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Accounting for Income Taxes

Timothy Robinson

ACCOUNTING FOR INCOME TAXES

by

Timothy J. Robinson

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INTRODUCTION

Some form of tax allocation has been required by generally accepted accounting principles (GAAP) since the early 1940's.[1] Both interperiod allocation (allocation of income tax expense between accounting periods) and intraperiod allocation (allocation of income tax expense between pretax income from continuing operations and other items) are required.

With the issuance of Statement of Financial Accounting Standards (SFAS) No. 96, Accounting for Income Taxes, on December 30, 1987, the Financial Accounting Standards Board (FASB) completed, or thought it completed, its five-year project on accounting for income taxes. SFAS No. 96 supersedes Accounting Principles Board (APB) Opinion No. 11, Accounting for Income Taxes, and amends or supersedes nearly all other accounting pronouncements related to income taxes.[2]

Only one year after the issuance of SFAS No. 96, the FASB issued SFAS No. 100, Accounting for Income Taxes -- Deferral of the Effective Date of FASB

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[1]Dennis R. Beresford, et al., Ernst & Whinney, FASB Research Report, Accounting for Income Taxes: A Review of Alternatives (Stamford, Conn.: FASB, 1983), pp. 135-6.

[2]FASB Statement No. 96, Accounting for Income Taxes (Stamford, Conn.: FASB, December 1987), par. 4.

Statement No. 96, which defers the effective date of SFAS No. 96 one year to fiscal years beginning after December 15, 1989.[3]

Due to its major changes to existing accounting principles, SFAS No. 96 will impact virtually all U.S. companies when (or if) it becomes effective.

This paper will study the old accounting principles for income tax allocation, the new requirements (SFAS No. 96), and examine some problems encountered by companies attempting to implement the new requirements.

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[3]FASB Statement No. 100, Accounting for Income Taxes -- Deferral of the Effective Date of FASB Statement No. 96 (Stamford, Conn.: FASB, December 1988), par. 3.

CHAPTER II

PRE-SFAS NO. 96 REQUIREMENTS

The question of whether or not to have income tax allocation is directly related to the question of what amount of income tax expense should be reported in the financial statements.

Income taxes payable for a period are generally calculated by applying a tax rate to taxable income and increasing or decreasing the result for tax surcharges or credits. Taxable income is equal to the excess of taxable revenues over deductible expenses. Each of the variables in determining the income tax payable--tax rate, taxable revenues, deductible expenses, tax surcharges or credits--is set by the government that assesses the tax. Income for financial reporting purposes, on the other hand, is determined by GAAP, which may or may not be the same as the rules established by the government for determining taxable income. Because of the differences in rules, income for financial reporting and taxable income are usually different.[1]

Should the amount of income tax expense to be reported in the financial statements be the amount of income taxes payable or some other amount? The Accounting Principles Board, in APB Opinion No. 11, specified that some other amount based on income for financial reporting purposes should be reported in the financial statements as income tax expense.

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[1]Beresford, et al., Ernst & Whinney, FASB Research Report, Accounting For Income Taxes: A Review of Alternatives, p. 19.

Summary of APB Opinion No. 11

A summary of the conclusions reached in APB Opinion No. 11 is 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. [Footnote reference omitted.]

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. [Footnote reference omitted.]

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 and a net noncurrent amount.[2]

Comprehensive Allocation and Timing Differences

As noted above, the APB concluded that income tax expense should include the tax effects[3] of revenue and expense transactions included in the determination of pretax income. This is known as comprehensive allocation.

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[2]APB Opinion No. 11, Accounting for Income Taxes (New York: AICPA, December 1967), par. 12.

[3]In paragraph 13.g of Opinion No. 11, the APB defined tax effects as "Differentials in income taxes of a period attributable to (1) revenue or expense transactions which enter into the determination of pretax accounting income in one period and into the determination of taxable income in another period, (2) deductions or credits that may be carried backward or forward for income tax purposes and (3) adjustments of prior periods (or of the opening balance of retained earnings) and direct entries to other stockholders' equity accounts which enter into the determination of taxable income in a period but which do not enter into the determination of pretax accounting income of that period."

The APB identified four types of transactions which give rise to what they define as "timing differences." Timing differences are the "differences between the periods in which the transactions affect taxable income and the periods in which they enter into the determination of pretax accounting income." Timing differences originate in one period and reverse in one or more subsequent periods.[4]

The four types of transactions giving rise to timing differences and an example of each are as follows:

1) Revenues or gains are included in taxable income later than they are included in pretax accounting income. For example, gross profits on installment sales are recognized for accounting purposes in the period of sale but are reported for tax purposes in the period the installments are collected.

2) Expenses or losses are deducted in determining taxable income later than they are deducted in determining pretax accounting income. For example, estimated costs of guarantees and of product warranty contracts are recognized for accounting purposes in the current period but are reported for tax purposes in the period paid or in which the liability becomes fixed.

3) Revenues or gains are included in taxable income earlier than they are included in pretax accounting income. For example, rents collected in advance are reported for tax purposes in the period in which they are received but are deferred for accounting purposes until later periods when they are earned.

4) Expenses or losses are deducted in determining taxable income earlier than they are deducted in determining pretax accounting income. For example, depreciation is reported on an accelerated basis for tax purposes but is reported on a straight-line basis for accounting purposes.[5]

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[4]APB Opinion No. 11, par. 15.

[5]Ibid.

Under comprehensive allocation, the tax effects of a timing difference must be recognized in the period in which the transaction first affects either pretax accounting income or taxable income (originates) and also must be recognized in the period in which the timing difference reverses. Included in income tax expense in the period in which the timing difference originates are all accruals, deferrals and estimates necessary to make the expense equal to what it would have been had the pretax income effect and the taxable income effect both occurred in the current period. Therefore, under comprehensive allocation, the tax effects of a transaction are recognized in the period in which the transaction occurs.[6]

Permanent Differences

A transaction which has an originating difference but is not followed by a reversing difference is referred to as a "permanent difference." Examples of permanent differences are interest earned on municipal obligations and premiums paid on officers' life insurance.[7] Income tax allocation is not used for permanent differences.[8]

Deferred Method of Income Tax Allocation

In addition to comprehensive allocation, APB Opinion No. 11 required companies to use the deferred method to measure the tax effects of timing differences.[9] Under the deferred method, the tax effects of current timing

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[6]R. D. Nair and Jerry J. Weygandt, "Let's Fix Deferred Taxes," Journal of Accountancy 151 (November 1981): 92.

[7]Donald J. Bevis and Raymond E. Perry, Accounting for Income Taxes--An Interpretation of APB Opinion No. 11 (New York: AICPA, 1969), p. 11.

[8]Nair and Weygandt, "Let's Fix Deferred Taxes," pp. 92.

[9]Ibid.

differences are deferred and allocated to income tax expense in the future periods when the timing differences reverse. "The deferred method emphasizes the tax effects of timing differences on income of the period in which the differences originate."[10]

The tax effect of a timing difference is calculated using the tax rates and laws in effect in the period in which the timing difference originates. The deferred taxes so computed are not adjusted for subsequent changes in tax laws or rates or to reflect the imposition of new taxes. The tax effects of any such changes are ultimately adjustments to income tax expense of the periods in which the timing difference reverses.[11]

The tax effect of a transaction which reduces taxes currently payable (or creates a refund of taxes because of a loss carryback) is treated as a deferred tax credit; the tax effect of a transaction which increases taxes currently payable (or reduces the amount of a refund of taxes because of a loss carryback) is treated as a deferred tax charge. A deferred tax credit or charge is amortized to income tax expense in future years as the original timing difference reverses and enters into the determination of pretax accounting income. Under the deferred method, these balance sheet amounts "do not represent receivables and payables in the usual sense."[12] Nair and Weygandt noted that

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[10]APB Opinion No. 11, par. 19.

[11]Beresford, et al., Ernst & Whinney, FASB Research Report, p. 54.

[12]Bevis and Perry, Interpretation, p.6.

". . . The deferred items are positive or negative tax savings and not economic resources or obligations. . . ."[13] while Drummond and Wigle took an interesting view of the balance sheet classification of deferred taxes:

> Originally, there was considerable controversy over whether deferred tax in the balance sheet represented a liability. Current practice carefully excludes deferred tax from the categories of both liabilities and shareholders' equity. Instead, the amount is described as a "deferred credit" (or, perhaps more aptly, as a dangling credit) and exiled to "no man's land."[14]

Perhaps it was this balance sheet classification more than anything else that spelled doom for the deferred method. In its conceptual framework project, the FAJB determined that the deferred method does not fit Concepts Statement No. 6's definitions.[15]

Under the deferred method, the deferred taxes relating to an originating timing difference are computed using a "with and without" calculation. The tax effect of the timing difference is equal to "the difference in income taxes payable that would result from (a) including the effect of the timing difference in the calculation of income taxes payable and (b) excluding the effect of the timing difference from such calculation."[16]

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[13]Nair and Weygandt, "Let's Fix Deferred Taxes," p. 92.

[14]Christina S. R. Drummond and Seymour L. Wigle, "Let's Stop Taking Comprehensive Tax Allocation for Granted," CA Magazine 114 (October 1981): 57.

[15]FASB Concepts Statement No. 6, Elements of Financial Statements (Stamford, Conn.: FASB, December 1985), par. 241.

[16]Bevis and Perry, Interpretation, p.7.

In computing the tax effects referred to above, the timing differences may be considered individually or similiar[17] timing differences may be grouped. If similar timing differences are grouped, the net change in deferred taxes for a period may be determined using either the "gross change method" or the "net change method."[18]

Under the gross change method, separate computations are made for each group for the tax effects on originating timing differences based on current tax rates using the with and without method. The amortization of deferred taxes on reversing timing differences is determined using the applicable tax rates reflected in the beginning-of-period account balances and some assumption about the order of reversal (for example, FIFO or average).[19]

Under the net change method, a separate computation is also performed for each group of similar timing differences. For each group, the originating and reversing differences occurring during a period are combined. The net change in the cumulative balance of the group of timing differences is then used to determine the current tax effect for the group. If the cumulative balance increases (current originating differences exceed current reversing differences)

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[17]Bevis and Perry define similar timing differences as "individual timing differences which arise from the same kinds of transactions." Examples given are the grouping together of all differences between accounting depreciation and tax depreciation as one group of similar differences and the grouping of all differences between accounting and taxable income arising from deferral for tax purposes of gross profit or installment sales as another group of similar differences. The Interpretation goes on to note that depreciation timing differences should not be grouped with installment sales timing differences. Bevis and Perry, Interpretation, p. 13.

[18]APB Opinion No. 11, par. 37.

[19]Beresford, et al., Ernst and Whinney, FASB Research Report, p. 68.

deferred taxes are provided at current rates using the with and without approach. If the cumulative balance decreases (current reversing differences exceed current originating differences) deferred taxes are amortized at current rates using the with and without approach. However, the total amount amortized cannot exceed the amount of deferred taxes for the group as of the beginning of the period.[20] See Figure 1 in Appendix A for an example of the computation of deferred taxes under the gross change and net change methods.

