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A CHRONOLOGICAL REVIEW OF THE AUTHORITATIVE LITERATURE ON INTERPERIOD TAX ALLOCATION: 1940-1985

Abstract: In this paper, the authoritative literature is reviewed chronologically to trace the development of interperiod tax allocation from its inception in the early 1940s to late 1985. The study reveals an evolution from acceptance of either the liability, deferred or net-of-tax methods of partial allocation to the deferred method of comprehensive allocation. The FASB's recent endorsement of the liability method of comprehensive allocation suggests a major theoretical shift from accounting policy followed since 1967.

Introduction

On January 27, 1982, reconsideration of an issue that had been debated for over forty years was initiated. The Financial Accounting Standards Board (FASB) added a project on accounting for income taxes to its agenda.

From enactment of the first income tax law in 1913 to the early 1940s, universal accounting practice (except for utilities) was to determine the income tax provision on the basis of income taxes payable. During that period income taxes were relatively low and the differences, if any, between pretax accounting income and taxable income caused no significant distortion of reported net income [Crawford, May 1946, p. 756]. Thus, income tax allocation was not an issue in this country until the decade of the forties. Since then, the controversy has ebbed and flowed, with changes in the authoritative accounting literature generally resulting from changes in the tax statutes and/or to minimize diversity in financial reporting.

The purpose in this paper is to trace the development of income tax allocation from the 1940s to the present. Research for the paper is limited primarily to the authoritative literature. No attempt is made to survey the whole body of literature on the subject. There

is no intent to argue the pros and cons of tax allocation nor of the various methods of application. While some secondary issues are necessarily broached, the primary thrust in the paper is the more controversial question of interperiod income tax allocation. This historical perspective should enrich our knowledge of the past and assist resolution of related issues currently and in the future.

1940-1950

The concepts of interperiod and intraperiod tax allocation were first introduced in the authoritative literature in December 1942 in Accounting Research Bulletin (ARB) No. 18, "Unamortized Discount and Redemption Premium on Bonds Refunded (Supplement)." Previously, in 1939, the Committee on Accounting Procedure (in ARB No. 2) had recognized two acceptable methods of accounting for discounts and premiums on bonds refunded: Immediate write-off by a charge in the income statement or to earned surplus, and amortization over the remaining life of the bonds refunded. In ARB No. 18, the Committee on Accounting Procedure (CAP) recognized that immediate write-off to earned surplus or amortization of the discount could lead to a serious distortion of the income statement.

While discouraging but not prohibiting immediate write-off to earned surplus (as opposed to the income statement), the bulletin required that the charge to surplus be tax-effected and that an amount at least equal to the reduction of current taxes to which the refunding gave rise be charged to the income statement. Although applied in a very specific case, tax effecting the charge to surplus was an early example of intraperiod tax allocation.

If one elected to amortize the discount over the remaining life of the bonds refunded, ARB No. 18 stated the following:

> One method of accomplishing the result required by the two preceding paragraphs would be to charge a portion of the unamortized discount equal in amount to the reduction of income tax, in the income statement of the period in which the benefit of tax reduction is reflected. Another method would be to create a reserve for future taxes by a charge in the income statement equal in amount to such tax reduction [1942, p. 152].

Thus, in this very narrow context, the CAP also introduced (without labeling it as such) interperiod tax allocation by either the net of tax method or the liability method.

A more comprehensive treatment of income tax allocation was discussed in ARB No. 23, "Accounting For Income Taxes," that was issued in December 1944. The debate over whether income taxes were an expense or a distribution of income was prevalent during this period. Also, it was common acceptable accounting practice to charge or credit losses and gains to earned surplus or to the income statement. Another common practice was to make the income tax provision equal to the income tax liability.

The significant distortion in income where an entity amortized discounts on bonds refunded had already been identified in ARB No. 18. Subsequent to the date of that bulletin, the U.S. government, under Section 124 of the Internal Revenue Code, had issued "Certificates of Necessity." These certificates permitted the amortization of the cost of "emergency facilities" considered essential to the war effort over a period of 60 months. Depreciation of such facilities at normal rates for book purposes and at accelerated rates for tax purposes generated significant differences in pre-tax accounting income and taxable income.

