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Opinions
of the
Accounting Principles Board

American Institute of Certified Public Accountants
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December, 1962 No. 2

ACCOUNTING FOR THE "INVESTMENT CREDIT"

1. The Revenue Act of 1962 provides for an "investment credit" which, in general, is equal to a specified percentage of the cost of certain depreciable assets acquired and placed in service after 1961. It is subject to certain statutory limitations and the amount available in any one year is used to reduce the amount of income tax payable for that year. The full amount of the investment credit is treated for income tax purposes as a reduction in the basis of the property. An investment credit once allowed is subject to recapture under certain circumstances set forth in the statute.

2. Some decision as to the nature of the investment credit, i.e., as to the *substance* of its essential characteristics, if not indispensable, is of great significance in a determination of its accounting treatment. We believe there can be but one useful conclusion as to the nature of the investment credit and that it must be determined by the weight of the pertinent factors.

3. Three concepts as to the substance of the investment credit have been considered by the Board: (a) subsidy by way of a contribution to capital; (b) reduction in taxes otherwise applicable to the income of the year in which the credit arises; and (c) reduction in a cost otherwise chargeable in a greater amount to future accounting periods.

4. There is no significant disagreement with the view that the investment credit is a factor which influences the determination of net income. The basic accounting issue before us therefore is not whether the investment credit increases net income but, rather, the accounting period(s) during which it should be reflected in the operating statement. Resolution of the accounting issue, in large part, rests upon the accounting principles relative to the realization of income. This is true for both regulated and nonregulated companies. (See paragraph 17 of this Opinion.)

Subsidy by way of a contribution to capital. This concept, in our opinion is the least rational because it runs counter to the conclusion that the investment credit increases the net income of some accounting period(s).

6. **Tax reduction.** The argument for this concept essentially is that since the in estment credit is made available by the Revenue Act of 1962 it is in substance a selective reduction in taxes related to the taxable income of the year in which the credit arises.

7. A refinement of the tax reduction concept advocates that 48% of the investment credit (the maximum extent to which the credit normally can increase net income, assuming that the income tax rate is 52%) should be recorded as a reduction of tax expense of the year in which the credit arises; the balance of 52% should be deferred to subsequent accounting periods, as provided in Chapter 10(b) of *Accounting Research Bulletin No. 43,* because of the statutory requirement that the basis of the property be reduced for tax purposes by the amount of the investment credit.

8. The General Rule of section 38 of the Revenue Act of 1962 provides that

> There shall be allowed, as a credit against the tax imposed by this chapter, the amount determined under sub-part B of this part.

The tax code has traditionally distinguished between exclusions from taxable income (which affect the computation of taxes payable on taxable income of the period) and credits to be applied to reduce taxes otherwise applicable to such taxable income (which do not enter into such computation). In our view the relevant materials support the interpretation that the investment credit is an administrative procedure to permit the taxpayer to withhold the cash equivalent of the credit from taxes otherwise payable and that it is not an element entering into the computation of taxes related to income of the period.

9. **Cost reduction.** We believe that the interpretation of the investment credit as a reduction in or offset against a cost otherwise chargeable in a greater amount to future accounting periods is supported by the weight of the pertinent factors and is based upon existing accounting principles.

10. In reaching this conclusion we have evaluated the pertinent portions of the legislative history of the investment credit, which we regard as significant but not decisive. We also evaluated the pertinent provisions of the Revenue Act of 1962 which, as earlier stated, require that the investment credit be treated as a reduction in the basis of the property which gives rise to the credit and which contain recapture and other provisions the effect of which is to make realization of the credit dependent to some degree on future events.

11. The investment credit under certain circumstances is transferable to the lessee of qualified property. We regard it as significant that in such cases the rules and regulations of the Treasury require the lessee to reduce his taxable deduction for rent over a four, six, or eight year period, depending upon the useful life category of the property.

12. In concluding that the cost reduction concept is based upon existing accounting principles we attach substantial weight to two points in particular. First, in our opinion, earnings arise from the use of facilities, not from their acquisition. Second, the ultimate realization of the credit is contingent to some degree on future developments. Where the incidence of realization of income is uncertain, as in the present circumstances, we believe the record does not support the treatment of the investment credit as income at the earliest possible point of time. In our opinion the alternative choice of spreading the income in some rational manner over a series of future accounting periods is more logical and supportable.

CONCLUSIONS

13. We conclude that the allowable[1] investment credit should be reflected in net income over the productive life of acquired property and not in the year in which it is placed in service.

14. A number of alternative choices for recording the credit on the balance sheet has been considered. While we believe the reflection of the allowable credit as a reduction in the net amount at which the acquired property is stated (either directly or by inclusion in an offsetting account) may be preferable in many cases, we recognize as equally appropriate the treatment of the credit as deferred income, provided it is amortized over the productive life of the acquired property.

15. We believe it preferable that the statement of income in the year in which the allowable investment credit arises should be affected only by the results which flow from the accounting for the credit set forth in paragraph 13. Nevertheless, reflection of income tax provisions, in the income statement, in the amount payable (that is, after deduction of the allowable investment credit) is appropriate provided that a corresponding charge is made to an appropriate cost or expense (for example, to the provision for depreciation) and the treatment is adequately disclosed in the financial statements of the first year of its adoption.

16. An investment credit should be reflected in the financial statements only to the extent that it has been used as an offset against income tax liability. Under the statute, unused investment credits

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[1] The first $25,000 of income tax payable plus 25% of the remainder. See paragraph 16 for treatment of unused investment credits.

may be carried back or forward to other years. The accounting for these carrybacks and carryforwards should be consistent with the provisions of *Accounting Research Bulletin No. 43,* Chapter 10(b), "Income Taxes," paragraphs 16 and 17. 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. Material amounts of unused investment credits should be disclosed.

