Statement of Financial Accounting Standards No. 37

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Balance Sheet Classification of Deferred Income Taxes

(an amendment of APB Opinion No. 11)

July 1980

Financial Accounting Standards Board
of the Financial Accounting Foundation
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FAS 37 Summary

This Statement specifies the basis for classification of deferred income taxes in a classified balance sheet. Deferred income taxes related to an asset or liability are classified the same as the related asset or liability. Deferred income taxes that are not related to an asset or liability are classified according to the expected reversal date of the timing difference.

INTRODUCTION

1. The FASB has been asked to clarify the classification of deferred income tax charges and credits related to the tax effects of certain timing differences (hereinafter referred to as "deferred income taxes"). The FASB also has been asked to clarify the balance sheet classification of the tax benefits related to "stock relief" under FASB Statement No. 31, *Accounting for Tax Benefits Related to U.K. Tax Legislation concerning Stock Relief*.

2. Paragraph 57 of APB Opinion No. 11, *Accounting for Income Taxes* (see paragraph 6 of this Statement), requires deferred income taxes to be classified in a balance sheet as current or noncurrent based on the classification of assets or liabilities related to the timing differences. Some timing differences, however, are not related to an asset or liability. Accordingly, the Board has concluded that it should amend paragraph 57 to clarify the classification of deferred income taxes when there is no asset or liability in the balance sheet related to the timing difference.

3. The Board also has concluded that it can reach an informed decision on the basis of existing data without a public hearing and that the effective date and transition specified in paragraph 5 are advisable in the circumstances.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Amendment to APB Opinion No. 11

4. The last two sentences of paragraph 57 of Opinion 11 are deleted and the following sentences and related footnotes are added to that paragraph:

> A deferred charge or credit is related to an asset or liability of reduction* if the asset or liability causes the timing difference to reverse. A deferred charge or credit that is related to an asset or liability shall be classified as current or noncurrent based on the classification of the related asset or liability. A deferred charge or credit that is not related to an asset or liability because (a) there is no associated asset or liability or (b) reduction of an associated asset or liability will not cause the timing difference to reverse shall be classified based on the expected reversal date of the specific timing difference.† Such classification disregards any additional timing differences that may arise and is based on the criteria used for classifying other assets and liabilities.
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> * As used here, the term "reduction" includes amortization, sale, or other realization of an asset and amortization, payment, or other satisfaction of a liability.
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> † Tax benefits related to "stock relief" that have been deferred under FASB Statement No. 31, *Accounting for Tax Benefits Related to U.K. Tax Legislation concerning Stock Reliej*, are not timing differences and should be classified the same as other liabilities based on the period of potential recapture.

Effective Date and Transition

5. This Statement shall be effective for financial statements for periods ending after December 15, 1980, with earlier application encouraged. Reclassification in previously issued financial statements is permitted but not required.

The provisions of this Statement need not be applied to immaterial items.

This Statement was adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board.

Donald J. Kirk, *Chairman*
Frank E. Block
John W. March

Robert A. Morgan
David Mosso
Robert T. Sprouse
Ralph E. Walters

Appendix A: BACKGROUND INFORMATION

6. Paragraph 57 of Opinion 11 states:

> Deferred charges and deferred credits relating to timing differences represent the cumulative recognition given to their tax effects and as such do not represent receivables or payables in the usual sense. They should be classified in two categories—one for the net current amount and the other for the net noncurrent amount. This presentation is consistent with the customary distinction between current and noncurrent categories and also recognizes the close relationship among the various deferred tax accounts, all of which bear on the determination of income tax expense. The current portions of such deferred charges and credits should be those amounts which relate to assets and liabilities classified as current. Thus, if installment receivables are a current asset, the deferred credits representing the tax effects of uncollected installment sales should be a current item; if an estimated provision for warranties is a current liability, the deferred charge representing the tax effect of such provision should be a current item.