The CAP concluded that "Income taxes are an expense . . ." [AICPA, 1944, p. 183]. With respect to charges or credits to earned surplus, the bulletin stated that they should be tax-effected and that the tax effect should be specifically disclosed and appropriately described in the income statement (intraperiod tax allocation).

Regarding the impact of the amortization of discounts on bonds refunded and of "certificates of necessity," the CAP identified these as timing differences and recommended partial interperiod tax allocation using the net of tax or the liability method.[1] Partial allocation is deduced from the statement that "neither allocation nor disclosure is necessary, however, in case of differences between the tax return and the income statement where there is a presumption that they will recur regularly over a comparatively long period of time." Bulletin 23 also permitted companies to disclose pertinent facts if allocation of income taxes was not practicable.

On a related issue of accounting for the tax effects of loss carrybacks and carryforwards, ARB No. 23 recommended including the tax benefits in the period in which they were realized with disclosure separate from operating results for the period.

On November 16, 1945, the Securities and Exchange Commission (SEC) stated its opposition to income tax allocation (among other issues) in Accounting Series Release No. 53, "In the Matter of

'Charges in Lieu of Taxes'. . . ." Actually, the Commission appeared to be not so much against tax allocation as it was the manner of disclosure, as evidenced by their conclusions:

1. The amount shown as provision for taxes should reflect only actual taxes believed to be payable under the applicable tax laws.
2. It may be appropriate, and under some circumstances such as a cash refunding operation it is ordinarily necessary, to accelerate the amortization of deferred items by charges against income when such items have been treated as deductions for tax purposes.
3. The use of the caption "Charges or provisions in lieu of taxes" is not acceptable.
4. If it is determined, in view of the tax effect now attributable to certain transactions, to accelerate the amortization of deferred charges or to write off losses by means of charges to the income account, the charge made should be so captioned as to indicate clearly the expenses or losses being written off.
5. The location within the income statement of any such special charge should depend on the nature of the item being written off. In the case of a public utility, for example, a special amortization of bond discount and expense should not be shown as an operating expense but should be classified as a special item along with other interest and debt service charges in the "other deductions" section.
6. It is appropriate to call attention to the existence of the special charge by the use of appropriate explanatory language in connection with intermediate balances and totals.
7. In the preparation of statements reflecting estimates of future earnings, it is ordinarily permissible to reflect as income taxes the amount which it is expected will be payable if such earnings are realized provided, of course, the assumptions as to the tax rates are disclosed.
8. In the preparation of statements which are designed to "give effect" to specified transactions, the provision for taxes may, depending on all the facts and circumstances, properly represent either (a) the actual taxes

> paid during the period adjusted to give effect to the specified transactions, or, (b) an estimate of the taxes that it is expected will be payable should the income of future years be equal in amount to the adjusted income shown in the statement. The statement should, of course, clearly show what the provision for taxes purports to represent [SEC, 1956, pp. 128-129].

The SEC questioned the CAP's contention that income taxes were an expense and that tax allocation "is purely an effort to have items shown in the income statement at what is considered to be a 'normal' amount." Nevertheless, in the specific case at issue, Virginia Electric and Power Company's 1944 Income Statement, net income in the SEC's revised statement was the same as in the original registration statement.

The American Institute of Accountants official response to ASR No. 53 was a statement by the research department in which the positions of the CAP and the SEC were reviewed and illustrated [AIA, 1946, pp. 127-129]. ARB No. 23 was not changed.

