Statement of Financial Accounting Standards No. 96

Note: This Statement has been completely superseded

FAS96 Status Page
FAS96 Summary

Accounting for Income Taxes

December 1987

Financial Accounting Standards Board
of the Financial Accounting Foundation
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Statement of Financial Accounting Standards No. 96

Accounting for Income Taxes

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FAS 96: Accounting for Income Taxes

FAS 96 Summary

This Statement establishes financial accounting and reporting standards for the effects of income taxes that result from an enterprise's activities during the current and preceding years. It requires an asset and liability approach for financial accounting and reporting for income taxes. This Statement supersedes APB Opinion No. 11, *Accounting for Income Taxes*. It also amends or supersedes other accounting pronouncements listed in Appendix D.

Objective of Accounting for Income Taxes

The objective in accounting for income taxes on an accrual basis 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 recognized in the financial statements and (b) as measured by the provisions of enacted tax laws. Other events not yet recognized in the financial statements may affect the eventual tax consequences of some events that have been recognized in the financial statements. But that change in tax consequences would be a result of those other later events, and the Board decided that the tax consequences of an event should not be recognized until that event is recognized in the financial statements.

The Basic Principles of Accounting for Income Taxes

To implement that objective, all of the following basic principles are applied in accounting for income taxes 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;
b. The current or deferred tax consequences of an event are measured by applying the provisions of enacted tax laws 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 expenses in future years or the future enactment of a change in tax laws or rates are not anticipated for purposes of recognition and measurement of a deferred tax liability or asset.

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The only exceptions in applying those basic principles are that this Statement (a) does not amend the requirements for recognition of deferred taxes for the areas identified in 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.

Temporary Differences

The tax consequences of most events recognized in the financial statements for a year are included in determining income taxes currently payable. However, tax laws often differ from the recognition and measurement requirements of financial accounting standards, and differences can arise between:

a. The amount of taxable and pretax financial income for a year
b. The tax bases of assets or liabilities and their reported amounts in financial statements.

Opinion 11 used the term *timing differences* for differences between the years in which transactions affect taxable income and the years in which they enter into the determination of pretax financial income. Timing differences create differences (sometimes accumulating over more than one year) between the tax basis of an asset or liability and its reported amount in financial statements. Other events such as business combinations may also create differences between the tax basis of an asset or liability and its reported amount in financial statements. All such differences collectively are referred to as *temporary differences* in this Statement.

The Deferred Tax Consequences of Temporary Differences

Temporary differences ordinarily become taxable or deductible when the related asset is recovered or the related liability is settled. In the Board's view, 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. The Board believes that assumption creates a requirement under accrual accounting to recognize the deferred tax consequences of temporary differences. A deferred tax liability or asset represents the amount of taxes payable or refundable in future years as a result of temporary differences at the end of the current year.

Deferred Tax Liabilities

A deferred tax liability is recognized for temporary differences that will result in *net* taxable amounts in future years. For example, a temporary difference is created between the reported amount and the tax basis of an installment sale receivable if, for tax purposes, some or

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all of the gain on the installment sale will be included in the determination of taxable income in future years. Future recovery of that receivable is inherently assumed in the statement of financial position for the current year. Because amounts received upon recovery of that receivable will be taxable, a deferred tax liability is recognized in the current year for the related taxes payable in future years.

The deferred tax liability meets the definition of a liability in FASB Concepts Statement No. 6, *Elements of Financial Statements.* The liability results from a past event—the installment sale at a profit. It is a present obligation of the enterprise—the amount is not yet payable to the government, but based on governmental rules and regulations, taxes will be payable when the receivable is recovered in future years. The deferred tax liability represents a probable future sacrifice—taxable amounts in future years will result from events whose occurrence is already assumed in an enterprise's statement of financial position for the current year, namely, recovery of the reported amount of the receivable. No other future events need occur.

Losses or expenses that might be incurred and recognized in financial statements in future years could offset net taxable amounts that result from temporary differences at the end of the current year. However, that change in tax consequences would be a result of events (a) that have not been recognized in the financial statements and (b) that are not inherently assumed in financial statements for the current year. The Board believes that the tax consequences of an event should not be recognized until that event is recognized in the financial statements.