7. Under Opinion 11, deferred income taxes are classified as current and noncurrent on the basis of how the related assets and liabilities are classified. The Board concluded that it should amend paragraph 57 of Opinion 11 to address the classification of deferred taxes when either (a) the timing difference is not related to an asset or liability because reduction of the asset or liability does not result in reversal of the timing difference or (b) there is no asset or liability related to the deferred income taxes.

8. Paragraph 10 of Statement 31 states that the Board believes U.K. "stock relief" does not have the characteristics of a timing or permanent difference. Therefore, the classification criterion of paragraph 57 of Opinion 11 does not apply. Those tax benefits shall be classified the same as other liabilities based on the period of potential recapture.

9. A proposed Interpretation, *Balance Sheet Classification of Deferred Income Taxes*, was released for comment on June 22, 1979. The proposed Interpretation of Opinion 11 addressed the classification of deferred income taxes related to timing differences associated with long-term construction contracts, undistributed earnings of subsidiaries, and a change in method of accounting for income tax reporting purposes. Fifty-one comment letters were received. The Interpretation proposed to clarify that deferred income taxes classified as current should be

reclassified to noncurrent only if the related asset or liability is reclassified to noncurrent. Many respondents to the proposed Interpretation questioned the appropriate balance sheet classification when the timing difference is not related to an asset or liability because realization of the asset or liquidation of the liability does not result in reversal of the timing difference. Others commented that there is no asset or liability related to the deferred income taxes for certain timing differences. The Board concluded that it should amend paragraph 57 of Opinion 11 to address the balance sheet classification of deferred income taxes in those circumstances.

10. An Exposure Draft of a proposed Statement, on *Balance Sheet Classification of Deferred Income Taxes*, an amendment of APB Opinion No. 11, was issued for public comment on March 14, 1980. The Board received 67 letters of comment in response to the Exposure Draft.

11. Some respondents suggested classifying deferred income taxes based on the net effect of (a) reversals of existing timing differences and (b) any additional timing differences that may arise. The Board concluded that balance sheet classification of deferred income taxes is based on the deferred income taxes that exist at the balance sheet date.

12. Other respondents suggested classifying *all* deferred income taxes based on when the timing differences reverse or classifying as current only those deferred income taxes that will actually be paid. The Board concluded, however, that such criteria would involve a more fundamental change in paragraph 57 of Opinion 11 that should not be considered at this time.

13. Several respondents to the Exposure Draft commented about the operating cycle in the illustration of construction contracts. The Board did not intend to address or change how an operating cycle is determined. Accordingly, that illustration has been revised to be consistent with the operating cycle concepts expressed in Chapter 3A, "Current Assets and Current Liabilities," of ARB 43.

14. Several comments were received on the capital lease illustration. Those comments suggested classifying the deferred income taxes like the asset or like the liability. The Board concluded that, based on the facts set forth in the capital lease illustration, the nature of lease timing differences and the classification of the associated deferred income taxes described in paragraph 27 are appropriate.

15. Some respondents of regulated utilities stated that regulatory accounting instructions for their industry required deferred income taxes to be classified with the associated asset or liability. Another respondent stated that their required system of accounts makes no provision for a current classification of deferred income taxes. This Statement clarifies classification of deferred income taxes when there is no asset or liability in the balance sheet related to the timing difference and does not otherwise change the classification criteria of Opinion 11. Also, this Statement does not modify the provision in paragraph 6 of Opinion 11 which states that Opinion 11 "does not apply. . . to regulated industries in those circumstances where the standards described in the Addendum (which remains in effect) to APB Opinion No. 2 are met...."

Appendix B: ILLUSTRATIONS OF BALANCE SHEET CLASSIFICATION OF DEFERRED INCOME TAXES

16. The examples in this appendix illustrate the balance sheet classification of certain types of deferred income taxes but do not encompass all possible circumstances. Accordingly, each situation should be resolved based on an evaluation of the facts, using the examples in this appendix as guides to the extent that they are applicable.