At the close of World War II (9/29/45), an executive order was issued declaring an end to the emergency period. Thus, any previously unamortized costs of emergency facilities were henceforth to be deducted for tax purposes over their remaining useful lives (recall that previously, their cost had been deductible for tax purposes over a period of 60 months). In ARB No. 27, "Emergency Facilities," the CAP reasoned as follows:

> It is the opinion of the committee that where the facts clearly indicate that the accelerated amortization or depreciation of emergency facilities at rates permitted for tax purposes has resulted in a carrying value materially less than that reasonably chargeable to revenues to be derived from the continued use of the facilities, . . ., the adjustment of accumulated amortization or depreciation of such facilities is appropriate. . . . Consideration of these factors, . . ., will usually result in the determination of a carrying value for emergency facilities less than the cost of the facility reduced by the depreciation that would have been appropriate had no certificate of necessity been involved [par. 7].

The significance of this bulletin in the context of income tax allocation, is that the recommendation of the CAP was consistent with the net of tax concept of tax allocation previously espoused.

The asset should be carried at less than its market value because all or a significant portion of its tax deductibility had been used up.

1950-1960

The Revenue Act of 1950 again provided for the issuance of certificates of necessity with amortization of all or part of the cost of emergency facilities over 60 months. In ARB No. 42, "Emergency Facilities — Depreciation, Amortization and Income Taxes," the CAP, for the first time, expressed clearly a preference for the liability method of allocating the tax effects of differential timing of depreciation on emergency facilities for book and tax purposes. The CAP also introduced the term "deferred income taxes" by stating that ". . . the related credit would properly be made to an account for deferred income taxes" [par. 12].

While stating a preference for the liability method of tax allocation, the bulletin said the net of tax method of presentation was still acceptable: "Although this procedure [net of tax method] will result in the same amount of net income as the procedure outlined in paragraph 12 [liability method], and therefore may be considered as acceptable, the committee regards the paragraph 12 procedure as preferable" [par. 13].

In June 1953, ARB No. 43, "Restatement and Revision of Accounting Research Bulletins," was issued. Chapter 9C was essentially a restatement of ARB No. 27 and Chapter 10 Section B was essentially a restatement of Bulletin No. 23.

The Internal Revenue Code of 1954 recognized declining-balance and sum-of-the-years' digits methods of depreciation for tax purposes. ARB No. 44, "Declining-Balance Depreciation," issued in October 1954, recognized that "there may be situations in which the declining-balance method is adopted for income tax purposes but other appropriate methods are followed for financial accounting purposes." [par. 4] In this case, the CAP recommended partial allocation stating that deferred taxes need not be recognized unless it is reasonably certain that the reduction in taxes in the earlier years is merely a deferment of income taxes until a relatively few years later, and then only if the amounts are material. In an unpublished paper, Sprouse [1981, p. 6] said "that ARB signified the beginning of a controversy about deferred income taxes in the U.S. that has raged continuously to this very day."

Following a brief period of debate as to the extent of tax allocation that was appropriate, the CAP issued ARB No. 44 (Revised)

in July 1958. This bulletin recommended allocation of all timing differences generated by the use of different depreciation methods for computing taxable income and pretax accounting income with one exception: ". . . 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 the earlier deduction of declining-balance depreciation for income-tax purposes only, will be allowed in future rate determinations" [par. 8]. In this case, full disclosure of the amount of deferred taxes not recognized in the accounts was required.

The bulletin further stated that where the cumulative tax deferral resulting from continuing asset expansion was expected to continue for a long or indefinite period the net of tax method of tax allocation was alternatively appropriate [par. 5]. Some certifying accountants interpreted this language as permitting the deferred tax account to be classified as earned surplus restricted for future income taxes.

To resolve the controversy, the CAP sent a letter to all members of the American Institute of Certified Public Accountants (AICPA) dated April 15, 1959 stating that it used the phrase "deferred tax account" in ARB No. 44 (Revised) in its ordinary connotation of an account that should be presented in the balance sheet as a liability or a deferred credit. The letter also said "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." This interpretation served notice that charges and credits to earned surplus were no longer accepted practice.

ARB No. 51, "Consolidated Financial Statements," issued in August 1959, concluded for the first time that including undistributed earnings of a subsidiary in the pretax accounting income of a parent in consolidation was a timing difference and provision for income taxes generally was required. The exception to the general case would apply where there was evidence of permanent reinvestment by the subsidiaries or a plan for a tax-free liquidation. Years later we refer to this as the "indefinite reversal criteria."