The September 1986 Exposure Draft, *Accounting for Income Taxes,* proposed a requirement to recognize a deferred tax liability for the areas identified in Opinion 23 and for deposits to statutory reserve funds by U.S. steamship enterprises. The Board views that proposal as consistent with the decision to reject the partial tax allocation approach to recognition of deferred taxes. The Board continues to believe that there is a recognizable liability for the deferred tax consequences of those temporary differences. However, the Board decided that, at this time, it would continue the exception to comprehensive recognition of deferred taxes for those temporary differences. Recognition of a deferred tax liability for analogous types of temporary differences is required.

Deferred Tax Assets

The tax benefit of temporary differences that will result in deductible amounts in future years is recognized in the following circumstances:

a. A deferred tax liability is reduced to the extent that those deductible amounts offset taxable amounts from other temporary differences in future years.
b. A deferred tax asset is recognized to the extent that *net* deductible amounts in future years would be recoverable by a carryback refund of taxes paid in the current or prior years.

A deferred tax asset is not recognized for any additional amount of temporary differences that will result in net deductible amounts in future years. That additional amount is, in substance, the same as a tax loss carryforward.

The results of applying the requirements of this Statement are sometimes described as

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asymmetrical because a deferred tax liability is always recognized for temporary differences that will result in net taxable amounts and a tax benefit is only recognized for temporary differences that will result in deductible amounts that reduce taxes otherwise paid or payable. 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 U.S. tax law, deductible amounts that do not reduce taxes otherwise paid or payable are a loss carryforward. Absent earning taxable income in the future, the tax benefit of a loss carryforward, as determined by the tax law, is zero. The Board believes that the requirements of this Statement are consistent with the tax law and that the results of applying this Statement are *representationally faithful,* a quality called for in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information.*

Income earned and recognized in financial statements in future years might permit realization of a tax benefit for net deductible amounts that result from temporary differences at the end of the current year. However, that change in tax consequences would be a result of events (a) that have not been recognized in the financial statements and (b) that are not inherently assumed in financial statements for the current year. The Board believes that the tax consequences of an event should not be recognized until that event is recognized in the financial statements, regardless of the probability that the event will occur in future years.

Tax-Planning Strategies

This Statement requires that recognition and measurement of a deferred tax liability or asset take into account tax-planning strategies (provided that they meet certain criteria) that would change the particular future years in which temporary differences result in taxable or deductible amounts. Tax-planning strategies either (a) reduce the recognized amount of taxes payable for temporary differences that will result in net taxable amounts in future years or (b) increase the recognized amount of tax benefits for temporary differences that will result in net deductible amounts in future years. Most strategies involve transactions that would accelerate the recovery of assets or settlement of liabilities to increase the recognizable tax benefit of deductions and tax credits. However, management would not need to actually apply the strategy in the future if income earned in a following year permits realization of the entire tax benefit of a loss or tax credit carryforward from the current year.

Measurement of a Deferred Tax Liability or Asset

A deferred tax liability or asset is determined at each financial statement date by applying the provisions of enacted tax laws to measure the deferred tax consequences of temporary differences that will result in net taxable or deductible amounts in each future year. In concept, the amount of deferred taxes payable or refundable in future years is determined as if a tax return were prepared for each future year. In practice, less detailed or aggregate calculations may be possible.

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A tax law may require that more than one comprehensive method or system be used to determine an enterprise's tax liability. If alternative systems exist, they should be used to measure an enterprise's deferred tax liability or asset in a manner consistent with the tax law.

Changes in Tax Laws or Rates

This Statement requires that a deferred tax liability or asset be adjusted in the period of enactment for the effect of an enacted change in tax laws or rates. A change in tax laws or rates is an event that has economic consequences for an enterprise. An enterprise's financial condition improves if it owes a smaller amount of taxes or if it would receive a larger refund. Its financial condition weakens if the enterprise owes more taxes or would receive a smaller refund.

Effective Date

This Statement is effective for fiscal years beginning after December 15, 1988, although earlier application is encouraged.

INTRODUCTION

1. This Statement addresses financial accounting and reporting for the effects of **income taxes** [1] that result from an enterprise's activities during the current and preceding years. **Income taxes currently payable** [2] for a year are determined by tax laws and regulations. **Taxable income** is multiplied by a specified tax rate (or rates), and the product is increased by tax surcharges or decreased by tax credits. Taxable income is the excess of taxable revenues over tax deductible expenses and exemptions for the year as defined by the governmental taxing authority. In some tax jurisdictions, there may be more than one method or system for determining the amount of taxes currently payable.