Installment Receivables

17. An enterprise reports profit on installment sales for tax purposes on the installment basis as receivables are collected. For financial reporting purposes, profit on installment sales is reported when the merchandise is delivered. The enterprise uses a one-year time period as the basis for classifying current assets and current liabilities on its balance sheet. Deferred income taxes are computed on the net change method. At December 31, 19X1, the balances of receivables reported on the installment method for tax purposes and of related deferred income taxes are as follows:

Installment Receivables:	
Amounts Due within One Year	$1,491,560
Amounts Due after One Year	3,835,440
Total	$5,327,000
Accumulated Deferred Income Tax Credits	
Related to Installment Receivables	$1,065,000

18. The deferred income tax credits relate to the installment receivables because collection of the receivables will cause the timing differences to reverse.[1] Accordingly, the enterprise would classify the deferred income tax credits the same as the related trade receivables. The trade receivables due within the next year represent 28 percent of the total trade receivables ($1,491,560/$5,327,000). Therefore, 28 percent of the related deferred income tax credits would be classified as current ($298,200).

Accounting Change for Tax Purposes

19. Deferred income taxes associated with an accounting change for tax purposes would be classified like the associated asset or liability if reduction of that associated asset or liability will cause the timing difference to reverse. If there is no associated asset or liability or if the timing difference will reverse only over a period of time, the deferred income taxes would be classified based on the expected reversal date of the specific timing difference.

20. An enterprise changes its method of handling bad debts for tax purposes from the cash method to the reserve method. Ten percent of the effect of the change at the beginning of calendar year 19X1 will be included as a deduction from taxable income each year for 10 years. The enterprise uses a one-year time period as the basis for classifying current assets and current liabilities on its balance sheet. At December 31, 19X1, the amount of the effect of the change that is yet to be included as a deduction from taxable income and the balance of the related deferred income taxes are as follows:

Amount of the effect of the change that is yet to be included as a deduction from taxable income (9/10 of total effect of the change)	$5,125,000
Accumulated Deferred Income Tax Debits Related to Accounting Change	$2,357,500

21. The deferred income taxes do not relate to trade receivables or provisions for doubtful accounts because collection or write-off of the receivables will not cause the timing differences to reverse; the timing differences will reverse over time. Accordingly, the enterprise would classify the deferred income tax debits based on the scheduled reversal of the related timing differences. One-ninth of the remaining timing differences are scheduled to reverse in 19X2, so one-ninth of the related deferred income tax debits would be classified as current at December 31, 19X1 ($261,944).

Method of Reporting Construction Contracts

22. An enterprise reports profits on construction contracts on the completed contract method for tax purposes and the percentage-of-completion method for financial reporting purposes. The deferred income tax credits do not relate to an asset or liability that appears on the enterprise's balance sheet; the timing differences will only reverse when the contracts are completed. Receivables that result from progress billings can be collected with no effect on the timing differences; likewise, contract retentions can be collected with no effect on the timing differences, and the timing differences will reverse when the contracts are deemed to be complete even if there is a waiting period before retentions will be received. Accordingly, the enterprise would classify the deferred income tax credits based on the estimated reversal of the related timing differences. Deferred income tax credits related to timing differences that will reverse within the same time period used in classifying other contract-related assets and liabilities as current (for example, an operating cycle) would be classified as current.