1960-1970

Some of the regulated public utilities had continued to treat the deferred income tax credit as a part of stockholders' equity, even though the CAP had rejected this alternative accounting in both

ARB No. 44 (Revised) and its letter to the AICPA membership dated April 15, 1959. Late in 1958, the SEC had announced in Release No. 4010 its intention to issue a statement of administrative policy on this issue. Carman Blough reported that after extended public hearings and fourteen months of further consideration, the SEC issued the proposed statement as Accounting Series Release No. 85 on February 29, 1960. In it, the Commission took a position that was consistent with the view expressed by the CAP in its 1959 letter to the membership [Blough, June 1960, p. 65]. In ASR No. 85, the SEC also imposed comprehensive tax allocation with the following statement:

> 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 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.

The SEC further stated that the CAP agreed with their position. Also, in a footnote, the SEC expressed support for the deferred method of comprehensive tax allocation whereas authoritative literature supported the liability approach.

In response to a comment from Carman G. Blough, Director of Research of the AICPA, the SEC issued ASR No. 86, dated April 12, 1960, in which the Commission stated it was not its intent in ASR No. 85 to "make mandatory the use of deferred tax accounting beyond the requirements of generally accepted accounting principles." Thus, Chapter 10B of ARB No. 43 and ARB No. 44 (Revised), as interpreted by the CAP, were supported and not modified by the releases of the SEC.

Accounting Principles Board (APB) Opinion No. 1, "New Depreciation Guidelines", issued in November 1962, was the profession's response to Revenue Procedure 62-21, "Depreciation Guidelines and Rules," which permitted significantly shorter depreciable lives for tax purposes than had previously been used. No new theory was introduced by the APB, rather the opinion reiterated the need for tax allocation where shorter lives were used for tax purposes than for financial accounting purposes.

In October 1965, APB Opinion No. 6, "Status of Accounting Research Bulletins", was issued, and, for the first time, the net of tax approach was not explicitly stated as an acceptable alternative for tax allocation. The APB called for either the deferred method or the liability method and introduced descriptive terms for each method:

> Provisions for deferred income taxes may be computed either (a) at the tax rate for the period in which the provision is made (the so-called 'deferred credit' approach) or (b) at the tax rate which is estimated will apply in the future (the so-called 'liability' approach) [par. 23].

Under the "deferred credit" method, the opinion stated ". . . Accordingly, the deferred amount is allocated to (drawn down in) the future periods based on the recorded tax benefit, which may be at a rate different from the then current rate," thus implying what we now refer to as the "gross change approach" to computing the tax deferral.

The lack of consensus regarding the circumstances that required allocation (partial allocation vs. comprehensive allocation) or the appropriate methods of tax allocation (deferred, liability, or net of tax method) motivated the APB to ask the Accounting Research Division of the AICPA to commission a research study on those issues. The study was conducted by Homer A. Black and was published as Accounting Research Study (ARS) No. 9, "Interperiod Allocation of Corporate Income Taxes," in 1966. Research studies are not considered authoritative, but ARS No. 9 is the most thorough treatise ever on this topic and its recommendations are included in this paper because of that. The study "begins with two accounting assumptions which have long been accepted by the majority of the profession: (1) income taxes are expenses rather than distributions of income, and (2) income taxes are to be allocated to applicable periods (corollary - disclosure of tax timing differences in a note is not an acceptable substitute)" [Black, 1966, p. 5].

The conclusions of ARS No. 9 are as follows:

1. Interperiod income tax allocation should be applied comprehensively, that is, to all material timing differences (comprehensive allocation) [p. 113].
2. Deferred tax credits should be recorded under the liability method. Deferred tax debits should be recorded under the

deferred method. The net of tax method is a poor tax allocation procedure and is not recommended [pp. 112-113].

