMBER 1967

11

# Accounting for Income Taxes

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*Issued by the Accounting Principles Board of the American Institute of Certified Public Accountants*

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## 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.

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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.

## 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 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.

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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.

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

## 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.
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

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[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.

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]

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

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

[7] See paragraph 33.

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 between 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; essentially 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

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

accounting 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 de-

ferred 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.

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 pur-

[9] See Paragraph 33.

poses 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 allocation 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 differ-

[10] See paragraph 19.

ences 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 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 evidence 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. Appro-

priate 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 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

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

[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.

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 occured 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 retroactive 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

[13] See paragraph 46.

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

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.

## OTHER UNUSED DEDUCTIONS AND CREDITS

### Opinion

53. The conclusions of this Opinion, including particularly the matters discussed in paragraphs 42-50 on tax reductions result-

ing 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 ex-

pense 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 disclosure (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 accountng 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 installment 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.

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

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.

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.*

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

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 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.*

Accounting Principles Board 1966-1967

Clifford V. Heimbucher
*Chairman*
Marshall S. Armstrong
Donald J. Bevis
John C. Biegler
Milton M. Broeker
George R. Catlett
W. A. Crichley
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Walter F. Frese
Newman T. Halvorson
LeRoy Layton
Oral L. Luper
John K. McClare
Robert J. Murphey
Louis H. Penney
John W. Queenan
Wilbert A. Walker
Frank T. Weston

## 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.

Revenue 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 col-

lected 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.