Bevis and Perry's Interpretation of Opinion No. 11 notes that for each kind of similar timing difference, any of the three methods discussed above may be used to compute the related deferred taxes. Once a method is chosen, it should be used consistently for the specific kind of similar differences. Should a company change its method of computation for a specific kind of similar difference, and if the effect of change was material, the company's auditor would be required to qualify his opinion regarding consistency.[21]

Operating Losses

An operating loss results for tax purposes when deductible expenses exceed taxable revenues. Current federal tax laws allow the operating losses of a period to be carried backward 3 years and carried forward 15 years to be applied as a reduction in computing the taxable income of the prior or future periods. As taxable income is reduced, taxes payable are also reduced resulting in a benefit to the entity.[22]

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[20]Ibid.

[21]Bevis and Perry, Interpretation, pp. 13-14.

[22]Beresford, et al., Ernst & Whinney, FASB Research Report, p. 95.

If the operating losses are carried backward, the benefit of the loss carryback is the receipt of a refund of prior taxes from the government.[23] This benefit is included in net income (loss) of the loss period since the benefit is measurable and realization is assured.[24]

Should a loss carryback occur at a time when net deferred tax credits exist, an adjustment of the deferred taxes may be necessary. The tax benefit of the loss carryback included in the income statement should be based on pre-tax accounting income rather than taxable income, in order to reflect the carryback tax benefit as if there were no timing differences. The difference between the benefit based on pretax income and the actual amount refundable should be added to or subtracted from the appropriate deferred tax account on the balance sheet.[25] For an example, see Figure 2 of Appendix A.

The tax benefit of a loss carryforward is treated differently than that of a loss carryback. This is because the realization of the tax benefit of a loss carryforward depends upon the existence of future taxable income. Therefore, the APB "concluded that the tax benefits of loss carryforwards should not be recognized until they are actually realized, except in unusual circumstances when realization is assured beyond any reasonable doubt at the time the loss carryforwards arise." Any tax benefits recognized when realized in future periods are to be reported as extraordinary items.[26]

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[23]Ibid.

[24]APB Opinion No. 11, par. 44.

[25]Bevis and Perry, Interpretation, p. 21.

[26]APB Opinion No. 11, par. 45.

In order for the realization of the future tax benefit to be assured beyond any reasonable doubt, both of the following conditions must exist:

> (a) the loss results from an identifiable, isolated and nonrecurring cause and the company either has been continuously profitable over a long period or has suffered occasional losses which were more than offset by taxable income in subsequent years, and
>
> (b) future taxable income is virtually certain to be large enough to offset the loss carryforward and will occur soon enough to provide realization during the carryforward period [emphasis omitted.][27]

Bevis and Perry offer two examples of the kinds of situations giving rise to loss carryforwards that may qualify for recognition during the loss period:

1. Losses resulting from the expropiration of a foreign subsidiary, or from the abandonment of one of several operations where the continuing operations are and have been profitable and are virtually certain to be profitable enough of offset the loss carryforwards, and

2. Losses of one or more subsidiaries of a profitable parent company where the carryforward will be made available as an offset against other taxable income by filing a consolidated tax return, or by claiming a bad debt deduction, or by some other means. On the other hand, it would not be appropriate to record a loss carryforward of a subsidiary company even though the parent and other subsidiaries are profitable if there are no specific plans to obtain the tax benefit from the loss.[28]

Should both conditions exist whereby the realization of the tax benefit of a loss carryforward is assured beyond a reasonable doubt, the benefit should be recorded as an asset and included in the determination of net income (loss) for

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[27]Ibid, par. 47.

[28]Bevis and Perry, Interpretation, pp. 24-25.

the loss period.[29] The benefit should be calculated using the rates expected to be in effect at the time of realization.[30] The related asset should be classified as current or noncurrent depending upon the period(s) in which the benefit is expected to be realized.[31]

As with loss carrybacks, should a loss carryforward occur at a time when net deferred tax credits exist, the deferred taxes may need to be adjusted. APB Opinion No. 11 provides that, in such situations:

> . . . net deferred tax credits should be eliminated to the extent of the lower of (a) the tax effect of the loss carryforward, or (b) the amortization of the net deferred tax credits that would otherwise have occurred during the carryforward period.[32]

As the loss carryforward is realized in a later period(s), the deferred taxes which were eliminated should be reinstated on a cumulative basis at the then current tax rates. The factor limiting the amount of deferred taxes that may be eliminated is indicated in clause (b) above.[33] See Figure 3 in Appendix A for an example of the computations.

For classification purposes, "if both current and non-current deferred tax credits exist when the future benefit of a loss carryforward is recognized as an offset, such benefit should be allocated between current and non-current deferred tax credits on a proportional basis."[34]

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[29]APB Opinion No. 11, par. 46.

[30]Ibid.

[31]Bevis and Perry, Interpretation, p. 25.

[32]APB Opinion No. 11, par. 48.

[33]Bevis and Perry, Interpretation, p. 25.

[34]Ibid, p. 26.

Tax Allocation Within a Period

APB Opinion No. 11 also requires tax allocation within a period or intra-period tax allocation. The tax expense for a period must be allocated among income before extraordinary items, extraordinary items, prior period adjustments (or of the opening balance of retained earnings) and direct entries to other shareholders' equity accounts. The tax expense related to income before extraordinary items is computed on pretax accounting income excluding those items not included in income before extraordinary items.[35] The difference between this amount and total tax expense is then allocated to the other items.[36]

If there is more than one other item included in extraordinary items, prior period adjustments and direct entries to shareholders' equity accounts, the total tax to be allocated to the other items is allocated among the individual items. The tax effect for each of the other items is calculated using the with and without method. The amount of tax allocable to the other items is then allocated to the individual items based on the proportion that the tax effect of each item bears to the total tax effects.[37]

"If an operating loss exists before extraordinary items, the tax consequences of such loss should be associated with the loss."[38]

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[35]APB Opinion No. 11, par. 52.

[36]Bevis and Perry, Interpretation, p. 34.

[37]Ibid, pp. 34-35.

[38]APB Opinion No. 11, par. 52.

Financial Statement Presentation--Income Statement

APB Opinion No. 11 requires the disclosure of the components of income tax expense including taxes payable, the tax effects of timing differences and the tax effects of operating losses. This disclosure may be made on the face of the income statement or in the notes to the financial statements.[39]

Also required is the disclosure of the "reasons for significant variations in the customary relationships between income tax expense and pretax accounting income, if they are not otherwise apparent from the financial statements or from the nature of the entity's business."[40] For example, if the statutory tax rate is 34 percent, and income tax expense for the period is 30 percent of pretax income, the reasons for the difference should be disclosed if they are not otherwise apparent.[41]

APB Opinion No. 11 also "recommends that the nature of significant differences between pretax accounting income and taxable income be disclosed."[42] In other words, "companies are advised to disclose, in addition to permanent differences, the nature of timing differences that underlie the deferred component of total income tax expense."[43]

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[39]Ibid, par. 60

[40]Ibid, par. 63.

[41]Beresford, et al., Ernst & Whinney, FASB Research Report, p. 124.

[42]APB Opinion No. 11, par. 63.

[43]Beresford, et al., Ernst & Whinney, FASB Research Report, p. 125.

Financial Statement Presentation--Balance Sheet

APB Opinion No. 11 specifies that deferred tax charges and deferred tax credits should be combined. The amounts to be presented in the balance sheet are the net current and the net noncurrent amounts.[44]

The classification of deferred taxes among current and noncurrent is determined based on criteria established by FASB Statement No. 37, Balance Sheet Classification of Deferred Income Taxes, which amended APB Opinion No. 11. SFAS No. 37 requires that deferred taxes be classified as current or noncurrent depending upon the classification of the asset or liability to which the deferred taxes relate. If a deferred tax charge or credit is not related to an asset or liability, it should be classified based on the period in which it is expected to reverse.[45]

Beresford, et al., summarize the provisions of SFAS No. 37 as follows:

> . . . a deferred tax charge or credit is related to an asset or liability if reduction of the asset or liability causes the underlying timing difference to reverse. For example, deferred taxes resulting from gross profit deferral on an installment sale are related to the asset (the account receivable) because reduction (for example, collection) of it would cause the timing difference to reverse.

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[44]Ibid, p. 121.

[45]Ibid, p. 121.

A deferred tax charge or credit is not related to an asset or liability if there is not an associated asset or liability, or if reduction of an associated asset or liability would not cause the underlying timing difference to reverse. Assume, for example, that a company uses the completed-contract method for tax purposes and the percentage-of-completion method for financial reporting purposes. Thus, for financial reporting purposes, the company recognizes income before it is taxed, and deferred tax credits accumulate until contracts are completed. There are no assets or liabilities associated with the contracts that, if they were reduced, would cause the income to be taxed and the timing difference to reverse. The deferred tax credits are not related to assets or liabilities, and they should be classified based on the estimated completion date of the contract.[46]

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[46]Ibid, pp. 121-2.

CHAPTER III

SFAS NO. 96 REQUIREMENTS

As noted in Chapter I, Statement of Financial Accounting Standards (SFAS) No. 96, Accounting for Income Taxes, which was issued in December 1987, superseded nearly all other accounting pronouncements related to income taxes.

While the accounting for income taxes prescribed by APB Opinion No. 11 focused on matching the income tax expense for a period with pretax accounting income (deferred method), SFAS No. 96 requires a balance sheet approach (the liability method). Under this balance sheet approach, the focus is "on those assets and liabilities that have a tax basis different from their recorded value for financial reporting."[1] Figure 4 in Appendix B summarizes the major differences between the new requirements of SFAS No. 96 and the old requirements.

Objective of Accounting for Income Taxes

Per SFAS No. 96, "the objective of accounting for income taxes is to recognize the amount of current and deferred taxes payable or refundable at the date of the financial statements (a) as a result of all events that have been

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[1]James T. Parks, "A Guide to FASB's Overhaul of Income Tax Accounting," Journal of Accountancy 165 (April 1988): 25.

recognized in the financial statements and (b) as measured by the provisions of enacted tax laws."[2] Parks summarizes the above as "...the goal [of accounting for income taxes] is to reflect in the balance sheet the appropriate assets or liabilities related to the future settlement of income tax obligations."[3]

Basic Principles of Accounting for Income Taxes

In order to implement the objective of accounting for income taxes discussed above, the following basic principles must be applied at the date of the financial statements:

a. A current or deferred tax liability or asset is recognized for the current or deferred tax consequences of all events that have been recognized in the financial statements; (italics omitted)

b. The current or deferred tax consequences of an event are measured based on provisions of the enacted tax law to determine the amount of taxes payable or refundable currently or in future years; and

c. The tax consequences of earning income or incurring losses or expense in future years or the future enactment of a change in tax laws are not anticipated for purposes of recognition and measurement of a deferred tax liability or asset.[4]

Stated another way, the basic principles of accounting for income taxes under SFAS No. 96 are: (a) the liability method is used with comprehensive allocation; (b) the tax laws which have been passed by government(s) are used to compute deferred tax liabilities or assets; and (c) the enterprise cannot assume any future change in tax laws nor that it will have any income or loss in the future.

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[2]FASB Statement No. 96, Accounting for Income Taxes, par. 7.

[3]Parks, "A Guide to FASB's Overhaul of Income Tax Accounting," p. 25.

[4]FASB Statement No. 96, par. 7.