3. ". . . to avoid overstating liabilities and misstating periodic net income, discounting of long-term tax liabilities is required whenever the interest factor is significant." The entity's internal rate of return is recommended as the appropriate discount rate [p. 115].
4. Tax effects of operating loss carryforwards should be recognized in the loss year when realization is substantially assured. If the carryforward benefit is not recognized in the loss year, it should be treated as a correction of the loss year results when realized [p. 115].

The earliest official response to the conclusions of ARS No. 9 was in APB Opinion No. 10 "Omnibus Opinion — 1966," in which the APB concluded "Pending further consideration of this subject and the broader aspects of discounting as it is related to financial accounting in general and until the Board reaches a conclusion on this subject, it is the Board's opinion that . . . deferred taxes should not be accounted for on a discounted basis" [par. 6]. Regarding the other issues addressed in ARS No. 9, the Board stated that it was "giving attention to the general subject with a view to issuing an opinion on it" [par. 6].

In the following year, December 1967, the APB issued Opinion No. 11, "Accounting for Income Taxes," the most complete and authoritative statement ever issued on the subject. The Board agreed with the assumption of ARS No. 9 that income taxes are an expense and summarized its major conclusions 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 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 carrybacks should be allocated to the loss periods. The tax effects of operating loss carryforwards 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 [par. 12].

In opting for the deferred method of comprehensive tax allocation, the Board concluded that partial allocation and both the liability and net of tax methods of interperiod tax allocation were unacceptable.

Thus, for the first time in twenty-five years, the SEC and the accounting profession had moved to a common ground on both the extent of and the method of interperiod tax allocation. From initial opposition to tax allocation (see ASR No. 53), the SEC had moved more rapidly than the profession to this position (ASR No. 85 had supported the deferred method of comprehensive allocation in 1960). As to the authoritative literature, the profession was the first to recognize the need for tax allocation (see ARB Nos. 18 and 23) and its thinking had evolved from allocation with respect to specific transactions (see ARB No. 18), to partial allocation using either the liability or net-of-tax methods, (see ARB No. 23), to partial allocation with a preference for the liability method (see ARB No. 42), to partial allocation under either the deferred method or the liability method (see APB Opinion No. 6), to the deferred method of comprehensive tax allocation.

Timing differences were differentiated from permanent differences and the opinion stipulated the with and without method of measuring the tax deferral generated by timing differences. Under certain conditions, either the net change approach or the gross change approach could be used.

The Board reaffirmed its opposition to discounting of deferred taxes (as previously stated in Opinion No. 10) pending further study.

In deferring modification of paragraph 16 of ARB No. 51 regarding accounting for income taxes in consolidation on undistributed earnings of subsidiaries, the Board reaffirmed the indefinite reversal criteria concept, i.e., income taxes need not be accrued by the parent if there is evidence of permanent reinvestment by the subsidiary or of a tax-free liquidation [par. 39].

Decisions affecting some special areas were deferred until further study:

1. Undistributed earnings of subsidiaries.
2. Intangible development costs in the oil and gas industry.
3. "General reserves" of stock savings and loan associations.
4. Amounts designated as "policyholders' surplus" by stock life insurance companies.
5. Deposits in statutory reserve funds by United States steamship companies [par. 38].

In APB Opinion No. 18, "The Equity Method of Accounting For Investments in Common Stock," the requirements of paragraph 16 of ARB No. 51 that income taxes be accrued on undistributed earnings of consolidated subsidiaries (except where the indefinite reversal criteria apply) were extended to include investments in common stock of unconsolidated subsidiaries, corporate joint ventures and other investee companies accounted for by the equity method in consolidated statements. Also included were equity method investments in parent company financial statements [par. 19J].