2. Income taxes currently payable for a particular year usually include the **tax consequences** of most **events** that are recognized in the financial statements for that year. However, because some significant exceptions exist, income taxes currently payable for a year:

a. May include the tax consequences of some events recognized in financial statements for an earlier or later year
b. May not include the tax consequences of some other events recognized in financial statements for the current year.

3. APB Opinion No. 11, *Accounting for Income Taxes,* was issued in 1967. Several accounting pronouncements amended, interpreted, or supplemented Opinion 11. Some people have supported those accounting and reporting requirements for income taxes. Others have criticized and questioned the underlying concepts, the complexity of the requirements, and the

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meaningfulness of the results. Critics have not agreed on any single alternative. In 1982, the Board added a project to its agenda to reconsider accounting for income taxes. This Statement is the result of that project.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Scope

4. This Statement establishes standards of financial accounting and reporting for income taxes that are currently payable and for the tax consequences of:

a. Revenues, expenses, gains, or losses that are included in taxable income of an earlier or later year than the year in which they are recognized in financial income
b. Other events that create differences between the tax bases of assets and liabilities and their amounts for financial reporting
c. Operating loss or tax credit carrybacks for refunds of taxes paid in prior years and carryforwards to reduce taxes payable in future years.

This Statement supersedes Opinion 11. It also supersedes or amends other accounting pronouncements listed in Appendix D.

5. The principles and requirements of this Statement are applicable to:

a. Domestic federal (national) income taxes (U.S. federal income taxes for U.S. enterprises) and foreign, state, and local (including franchise) taxes based on income
b. An enterprise's [3] domestic and foreign operations that are consolidated, combined, or accounted for by the equity method
c. Foreign enterprises in preparing financial statements in accordance with U.S. generally accepted accounting principles.

6. This Statement does not address:

a. The method of accounting for the U.S. federal investment tax credit (ITC) and for foreign, state, and local investment tax credits or grants (The deferral and flow-through methods as set forth in APB Opinions No. 2 and No. 4, *Accounting for the "Investment Credit,"* continue to be acceptable methods to account for the U.S. federal ITC.)
b. Discounting (Paragraph 6 of APB Opinion No. 10, *Omnibus Opinion—1966,* addresses that subject.)
c. Allocation of income taxes among components of a business enterprise (other than the disclosures required by this Statement)

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d. Accounting for income taxes in interim periods (other than the effect of an enacted change in tax laws or rates). (APB Opinion No. 28, *Interim Financial Reporting,* and other accounting pronouncements address that subject.)

Basic Principles

7. 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 recognized in the financial statements and (b) as measured by the provisions of enacted tax laws. To implement that objective, all of the following basic principles [4] are applied in accounting for income taxes 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;
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 expenses in future years or the future enactment of a change in tax laws or rates are not anticipated for purposes of recognition and measurement of a deferred tax liability or asset.

Generally accepted accounting principles specify the timing of recognition of events in financial statements, and the tax consequences of events [5] (as measured by the provisions of enacted tax laws) are recognized when the events are recognized in financial statements. Events that have not been recognized at the date of the financial statements under generally accepted accounting principles may affect the eventual tax consequences of other events that have been recognized at that date. However, those tax effects are recognized when the events that cause them are recognized under generally accepted accounting principles.

8. The only exceptions in applying those basic principles are that this Statement (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 (paragraph 23).

Temporary Differences

9. The tax consequences of most events recognized in the current year's financial statements are included in determining income taxes currently payable. However, because tax laws and financial accounting standards differ in their recognition and measurement of assets, liabilities,

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equity, revenues, expenses, gains, and losses, differences arise between the following:

a. The amount of taxable income and pretax financial income for a year
b. The tax bases of assets or liabilities and their reported amounts in financial statements.

10. 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. Examples follow:

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.
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 an 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 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.
f. *ITC accounted for by the deferral 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 future 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

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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 future recovery of the amount 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 accounted for as 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.

The following example illustrates two of the above situations. The amount of an enterprise's depreciable assets reported in its financial statements is $1,500, and their tax basis is $900. The $600 difference might be attributable to accelerated deductions for tax purposes or to an excess of assigned value if the assets were acquired in a business combination accounted for by the purchase method. Future recovery of the $1,500 reported amount of the depreciable assets will result in $600 of taxable amounts in future years because the tax basis of those assets is only $900.

