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Statement of administrative policy regarding balance sheet treatment of credit equivalent to reduction in income taxes

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For IMMEDIATE Release Monday, February 29, 1960

SECURITIES AND EXCHANGE COMMISSION
Washington 25, D. C.

SECURITIES ACT OF 1933
Release No. 4191
SECURITIES EXCHANGE ACT OF 1934
Release No. 6189
HOLDING COMPANY ACT
Release No. 14173
INVESTMENT COMPANY ACT OF 1940
Release No. 2977
ACCOUNTING SERIES
Release No. 85

STATEMENT OF ADMINISTRATIVE POLICY REGARDING
BALANCE SHEET TREATMENT OF CREDIT EQUIVALENT TO REDUCTION
IN INCOME TAXES

On December 30, 1958, in Securities Act Release No. 4010 ^{1/} the Commission gave notice of its intention to announce a statement of administrative policy regarding the balance sheet treatment, in financial statements filed with the Commission, of the credit equivalent to the reduction of income taxes arising from the deduction of costs for income tax purposes at a more rapid rate than for financial statement purposes. Comments and views thereon were submitted and oral presentation before the Commission was made by interested persons on April 8 and 10, 1959.

Under various statutes administered by it, the Commission has the authority and the corresponding responsibility to require that the financial statements filed with it be prepared in a manner which provides adequate and fair disclosure. This statement of policy is designed to advise all interested persons of the Commission's views as to the presentation in financial statements filed with the Commission of the credit arising when deferred tax accounting is employed. It pertains to the propriety of designating as earned surplus (or its equivalent) or in any manner as a part of equity capital, in financial statements filed with this Commission, the accumulated credit arising from accounting for reductions in income taxes for various items, including those under Section 167 (liberalized depreciation) and Section 168 (accelerated amortization of emergency facilities) of the Internal Revenue Code of 1954. It is not intended to direct or establish any system of accounts or to specify the manner in which a particular item shall be recorded on the books of the reporting companies, nor is it intended in any way to affect the requirements of any other governmental agency, federal or

^{1/} This was also issued as Securities Exchange Act Release No. 5844; Holding Company Act Release No. 13894; and Investment Company Act Release No. 2814. It was also published in 24 Federal Register 271 and bears Federal Register Document No. 59-243.

state, with respect to the manner in which such books of account shall be kept. 2/

The problem arises from the deduction of costs for income tax purposes at a faster rate than for financial statement purposes where the difference is material. The amount of income tax payable for any period is affected by the amount of costs deducted in determining taxable income. In a year in which costs are deducted for tax purposes in amounts greater than those used for financial statement purposes, then, unless corrected, there is a failure properly to match costs and revenues in the financial statements by the amount of the tax effect of the cost differential. To correct the resultant distortion in periodic net income after taxes, it is therefore necessary to charge income in earlier years with an amount equal to the tax reduction and to return this amount to income in subsequent years when the amount charged for financial statement purposes exceeds the amount deducted for tax purposes. 3/ It is our understanding

2/ Representatives of companies subject to the jurisdiction of the Commission under the Public Utility Holding Company Act of 1935 as registered holding companies or subsidiary companies thereof have contended that this Commission has no power to prescribe the manner in which the accumulated credit arising from deferred tax accounting should be classified in the accounts of the company. In support of this contention, reference was made to Section 20(b) of that Act. That section provides that "in the case of the accounts of any company whose methods of accounting are prescribed under the provisions of any law of the United States or of any State, the rules and regulations or orders of the Commission in respect of accounts shall not be inconsistent with the requirements imposed by such law or any rule or regulation thereunder; . . ." [emphasis supplied] For reasons stated above, this contention misconceives the nature of the action herein taken.

In this connection the Commission today modified Rule 28 promulgated under the Public Utility Holding Company Act of 1935 (17 CFR 250.28) so as to conform the language of that rule with the policy here announced. Rule 28 provided, so far as is here pertinent, that no registered holding company or subsidiary thereof could publish financial statements inconsistent with its book accounts. The rule as modified provides, in effect, that a registered holding company or subsidiary thereof need not conform its published financial statements with its book accounts where such deviation is authorized or required by this Commission by rule, regulation, order, statement of administrative policy, or otherwise. (Holding Company Act Release No. 14172)

3/ Since the deferral is made for the purpose of allocating to future periods the effect on income of the current tax reduction, it is not contemplated that the portion returned to income will exactly offset the increased tax to be paid in future years. The amount of additional taxes payable in future years may vary from the reduction obtained earlier because of changes in the tax rates or because of failure to earn taxable income corresponding to the tax reduction previously taken.