Positions on accounting for income taxes in three of the five special areas that had been deferred for further study in APB Opinion No. 11 (see above) were taken in APB Opinion No. 23, "Accounting For Income Taxes-Special Areas," issued April 1972. In this opinion, the Board concluded that "including undistributed earnings of a subsidiary in the pretax accounting income of a parent company, either through consolidation or accounting for the investment by the equity method, may result in a timing difference, in a difference that may not reverse until indefinite future periods, or in a combination of both types of differences, depending on the intent and actions of the parent company" [par. 9] (a reaffirmation of paragraph 16 of ARB No. 51 and APB Opinion No. 18, paragraph 19J). This literature, however used the term "indefinite reversal criteria" for the first time and extended the concept to investments in corporate joint ventures, bad debt reserves of savings and loan associations and "policyholders surplus" of stock life insurance companies. In the latter two areas, indefinite reversal was presumed to be the general case, however, and not the exception. One could argue, of course, that introduction of the indefinite reversal criteria in these specific situations was a means of invoking partial allocation without recognizing it as such.

Concurrently, APB Opinion No. 24, "Accounting For Income Taxes-Investments in Common Stock Accounted for by the Equity

Method (other than subsidiaries and corporate joint ventures)," determined that the tax effects of differences between taxable income and pretax accounting income attributable to an investor's share of such investee companies accounted for by the equity method have the essential characteristics of timing differences and tax allocation is required. Accounting for this type investment is different from undistributed earnings of subsidiaries and investments in corporate joint ventures because of the inability of the investor to exercise control over the investee and, therefore, the indefinite reversal criteria do not apply.

Up to this point in time, the authoritative literature had not addressed accounting for income taxes in interim financial statements. In May 1973, APB Opinion No. 28 stated that "income tax provisions should be determined under the procedures set forth in APB Opinion Nos. 11, 23, and 24" [par. 19].

Two phenomena were associated with the issuance of Financial Accounting Standards Board (FASB) Statement No. 9: Action on accounting for income taxes for oil and gas producing companies had been deferred in APB Opinion No. 11, and the Tax Reduction Act of 1975 substantially reduced or eliminated percentage (statutory) depletion for many oil and gas companies.

Prior to Opinion No. 11 and up to the effective date of FASB Statement No. 9 (1/1/75), some oil and gas producing companies allocated income taxes with respect to intangible drilling and development costs (IDC) and some did not. Those companies not allocating taxes generally cited the interaction of percentage depletion as the conceptual basis. Statement No. 9 required interperiod tax allocation for IDC and other costs associated with exploration for or development of oil and gas reserves that enter into determination of taxable income and pretax accounting income in different periods. This statement also permitted but did not require an entity to recognize the interaction of percentage depletion. With the issuance of Statement No. 9, all of the special areas deferred for further study in APB Opinion No. 11 had been addressed in the authoritative literature except for deposits in statutory reserve funds by United States steamship companies.

Although FASB Statement No. 9 permitted recognition of the interaction of percentage depletion with book/tax timing differences, the question of whether interaction should be recognized was not addressed. In FASB Statement No. 19, however, the Board concluded that recognition of the above interaction would be inconsistent with comprehensive tax allocation and that excess statutory

depletion should be accounted for as a permanent difference, i.e., interaction should not be recognized.

In April 1978, the FASB responded to those wanting to apply the indefinite reversal criteria of APB Opinion No. 23 to other areas in Interpretation No. 22, "Applicability of Indefinite Reversal Criteria of Timing Differences." The Board stated the provisions of APB Opinion No. 23 do not apply to timing differences other than those specified in that opinion.

Less than two years later, however, the FASB applied the indefinite reversal criteria in Statement No. 31, "Accounting for Tax Benefits Related to U.K. Tax Legislation Concerning Stock Relief," (September 1979). The Board determined that the tax benefit of "stock relief" provided by the U.K. tax law should be deferred only if recapture was probable within the six year recapture period.

