1958

Declining-balance depreciation (supersedes accounting research bulletin no. 44 issued in October 1954); Accounting Research Bulletin, no. 44 (revised)

American Institute of Certified Public Accountants. Committee on Accounting Procedure

Accounting Research BULLETINS

★

Issued by the
Committee on Accounting Procedure
American Institute of
Certified Public Accountants
270 Madison Avenue, New York 16, N. Y.

July, 1958

No. 44
(Revised)

Declining-balance Depreciation

(Supersedes Accounting Research Bulletin No. 44 issued in October 1954)

1. The declining-balance method of estimating periodic depreciation has a long history of use in England and in other countries including, to a limited extent, the United States. Interest in this method has been increased by its specific recognition for income-tax purposes in the Internal Revenue Code of 1954.

2. The declining-balance method is one of those which meets the requirements of being "systematic and rational."[1] In those cases where the expected productivity or revenue-earning power of the asset is relatively greater during the earlier years of its life, or where maintenance charges tend to increase during the later years, the declining-balance method may well provide the most satisfactory allocation of cost. The conclusions of this bulletin also apply to other methods, including the "sum-of-the-years-digits" method, which produce substantially similar results.

3. When a change to the declining-balance method is made for general accounting purposes, and depreciation is a significant factor in the determination of net income, the change in method, including the effect thereof, should be disclosed in the year in which the change is made.

4. There may be situations in which the declining-balance method is adopted for income-tax purposes but other appropriate methods are used for financial accounting purposes. In such cases, accounting rec-

[1] Accounting Terminology Bulletin No. 1, par. 56.

ognition should be given to deferred income taxes if the amounts thereof are material, except in those rare cases, such as are mentioned in paragraph 8, where there are special circumstances which may make such procedure inappropriate. The foregoing provision as to accounting recognition of deferred income taxes applies to a single asset, or to a group of assets which are expected to be retired from service at about the same time; in this case an excess of depreciation taken for income-tax purposes during the earlier years would be followed by the opposite condition in later years, and there would be a tax deferment for a definite period. It applies also to a group of assets consisting of numerous units which may be of differing lengths of life and which are expected to be continually replaced; in this case an excess of depreciation taken for income-tax purposes during the earlier years would be followed in later years by substantial equality between the annual depreciation for income-tax purposes and that for accounting purposes, and a tax deferment would be built up during the earlier years which would tend to remain relatively constant thereafter. It applies further to a gradually expanding plant; in this case an excess of depreciation taken for income-tax purposes may exist each year during the period of expansion in which event there would be a tax deferment which might increase as long as the period of expansion continued.

5. Where it may reasonably be presumed that the accumulative difference between taxable income and financial income will continue for a long or indefinite period, 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.

DISCUSSION

6. Following the passage of the Internal Revenue Act of 1954 in August of that year, permitting the use of declining-balance and similar accelerated depreciation methods for federal income-tax purposes, the committee anticipated that many companies would be considering whether such methods should be adopted for general accounting purposes. In October of that year, Accounting Research Bulletin No. 44 was issued in which the committee stated that such accelerated methods met the requirement of being "systematic and rational." The

committee also stated that when such methods were adopted for general accounting purposes, appropriate disclosure of the change should be made whenever depreciation was a significant factor in the determination of net income.

7. Since the issuance of Accounting Research Bulletin No. 44, the committee has been observing and studying cases involving the application of the bulletin. Studies of published reports and other source material have indicated that, where material amounts are involved, recognition of deferred income taxes in the general accounts is needed to obtain an equitable matching of costs and revenues and to avoid income distortion, even in those cases in which the payment of taxes is deferred for a relatively long period. This conclusion is borne out by the committee's studies which indicate that where accelerated depreciation methods are used for income-tax purposes only, most companies do give recognition to the resultant deferment of income taxes or, alternatively, recognize the loss of future deductibility for income-tax purposes of the cost of fixed assets by an appropriate credit to an accumulated amortization or depreciation account applicable to such assets.

8. 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.

9. In those rare situations in which accounting for deferred income taxes is not appropriate, full disclosure should be made of the amount of deferred income taxes arising out of the difference between the financial statements and the tax returns when the declining-balance method is adopted for income-tax purposes but other appropriate methods are used for financial accounting purposes.

10. The committee believes that, in applying the provisions of this bulletin to cases where there was no accounting recognition of deferred income taxes for the years since 1953, the entries made for periods

subsequent to the issuance of this bulletin should be based upon all assets acquired after 1953 as to which the declining-balance method has been elected for tax purposes. As is indicated in the "Notes" to each Accounting Research Bulletin, opinions of the committee are not intended to be retroactive unless they contain a statement of such intention. If a retroactive adjustment is made for prior periods, the adjustment may be made in a lump sum, or the deficiency may be systematically accumulated over a reasonable future period of time.