	Financial Reporting	**Tax Return**
Income before depreciation	$1,500	$1,500
Depreciation	1,500	900
Income before taxes (or taxable income)	$ —	$ 600

11. Examples (a)-(d) in paragraph 10 pertain to revenues, expenses, gains, or losses that are included in taxable income of an earlier or later year than the year in which they are recognized in financial income. Those differences between taxable income and pretax financial income also create differences (sometimes accumulating over more than one year) between the tax basis of an asset or liability and its reported amount in the financial statements. Examples (e)-(i) pertain to other events that create differences between the tax basis of an asset or liability and its reported amount in the financial statements. For all nine examples, the differences result in taxable or deductible amounts when the reported amount of an asset or liability in the financial statements is recovered or settled, respectively. This Statement refers collectively to the types of differences illustrated by those nine examples and to the ones described in paragraph 12 as **temporary differences.**[8]

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12. Some temporary differences cannot be identified with a particular asset or liability for financial reporting. One example is a long-term contract that is accounted for by the percentage-of-completion method for financial reporting and by the completed-contract method for tax purposes. The temporary difference (income on the contract) is deferred income for tax purposes that becomes taxable when the contract is completed. Another example is organizational costs that are recognized as expenses when incurred for financial reporting if, for tax purposes, the costs are deferred and deducted in a later year. In both instances, there is no related, identifiable asset or liability for financial reporting but there is a temporary difference that results from an event that has been recognized in the financial statements, and based on provisions in the tax law, the temporary difference will result in taxable or deductible amounts in future years.

13. The amount actually recovered for a particular asset or paid to settle a particular liability in a subsequent year may be different from the amount recognized for financial reporting in the current year. If so, the tax consequences of recovering that asset or settling that liability may also be an amount that is different from the amount of tax consequences recognized in the current year. That change in the tax consequences (a) would be the result of a gain or loss from future recovery or settlement (or adjustment) of that asset or liability and (b) would be recognized when that gain or loss is recognized.

Recognition and Measurement

14. A liability or asset shall be recognized for the **deferred tax consequences** of all [9] temporary differences, that is, the amount of taxes payable or refundable in future years as a result of the deferred tax consequences (as measured by the provisions of enacted tax laws) of events recognized in financial statements in the current or preceding years. The recognition and measurement of a deferred tax liability or asset shall not assume any taxable or deductible amounts in future years as a result of events that have not been recognized in the financial statements at the end of the current year.

15. Incurring losses or generating profits in future years are future events that are not recognized in financial statements for the current year and are not inherently assumed in financial statements for the current year. Those future events shall not be anticipated, regardless of probability, for purposes of recognizing and measuring a deferred tax liability or asset in the current year. The tax consequences of those future events shall be recognized and reported in financial statements in future years when the events occur.

16. **Deferred tax expense or benefit** shall be recognized for the net change during the year in an enterprise's deferred tax liability or asset.[10] That amount together with income taxes currently payable or refundable is the total amount of income tax expense or benefit for the year. Income tax expense or benefit for the year shall be allocated among continuing operations, discontinued operations, extraordinary items, the cumulative effect of accounting changes, prior

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period adjustments, **gains and losses included in comprehensive income but excluded from net income,** and capital transactions.

Annual Computation of a Deferred Tax Liability or Asset

17. In concept, this Statement requires determination of the amount of taxes payable or refundable in each future year as if a tax return were prepared for the net amount of temporary differences that will result in taxable or deductible amounts in each of those years. That concept is illustrated by the following procedures. If alternative tax systems exist, those procedures are applied in a manner consistent with the tax law. The procedures are applied separately for each tax jurisdiction.

a. Estimate the particular future years in which temporary differences will result in taxable or deductible amounts.
b. Determine the *net* taxable or deductible amount in each future year.
c. Deduct **operating loss carryforwards for tax purposes** (as permitted or required by tax law) from net taxable amounts that are scheduled to occur in the future years included in the loss carryforward period.
d. Carry back or carry forward (as permitted or required by law) net deductible amounts occurring in particular years to offset net taxable amounts that are scheduled to occur in prior or subsequent years.