The only exceptions in applying the basic principles are the SFAS No. 96:

> . . . (a) does not amend the requirements for recognition of deferred taxes for the areas addressed by APB Opinion No. 23, Accounting for Income Taxes--Special Areas, (b) does not address recognition of deferred taxes for deposits in statutory reserve funds by U.S. steamship enterprises, (c) does not amend accounting for leveraged leases as required by FASB Statement No. 13, Accounting for Leases, and FASB Interpretation No. 21, Accounting for Leases in a Business Combination, and (d) prohibits recognition of a deferred tax liability or asset related to goodwill . . . [5]

Temporary Differences

As discussed in Chapter II, income tax accounting under APB Opinion No. 11 focused on the income statement. In order to match tax expense with pretax income, deferred taxes were computed on "timing differences" which are the differences between the periods in which transactions affect taxable income and the periods in which they are included in pretax accounting income.

As noted above, accounting for income taxes under SFAS No. 96 focuses on the balance sheet. Therefore, SFAS No. 96 recognizes that not only are there differences between the amount of taxable income and the amount of pretax financial income for a period but that these differences, as well as other events, cause differences between the tax bases of assets or liabilities and their reported amounts in financial statements.[6] SFAS No. 96 uses the term "temporary differences" to describe all such book/tax differences.[7]

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[5]Ibid, par. 8.

[6]Ibid, par. 9.

[7]Arthur Andersen & Co., Basic Concepts of SFAS No. 96 "Accounting for Income Taxes" (n.p.: Arthur Andersen & Co., February 1989), p. 32.

Perhaps the key factor in accounting for income taxes under SFAS No. 96 is the following:

> An assumption inherent in an enterprise's statement of financial position prepared in accordance with generally accepted accounting principles is that the reported amounts of assets and liabilities will be recovered and settled, respectively.[6] Because of that assumption, a difference between the tax basis of an asset or a liability and its reported amount in the statement of financial position will result in taxable or deductible amounts in some future year without regard to other future events. . . .
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> [6] . . . That concept and its application have a significant effect on the accounting for the tax consequences of an event.[8]

An example of this situation offered by Arthur Andersen & Co. "is that a company that has deferred income or accelerated deductions for tax purposes need not make one more dollar of profit in the future in order to generate taxable income. Even if in the future the company only breaks even on its financial statements, it will still have to pay taxes because of the income it previously deferred or the deductions it previously accelerated for tax purposes."[9] The FASB concluded that because of the above assumption the future taxes related to temporary differences should be recorded as a liability under accrual accounting.[10]

Examples of temporary differences are as follows:

a. Revenues or gains that are taxable after they are recognized in financial income. An asset (for example, a receivable from an installment sale) may be recognized for revenues or gains that will result in future taxable amounts when the asset is recovered.

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[8]FASB Statement No. 96, par. 10.

[9]Arthur Andersen & Co., Basic Concepts of SFAS No. 96, p.3.

[10]Ibid and FASB Statement No. 96, par. 79.

b. Expenses or losses that are deductible after they are recognized in financial income. A liability (for example, a product warranty liability) may be recognized for expenses or losses that will result in future tax deductible amounts when the liability is settled.

c. Revenues or gains that are taxable before they are recognized in financial income. A liability (for example, subscriptions received in advance) may be recognized for the advance payment for goods or services to be provided in future years. For tax purposes, the advance payment is included in taxable income upon the receipt of cash. Future sacrifices to provide goods or services (or future refunds to those who cancel their orders) will result in future tax deductible amounts when the liability is settled.

d. Expenses or losses that are deductible before they are recognized in financial income. The cost of an asset (for example, depreciable personal property) may have been deducted for tax purposes faster than it was depreciated for financial reporting. Amounts received upon future recovery of the amount of the asset for financial reporting will exceed the remaining tax basis of the asset, and the excess will be taxable when the asset is recovered.

e. A reduction in the tax basis of depreciable assets because of tax credits.[7] Amounts received upon further recovery of the amount for financial reporting will exceed the remaining tax basis of the asset, and the excess will be taxable when the asset is recovered.

f. ITC accounted for by the deferred method. Under Opinion 2, ITC is viewed and accounted for as a reduction of the cost of the related asset (even though, for financial statement presentation, deferred ITC may be reported as deferred income.) Amounts received upon further recovery of the reduced cost of the asset for financial reporting will be less than the tax basis of the asset, and the difference will be tax deductible when the asset is recovered.

g. Foreign operations for which the reporting currency is the functional currency. Under FASB Statement No. 52, Foreign Currency Translation, certain assets and liabilities are remeasured from the foreign currency into U.S. dollars using historical exchange rates when the reporting currency is the functional currency. After a change in exchange rates, there will be a difference between the foreign tax basis and the foreign currency equivalent of the U.S. dollar historical cost of those assets and liabilities. That difference will be taxable or deductible for foreign tax purposes when the reported amounts of the assets and liabilities are recovered and settled, respectively.

h. An increase in the tax basis of assets because of indexing for inflation. The tax law for a particular tax jurisdiction might require adjustment of the tax basis of a depreciable (or other) asset for the effects of inflation. The inflation-adjusted tax basis of the asset would be used to compute future tax deductions for depreciation or to compute gain or loss on sale of the asset. Amounts received upon further recovery of the asset for financial reporting will be less than the remaining tax basis of the asset, and the difference will be tax deductible when the asset is recovered.

i. Business combinations accounted for by the purchase method. There may be differences between the assigned values and the tax bases of the assets and liabilities recognized in a business combination for a purchase under APB Opinion No 16, Business Combinations. Those differences will result in taxable or deductible amounts when the reported amounts of the assets and liabilities are recovered and settled, respectively.

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[7]The Tax Equity and Fiscal Responsibility Act of 1982 provides taxpayers with the choice of either (a) taking the full amount of Accelerated Cost Recovery System (ACRS) deductions and a reduced tax credit (that is, investment tax credit and certain other tax credits) or (b) taking the full tax credit and a reduced amount of ACRS deductions. (Italics omitted)[11]

There are some temporary differences that cannot be identified with a particular asset or liability for financial reporting. An example of such a case is a long-term contract that is accounted for by the percentage-of-completion method for financial reporting and, for tax purposes, by the completed contract method. Although no related, identifiable asset or liability exists for financial reporting, there is a temporary difference that results from an event that has been recognized in the financial statements and that temporary difference will result in taxable or deductible amounts in future years.[12] Therefore, to identify temporary differences, it is important to look at both book and tax balance sheets.[13]

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[11]FASB Statement No. 96, par. 10.

[12]Ibid, par. 12.

[13] Arthur Andersen & Co., Basic Concepts of SFAS No. 96, p. 36.

Calculating Deferred Tax Assets and Liabilities

Once the temporary differences have been identified, the following steps are used to calculate deferred taxes under SFAS No. 96:

1. Estimate [schedule] the individual future years in which the current period's temporary differences will result in net taxable or deductible amounts. Do this year by year.

2. Carry back or carry forward--in accordance with current tax regulations--net deductible amounts occurring in individual years to offset net taxable amounts scheduled to occur in prior or subsequent years. (No assets are recognized for any net remaining amount of operating loss carryforward.)

3. To calculate net deferred tax liabilities

   ° Calculate the amount of tax for the net taxable amounts scheduled to occur in each year. The calculations should use the statutory rates for each year and give effect to special capital gains rates, the alternative minimum tax and other provisions in the law that effect the tax calculation.

   ° Recognize deferred tax liabilities for the aggregate amount of taxes payable in each future year.

4. Recognize net deferred tax assets only when future net deductible amounts can be realized by loss carryback to reduce taxes paid in the current year or a prior year. No assets are recognized for any additional net deductible amounts in future years.[14]

In addition, "tax-planning strategies" must be used to the extent that they would decrease the amount of deferred tax liabilities or increase the amount of deferred tax assets otherwise computed by the steps above.[15]

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[14]Parks, "A Guide to FASB's Overhaul of Income Tax Accounting," p. 30.

[15]FASB Statement No. 96, par. 19.

Scheduling

In theory, SFAS No. 96 requires that the deferred tax liabilities and assets be determined as if a tax return were prepared for each of the future years.[16] Therefore, the first step in calculating the deferred taxes is to schedule the years in which the temporary differences are expected to reverse or result in net taxable or deductible amounts. The reversal pattern of temporary differences could be based on a number of factors including (1) tax law requirements that stipulate the timing of recognition in the tax return, (2) historical experience for normal, recurring temporary differences, and (3) management's judgement.[17] Scheduling is required to the extent it is needed to: (a) determine the proper amount of the current portion of deferred taxes in a classified balance sheet, (b) determine the amount of deferred tax assets which may be recognized based on offsetting, (c) determine the amounts and expiration dates of book operating loss and tax credit carryforwards for financial statement disclosures, and (d) facilitate the appropriate consideration of alternative tax systems, tax laws and rates that differ for carryforward and carryback periods and limitations on tax losses and credits.[18] (See Figure 5 in Appendix C.)

Carry Back or Carry Forward Net Deductible Amounts

Once the temporary differences have been scheduled any net deductible amounts in individual years must be carried back or carried forward, in

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[16]Ibid, par. 17.

[17]Arthur Andersen & Co., Basic Concepts of SFAS No. 96, p. 6.

[18]E. Raymond Simpson et al., A Guide to Implementation of Statement 96 on Accounting for Income Taxes: Questions and Answers, FASB Special Report (Norwalk, Conn.: FASB, 1989), p.1 and Arthur Andersen & Co., Basic Concepts of SFAS No. 96, p. 6.

accordance with current tax regulations, to offset net taxable amounts in other years. (See Figure 6 in Appendix C.)

Calculate Net Deferred Tax Liabilities

After the net deductible amounts have been carried back or carried forward, deferred taxes for the net taxable amounts scheduled to occur in each year are calculated. The calculations must take into consideration all applicable aspects of the tax law including credits, alternative tax systems, limitations, graduated tax rates, and any aspects of the tax law that have been enacted but have a delayed effect.[19] (See Figure 7 in Appendix C.)

The FASB considered whether these deferred tax liabilities meet the definition of a liability per FASB Concepts Statement No. 6 (SFAC No. 6), Elements of Financial Statements.[20] Paragraph 36 of SFAC No. 6 states that:

> A liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened. . . .[21]

The FASB concluded that the first characteristic was met because "[t]emporary differences will become taxable amounts in future years as a result of events whose occurrence is already inherently assumed in an

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[19]Arthur Andersen & Co., Basic Concepts of SFAS No. 96, p. 8.

[20]FASB Statement No. 96, par. 83.

[21]FASB Concepts Statement No. 6, Elements of Financial Statements, par. 39.

enterprise's statement of financial position for the current year, namely, recovery or settlement of the recognized and reported amounts of an enterprise's assets or liabilities." The government will then levy taxes on these taxable amounts.[22]

Because of the assumption that temporary differences will become taxable amounts and that the government will then levy taxes on these taxable amounts, the FASB "concluded that the only question is when, not whether, the tax obligation will be settled, and therefore, the second characteristic of a liability is met."[23]

The third characteristic of a liability requires that the transaction or obligating event has already happened. In the view of the FASB, the events that create temporary differences also give rise to deferred tax obligations. The FASB then "concluded that tax obligations are incurred when temporary differences originate and that tax obligations are settled when temporary differences result in taxable amounts in future years."[24]

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[22]FASB Statement No. 96, par. 85.

[23]Ibid, par. 88.

[24]Ibid, par. 89. Although not specified in this paragraph of SFAS No. 96, the critical factor again is the inherent assumption that an enterprise's assets will be recovered and its liabilities settled. Without this assumption, Rosenfeld and Dent concluded that the third characteristic of a liability was not met. In their example of a sale recognized immediately for book purposes and under the installment method for tax purposes, they reasoned that "...the obligation for future income taxes nevertheless would be a result of [the future receipts of the installments], in conjunction with a past event [the sale], and the third criterion wouldn't be met."