The statement entitled "Declining-balance Depreciation" (July 1958) was adopted unanimously by the twenty-one members of the committee, of whom five, Messrs. Burns, Graham, Halvorson, Jennings, and Powell, assented with qualification.

Mr. Burns objects to the exceptions mentioned in paragraph 4 and discussed in paragraphs 8 and 9. He believes that accounting principles apply equally to all companies operated for profit and that the exceptions referred to are wholly inconsistent with the basic principles stated in paragraph 4; further, that the last sentence of paragraph 8 is based upon an untenable concept, namely, that accounting resulting from the application of an accounting rule prescribed by a regulatory commission may properly be approved by public accountants notwithstanding the fact that the rule is clearly contrary to generally accepted accounting principles.

Mr. Graham objects to the exceptions mentioned in the second sentence of paragraph 4 and discussed in the last sentence of paragraph 8 and in paragraph 9. He believes that accepted accounting principles should be applied uniformly to all corporations, including regulated companies. He does not believe that rate-making rules which are in conflict with these accepted principles constitute a sound basis for sanctioning a departure from these principles in financial reporting. Furthermore, he disagrees with the validity of the assumption which, by implication, forms the basis for this exception; he does not believe that public utility rates will always be adjusted automatically to compensate fully, or even substantially, for increases in future income taxes; he believes that this assumption is not in accord with the known realities of rate regulation and is not, therefore, a proper basis for the anticipation of future revenues.

Mr. Halvorson dissents from the recommendations of paragraph 4 because he believes its requirements for accounting recognition of deferred income taxes should be limited to a requirement for compliance with the recommendations of chapter 10(b) of Accounting Research Bulletin No. 43; he believes that paragraph 4 is effectively a revision of chapter 10(b) and that it is improper thus to make a substantive change in the committee's existing recommendations for tax allocation in the guise of a revision of a bulletin on depreciation.

Messrs. Jennings and Powell dissent from the conclusion (expressed in paragraph 4 and implied in the related discussion) that where the declining-balance method is adopted for income-tax purposes but other appropriate methods are used for financial accounting purposes, there should be accounting recognition of deferred income taxes, except for certain rare cases. They believe this calls for more extensive allocation of income taxes among periods of time than is necessary or desirable, especially where the situation is such that the so-called tax deferment is in effect a permanent tax reduction. Further, they object to the use of a bulletin on depreciation incidentally as a vehicle for making an important change in the committee's views, as set forth in previous bulletins, on accounting for income taxes.

NOTES

(See Introduction to *Accounting Research Bulletin* No. 43.)

1. Accounting Research Bulletins represent the considered opinion of at least two-thirds of the members of the committee on accounting procedure, reached on a formal vote after examination of the subject matter by the committee, the technical services department, and the director of research. Except in cases in which formal adoption by the Institute membership has been asked and secured, the authority of the bulletins rests upon the general acceptability of opinions so reached.

2. Opinions of the committee are not intended to be retroactive unless they contain a statement of such intention. They should not be considered applicable to the accounting for transactions arising prior to the publication of the opinions. However, the committee does not wish to discourage the revision of past accounts in an individual case if the accountant thinks it desirable in the circumstances. Opinions of *the committee should be considered as applicable only to items which are material and significant in the relative circumstances.*

3. It is recognized also that any general rules may be subject to exception; it is felt, however, that the burden of justifying departure from accepted procedures must be assumed by those who adopt other treatment. Except where there is a specific statement of a different intent by the committee, its opinions and recommendations are directed primarily to business enterprises organized for profit.

COMMITTEE ON ACCOUNTING PROCEDURE (1957-58)

WILLIAM W. WERNTZ, Chairman	WILLIAM P. HUTCHISON	WELDON POWELL
NORTON M. BEDFORD	DONALD R. JENNINGS	SAMUEL L. READY
GARRETT T. BURNS	RALPH E. KENT	WALTER R. STAUB
KEITH W. DUNN	GEORGE W. LAFFERTY	WILLIAM J. von MINDEN
CARL M. ESENOFF	JOHN F. MACHA	EDWARD B. WILCOX
WILLARD J. GRAHAM	JOHN K. McCLARE	——
NEWMAN T. HALVORSON	HERBERT E. MILLER	CARMAN G. BLOUGH
CHARLES A. HOYLER	JOHN PEOPLES	Director of Research

American Institute of Certified Public Accountants

270 MADISON AVENUE, NEW YORK 16, N. Y.

April 15, 1959

TO THE MEMBERS OF THE AMERICAN INSTITUTE
OF CERTIFIED PUBLIC ACCOUNTANTS

GENTLEMEN:

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.

Three of the twenty-one members of the committee, Messrs. Jennings, Powell and Staub, dissented to the issuance at this time of any letter interpreting Accounting Research Bulletin No. 44 (revised).

COMMITTEE ON ACCOUNTING PROCEDURE

By WILLIAM W. WERNTZ, *Chairman*