Deferred Tax Assets

e. Recognize a deferred tax asset for the tax benefit of net deductible amounts that could be realized by loss carryback from future years (1) to reduce a current deferred tax liability and (2) to reduce taxes paid in the current or a prior year. (No asset is recognized for any additional net deductible amounts in future years.)

Deferred Tax Liabilities

f. Calculate the amount of tax for the remaining net taxable amounts that are scheduled to occur in each future year by applying presently enacted tax rates and laws for each of those years to the type and amount of net taxable amounts scheduled for those years.
g Deduct **tax credit carryforwards for tax purposes** (as permitted or required by law) from the amount of tax (calculated above) for future years that are included in the carryforward periods. (No asset is recognized for any additional amount of tax credit carryforward.)
h. Recognize a deferred tax liability for the remaining amount of taxes payable for each future year.

Tax-Planning Strategies

i. **Tax-planning strategies** that meet certain criteria (paragraph 19) are used for purposes of *estimating the years* in which temporary differences will result in taxable or deductible amounts (step (a) above). By applying such a strategy:

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(1) Amounts may become deductible in a different year and thereby provide a tax benefit by offsetting (step (d)) or by loss carryback (step (e)).
(2) Amounts may become taxable in a different year before a loss or tax credit carryforward expires (steps (c) and (g)) or in a particular year that maximizes the benefit of tax credits, for example, foreign tax credits (steps (f) or (g)).

18. In practice, the following approach sometimes may reduce the extent of scheduling and the detailed calculations described above for some tax jurisdictions.

a. Identify the type and nature of an enterprise's temporary differences.
b. For each type of temporary difference, determine whether the tax law precludes or effectively precludes tax-planning strategies that would change the particular future years in which temporary differences will result in taxable or deductible amounts.
c. For types of temporary differences for which the tax law precludes or effectively precludes tax-planning strategies, scheduling or other procedures may be necessary to determine whether deductible amounts in future years offset taxable amounts.
d. For all other types of temporary differences, determine whether there is a tax-planning strategy that meets the criteria of paragraph 19, and if there is, those temporary differences may be offset for deferred tax calculations.

Criteria for Tax-Planning Strategies

19. Measurement of a deferred tax liability or asset shall take into account tax-planning strategies that would change the particular future years in which temporary differences result in taxable or deductible amounts. Tax-planning strategies either reduce the recognized amount of taxes payable for net taxable amounts in future years or increase the recognized amount of tax benefits for net deductible amounts in future years. A tax-planning strategy (including elections for tax purposes that are required or permitted by the tax law) shall 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 the 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 a significant cost.

An Enacted Change in Tax Laws or Rates

20. A deferred tax liability or asset shall be adjusted for the effect of a change in tax law or rates. The effect shall be included in income from continuing operations for the period that includes the enactment date.

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A Change in the Tax Status of an Enterprise

21. An enterprise's tax status may change from nontaxable to taxable. An example is a change from a partnership to a corporation. Temporary differences may be created or eliminated at the date of the change in tax status. A deferred tax liability shall be recognized for temporary differences in accordance with the requirements of this Statement at the date that a nontaxable enterprise becomes a taxable enterprise. A deferred tax liability or asset shall be eliminated at the date an enterprise ceases to be a taxable enterprise. The effect of recognizing or eliminating the deferred tax liability or asset shall be included in income from continuing operations.

Regulated Enterprises

22. Regulated enterprises that meet the criteria for application of FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation,* are not exempt from the requirements of this Statement. Specifically, this Statement:

a. Prohibits net-of-tax accounting and reporting
b. Requires recognition of a deferred tax liability (1) for tax benefits that are flowed through to customers when temporary differences originate and (2) for the equity component of the allowance for funds used during construction
c. Requires adjustment of a deferred tax liability or asset for an enacted change in tax laws or rates.

If it is probable that the future increase or decrease in taxes payable for items (b) and (c) above will be recovered from or returned to customers through future rates, an asset or liability shall be recognized for that probable future revenue or reduction in future revenue pursuant to paragraphs 9-11 of Statement 71. That asset or liability also is a temporary difference, and a deferred tax liability or asset shall be recognized for the deferred tax consequences of that temporary difference.