Recognize Net Deferred Tax Assets

A significant change in accounting for income taxes under SFAS No. 96 is the limitation of the circumstances when deferred tax assets can be recognized.[25] Deferred tax assets are only recognized when the deferred tax consequences of future deductible amounts can be realized (based on loss carryback provisions in the tax law) by refund of taxes paid in the current or a prior year. Any additional amounts of future net deductible amounts are treated like operating loss carryforwards. Deferred tax assets are not recognized for such additional amounts.[26] (See Figure 8 in Appendix C.)

In FASB No. 96, the Board notes that the above requirements are sometimes "described as asymmetrical." A deferred tax liability is always recognized for temporary differences that result in net taxable amounts but a tax benefit is only recognized for temporary differences that result in net deductible amounts that reduce taxes otherwise paid or payable. In the words of the FASB, the reasoning behind this treatment is as follows:

> That asymmetry, however, is an accurate reflection of U.S. tax law. The U.S. tax law is not evenhanded. Net taxable amounts always result in current tax payments. Deductible amounts, on the other hand, only result in a current tax benefit if they offset taxable amounts, either in the same year or in a prior year that is subject to a claim for carryback refund. Under the U.S. tax law, deductible amounts that do not reduce taxes otherwise paid or payable are a net operating loss carryforward. Prior to earning taxable income, the current tax benefit of a net operating loss carryforward, as determined by the tax law, is zero. The results . . . [of applying

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[25]Parks, "A Guide to FASB's Overhaul of Income Tax Accounting," p. 25.

[26]FASB Statement No. 96, par. 39.

SFAS No. 96] are symmetrical with the tax law--they are representationally faithful,[27] a quality called for in FASB Concepts Statement No. 2, Qualitative Characteristics of Accounting Information.[28]

Operating Losses

Accounting for the tax benefit of an operating loss carryback under FASB Statement No. 96 is similar to that required by APB Opinion No. 11. An asset is recognized for the amount of prior year(s) taxes that are refundable by carryback of the current year's operating loss.[29]

An operating loss carryforward "is recognized as a reduction of a deferred tax liability for temporary differences that will result in taxable amounts during the operating loss . . . carryforward period. Carryforward amounts from prior years are available . . . to reduce a deferred tax liability for temporary differences that arise in the current year." Statutory limitations on the utilization of an operating loss must be taken into account in determining the amount by which a deferred liability is reduced.[30] (See Figure 9 in Appendix C.)

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[27]Per SFAC No. 2, "Representational faithfulness is correspondence or agreement between a measure or description and the phenomenon it purports to represent. In accounting, the phenomena to be represented are economic resources and obligations and the transactions and events that change those resources and obligations. (Footnote reference omitted.)" FASB Concepts Statement No. 2, Qualitative Characteristics of Accounting Information (Stamford, Conn.: FASB, May 1980), par. 63.

[28]FASB Statement No. 96, par. 110.

[29]FASB Statement No. 96, par. 49. Paragraphs 49-51 of this section of SFAS No. 96 specify that tax benefits of unused tax credit carrybacks and carryforwards are to be treated the same as those of operating losses.

[30]Ibid, par. 50.

Tax-Planning Strategies

A new concept introduced by SFAS No. 96 is the use of "tax-planning strategies." Tax-planning strategies "change the particular future years in which temporary differences result in taxable or deductible amounts [and] either reduce the amount of taxes payable for net taxable amounts in future years or increase the amount of tax benefits for net deductible amounts in future years." To be used, a tax-planning strategy must meet both of the following criteria:

a. It must be a prudent and feasible strategy over which management has discretion and control. Management must have both the ability and the intent to implement the strategy, if necessary, to reduce taxes.

b. It cannot involve significant cost to the enterprise, that is, significant expenses to implement that underlying transaction or significant losses as a result of changing the particular future years in which an asset is recovered or a liability is settled. The tax benefit derived from the strategy shall not be viewed as a reduction of the cost of the strategy for the purpose of determining whether that strategy gives rise to significant cost.[31]

Tax planning strategies generally alter only the year in which the temporary differences will result in future taxable or deductible amounts. Strategies cannot create new income or expense nor can they anticipate any book income or losses in future years. Typical uses of tax-planning strategies might be to accelerate income for tax in order to offset net deductible amounts of an operating loss carryforward or to accelerate deductions for tax to offset net taxable amounts for years to which an operating loss may be carried back.[32]

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[31]Ibid, par. 19.

[32]Arthur Andersen & Co., Basic Concepts of SFAS No. 96, pp. 51-3.

Some examples of possible tax-planning strategies include:

- Sale/leaseback of plant at book value to accelerate income for tax.
- Disposal of obsolete inventory at book value to accelerate deduction for tax.
- Sale of loans at book value to accelerate deduction for allowance for bad debts for tax.
- Pre-funding of long-term pension obligations to accelerate deductions for tax.
- Sale of installment sale receivables to accelerate income for tax.

These strategies accelerate or delay the recognition of existing temporary differences but do not anticipate any future book gains or losses.[33]

Figure 10 in Appendix C illustrates how a tax-planning strategy is incorporated into the computation of a deferred tax liability. The example demonstrate how a tax-planning strategy can significantly reduce a deferred tax liability.[34]

Changes in Tax Laws or Rates

Because SFAS No. 96 specifies that the liability method of accounting for income taxes be used, deferred taxes must be adjusted for the effect of a change in tax law or rates. The effect of the change is included in income from continuing operations for the period that includes the enactment date.[35]

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[33]Ibid, p. 53.

[34]Ibid, p. 54.

[35]FASB Statement No. 96, par. 20.

Financial Statement Presentation and Disclosure

As was required under APB Opinion No. 11, SFAS No. 96 requires companies with a classified balance sheet to segregate their deferred tax liabilities or assets into current and noncurrent amounts. However, the current or noncurrent classification is now based on when the temporary differences are expected to reverse--not upon the balance sheet classification of the underlying assets or liabilities giving rise to the temporary differences as was the case under APB Opinion No. 11. Therefore, a company might disclose separately as current the portion of its deferred taxes reversing within the next year even though the underlying assets or liabilities are classified as noncurrent (for example, depreciable fixed assets).[36]

SFAS No. 96 specifies that the following information be disclosed when deferred taxes are not recognized for any of the APB Opinion No. 23 items or for deposits in statutory reserve funds by U.S. steamship enterprises:

a. A description of the types of temporary differences for which a deferred tax liability has not been recognized and the types of events that would cause those temporary differences to become taxable

b. The cumulative amount of each type of temporary difference

c. The amount of the unrecognized deferred tax liability for any unremitted earnings if determination of that liability is practicable or a statement that determination is not practicable and the amount of withholding taxes that would be payable upon remittance of those earnings

d. The amount of the unrecognized deferred tax liability for temporary differences other than unremitted earnings (that is, the bad debt reserve of stock or mutual savings and loan association or a mutual savings bank, the policyholders' surplus of a life insurance enterprise, and the statutory reserve funds of a U.S. steamship enterprise).[37]

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[36]Parks, "A Guide to FASB's Overhaul of Income Tax Accounting," p. 30.

[37]FASB Statement No. 96, par. 25.

SFAS No. 96 requires that income tax expense be allocated to continuing operations, discontinued operations, extraordinary items, cumulative effect of an accounting change, prior period adjustments, capital transactions and comprehensive income excluded from net income (e.g., translation adjustments).[38] The amount allocated to each item must be disclosed for each year for which those items are presented.[39]

The amount of income tax expense allocated to continuing operations should be determined exclusive of any other category of items (e.g., extraordinary items). For the other categories of items, income taxes are allocated to a category of items based on the incremental effect that that category has on income tax expense. The amount of taxes allocated to other categories of items is the difference between total income tax expense or benefit and the amount allocable to continuing operations.[40]

When allocating to two or more categories of items other than continuing operations, the sum of the individual incremental tax effects for each category of items may not equal the total incremental effect. This might happen when, for example, there is a statutory limitation on the use of a tax credit. In this situation, the incremental tax effect should be allocated to categories other than continuing operations as follows:

a. Determine the incremental tax benefit of the total net loss for all net loss categories

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[38]Arthur Andersen & Co., Basic Concepts of SFAS No. 96, p. 14.

[39]FASB Statement No. 96, par. 26.

[40]Arthur Andersen & Co., Basic Concepts of SFAS No. 96, p. 14.

b. Apportion that incremental tax benefit ratably to each net loss category

c. Apportion ratably to each net gain category the difference between (1) the incremental tax effect of all categories other than continuing operations and (2) the incremental tax benefit of the total net loss for all net loss categories.[41]

See Figure 11 in Appendix C for an example of the process.

Disclosure is required for the following significant components of income tax expense attributable to continuing operations:

a. Current expense or benefit (equal to taxes payable or refundable per the company's tax return).

b. Deferred expense or benefit (exclusive of adjustment due to enacted changes in tax law or change in the tax status of the company).

c. Investment tax credit and other credits.

d. Recognized benefits of operating loss carryforwards.

e. Effect of change in tax law.

f. Effect of change in tax status.[42]

The current-period recognition of a benefit from an operating loss carryforward from a previous year is no longer always reported as an extraordinary item. "Under [SFAS No. 96], the benefit is generally reported in the same way as the current income that allows the loss carryforward to be used."

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[41]FASB Statement No. 96, par. 74.

[42]Ibid, par. 27.

For example, if an operating loss carryforward is used to reduce current-year earnings from continuing operations, the benefit of the loss carryforward would be recognized as an adjustment of the current year's tax provision for continuing operations.[43]

Similar to previous requirements of the Securities and Exchange Commission, SFAS No. 96 now requires all companies to disclose the reconciliation of reported income tax expense attributable to continuing operations to the amount of income tax expense that would have resulted from applying domestic federal statutory tax rates to pretax income from continuing operations. Public companies must disclose the amount and nature of the reconciling items while non-public enterprises may omit a numerical reconciliation and discuss only the nature of the items.[44]

Other disclosures required by SFAS No. 96 include (1) the amounts and expiration dates of operating loss and tax credit carryforwards for both financial reporting and tax purposes, and (2) a description of the types of temporary differences that give rise to the deferred tax liability (or asset) on the balance sheet.[45]

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[43]Parks, "A Guide to FASB's Overhaul of Income Tax Accounting," p. 30.

[44]Arthur Andersen & Co., Basic Concepts of SFAS No. 96, p. 15.

[45]SFAS No. 96, pars. 24 and 29.

CHAPTER IV

IMPLEMENTATION PROBLEMS

As was noted in Chapter I, only one year after the issuance of SFAS No. 96, the FASB issued SFAS No. 100 which defers the effective date of SFAS No. 96 for one year to fiscal years beginning after December 15, 1989. The primary reasons for the deferral of the effective date were that

> . . . preparers of financial statements as well as auditors expressed concern about the degree of complexity involved in applying the provisions of Statement 96. They also expressed concern about having insufficient time to study and understand the forthcoming guidance on implementation issues before the required application of Statement 96 in the first quarter of fiscal years beginning after December 15, 1988. Implementing the Tax Reform Act of 1986 aggravated the difficulties of applying Statement 96 and concerns were expressed about the time needed to obtain necessary data for foreign operations.[1]

More recently, the FASB has talked about deferring the effective date yet again.[2]

This chapter will look at some of the new requirements of accounting for deferred taxes which this author believes will be the most difficult for companies trying to implement SFAS No. 96.

