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Balance sheet classification of deferred income taxes arising from installment sales

United States. Securities and Exchange Commission

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SECURITIES AND EXCHANGE COMMISSION
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SECURITIES ACT OF 1933
Release No. 4811
SECURITIES EXCHANGE ACT OF 1934
Release No. 7763
HOLDING COMPANY ACT OF 1935
Release No. 15359

INVESTMENT COMPANY ACT OF 1940
Release No. 4426
ACCOUNTING SERIES
Release No. 102

BALANCE SHEET CLASSIFICATION OF
DEFERRED INCOME TAXES ARISING FROM INSTALLMENT SALES

It has come to the attention of the Securities and Exchange Commission that diverse practices exist regarding the balance sheet classification of deferred income taxes arising from the use of the installment method of reporting gross profit for income tax purposes. The majority of companies having installment receivables classified as current assets classify the related deferred income taxes as a noncurrent credit item, while some classify the deferred income taxes as a current liability or as a deduction from the receivables. It is understood that, at the end of their current fiscal years, some registrants intend to change from current to noncurrent the classification of the deferred income taxes if other companies continue to classify the related deferred income taxes as a noncurrent item. The Commission's staff has noted that some companies have recently changed their reporting practices to show such deferred income taxes as a noncurrent item while retaining the related installment receivables among current assets.

The classification of deferred income taxes related to installment receivables as noncurrent is significant when considered in light of the practice of classifying assets and liabilities as current or noncurrent in accordance with the normal operating cycle of the business. In Regulation S-X the Commission recognized the operating cycle treatment in the determination of working capital. 1/

The installment receivables and related deferred income taxes pertaining to the same operating cycle clearly are both either current or noncurrent. There is no justification from the standpoint of either proper accounting or fair financial reporting for the use of the operating cycle approach for installment receivables and not for the related deferred income taxes. Obligations for items which have entered into the operating cycle and which mature within the operating cycle should be included in current liabilities when the related receivables are included in current assets, in order to present fairly the working capital position. 2/

1/ Regulation S-X, Rules 3-13 and 3-14. *Cf*. American Institute of Certified Public Accountants Accounting Research Bulletin No. 43, Chapter 3A, Current Assets and Current Liabilities.

2/ *Cf*. "Inventory of Generally Accepted Accounting Principles for Business Enterprises" by Paul Grady, Accounting Research Study No. 7, American Institute of Certified Public Accountants, New York, 1965, pp. 28, 29 and 65.

The deduction of the deferred income taxes from the related installment receivables is not considered to be an appropriate procedure; the current value of the receivables is not affected by the amount of the tax deferral. The deferral is not a valuation reserve but a credit item representing cash retained in the business by the deferral of tax payments under the alternate tax provisions.

In view of the increasing use by many companies of installment sales and similar credit practices and the significance of the increasing amounts of the related deferred income taxes involved, the Commission deems it appropriate to state its opinion as to the proper reporting to be followed with respect to such deferred income taxes. 3/ Where installment receivables are classified as current assets in accordance with the operating cycle practice, the related liabilities or credit items maturing or expiring in the time period of the operating cycle, including the deferred income taxes on installment sales, should be classified as current liabilities. Installment receivables not realizable within one year and the related deferred income taxes may be classified consistently as noncurrent items. In financial statements filed with the Commission for fiscal years ending on or after December 31, 1965, assets and liabilities entering into the operating cycle shall be classified consistently as current or noncurrent items. In addition, appropriate disclosure of the classification followed and amounts involved should be given.

3/ Accounting Series Release No. 4, reaffirmed in Accounting Series Release No. 96.