1980-1985

FASB Statement No. 37, "Balance Sheet Classification of Deferred Income Taxes," issued July 1980, clarified the requirements of APB Opinion No. 11 that deferred taxes be classified as current or noncurrent based on the classification of the related asset or liability as follows:

> A deferred charge or credit is related to an asset or liability if reduction of the asset or liability causes the timing difference to reverse. A deferred charge or credit that is related to an asset or liability shall be classified as current or noncurrent based on the classification of the related asset or liability. A deferred charge or credit that is not related to an asset or liability because (a) there is no associated asset or liability or (b) reduction of an associated asset or liability will not cause the timing difference to reverse shall be classified based on the expected reversal date of the specific timing difference. Such classification disregards any additional timing differences that may arise and is based on the criteria used for classifying other assets and liabilities [par. 4].

With the enactment of the Economic Recovery Act of 1981 that introduced a new "accelerated cost recovery system" (ACRS) for depreciable assets, renewed efforts were directed toward reconsideration of comprehensive interperiod tax allocation based on

the deferred method. The literature suggests the major concerns about interperiod tax allocation were as follows:

1. Perhaps the greatest concern was the increasing magnitude of the amount of deferred income taxes reported. Compounding this already empirically validated phenomenon was that under ACRS not only were current deferred income tax balances expected to accelerate; they also would appear on some enterprises' balance sheets that had not previously had different amounts of depreciation for book and tax purposes [Sprouse, 1981, p. 7].
2. The complexity of applying the deferred method comprehensively. Recognition of the interplay of deferred income taxes and unused investment tax credits (see FASB Interpretation 25) had significantly increased that complexity [Sprouse, 1981, p. 8].
3. The concern of many managers and users about how to interpret deferred taxes. Moreover, considering the complexity of calculation and the difficulty of interpreting the meaning, did the cost exceed the benefits [Sprouse, 1981, p. 8]?
4. The inconsistency of the deferred method and the FASB conceptual framework. Specifically, in Concepts Statement No. 3, the Board said that only the net of tax and liability methods are compatible with the definitions therein [Beresford et al, 1982, p. 5].
5. Critics also suggested that the deferred method of comprehensive tax allocation was not in harmony with some other countries' principles and, thus, contrary to international harmonization of generally accepted accounting principles [Beresford et al, 1983, p. 6].

In response to the above concerns the FASB added a major project on "Accounting for Income Taxes" to its agenda on January 27, 1982. As part of this project, Ernst & Whinney completed a survey of the existing literature on accounting for income taxes that was published as a research report by the FASB in July 1983. [Beresford et al, 1983] Two studies sponsored by the American Gas Association and the Edison Electric Institute were completed by Coopers & Lybrand and Arthur Andersen & Co. in February 1983.[2] Research sponsored by the Financial Executives Research Foundation focusing on the impact of interperiod tax allocation on reported financial information and on the views of financial statement

preparers and carried out by James E. Wheeler of the University of Michigan has been completed, not yet published.

In August 1983, a Discussion Memorandum, "Analysis of Issues Related to Accounting for Income Taxes," was issued. Public hearings were held in April 1984 and three special meetings were held in May 1984 to obtain the views of preparers, users, and auditors associated with the financial statements of small companies.

At a meeting on June 12, 1984, the Board tentatively decided that comprehensive interperiod tax allocation should be required. The Board did not address interperiod tax allocation for special areas, such as those noted in APB Opinion No. 23, at that meeting. In December 1984, the Board tentatively decided in favor of the liability method of comprehensive tax allocation. In FASB Status Report No. 164, January 10, 1985, the following also was reported:

> The Board believes that accounting for the tax benefit of NOL and ITC carryforwards should be the same. The tax benefit should reduce net deferred tax liabilities that mature during the carryforward period, and the Board tentatively favors recognition of an asset for any remaining benefit if certain conditions are met. Whether the basic methods (deferral and flow-through) to account for investment tax credits should remain within the scope of this project was discussed, but no decision was reached [p. 3].