that such deferred tax accounting is in accordance with generally accepted accounting principles. 4/

With specific reference to depreciation, since the total deduction allowed over the life of an asset is limited to its cost and hence is not affected by the method by which it is deducted from income, acceleration of tax deductions in earlier years results in deferring to later years the payment of taxes on an amount equivalent to the cost differential. 5/ Because of the interrelationship between income taxes and depreciation, the Commission is of the view that in the earlier years the charge equivalent to the tax reduction should be treated either (1) as a provision for future taxes in the income statement with a corresponding credit in the balance sheet to a non-equity caption such as a deferred tax credit, 6/ or (2) as additional depreciation in the income

4/ Accounting Research Bulletins issued by the Committee on Accounting Procedure of the American Institute of Certified Public Accountants: No. 42, November 1952; No. 43, June 1953, Chs. 9c and 10b; No. 44, October 1954; No. 44 (Revised), July 1958.

An exception to this practice is stated in paragraph 8 of Accounting Research Bulletin No. 44 (Revised), which provides that:

"Many regulatory authorities permit recognition of deferred income taxes for accounting and/or rate-making purposes, whereas some do not. The committee believes that they should permit the recognition of deferred income taxes for both purposes. However, where charges for deferred income taxes are not allowed for rate-making purposes, accounting recognition need not be given to the deferment of taxes if it may reasonably be expected that increased future income taxes, resulting from the earlier deduction of declining-balance depreciation for income-tax purposes only, will be allowed in future rate determinations."

It is the understanding of this Commission that the exception recognizes the position of those regulatory agencies which permit public utilities to deduct only the actual taxes payable in a given year, and the Commission raises no question as to the propriety of the exception.

5/ Where there is no difference between the amount of cost deducted for income taxes and the amount deducted for financial statement purposes, such as where declining-balance depreciation is taken both for tax and financial statement purposes, there is, of course, no occasion for deferred tax accounting.

6/ This would not prohibit companies from utilizing in financial statements filed with this Commission the balance sheet captions and classification of deferred taxes prescribed by the Federal Power Commission in its Orders Nos. 203 and 204, Dockets Nos. R-158 and R-159,

/continued/

statement with a corresponding addition to the accumulated provision for depreciation in the balance sheet. 7/ In the Commission's view it is improper to charge income with an item required for the proper determination of net income and concurrently to credit earned surplus.

A number of comments indicated that, should the Commission take the foregoing position, it should be limited to matters connected with depreciation and amortization or, if not so limited, any additional items embraced within this principle should be clearly specified. It is the Commission's view, however, that comparable recognition of tax deferment should be made in all cases in which there is a tax reduction resulting from deducting costs for tax purposes at faster rates than for financial statement purposes. 8/

The Committee on Accounting Procedure of the American Institute of Certified Public Accountants agrees with the position expressed above. Accounting Research Bulletin No. 44 (Revised) states, in connection with the deduction of depreciation for income tax purposes at a more rapid rate than for financial accounting purposes, that the accounting company should employ deferred tax accounting and that it is "alternatively appropriate, instead of crediting a deferred tax account, to recognize the related tax effect as additional amortization or depreciation applicable to such assets in recognition of the loss of future deductibility for income-tax purposes." A difference of opinion arose among certifying accountants whether the language of this bulletin permitted the deferred tax account to be classified as earned surplus restricted for future income taxes. To resolve the controversy, the Committee on Accounting Procedure sent a letter dated April 15, 1959, to all members of the Institute in which it clarified the bulletin on the point. The pertinent portion of the letter reads:

6/ [continued] respectively, issued May 29, 1958. Nor has there been called to the Commission's attention the provisions of any law of the United States or any rule or regulation thereunder prescribing methods of accounting which would prohibit any companies from following, in reports filed with us pursuant to the Securities Exchange Act of 1934, the balance sheet treatment set forth herein. See Section 13(b) of that Act.

7/ In either case there should be an appropriate explanation with disclosure of the amounts involved.

8/ This is, of course, subject to the general qualification under our rules that the amounts in question are material. The term "material," when used to qualify a requirement for the furnishing of information as to any subject, unless the context of a provision in a form otherwise requires, limits the information required to those matters as to which an average prudent investor ought reasonably to be informed before buying or selling the security registered. (See the rules and regulations under certain of the pertinent Acts: 17 CFR 230.405; 17 CFR 240.12b-2; 17 CFR 270.8b-2.)