Unremitted Foreign Earnings of Subsidiaries

23. An enterprise provides U.S. income taxes on the portion of its unremitted foreign earnings

that are not considered to be permanently reinvested in its consolidated foreign subsidiary. The foreign earnings are included in U.S. taxable income in the year in which dividends are paid. The enterprise uses a one-year time period as the basis for classifying current assets and current liabilities on its balance sheet. At December 31, 19X1, the accumulated amount of unremitted earnings on which taxes have been provided and the balance of the related deferred income taxes are as follows:

Accumulated unremitted earnings on which taxes have been provided:	
Expected to be remitted within one year	$ 9,800,000
Not expected to be remitted within one year	2,700,000
Total	$12,500,000
Accumulated Deferred Income Tax Credits Related to Unremitted Earnings	$ 1,250,000

24. The deferred income tax credits do not relate to an asset or liability on the consolidated balance sheet; the timing difference will only reverse when the unremitted earnings are received from the foreign subsidiary by the parent. A payment between consolidated affiliates does not change the consolidated balance sheet, so no item on the consolidated balance sheet would be liquidated. Unremitted earnings expected to be remitted within the next year represent 78 percent of the total unremitted earnings for which tax has been provided ($9,800,000/$12,500,000). Therefore, 78 percent of the related deferred income tax credits would be classified as current on the consolidated balance sheet ($975,000).

25. If the subsidiary were accounted for on the equity method rather than consolidated (e.g., a subsidiary reported on the equity method in separate parent company financial statements), the deferred income taxes would relate to the recorded investment in the subsidiary. The payment of dividends that causes the reversal of the timing difference would be accompanied by a reduction of the recorded investment in the subsidiary. Therefore, the deferred income tax credits would be classified the same as the related investment in the subsidiary.

Capital Lease

26. An enterprise is the lessee under one major lease that is reported as an operating lease for tax purposes and as a capital lease for financial reporting purposes. The enterprise uses a one-year time period as the basis for classifying current assets and current liabilities on its balance sheet. At December 31, 19X1, certain data related to the lease are as follows:

Accumulated Lease Timing Differences [2]	$1,020,900
Accumulated Deferred Income Tax Charges Related to Lease Timing Differences	410,000

Amounts relevant to 19X2:		
Rental expense for tax purposes		$ 579,000
Book expenses:		
Depreciation	$250,000	
Interest	210,500	460,500
Net Reversing Timing Differences		$ 118,500

27. The lease timing differences result from the difference between rental expense reported for tax purposes and the total of interest expense and depreciation expense for financial reporting. Therefore, the deferred income taxes could be considered to relate to both the capitalized leased asset and the recorded lease obligation and not to any specific asset or liability. Accordingly, the enterprise would classify the deferred income tax charges based on the estimated reversal of the related timing differences. The timing differences that will reverse within the next year amount to $118,500 or 12 percent of the total accumulated lease timing differences ($1,500/$1,020,900). Therefore, 12 percent of the related deferred tax charges would be classified as current ($49,200).

Depreciation

28. An enterprise computes its depreciation expense on accelerated methods for tax purposes. For financial reporting purposes, depreciation expense is computed on the straight-line method. The enterprise uses a one-year time period as the basis for classifying current assets and current liabilities on its balance sheet.

29. The deferred income tax credits relate to the fixed assets because sale of the assets would cause the timing differences to reverse.[3] Accordingly, the enterprise would classify the deferred income taxes the same as the related fixed assets. No portion of those deferred income tax credits would be classified as current.

Footnotes

FAS37, Appendix B, Footnote 1--Under the net change method, deferredincome taxes are computed as though the timing differences at the end of the period were the same timing differences that existed at the beginning of the period except to the extent that the aggregate amount changes. That approach is not used for balance sheet classification because balance sheet classification is based on the nature of the specific timing differences that exist and that relate to the deferred income taxes at the balance sheet date.

FAS37, Appendix B, Footnote 2--The accumulated timing differences related to a lease that is reported as a capital lease for financial reporting purposes and as an operating lease for tax purposes could be determined based on amounts in the balance sheet rather than based on the difference in amounts reported as expense for book and tax purposes in prior years. If there is no accrued or prepaid rent for tax purposes, the accumulated timing differences would be the difference between the present value of the lease obligation and the net book value of the leased asset, both as reported in the financial statements.

FAS37, Appendix B, Footnote 3--See footnote 1.