Progress on the income tax project also was reported in FASB Status Report No. 168 dated July 10, 1985. Tentative positions announced in that document were confirmed and extended in FASB Status Report No. 170, October 8, 1985, as follows:

> The Board has addressed all of the issues in the 1983 discussion memorandum except (a) accounting requirements for private or small public companies, (b) financial statement disclosures, and (c) transition provisions for adopting the new accounting standards for income taxes.
>
> The Board has decided that comprehensive interperiod tax allocation should be required. The Board has also decided to reject the notion of "indefinite reversal" as set forth in APB Opinion No. 23, "Accounting for Income Taxes — Special Areas."
>
> The Board favors a tax liability (or asset) approach to interperiod tax allocation. However, the Board decided to

exclude discounting from the income tax issues to be addressed at this time.

Deferred tax liabilities and assets should be adjusted to reflect any enacted changes in tax rates or laws that will be effective for the years in which deferred tax liabilities and assets mature. In addition, the Board tentatively favors measurement of deferred tax liabilities and assets (a) using tax rates expected to be applicable to the settlement of the deferred tax liabilities and (b) using feasible and prudent tax-planning alternatives.

Recognition requirements should be the same for (a) tax assets resulting from prepayment of taxes, (b) net operating loss (NOL) carryforwards, and (c) tax credit carryforwards. Those three types of future tax benefits should be recognized as a reduction of deferred tax liabilities that mature during the same future periods. In addition, tax assets should be recognized if they can be realized by an NOL carryback in a year for which taxes were paid. Otherwise, the three types of future tax benefits should be recognized in the year(s) that they reduce taxes payable on the tax return. When realized, the tax benefits ordinarily should be reported as a reduction of income tax expense attributable to continuing operations and should not be reported as extraordinary items.

The Board has decided against a discounted, net-of-tax approach to assigning amounts to the individual assets acquired and liabilities assumed when a business combination is accounted for as a purchase under APB Opinion No. 16, "Business Combinations." Instead, a deferred tax liability or asset should be recognized based on the same recognition requirements described above for other situations. Subsequent realization of tax benefits (NOL and tax credit carryforwards or an excess of tax basis over the net amount assigned to the net assets acquired) not recognized at the acquisition date should be applied to reduce goodwill. After goodwill is reduced to zero, additional benefits realized should be included in the determination of income.

Most of the present accounting requirement for income taxes in periods would remain unchanged. However, a

> tax asset should not be recognized for future tax benefits (for example, an NOL carryforward) that will not be realized in subsequent interim periods of the current year. Income taxes should continue to be allocated between income from continuing operations, items other than income from continuing operations (for example, extraordinary items), and stockholders' equity (for items of comprehensive income such as translation adjustments that are initially reported in stockholders' equity). However, income taxes should not be allocated to stockholders' equity for the tax effect of (a) stock compensation plans that create permanent differences betwen compensation expense for financial reporting and for taxes and (b) the tax deductibility of dividends paid to stockholders.
>
> The Board has tentatively decided that the issue of the basic method to account for investment and other tax credits should be removed from the scope of this project.

The Board's tentative decision to favor a tax liability (or asset) approach to interperiod tax allocation is a major theoretical shift in accounting policy, but it is consistent with positions stated in Statement of Financial Accounting Concepts No. 3:

> Both the liability and the net-of-tax method are compatible with the definitions [of elements] in this Statement. Only the deferred method that is prescribed by APB Opinion No. 11, *Accounting for Income Taxes,* does not fit the definitions [pars. 163-164].

The decision to exclude discounting from the income tax issues to be addressed at this time is theoretically inconsistent with the liability method, however, and must be viewed as expedient.

Likewise, the removal of the issue of the basic method to account for investment and other tax credits from the scope of the project appears inconsistent with the liability method and should be considered a political solution.

FOOTNOTES

[1]The liability method is inferred from Peloubet's dissent: ". . . the consistent application of the bulletin to reserves would be difficult and confusing, requiring the use of charges or credits net of tax, the amount of which was not known with any certainty."

[2]*Interperiod Allocation of Income Taxes,* A Study Sponsored by the Edison Electric Institute and the American Gas Association, New York: Coopers & Ly-

brand, 1983. and *Study Document on Accounting For Income Tax,* Sponsored by the American Gas Association and Edison Electric Institute, Chicago: Arthur Andersen & Co., 1983.

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