17. Authorities having jurisdiction over regulated business may require that the investment credit be accounted for in some manner not consistent with the conclusions expressed in this Opinion. We have previously stated our position on the issues involved in such a case *(The Journal of Accountancy,* December 1962, page 67—reprinted as an Addendum to this Opinion). The position there taken is intended to permit the so-called "flow through" treatment only in those circumstances where the standards described in that statement are met.

The Opinion entitled "Accounting for the 'Investment Credit'" was adopted by the assenting votes of fourteen members of the Board, of whom one, Mr. McEachren, assented with qualification. Messrs. Bevis, Black, Cannon, Powell, Tippit, and Walker dissented.

Mr. McEachren agrees with the conclusion that the investment credit should be reflected in net income over the productive life of acquired property but disagrees with the inclusion of paragraphs 9, 10, and 12 to the extent that they argue that the investment credit is a reduction of cost. Whether or not it is a reduction of cost is a question with many ramifications and subject to different interpretations under differing circumstances and in any event is not relevant to the matter here involved. He believes that the fundamental basis for the conclusion in paragraph 13 is that "earnings arise from the use of facilities; not from their acquisition."

Messrs. Bevis, Powell, and Tippit believe that the pertinent factors preponderantly support the view that the investment credit is in substance a reduction in income taxes. They consider that the generally accepted accounting principles applicable (including the pronouncements of the former Committee on Accounting Procedure, especially those relating to the accounting for income taxes and to the reporting of income, which are still in effect) preponderantly support the treatment of the investment credit as a reduction of the provision for current income taxes in the year in which the credit arises. They believe specifically, that the generation of taxable income for the year in and by

itself, rather than the future productive use of the related property, effects the realization of the credit. They point out that opinions received by the Board from practitioners and businessmen make it clear that the "48-52" method discussed in paragraph 7 of the Opinion has at least as wide acceptance among these groups as the method sponsored by the majority of the Board. They believe that, in the circumstances, the "48-52" method must also be considered to have substantial authoritative support and, therefore, to be generally acceptable.

Messrs. Black and Cannon dissent from the conclusion that there is only one acceptable accounting treatment of the investment credit. While not objecting to reflecting the investment credit over the productive life of the acquired property, they believe that it would be preferable to defer only that part of the credit (52%) equivalent to the increased taxes in future years arising from the reduction in the tax base of the property acquired.

Mr. Walker concurs with the method set forth in the Opinion as the preferred basis for treatment of the investment credit, but it is his opinion that, with adequate disclosure, it should be considered an acceptable alternative to reduce the taxes of the year in which the credit arises by an appropriate portion of such credit.

NOTE

Unless otherwise indicated 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 where formal adoption by the Council or the membership of the Institute has been asked and secured, 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 the Board's recommendations must be assumed by those who adopt other practices. Recommendations of the Board are not intended to be retroactive, nor applicable to immaterial items.

ADDENDUM

ACCOUNTING PRINCIPLES FOR REGULATED INDUSTRIES

The following statement, referred to in paragraph 17 of the Opinion and approved by the Board, originally appeared in *The Journal of Accountancy,* December 1962, p. 67:

1. The basic postulates and the broad principles of accounting comprehended in the term "generally accepted accounting principles" per-

tain to business enterprises in general. These include public utilities, common carriers, insurance companies, financial institutions, and the like that are subject to regulation by government, usually through commissions or other similar agencies.

2. However, differences may arise in the application of generally accepted accounting principles as between regulated and nonregulated businesses, because of the effect in regulated businesses of the rate-making process, a phenomenon not present in nonregulated businesses. Such differences usually concern mainly the time at which various items enter into the determination of net income in accordance with the principle of matching costs and revenues. For example, if a cost incurred by a regulated business during a given period is treated for rate-making purposes by the regulatory authority having jurisdiction as applicable to future revenues, it may be deferred in the balance sheet at the end of the current period and written off in the future period or periods in which the related revenue accrues, even though the cost is of a kind which in a nonregulated business would be written off currently. However, this is appropriate only when it is clear that the cost will be recoverable out of future revenues, and it is not appropriate when there is doubt, because of economic conditions or for other reasons, that the cost will be so recoverable.

3. Accounting requirements not directly related to the rate-making process commonly are imposed on regulated businesses by orders of regulatory authorities, and occasionally by court decisions or statutes. The fact that such accounting requirements are imposed by the government does not necessarily mean that they conform with generally accepted accounting principles. For example, if a cost, of a kind which in a nonregulated business would be charged to income, is charged directly to surplus pursuant to the applicable accounting requirements of the regulatory authority, such cost nevertheless should be included in operating expenses or charged to income, as appropriate in financial statements intended for use by the public.

4. The financial statements of regulated businesses other than those prepared for filing with the government for regulatory purposes preferably should be based on generally accepted accounting principles (with appropriate recognition of rate-making considerations as indicated in paragraph 2) rather than on systems of accounts or other accounting requirements of the government.

5. *Generally Accepted Auditing Standards* lists four standards of reporting, the first of which says that "The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting." In reporting on the financial statements of regulated businesses, the independent auditor should observe this standard and should deal with material variances from generally accepted accounting principles (with appropriate recognition of rate-making con-

siderations as indicated in paragraph 2), if the financial statements reflect any such variances, in the same manner as in his reports on nonregulated businesses.

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