Business Combinations

23. A deferred tax liability or asset shall be recognized in accordance with the requirements of this Statement for differences between the assigned values and the tax bases of the assets and liabilities (except goodwill, unallocated "negative goodwill," and leveraged leases) recognized in a purchase business combination. If not recognized at the acquisition date, the tax benefits of an acquired **operating loss or tax credit carryforward for financial reporting** that are recognized in financial statements after the acquisition date shall (a) first be applied to reduce to zero any goodwill and other noncurrent intangible assets related to the acquisition and (b) next be recognized as a reduction of income tax expense.

Financial Statement Presentation and Disclosure

24. A deferred tax liability or asset shall be classified in two categories—the current amount

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and the noncurrent amount—in a classified statement of financial position. The current amount of a deferred tax liability or asset shall be the net deferred tax consequences of:

a. Temporary differences that will result in net taxable or deductible amounts during the next year
b. Temporary differences related to an asset or liability that is classified for financial reporting as current because of an operating cycle that is longer than one year
c. Temporary differences for which there is no related, identifiable asset or liability for financial reporting (paragraph 12) whenever *other* related assets and liabilities are classified as current because of an operating cycle that is longer than one year.

Deferred tax liabilities and assets attributable to different tax jurisdictions shall not be offset. The types of temporary differences that give rise to significant portions of a deferred tax liability or asset shall be disclosed. A **public enterprise** that is not subject to income taxes because its income is taxed directly to its owners shall disclose that fact and the net difference between the tax bases and the reported amounts of the enterprise's assets and liabilities.

25. The following information shall be disclosed whenever a deferred tax liability is not recognized for any of the areas addressed by Opinion 23 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 a 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).

26. The amount of income tax expense or benefit allocated to continuing operations, discontinued operations, extraordinary items, the cumulative effect of accounting changes, prior period adjustments, gains and losses included in comprehensive income but excluded from net income, and capital transactions shall be disclosed for each year for which those items are presented.

27. The significant components of income tax expense attributable to continuing operations for each year presented shall be disclosed in the financial statements or notes thereto. Those components would include, for example:

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a. **Current tax expense [11] or benefit**
b. Deferred tax expense or benefit, exclusive of (f) below
c. Investment tax credits
d. Government grants (to the extent recognized as a reduction of income tax expense)
e. The benefits of operating loss carryforwards
f. Adjustments of a deferred tax liability or asset for enacted changes in tax laws or rates or a change in the tax status of an enterprise.

28. The reported amount of income tax expense attributable to continuing operations for the year shall be reconciled (using percentages or dollar amounts) to the amount of income tax expense that would result from applying domestic federal statutory tax rates to pretax income from continuing operations. The "statutory" tax rates shall be the regular tax rates if there are alternative tax systems. The estimated amount and the nature of each significant reconciling item shall be disclosed. A **nonpublic enterprise** shall disclose the nature of significant reconciling items but may omit a numerical reconciliation.

29. The amounts and expiration dates (or a reasonable aggregation of expiration dates) of operating loss and tax credit carryforwards for financial reporting (that is, amounts not already recognized as reductions of a deferred tax liability) and for tax purposes (that is, amounts available to reduce taxes payable on tax returns in future years) shall be disclosed. An operating loss carryforward for financial reporting includes the amount of future tax deductions (temporary differences) for which a tax benefit has not been recognized in the financial statements. If significant, the amount of net operating loss or tax credit carryforwards for which any tax benefits will be applied to reduce goodwill and other noncurrent intangible assets (of an acquired enterprise) shall be disclosed separately.

30. An enterprise that is part of a group that files a consolidated tax return shall disclose in its separately issued financial statements:

a. The amount of current and deferred tax expense for each statement of earnings presented and the amount of any tax-related balances due to or from affiliates as of the date of each statement of financial position presented
b. The principal provisions of the method by which the consolidated amount [12] of current and deferred tax expense is allocated to members of the group and the nature and effect of any changes in that method (and in determining related balances to or from affiliates) during the years for which the disclosures in (a) above are presented.

Application of the Standards to Specific Aspects of Accounting for Income Taxes

31. Appendix A provides additional discussion and illustrations of how the provisions of this Statement shall be applied to specific aspects of accounting for income taxes. Appendix A constitutes an integral part of the requirements of this Statement.

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Effective Date and Transition

32. This Statement shall be effective for fiscal years beginning after December 15, 1988. Earlier application is encouraged. Financial statements for fiscal years before the effective date may be restated to conform to the provisions of this Statement. Initial application of this Statement shall be as of the beginning of an enterprise's fiscal year.