"Question has been raised with respect to the intent of the committee on accounting procedure in using the phrase 'a deferred tax account' in Accounting Research Bulletin No. 44 (revised), Declining-balance Depreciation, to indicate the account to be credited for the amount of the deferred income tax (see paragraphs 4 and 5).

"The committee used the phrase in its ordinary connotation of an account to be shown in the balance sheet as a liability or a deferred credit. A provision in recognition of the deferral of income taxes, being required for the proper determination of net income, should not at the same time result in a credit to earned surplus or to any other account included in the stockholders' equity section of the balance sheet." 9/

While some accounting firms that appeared before the Commission urged that it was appropriate to designate as a part of earned surplus the credit arising from deferred tax accounting despite the opinion of the Committee on Accounting Procedure, the Commission disagrees. Moreover, the fact that there may be some authoritative support for different methods of classifying this deferred tax account does not preclude the Commission from determining for the future the manner in which the item should be classified in financial statements filed with it. In fact, as enunciated by the Commission in Accounting Series Release No. 4, dated April 25, 1938, the question of authoritative support is pertinent only where the position of the Commission has not previously been published in official releases. 10/

Arguments have been advanced, particularly on behalf of public utility companies, to the effect that from analytical and rate-making viewpoints the treatment prescribed herein might have undesirable results upon investors and consumers. However, it is entirely appropriate that regulatory agencies treat the accumulated credit arising from

9/ It may be noted that 18 of the 21 members of the Committee approved the letter. The three who did not merely dissented to the issuance at that time of any letter interpreting the bulletin.

10/ That release provided in pertinent part:

"In cases where there is a difference of opinion between the Commission and the registrant as to the proper principles of accounting to be followed, disclosure will be accepted in lieu of correction of the financial statements themselves only if the points involved are such that there is substantial authoritative support for the practices followed by the registrant and the position of the Commission has not previously been expressed in rules, regulations, or other official releases of the Commission, including the published opinions of its chief accountant."

deferred tax accounting in whatever manner they deem most relevant to their purposes. 11/

Some of the comments on Release No. 4010 questioned the authority of the Commission to deal with the subject of this release. But these comments apparently fail to recognize that a statement of administrative policy is merely an announcement of the manner in which the Commission intends to enforce the statutes which it administers. Publication of a statement of administrative policy such as this is in accord with long-established Commission practice expressed in Accounting Series Release No. 4, quoted above. Although the Commission is of the view that there is ample authority for it to adopt specific rules as to the form and content of financial statements filed with it with respect to the subject of this release, 12/ it is, instead, hereby announcing that, since any requirement in the statutes it administers calling for the filing of financial statements contemplates that they not be misleading or inaccurate, the filing with it of such statements which do not conform to the policy expressed herein would require appropriate action to be taken by the Commission. 13/

11/ So far as this Commission is concerned, since it believes that classifying the item as a component part of common stock equity is misleading for financial statement purposes, it does not intend to consider the item as a part of common stock equity for analytical purposes, although it may give consideration to the item as one of a number of relevant factors in appraising the overall financial condition of a company. The Commission, of course, does not have jurisdiction over rate-making, although under the Public Utility Holding Company Act of 1935 it is concerned with the interests of consumers. Alleged adverse results as to investors and consumers are no different from those complained of whenever any requirement designed to assure financial stability is imposed.

12/ See, e.g., Section 19(a) and paragraphs 25 and 26 of Schedule A of the Securities Act of 1933; Sections 12, 13, and 23 of the Securities Exchange Act of 1934; Sections 5(b)(2), 7(a), 10(a), 14, and 20(a) of the Public Utility Holding Company Act of 1935; and Sections 30 and 38 of the Investment Company Act of 1940.

13/ For example, in connection with applications filed under Section 6(b) or declarations filed under Section 7 of the Public Utility Holding Company Act of 1935, where the financial statements do not conform to the policy expressed herein, the Commission would presumably condition any order granting the application or permitting the declaration to become effective so as to require that such financial statements do so conform.

For the foregoing reasons, on and after the effective date of this statement of administrative policy, any financial statement filed with this Commission which designates as earned surplus (or its equivalent) or in any manner as a part of equity capital (even though accompanied by words of limitation such as "restricted" or "appropriated") the accumulated credit arising from accounting for reductions in income taxes resulting from deducting costs for income tax purposes at a more rapid rate than for financial statement purposes will be presumed by the Commission to be misleading or inaccurate despite disclosure contained in the certificate of the accountant or in footnotes to the statements, provided the amounts involved are material.

This statement of administrative policy shall become effective on April 30, 1960.

By the Commission.

Orval L. DuBois
Secretary

February 29, 1960