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[1]FASB Statement No. 100, par. 6.

[2]Lee Berton, "FASB to Delay Its Complex Rule on Deferred Taxes," Wall Street Journal, 13 July 1989, p. A6.

Scheduling

Fischer suggests that "Perhaps the single most onerous aspect of applying FASB Statement No. 96 is scheduling, by year, all temporary differences."[3]

The amount of scheduling needed to compute deferred taxes will vary from company to company. In its guide to implementing SFAS No. 96, the FASB states:

> The need for scheduling is dependent on the facts of each situation and the requirements for:
>
> a. Classification of a deferred tax liability or asset as current or noncurrent in a classified statement of financial position
>
> b. Recognition of tax benefits based on offsetting, and disclosure of the amounts and expiration dates (or a reasonable aggregation of expiration dates) of operating loss and tax credit carryforwards for financial reporting
>
> c. Measurements based on enacted tax laws and rates, including (1) alternative tax systems, (2) tax rates that are different for carryforward and carryback periods, and (3) limitations on utilization of tax credits.
>
> Scheduling is required to satisfy those requirements of Statement 96.[4]

Adding further complexity to the matter is the requirement that separate deferred tax computations (and the scheduling needed to do the computations) must be done for each state, local or foreign tax jurisdiction for which the deferred tax expense is "significant."[5] Therefore, it is unlikely that a taxable enterprise would be able to compute its deferred taxes without performing some amount of scheduling.

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[3]Michael J. Fischer, "Shortcutting FASB No. 96's Scheduling Exercise," Journal of Accountancy 167 (February 1989): 42.

[4]E. Raymond Simpson, et al., A Guide to Implementation of Statement 96, p. 1.

[5]Ibid, pp. 7-8.

To reduce the amount of scheduling required to compute deferred taxes, Fischer has proposed a "shortcut approach." The seven steps to Fischer's method are as follows:

1. Identify type and nature of company's temporary differences.
2. Schedule by year all future net tax deductible amounts arising from temporary differences.
3. Schedule by year future net taxable amounts to the extent necessary to determine recognizability of scheduled tax deductible amounts.
4. Schedule remaining net taxable amounts as "indefinite."
5. Apply carryforward and carryback rules.
6. Determine net taxable income for each scheduled year and indefinite future.
7. Apply appropriate tax rate to determine deferred tax liability.[6]

Fischer suggests that "for simplicity, the scheduling of net taxable items should begin with those most easily scheduled. Once the recognizability of future deductible amounts is determined, the remaining amount of net taxable items can be scheduled to occur in the indefinite future, since their exact timing won't affect the amount of deferred taxes recorded."[7] See Figure 12 in Appendix D for an example of the use of Fischer's method.

The cost of scheduling can be enormous. Thomas Jones, senior vice president, finance, of Citicorp, estimates SFAS No. 96 is costing the bank about $3 million to implement. The Wall Street Journal quoted him as saying "The

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[6]Fischer, "Shortcutting FASB No. 96's Scheduling Exercise," p. 43.

[7]Ibid, pp. 43-44.

FASB's tax standard is requiring us to figure out complex tax schedules for operations in 90 countries and at least 30 states and has taken up to 15 people at the bank almost 12 months to calculate."[8]

Deferred Taxes and the AMT

The 1986 Tax Reform Act enacted a new corporate alternative minimum tax (AMT) and repealed the corporate add-on minimum tax. Under this tax law, a corporation must compute its income tax liability using both the "regular" tax system and the AMT system. The corporation must pay the greater of the two amounts.[9]

SFAS No. 96 requires that, where more than one comprehensive method or system must be used to determine an enterprise's tax liability (such as with the AMT system described above), the enterprise's deferred taxes must also be calculated in the same manner.[10] An enterprise should use the same assumptions and tax-planning strategies, including elections for tax purposes, for deferred tax calculations under both the regular and AMT systems.[11]

Accounting for deferred taxes under the AMT or another comprehensive alternative tax system may result in a large increase in the amount of record keeping required. Companies will need to "maintain records to keep track of all

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[8]Lee Berton, "Accounting-Board Rulings Make Business See Red," Wall Street Journal, 21 March 1989, p. A26.

[9]Lee G. Knight, Ray A. Knight, and Neal T. McGrath, "Double Jeopardy: The AMT and FASB 96," Journal of Accountancy 167 (May 1989): 40.

[10]FASB Statement No. 96, par. 47.

[11]E. Raymond Simpson, et al., A Guide to Implementation of Statement 96, p. 71.

items computed differently for AMT purposes--for example, NOLs, foreign tax credits, depreciation, installment sales and long-term contracts. Maintaining records for depreciation [may be] particularly difficult: In addition to book and regular tax depreciation records, records must be kept for both the AMT and the ACE [adjusted current earnings] depreciation adjustments."[12]

While a detailed discussion of the AMT is beyond the scope of this paper, an example of the interaction of SFAS No. 96 and the AMT is presented in Figure 13 in Appendix D to demonstrate some of the complexities involved. Knight et al. describe this interaction between SFAS No. 96 and the AMT as " . . . the most complicated accounting standard ever issued [meeting] the messiest tax law ever passed, [resulting in] an accountant's nightmare."[13]

The required use of tax-planning strategies to calculate deferred taxes (see Chapter 3) will also complicate matters. Undoubtedly, it will take financial statement preparers and their auditors some time to become accustomed to using the strategies to compute deferred taxes.

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[12]Knight, et al., "Double Jeopardy: The AMT and FASB 96," p. 48.

[13]Ibid, p. 40.

CHAPTER V

SUMMARY AND CONCLUSION

Prior to the issuance, in December 1987, of SFAS No. 96, accounting for income taxes was primarily determined by the requirements of APB Opinion No. 11.

APB Opinion No. 11 required the use of the deferred method of accounting for income taxes. Under the deferred method the focus is on the income statement. Income tax expense is provided for based upon pre-tax financial income adjusted for any permanent differences. The difference between the tax expense so computed and the taxes actually payable is the deferred tax effect for the year. The amount of deferred taxes carried in the balance sheet is not adjusted for any subsequent change in tax laws. The recognition of a loss carryforward is always treated as an extraordinary item.

SFAS No. 96 supersedes APB Opinion No. 11 and nearly all of the other authoritative pronouncements affecting the accounting for income taxes. SFAS No. 96 requires the use of the liability method of accounting for income taxes which focuses on the balance sheet. Under this approach, deferred taxes are provided for all temporary differences between the book and tax bases of an enterprise's assets and liabilities. The amount of deferred taxes recorded in the balance sheet is adjusted for a subsequent change in tax rates or laws. The amount of income tax expense for a year is the sum of taxes currently payable and the change in the balance sheet deferred tax balances for the year. The nature of the income allowing the use of a loss carryforward determines the income statement classification of the related benefit.

One year after the issuance of SFAS No. 96, the FASB issued SFAS No. 100 which deferred the effective date of Statement 96 for one year. More recently, the FASB has discussed deferring it yet again. One wonders how long the effective date can be postponed. If SFAS No. 96 is so difficult for companies to implement the FASB may be pressured to modify it or withdraw it altogether.

The FASB determined that the liability method required by SFAS No. 96 fits into its accounting concepts project while the deferred method required by APB Opinion No. 11 does not. Hopefully, the use of the liability method will provide more useful information to uses of financial statements.

Finally, this author found it ironic that Dennis R. Beresford, Chairman of the FASB at the time SFAS No. 96 was adopted and who voted for the statement, wrote the following in a June 1982 article:

> I think we can also dismiss the liability approach as a viable alternative [to the deferred method]. Although the approach is somewhat more logical and reliable, particularly in respect to the balance sheet effects, this change alone would be so inconsequential that it would hardly be worth the effort. Clearly any change in the accounting for income taxes would have to "make a difference" to be credible.[1]

Apparently he had a change of heart.

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[1]Dennis R. Beresford, "Deferred Tax Accounting Should Be Changed," The CPA Journal 52 (June 1982): 22.

APPENDIX A

Examples of
Pre-SFAS No. 96
Requirements

Figure 1:

COMPUTATION OF DEFERRED TAXES UNDER BOTH THE GROSS CHANGE AND NET CHANGES METHODS

EXHIBIT 1

COMPUTATION OF DEFERRED TAXES UNDER
ALTERNATIVE APPROACHES FOR
TWO KINDS OF TIMING DIFFERENCES

Assumptions

1. All prior deferred taxes are at an average rate of 48%
2. Current period tax rate is 48% less surtax exemption and plus 10% surcharge
3. Current period investment credit is $0

	Gross Change Method	Net Change Method
	(thousands of dollars)	
Computation of taxable income		
Pretax accounting income	$500	$500
Timing differences from use of accelerated depreciation for tax purposes and straightline depreciation for accounting purposes:		
Originating--tax depreciation in excess of accounting depreciation	(500)	
Reversing--accounting depreciation in excess of tax depreciation	100	
Net change		(400)
Timing differences from use of installment method for tax purposes and accrual method for accounting purposes:		
Originating--gross margin on current period sales uncollected at end of period	(300)	
Reversing--gross margin on prior period sales collected during current period	400	
Net change	$200	$200
Computation of tax estimated to be currently payable		
48% rate	$ 96	$ 96
Surtax exemption	(6)	(6)
10% surcharge	9	9
	$ 99	$ 99

Figure 1 - Continued:

	Gross Change Method	Net Change Method
	(thousands of dollars)	
Computation of deferred tax on depreciation timing difference		
Taxable income	$200	$200
Originating or net change in depreciation timing differences	500	400
Adjusted taxable income--"without" timing differences	$700	$600
Tax on adjusted taxable income	$363 (a)	$310 (a)
Tax currently payable	99	99
Differential equivalent to tax effects of timing differences to be added to deferred tax credit	$264	$211
Computation of deferred tax on deferred gross margin timing differences		
Taxable income	$200	$200
Originating or net change in gross margin timing differences	300	(100)
Adjusted taxable income--"without" timing differences	$500	$100
Tax on adjusted taxable income	$257 (a)	$ 46 (a)
Tax currently payable	99	99
Differential equivalent to tax effects of timing differences to be added to (or deducted from) deferred tax credit	$158	$(53)
Summary of changes in deferred tax credit balance		
Additions to deferred credits arising from originating differences:		
Depreciation	$264	
Deferred gross margin	158	
Arising from increase in cumulative depreciation differences		$211
Amortization of deferred credits arising from reversing differences:		
Depreciation--(48% of $100)	(48)	
Deferred gross margin--(48% of $400)	(192)	
Net amortization arising from reduction in cumulative deferred gross margin		(53)
Net Increase	$182 (b)	$158 (b)

Figure 1 - Continued:

NOTES:

(a) 48% of adjusted taxable income ("without" timing difference), less surtax exemption of $6 and plus 10% surcharge.

(b) The difference between the net increase in the deferred tax credit balance of $182 under the gross change method and $158 under the net change method, or $24 (in effect 4.8% of $500, the aggregate amount of reversing timing differences) represents the effect of using (1) under the gross change method the current tax rate for originating differences and the effective prior period rates for reversing differences and (2) under the net change method the current tax rate for the cumulative net effect of both originating and reversing differences.

