HISTORY OF ACCOUNTING FOR DEFERRED TAXES

In the history of accounting standard setting, few issues have caused as much commotion as that of accounting for deferred income taxes. The debate began with a basic conceptual issue: Are income taxes paid by a business to be considered as expenses of doing business or as a distribution of income to government entities? If viewed as a distribution of income, the amount of income taxes paid each period could be shown as the portion of financial income that is not available to the owners of the business. This amount would be determined by the tax laws in effect each period, and the existence of temporary differences would be of no consequence in the financial statements. If income taxes are considered to be business expenses, however, then the underlying concept of accrual accounting requires that the impact of temporary differences be reflected in the financial statements.

As the number of differences between pretax financial income and taxable income began to increase in the late 1940s and early 1950s, there were many articles in the accounting literature arguing the merits of these two positions. When the AICPA Committee on Accounting Procedures issued a consolidated set of accounting procedures in 1953, Accounting Research Bulletin (ARB) No. 43, it chose to consider income taxes as expenses, concluding that

> Income taxes are an expense that should be allocated, as other expenses are allocated. What the income statement should reflect under this head, as under any other head, is the expense properly allocable to the income included in the income statement for the year.[1]

Once the decision was made to classify income taxes as expenses, the next critical conceptual issues were how to measure income tax expense each period and then how to report the difference between the amount shown as income tax expense on the income statement and the amount of income taxes actually paid based on taxable income. No guidance on this issue was included in ARB No. 43, but in 1967, the Accounting Principles Board issued Opinion No. 11, "Accounting for Income Taxes," the standard that governed this area for over 20 years. Under APB Opinion No. 11, the deferred method was used in accounting for income taxes. Under this method, income tax expense is the amount of tax that would have been paid based on financial income and using the current year's tax rate. The deferred method of allocation emphasizes the income statement—income tax expense is computed directly on the current year's financial income, and the deferred tax on the balance sheet (debit or credit) is a residual amount, the difference between the expense and the taxes payable for the period. Changes in future tax rates are not considered even though the actual tax effect will depend on the rates in effect when differences reverse. Thus, under the deferred method, over time deferred tax balances become meaningless as a measure of assets (future tax benefits) or liabilities (future tax payments).

The FASB expressed concern over the deferred method of reporting income taxes in Statement No. 3, "Elements of Financial Statements of Business Enterprises," issued in 1980. The Board concluded that deferred income tax amounts reported on the balance sheet did not meet the newly established conceptual framework definitions of assets and liabilities.[2] Other criticisms leveled against the deferred method included inconsistencies in the various accounting requirements, emphasis on procedures with little theoretical justification, and the excessive time and cost involved in applying APB Opinion No. 11 relative to the benefits.[3]

These concerns led the FASB to add income taxes to its agenda in 1982. For five years the Board issued Discussion Memorandums, held public hearings, and considered the many arguments. The Board was determined to make income tax accounting meet the asset and liability definitions of the conceptual framework. The result was the issuance in December 1987 of FASB Statement No. 96, which abandoned the deferred method of interperiod tax allocation in favor of the asset and liability method. The stated objectives of the asset and liability method are as follows:

> One objective of accounting for income taxes is to recognize the amount of taxes payable or refundable for the current year. A second objective is to recognize deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an enterprise's financial statements or tax returns.[4]

The second objective points out a fundamental difference between the asset and liability method and the deferred method. The asset and liability method emphasizes the reporting of balance sheet amounts that measure the future tax consequences of temporary differences. Deferred tax assets and liabilities are measured and recorded by applying currently enacted tax rates and laws that will be in effect when the differences reverse,[5] and the income tax expense reported on the income statement is a residual amount. Further, when tax rate changes are enacted in subsequent periods, deferred tax asset and liability balances are adjusted to reflect the impact of the changes.

After FASB Statement No. 96 was issued and before its mandatory implementation date, many companies became concerned when they began to see the effect the standard would have on their financial statements and the cost they would incur in implementing it. From a theoretical perspective, some opposed the inconsistent treatment of deferred tax liabilities and deferred tax assets. Others complained that because the deferred tax liability amount is not discounted to its present value and may never be paid anyway, it doesn't represent a true liability. Others argued that the FASB is fundamentally misguided in emphasizing deferred tax reporting on the balance sheet when historically the topic of deferred taxes arose in the context of proper reporting of tax expense on the income statement. Practitioners objected to the complex scheduling requirements and to the requirement to devise hypothetical tax strategies. One firm, CITICORP, estimated that it would cost $3,000,000 to implement the standard. The objections became so strong that the FASB postponed the implementation date from 1988 to 1989,[6] from 1989 to 1991,[7] and then from 1991 to 1992.[8]

In response to the issuance of Statement No. 96, the FASB "received (a) requests for about 20 different limited-scope amendments to Statement No. 96, (b) requests to change the criteria for recognition and measurement of deferred tax assets to anticipate, in certain circumstances, the tax consequences of future income, and (c) requests to reduce the complexity of scheduling the future reversals of temporary differences and considering hypothetical tax-planning strategies."[9] These requests to amend FASB Statement No. 96 were considered at 41 public Board meetings and three Implementation Group meetings. On June 5, 1991, the FASB issued an Exposure Draft that proposed superseding FASB Statement No. 96 and several other accounting pronouncements. Finally, in February 1992, FASB Statement No. 109 was issued. Many hope that this whole area of accounting for deferred taxes has settled down.

QUESTIONS:

1. Many were concerned that the extended flap over deferred tax accounting hurt the credibility of the FASB. What dangers are there in a loss of prestige by the FASB?
2. Should pressure from practitioners be allowed to influence the FASB's deliberations?
3. In your opinion, were the time and resources spent in the area of deferred taxes by the FASB, practitioners, and other interest groups worth the benefits?

SOURCES:

1. *Accounting Research Bulletin No. 43,* "Income Taxes," New York: AICPA, 1953, Ch. 10, Section B, par. 4.
2. *Statement of Financial Accounting Concepts No. 3,* "Elements of Financial Statements of Business Enterprises," Stamford, CT: Financial Accounting Standards Board, 1980, par. 164.
3. Ibid.
4. *Statement of Financial Accounting Standards No. 96,* "Accounting for Income Taxes," Stamford, CT: Financial Accounting Standards Board, 1987, pars. 197–198.
5. Changes in tax rates and other provisions of the tax law often are legislated prior to the years in which they become effective. For example, the 1986 Tax Reform Act legislated a phased tax rate reduction over three years.
6. *Statement of Financial Accounting Standards No. 100,* "Accounting for Income Taxes—Deferral of the Effective Date of FASB Statement No. 96," Norwalk, CT: Financial Accounting Standards Board, 1988.
7. *Statement of Financial Accounting Standards No. 103,* "Accounting for Income Taxes—Deferral of the Effective Date of FASB Statement No. 96," Norwalk, CT: Financial Accounting Standards Board, 1989.
8. *Statement of Financial Accounting Standards No. 108,* "Accounting for Income Taxes—Deferral of the Effective Date of FASB Statement No. 96," Norwalk, CT: Financial Accounting Standards Board, 1992.
9. *Exposure Draft of Proposed Statement of Financial Accounting Standards,* "Accounting for Income Taxes," Norwalk, CT: Financial Accounting Standards Board, 1991, Appendix C, par. 266.