Figure 1 - Continued:

EXHIBIT 1a

COMPUTATION OF DEFERRED TAXES UNDER

ALTERNATIVE APPROACHES FOR

TWO KINDS OF TIMING DIFFERENCES

Assumptions

Same as Exhibit 1, except current period investment credit is $50.

	Gross Change Method	Net Change Method
	(thousands of dollars)	
Computation of taxable income		
Same as Exhibit 1		
Computation of tax estimated to be currently payable		
48% rate	$ 96	$ 96
Surtax exemption	(6)	(6)
10% surcharge	9	9
Allowable investment credit	(50)	(50)
	$ 49	$ 49
Computation of deferred tax on depreciation timing difference		
Taxable income	$200	$200
Originating or net change in depreciation timing differences	500	400
Adjusted taxable income--"without" timing differences	$700	$600
Tax on adjusted taxable income	$313 (a)	$260 (a)
Tax currently payable	49	49
Differential equivalent to tax effects of timing differences to be added to deferred tax credit	$264	$211

Figure 1 - Continued:

	Gross Change Method	Net Change Method
	(thousands of dollars)	
Computation of deferred tax on deferred gross margin timing differences		
Taxable income	$200	$200
Originating or net change in gross margin timing differences	300	(100)
Adjusted taxable income--"without" timing differences	$500	$100
Tax on adjusted taxable income	$207 (a)	$ 10 (b)
Tax currently payable	49	49
Differential equivalent to tax effects of timing differences to be added to (or deducted from) deferred tax credit	158	$(39)
Summary of changes in deferred tax credit balance		
Additions to deferred credits arising from originating differences:		
Depreciation	$264	
Deferred gross margin	158	
Arising from increase in cumulative depreciation differences		$211
Amortization of deferred credits arising from reversing differences:		
Depreciation--(48% of $100)	(48)	
Deferred gross margin--(48% of $400)	(192)	
Net amortization arising from reduction in cumulative deferred gross margin		(39)
Net Increase	$182	$172 (c)

Figure 1 - Continued:

NOTES:

(a) 48% of adjusted taxable income ("without" timing difference), less surtax exemption of $6, plus 10% surcharge and less allowable investment credit of $50.

(b) 48% of adjusted taxable income ("without" timing difference), less surtax exemption of $6, plus 10% surcharge and less maximum investment credit of $36 ($25 plus 50% of the difference between $46 and $25).

(c) The difference between the net increase in the deferred tax credit balance under the net change method of $158 in Exhibit 1 and $172 in Exhibit 1a, or $14, arises from the influence of the investment credit. It should be noted that under the gross change method the full investment credit of $50 is utilized in all of the computations "with and without inclusion of the transaction creating the difference between taxable income and pretax accounting income." Under the net change method the utilization of the investment credit is limited to $36 in the computation of the tax effects of deferred gross margin timing differences whereas $50 is utilized in the computation of depreciation timing differences. (See section on "Investment Credit Carrybacks and Carryforwards.")

SOURCE: Donald J. Bevis and Raymond E. Perry, Accounting for Income Taxes-An Interpretation of APB Opinion No. 11 (New York: AICPA, 1969), pp. 16-19.

Figure 2:

APPLICATION OF LOSS CARRYBACK
AGAINST EXISTING DEFERRED TAX CREDITS

	Income (Loss) Before Income Taxes		Income Tax Expense (Credit)						Cumulative Net Deferred Tax Credits
Year	Accounting	Taxable	Current		Deferred		Total		
1	$ 15,000	$ 5,000	$ 2,000		$ 5,000		$ 7,500		$ 5,000
2	15,000	5,000	2,500		5,000		7,500		10,000
3	15,000	5,000	2,500		5,000		7,500		15,000
4	15,000	5,000	2,500		5,000		7,500		20,000
5	(35,000)	(45,000)	(7,500)	(A)	(10,000)	(B)	(17,500)		10,000 (C)
6	5,000	15,000	0	(A)	2,500	(D)	2,500		12,500

Assumptions:

1. 50% tax rate for all years.
2. Surtax exemptions and investment credits ignored.

NOTES:

(A) Taxes paid in years 2, 3 and 4 aggregating $7,500 become refundable as a result of the carryback of the loss from year 5. No tax is payable in year 6 because of the loss carryforward from year 5.

(B) For years 2 through 5 cumulative accounting income is $10,000, which at a 50% rate requires a deferred tax credit of $5,000. Accordingly a reduction in deferred tax credits of $10,000 is required. In effect, a loss carryforward has been recognized to that extent. (See section on "Recognition of Carryforwards as Offset to Deferred Tax Credits.")

(C) The cumulative deferred tax credit at end of year 5 consists of $5,000 from year 1 plus $5,000 for years 2 through 5.

(D) Represents the tax benefit ($2,500) of the loss carryforward to year 6 previously recognized in year 5.

SOURCE: Donald J. Bevis and Raymond E. Perry, Accounting for Income Taxes--An Interpretation of APB Opinion No. 11 (New York: AICPA, 1969), p. 22.

Figure 3:

EXAMPLE OF LOSS CARRYFORWARD RECOGNIZED AS OFFSET TO NET DEFERRED TAX CREDITS

Year	Income Before Income Taxes		Depreciation		Income Tax Expense (1)			Cumulative Net Deferred Tax Credits
	Accounting	Taxable	Accounting	Tax	Current (2)	Deferred (F)	Total	
1	$ 15,000	$ 5,000	$ 10,000	$ 20,000	$ 2,500	$ 5,000	$ 7,500	$ 5,000
2	15,000	5,000	10,000	20,000	2,500	5,000	7,500	10,000
3	15,000	5,000	10,000	20,000	2,500	5,000	7,500	15,000
4	15,000	5,000	10,000	20,000	2,500	5,000	7,500	20,000
5	(54,000) (3)	(64,000) (3)	10,000	20,000	(7,500) (A)	(15,000) (B) (2,000) (C)	(24,500)	3,000
6	2,000	6,000	10,000	6,000	-	(2,000) 3,000	1,000 (D)	4,000
7	2,000	6,000	10,000	6,000	-	(2,000) 3,000	1,000 (D)	5,000
8	2,000	6,000	10,000	6,000	-	(2,000) 3,000	1,000 (D)	6,000
9	2,000	6,000	10,000	6,000	-	(2,000) 3,000	1,000 (D)	7,000
10	5,000	9,000	10,000	6,000	-	(2,000) 4,500	2,500 (D)	9,500
11	10,000	16,000	10,000	4,000	8,000	(1,900) (E)	6,100	7,000
12	10,000	16,000	10,000	4,000	8,000	(1,900) (E)	6,100	5,700
13	10,000	16,000	10,000	4,000	8,000	(1,900) (E)	6,100	3,800
14	10,000	16,000	10,000	4,000	8,000	(1,900) (E)	6,100	1,900
15	10,000	16,000	10,000	4,000	8,000	(1,900) (E)	6,100	-
	$69,000	$69,000	$150,000	$150,000	$42,500	$ -	$42,500	$ -

Figure 3 - Continued:

ADDITIONAL ASSUMPTIONS:

(1) 50% tax rate for all years and surtax exemptions and investment credits ignored.

(2) Equal to amount payable (or refundable) each year.

(3) Loss carryforward of $9,000 on accounting and $49,000 on tax basis is not assured beyond any reasonable doubt.

NOTES:

(A) Refund of taxes paid in years 2-4 available because of loss carryback.

(B) Adjustment of deferred credit from timing difference recognized in years 2-4 (carryback period) in accordance with paragraph 44 of Opinion. No deferred credit is required for year 5 since tax refund computed with timing difference is same as refund computed without timing difference.

(C) The tax benefit of the loss carryforward that may be recognized is the lower of (1) the tax effect of carryforward for accounting purposes of $4,500 (computed as 50% of $9,000); or (2) the amortization of remaining deferred tax credits that would otherwise occur during the carryforward period of $2,000 (computed as $20,000--timing difference reversing in years 6-10--divided by $50,000--aggregate, timing difference at end of year 5--or 40% applied to $5,000 deferred credit from year 1). The $2,000 limitation prevails.

(D) During each of the years 6 through 10, amortization of deferred tax credits on a cumulative basis of $2,000 is recognized on the basis of 50% of $4,000 reverse timing differences. In each of these years, deferred credits are restored to the extent of realization of the loss carryforward equal to tax that would otherwise be currently payable in year 6 through 9 of $3,000 each year, and in year 10 of $4,500. Full benefit of carryforward is added to deferred credits because aggregate net deferred credits never exceed amounts that would have been recorded if there had been no operating loss.

(E) The accumulated deferred tax at the end of year 10 is $9,500 which must be amortized equally during each of the years 11 through 15 since timing differences reverse in equal annual amounts of $6,000 during those years.

(F) The average rate assumption has been used in the amortization of deferred tax credits upon reversal of the depreciation timing differences. A first-in, first-out assumption could have been applied.

SOURCE: Donald J. Bevis and Raymond E. Perry, Accounting for Income Taxes--An Interpretation of APB Opinion No. 11 (New York: AICPA, 1969), pp. 28-29.

APPENDIX B

Summary of Major Differences Between Present Requirements and SFAS No. 96

Figure 4:

Summary of Major Differences Between Present Requirements and SFAS No. 96

Issue	Present Requirements	SFAS No. 96
1. Objective	To match tax expense with the related revenues and expenses that are recognized in pretax financial income.	To recognize a tax liability or asset for the tax consequences of amounts that will become taxable or deductible in future years as a result of past transactions or events.
2. Accounting method	Deferred method.	Liability method.
3. Basic approach:		
a. Differences addressed	Deals with timing differences between the year in which the transaction affects taxable income and the year in which it is recognized in financial income.	Deals with differences between the reported amount of an asset or liability in the financial statements and its tax basis.
b. Differences disregarded	Disregards permanent differences between taxable and financial income that will not reverse or turn around in other years.	Disregards only those transactions and events that under existing tax law will never affect taxable income or taxes payable.
c. What is computed	Computes the incremental effect of timing differences on income tax expense for the year in which timing differences originate.	Computes the future tax sacrifice or benefit attributable to differences between the tax basis and the financial statement reported amount of assets and liabilities.

Figure 4 - Continued:

Issue	Present Requirements	SFAS No. 96
d. How it is computed	Uses with and without calculations by the gross or net change method for individual timing differences or for each group of similar timing differences.	Uses computations that apply enacted tax rates and laws to the taxable or deductible amounts that will arise from recovery of an enterprise's assets and settlement of its liabilities.
e. Deferred tax elements	Computed amounts per above is deferred income tax expense for the year.	Computed amount per above is a tax liability (or asset) for which payment (or receipt) is deferred.
	Cumulative, unreversed balance of deferrals for the current and prior years is a deferred credit or charge to be allocated to income tax expense in future years (it is not considered to be a receivable or payable).	Net change in that tax liability (or asset) for the year is the amount of income tax expense for which payment (or receipt) is deferred.
4. Recognition:		
a. Exceptions	Expect as specified in Opinion No. 23, deferred taxes are required for all timing differences, including timing differences that may not reverse until indefinite future years. Some additional exceptions (e.g., gains reported pursuant to SEC Staff Accounting Bulletin No. 51) are permitted in practice based on analogies to items in Opinion No. 23.	Same as present requirements, except that no analogies may be made to the exceptions specified in Opinion No 23. If the item is not specifically addressed in Opinion No. 23, deferred taxes are to be provided.

Figure 4 - Continued:

Issue	Present Requirements	SFAS No. 96
b. Tax assets	Net deferred charges are recognized as "assets" based on the results of with and without calculations, subject to realizability tests.	A deferred tax asset is recognized only for the tax benefit of future net tax deductions that could be realized by loss carryback from the future year to reduce taxes paid in the current or a prior year.
5. Measurement:		
a. Tax rate	Tax effects of timing differences are measured by with and without calculations using tax rates (ordinary income, capital gain, etc.) that are applicable to the types of timing differences in the year that they originate.	A tax liability is measured using tax rates (ordinary income, capital gain, etc.) that are applicable to the types of taxable income that are expected to arise in future years.
b. Graduated tax rates	Tax effects of timing differences are measured using the incremental tax rates applicable to an enterprise for the year that timing differences originate.	A tax liability is measured using the graduated tax rates that would be applicable to taxable amounts arising in future years. Average tax rates may be used if the result would not differ materially.
c. Change in tax law or rate	Gross change method: Effect is recognized in the future years when timing differences reverse.	Effect is recognized at the enactment date of the change in tax law or rate.

Figure 4 - Continued:

Issue	Present Requirements	SFAS No. 96
	Net change method: Effect is recognized in future years if reversal of all of a particular type of timing difference occurs.	
6. Loss Carryforwards:		
a. Recognize an asset	Yes, if realization is assured beyond any reasonable doubt.	No.
b. Reduce deferred credits arising in a year subsequent to the year of the loss	An issue that is currently debated in practice.	Loss carryforwards from prior years reduce a deferred tax liability arising in the current year; carryforward amounts realized on the tax return are no longer available to reduce a deferred tax liability.
c. Extraordinary item	Tax benefit of a loss carryforward is reported as an extraordinary item when it is recognized in a subsequent year.	Classification of the tax benefit of a loss carryforward (carry-back) should be determined by the source of income (loss) in the current year and not by the source of the loss (income) in a prior year.

Figure 4 - Continued:

Issue	Present Requirements	SFAS No. 96
7. Tax-planning strategies: a. Applicability	To (a) undistributed earnings of subsidiaries, and corporate joint ventures, (b) certain reserves of savings and loan associations, (c) "policyholders' surplus" of stock life insurance companies, and (d) deposits in statutory reserve funds by U.S. steamship enterprises. Consideration is optional.	To the tax consequences of differences between the reported amount of an asset or liability in the financial statements and its tax basis. Consideration is not elective.
b. Types of strategies	Pertains to whether earnings will be distributed and, if distributed, the type of income (dividend, capital gain, ordinary, etc.) and the related tax credits or deductions.	In additions to types of strategies permitted under present requirements, pertains to changing the timing of expected reversal of temporary differences to utilize expiring carryforwards or carrybacks or to maximize the benefits of tax credits or deductions.
c. Criteria	Evidence based on all facts and circumstances.	A tax-planning strategy must ° be a prudent and feasible strategy over which management has discretion and control; management must have the ability and intent to implement the strategy if necessary, to reduce taxes, and ° give rise to no significant cost.

Figure 4 - Continued:

Issue	Present Requirements	SFAS No. 96
8. Purchase business combinations:		
a. Differences between assigned values and tax bases	Net-of-tax values are assigned to the assets and liabilities of the acquired enterprise.	A tax liability or asset is recognized for the tax consequences of differences between the assigned values and the tax bases of the assets and liabilities of the acquired enterprise.
b. Subsequent recognition of carryforward amounts	Subsequent recognition of loss carryforwards results in retroactive restatement of the purchase transaction.	Subsequent recognition of loss and ITC carryforwards are both accounted for in the current year and there is no retroactive restatement.
	Subsequent recognition of ITC carryforwards is not retroactive.	
c. Accounting when subsequently recognized	Positive goodwill is reduced to zero, then noncurrent assets are reduced, and any additional amounts are negative goodwill.	Positive goodwill and noncurrent intangible assets are reduced to zero and any additional amounts are reported as a reduction of income tax expense.
9. Equity transactions:		
a. Stock compensation plans	Tax benefit of tax deduction for which there is no related financial expense is allocated to stockholders' equity.	Same as present requirements.

Figure 4 - Continued:

Issue	Present Requirements	SFAS No. 96
b. Dividends paid	Tax benefit (if any) of dividends paid is allocated to stock-holders' equity.	Tax deductibility of dividends paid is viewed in substance as tax-free income to the enterprise and is recognized as a reduction of income tax expense.
10. Balance sheet classification (current/ non-current) of deferred taxes related to recorded assets and liabilities.	Classified the same as the related asset or liability.	Classified based on the expected reversal date of the temporary difference.
11. Investment tax credit	An enterprise may elect the flow-through or deferral method.	Same as present requirements.
12. Income taxes in interim periods	Tax expense for interim periods is measured using an estimated annual effective tax rate that is determined by expectations about income tax expense for the annual period.	Generally same as present requirements.
13. Alternative minimum tax (AMT)	Incorporate AMT with and without computation. Tax benefit of AMT credit carryforward arising for financial reporting purposes may be recorded ° as an asset if realization is assured beyond a reasonable doubt (rare), or	Incorporate AMT in computation of current and deferred tax liability. Tax benefit of AMT credit carryforward may be recorded to the extent it can reduce deferred tax liability, subject to relevant tax law limitations.

Figure 4 - Continued:

Issue	Present Requirements	SFAS No. 96
	° as a reduction of existing net deferred tax credits, subject to certain limitations.	

SOURCE: Arthur Andersen & Co., Accounting News Briefs, Summary of FASB Statement No. 96, "Accounting for Income Taxes" (n.p. Arthur Andersen & Co., January 1988), pp. 8-11.

APPENDIX C

Examples of SFAS No. 96 Requirements

Figure 5:

SCHEDULING OF TEMPORARY DIFFERENCES

At the end of year 1, the reported amount of an enterprise's installment receivables is $3,300, and the tax basis of those receivables is $1,800. An assumption inherent in the enterprise's statement of financial position for year 1 is that the $3,300 reported amount of installment receivables will be recovered in future years. Future recovery of the $3,300 amount will result in $1,500 ($3,300-$1,800) of taxable amounts ($300 per year in years 2-6). In addition, at the end of year 1, a $1,300 liability for estimated expenses has been recognized in the financial statements, and those expenses will be deductible for tax purposes in year 5 when the liability is expected to be paid. Those two temporary differences are estimated to result in taxable or deductible amounts in future years as presented below.

	Year 2	Year 3	Year 4	Year 5	Year 6
Taxable amounts	$300	$300	$300	$ 300	$300
Deductible amounts	--	--	--	(1,300)	--
	300	300	300	(1,000)	300

SOURCE: FASB Statement No. 96, Accounting for Income Taxes (Stamford, Conn.: FASB, December 1987), par. 38.

Figure 6:

CARRYBACK OR CARRYFORWARD OF
NET DEDUCTIBLE AMOUNTS (OFFSETTING)

(Assume the same facts as the example in Figure 5.)

	Year 2	Year 3	Year 4	Year 5	Year 6
Taxable amounts	$300	$300	$300	$ 300	$300
Deductible amounts	--	--	--	(1,300)	--
	300	300	300	(1,000)	300
Loss carryback	(300)	(300)	(300)	900	--
Loss carryforward	--	--	--	100	--
Net taxable amount	$ --	$ --	$ --	$ --	$200

The $1,300 deductible amount in year 5:

a. Offsets the $300 that becomes taxable in year 5.

b. Offsets (by loss carryback) the $900 that becomes taxable in years 2-4.

c. Offsets (by loss carryforward) $100 of the $300 that becomes taxable in year 6.

[The offsets by carryback and carryforward are possible because current federal tax law allows operating losses to be carried back 3 years and carried forward 15 years.]

SOURCE: FASB Statement No. 96, Accounting for Income Taxes (Stamford, Conn.: FASB, December 1987), par. 38.

Figure 7:

CALCULATION OF NET DEFERRED TAX LIABILITIES

(Assume the same facts as the examples in Figures 5 and 6.)

	Year 2	Year 3	Year 4	Year 5	Year 6
Net taxable amount	$ --	$ --	$ --	$ --	$200

Assuming a 40 percent tax rate, a net deferred tax liability for $80 ($200 at 40 percent) is recognized at the end of year 1.

SOURCE: FASB Statement No. 96, Accounting for Income Taxes (Stamford, Conn.: FASB, December 1987), par. 38.

Figure 8:

RECOGNITION OF DEFERRED TAX ASSETS

The following example illustrates recognition of a net deferred tax asset for temporary differences. Year 1, the current year, is an enterprise's first year of operations. The enterprise has a pretax financial loss and taxable income for year 1. The reconciliation between those two amounts is as follows:

Pretax financial loss	$ (100)
Estimated expenses that will be deductible for tax purposes when paid	2,000
Installment sale gain taxable when the receivables are collected	(1,200)
Taxable income	$ 700

At the end of year 1, the reported amount of the enterprise's installment receivables in the financial statements is $3,000, and the tax basis of those receivables is $1,800. Future recovery of the reported amount of the installment receivables will result in $1,200 of taxable amounts ($300 per year in years 2-5). Also, a $2,000 liability for estimated expenses has been recognized in the financial statements in year 1, and those expenses will be deductible in year 4 when the liability is expected to be paid.

Those two temporary differences are estimated to result in taxable or deductible amounts in future years (years 2-5) as presented below.

	Current Year	Year 2	Year 3	Year 4	Year 5
Taxable income	$700	$ -	$ -	$ -	$ -
Taxable amounts	-	300	300	300	300
Deductible amount	-	-	-	$(2,000)	-
	700	300	300	(1,700)	300
Loss carryback	(700)	(300)	(300)	1,300	-
Loss carryforward	-	-	-	300	(300)
Net operating carryforward	$ -	$ -	$ -	$ (100)	$ -

The $2,000 deductible amount in year 4:

a. Offset (by loss carryback and carryforward) the $1,200 of taxable amounts ($300 per year) in years 2-5

b. Offsets (by loss carryback) the $700 of taxable income in the current year

c. Gives rise to a $100 net deductible amount in year 4 that does not offset taxable amounts in any year.

Figure 8 - Continued:

At the end of year 1, the enterprise:

a. Recognizes taxes currently payable for $700 of taxable income in year 1

b. Recognizes a net deferred tax asset for the deferred tax benefit of $700 of deductions in year 4 that offset (by loss carryback procedures) taxable income for the current year

c. Does not recognize a tax benefit for the $100 net deductible amount (in year 4) that, in substance, is the same as an operating loss carryforward.

SOURCE: FASB Statement No. 96, Accounting for Income Taxes (Stamford, Conn.: FASB, December 1987), par. 39.

Figure 9:

RECOGNITION OF A TAX BENEFIT FOR CARRYFORWARDS

The following example illustrates recognition of the tax benefit of an operating loss in the loss year and in subsequent carryforward years. The assumptions are as follows:

a. An operating loss occurs in year 5, and the enacted tax rate is 40 percent for all years.

b. The only difference between financial and taxable income results from use of accelerated depreciation for tax purposes. Differences that arise between the reported amount and the tax basis of depreciable assets in year 1-7 will result in taxable amounts before the end of the loss carryforward period from year 5.

c. Financial income, taxable income, and taxes currently payable or refundable are as follows:

	Year 1	Years 2-4	Year 5	Year 6	Year 7
Pretax financial income	$2,000	$ 5,000	$(8,000)	$ 2,000	$ 7,000
Depreciation differences	(800)	(2,200)	(600)	(800)	(600)
Loss carryback	-	-	2,800	-	-
Loss carryforward	-	-	-	(5,800)	(4,600)
Taxable income (loss)	$1,200	$ 2,800	$(5,800)	$(4,600)	$ 1,800
Taxes payable (refundable)	$ 480	$ 1,120	$(1,120)	$ -	$ 720

A liability for the deferred tax consequences that will result in taxable amounts in future years is calculated as follows:

	Year 1	Years 2-4	Year 5	Year 6	Year 7
Unreversed differences:					
Beginning amount	$ -	$ 800	$ 3,000	$ 3,600	$ 4,400
Additional amount	800	2,200	600	800	600
Total	800	3,000	3,600	4,400	5,000
Tax loss carryforward	-	-	(5,800)	(4,600)	-
Net taxable amount	$ 800	$ 3,000	$ -	$ -	$ 5,000

Figure 9 - Continued:

	Year 1	Years 2-4	Year 5	Year 6	Year 7
Deferred tax liability (40 percent):					
At end of period	$ 320	$ 1,200	$ -	$ -	$2,000
At beginning of period	-	320	1,200	-	-
Deferred tax expense (benefit)	$ 320	$ 880	$(1,200)	$ -	$2,000

Total tax expense for each period is as follows:

	Year 1	Years 2-4	Year 5	Year 6	Year 7
Tax expense:					
Payable	$ 480	$ 1,120	$(1,120)	$ -	$ 720
Deferred	320	880	(1,200)	-	2,000
Total	$ 800	$ 2,000	$(2,320)	$ -	$2,720

In year 5, $2,800 of the loss is carried back to reduce taxable income in years 2-4, and $1,120 of taxes paid for those years is refunded. The $5,800 loss carryforward exceeds the $3,600 of temporary differences that will result in taxable amounts in future years. Therefore, the $1,200 deferred tax liability at the beginning of year 5 is eliminated.

In year 6, a portion of the loss carryforward is used to offset taxable income earned in year 6. The remaining $4,600 of loss carryforward at the end of year 6 exceeds the $4,400 of temporary differences, and there is no deferred tax liability.

In year 7, the loss carryforward is used up, and $720 of taxes are payable on net taxable income of $1,800. No loss carryforward offsets the $5,000 of temporary differences that will result in taxable amounts in future years, and a $2,000 deferred tax liability is recognized.

SOURCE: FASB Statement No. 96, Accounting for Income Taxes (Stamford, Conn.: FASB, December 1987), par. 50.

Figure 10:

USE OF TAX-PLANNING STRATEGIES

The following example illustrates how a tax-planning strategy is incorporated into the computation of a deferred tax liability. It demonstrates how a strategy can significantly reduce a deferred tax liability.

Assumptions

° Taxable income in Year 1 is $1,000.

° Tax rate is 30% in all years (no AMT).

° Cumulative temporary differences at the end of Year 1--income (deduction):

- Depreciation (HQ Bldg.) = $800.

- Depreciation (Other) = $3,000.

- Postretirement benefits = $(4,090).

° There is no carryback ability beyond Year 1.

Figure 10 - Continued:

Scheduling and Measurement

The first step is to schedule the reversal of these temporary differences. Based on the expected turn-around of these items (i.e., without any intervention by management to alter the "normal" reversal pattern), the deferred tax computation would be as follows:

	Year 2	Year 3	Year 4	Year 5	Years 6 - 20	Years 21-40	Total
Temporary Differences:							
Depreciation -							
Headquarters	$ 20	$ 20	$ 20	$ 20	$ 300	$ 420	$ 800
Other	550	700	400	400	950	-	3,000
Postretirement benefits	(500)	(600)	(650)	(1,340)	(1,000)	-	(4,090)
	$ 70	$ 120	$(230)	$ (920)	$ 250	$ 420	$ (290)
Loss Carrybacks:							
Year 4 loss to Year 1	-	-	230	-	-	-	-
Year 5 loss to Years 2-3	(70)	(120)	-	190	-	-	-
Loss Carryforward	-	-	-	250	(250)	-	-
Taxable income loss	$ -	$ -	$(230)*	$ (480)*	$ -	$ 420	$ (290)
Tax liability (asset) at 30%	$ -	$ -	$ (69)*	$ -**	$ -	$ 126	$ 57

Before considering net operating losses, the company has net taxable amounts in Years 2, 3, 6 and beyond. Net deductible amounts arise in Years 4 and 5 and are carried back (including against current-year taxable income) and forward to the extent possible. Net deductions of $230 in Year 4 can be carried back to reduce taxable income of $1,000 in Year 1. The $920 net deduction in Year 5 can be carried back to some extent and also forward to some extent. But even after all carryover opportunities are utilized, an unbenefitted deductible amount (a book net operating carryforward) of $480 remains. The net result is a total deferred tax liability of $57 at the end of Year 1.

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* Benefit can be recognized due to carryback ability.

** Carryforward--no benefit recognized. This represents a book net operating loss carryforward.

Figure 10 - Continued:

Scheduling and Measurement Revised

The company then identifies a tax-planning strategy to sell and lease-back its Headquarters building in Year 2. Because the sale will be at book value (consistent with the book break-even assumption), this strategy will accelerate the entire $800 temporary difference related to the building into Years 2's tax return. The result is that the company will have more taxable income (and more carryback activity) in the early years of the schedule, as shown below.

	Year 2	Year 3	Year 4	Year 5	Years 6 - 20	Years 21-40	Total
Temporary Differences:							
Headquarters building Depreciation	$ 20	$ 20	$ 20	$ 20	$ 300	$ 420	$ 800
Sale/Leaseback	780	(20)	(20)	(20)	(300)	(420)	-
Depreciation - Other	550	700	400	400	950	-	3,000
Postretirement benefits	(500)	(600)	(650)	(1,340)	(1,000)	-	(4,090)
	$ 850	$ 100	$(250)	$ (940)	$ (50)	$ -	$ (290)
Loss Carrybacks:							
Year 4 loss to Year 1	-	-	250*	-	-	-	-
Year 5 loss to Years 2-3	(850)	(90)	-	940	-	-	-
Taxable income loss	$ -	$ 10	$(250)*	$ -	$ (50)**	$ -	$ (290)
Tax liability (asset) at 30%	$ -	$ 3	$ (75)*	$ -	$ -**	$ -	$ (72)

Look at the effect this tax-planning strategy has on the deferred tax computation. Temporary differences are scheduled as before, but the sale/leaseback tax-planning strategy moves the $800 temporary difference into Year 2 from Years 3 through 40. This gives the company more carryback ability for the large loss in Year 5, and a $75 tax asset is generated in Year 4, offset by a $3 liability in Year 3 yielding a total deferred tax asset of $72.

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* Benefit can be recognized due to carryback ability.

** Carryforward--no benefit recognized. This represents a book net operating loss carryforward.

Figure 10 - Continued:

Comparison of Results

Comparing the two alternatives, we see that the strategy clearly improves the company's deferred tax position.

Deferred Taxes	Year 2	Year 3	Year 4	Year 5	Years 6 - 20	Years 21-40	Total
With tax planning - tax liability (asset) at 30%	$ -	$ -	$ (75)	$ -	$ -	$	$ (72)
Without tax planning - tax liability (asset) at 30%	$ -	$ -	$ (69)	$ -	$ -	$ 126	$ 57

Before considering the tax-planning strategy, the loss carryforward was $480; after the strategy, the carryforward was reduced to $50. Also, before considering the strategy, the deferred liability was $57--after, the deferred asset is ($72)--a $129 reduction of tax expense. It is possible that additional strategies could reduce the tax expense further because the company still has a book NOL carryforward of $50. Remember that SFAS No. 96 states that "consideration of tax-planning strategies is not elective" (Paragraph 61). Management must look for and consider qualifying strategies to minimize a tax liability or maximize a tax asset. Again, the question is, if faced with the exact tax situation we saw on the first schedule in this example, i.e., a liability of $57, is there something management could (ability) and would (intent) do to minimize that liability in a prudent, inexpensive manner? If so, that strategy must be considered in measuring the deferred tax.

In this example, the strategy employed a prudent, feasible transaction that management has the ability to effect at no significant cost. The strategy did not create any book income or loss (the building was "sold" for book value) but rather changed the otherwise normal reversal pattern of $800 of future taxable income. Thus, the criteria in SFAS No. 96 were met.

SOURCE: Arthur Andersen & Co., Basic Concepts of SFAS No. 96 "Accounting for Income Taxes" n.p. Arthur Andersen & Co., February 1989, pp. 54-57.

Figure 11:

ALLOCATION OF INCOME TAX EXPENSE TO CONTINUING OPERATIONS AND OTHER COMPONENTS OF INCOME

The following example illustrates allocation of income tax expense if there is more than one category of items other than income from continuing operations. The assumptions are as follows:

a. The tax rate is 34 percent.

b. The enterprise has $300 of tax credits available subject to a limitation of 90 percent of taxes payable. There are no temporary differences.

c. Pretax financial income for the year comprises:

Income from continuing operations	$ 600
Discontinued operations	(100)
Extraordinary items	500
Cumulative effect of an accounting change	(200)
Total pretax financial income	$ 800

d. Income tax expense attributable to continuing operations and total income tax expense are determined below.

	Continuing Operations	Total
Pretax financial income	$600	$800
Tax at 34 percent	$204	$272
Tax credits (90 percent limitation)	184	245
Tax expense	$ 20	$ 27

Figure 11 - Continued:

The incremental effect on income taxes that results from all categories of items other than continuing operations is $7 ($27 - $20). For the year, the enterprise has two net loss categories: discontinued operations (loss category #1) and the cumulative effect of an accounting change (loss category #2).

The incremental tax effect of (a) the sum of all net loss categories and (b) each net loss category is determined below.

	Sum of Loss Categories	Loss Category #1	Loss Category #2
Taxable income	$ 800	$ 800	$ 800
Loss category	(300)	(100)	(200)
Taxable income without the loss category	$1,100	$ 900	$1,000
Tax at 34 percent	$ 374	$ 306	$ 340
Tax credits (90 percent limitations)	300	275	300
Tax without the loss category	$ 74	$ 31	$ 40
Total tax expense for the year	27	27	27
Incremental tax effect	$ 47	$ 4	$ 13

A $47 tax benefit is allocated to the sum of the net loss categories. That tax benefit is apportioned ratably to each net loss category based on the incremental tax benefit of each net loss category.

	Each Loss Category		Apportioned
	Amount	Percent	Amounts
Loss category #1	$ 4	24	$11
Loss category #2	13	76	36
	$17	100%	$47

The $54 of tax expense allocated to the single net-gain category is the difference between the $7 of tax expense for all items other than income from continuing operations and the $47 of tax benefit for both net loss categories.

Figure 11 - Continued:

Total tax expense is allocated as follows:

	Pretax Income	Tax Expense
Income from continuing operations	$ 600	$ 20
Discontinued operations	(100)	(11)
Extraordinary items	500	54
Change in accounting	(200)	(36)
	$ 800	$ 27

The example above assumes that each category of items comprise a single item. If any category has more than one item, a procedure similar to that illustrated in this example would be used to allocate the total tax effect of that category to its components.

SOURCE: FASB Statement No. 96, Accounting for Income Taxes (Stamford, Conn.: FASB, December 1987), par. 74.

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