33. For the earliest year restated or for the year this Statement is first adopted if no prior year is restated, the effect of applying this Statement on the amount of deferred tax charges or credits at the beginning of the fiscal year shall be reported as the effect of a change in accounting principle in a manner similar to the cumulative effect of a change in accounting principle as described in paragraph 20 of APB Opinion No. 20, *Accounting Changes,* except for any effects of the type required by this Statement to be excluded from net income (for example, refer to paragraph 54 for the manner of reporting certain tax benefits subsequent to a quasi reorganization). Those latter effects shall be recognized in a manner consistent with the reporting requirements of this Statement. If the earliest year restated is not presented in the financial statements, the beginning balance of retained earnings (and, if necessary, any other components of stockholders' equity) for the earliest year presented shall be adjusted for the effect of the restatement as of that date. Pro forma effects of retroactive application (Opinion 20, paragraph 21) are not required if statements of earnings presented for prior years are not restated.

34. When initially presented, the financial statements for the year this Statement is first adopted shall disclose:

a. The effect of adopting this Statement on income from continuing operations, income before extraordinary items, and on net income (and on related per share amounts) for the year of adoption if restated financial statements for the prior year are not presented
b. The effect of any restatement on income from continuing operations, income before extraordinary items, and on net income (and on related per share amounts) for each year presented.

35. If financial statements for prior years are restated, all purchase business combinations that were consummated in those prior years shall be remeasured in accordance with the requirements of this Statement. A purchase business combination consummated prior to the beginning of the earliest year restated or prior to the year for which this Statement is first applied (if no prior year is restated) shall not be remeasured, and the remaining balances of any assets and liabilities recognized in that purchase business combination shall not be adjusted to pretax amounts (that is, any remaining amounts that were originally assigned on a net-of-tax basis pursuant to paragraph 89 of Opinion 16 shall not be adjusted). Except for leveraged leases, any differences between those remaining balances and their tax bases are temporary differences, and a deferred tax liability or asset shall be recognized for those temporary differences pursuant to the requirements of this Statement as of the beginning of the year for which this Statement is first

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applied. The effect of that adjustment shall be included in the effect of initially applying this Statement and reported in accordance with the provisions of paragraph 33.

36. Some regulated enterprises that meet the criteria for application of Statement 71 have accounted for construction in progress on a net-of-tax or after-tax basis. Upon initial application of this Statement, those enterprises shall adjust the reported amount of construction in progress to the amount that would have resulted from applying the requirements of this Statement to that construction in progress in all prior years. The reported amount of plant in service at the beginning of the earliest year restated or at the beginning of the year for which this Statement is first applied (if no prior year is restated) shall not be adjusted. Any difference between the reported amount and the tax basis of that plant in service is a temporary difference, and a deferred tax liability shall be recognized for that temporary difference. If it is probable that amounts required for settlement of that deferred tax liability will be recovered from customers through future rates, an asset and the related deferred tax liability for that additional temporary difference shall be recognized for that probable future revenue. Any net effect of applying the provisions of this paragraph shall be included in the effect of initially applying this Statement and reported in accordance with the provisions of paragraph 33.

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

This Statement was adopted by the affirmative votes of five members of the Financial Accounting Standards Board. Messrs. Mosso and Northrop dissented.

Mr. Mosso dissents because he believes the tax recognition model prescribed by this Statement falls short of a design that would achieve the objective of accrual accounting, that is, to recognize the financial consequences of an event in the same year that the event is recognized (Concepts Statement 6, paragraphs 139 and 140). For example, the financial consequences of an installment sale might include future cash inflows from collecting the receivable, future cash outflows for product warranty expense, tax payments relating to the receivable collection, and tax deductions relating to the warranty payments. He believes that the future tax effects of both the installment sale and the warranty expense should be recognized at the time of sale if their future occurrences are probable. Under this Statement; the tax effect of the installment sale is always recognized at the time of sale; the tax effect of the warranty expense is recognized only at such times as there are offsettable deferred tax liabilities or carryback income. Probability of future cash flows is not a consideration under the Statement for recognizing either deferred tax assets or liabilities.

In his view, the flaw in the model is its omission of most future taxable income. The omission has the effect of assuming that future taxable revenues will exactly equal future deductible expenses, except for reversing temporary differences (paragraphs 14 and 15 of the Statement). That creates an asymmetry in the recognition model. Potential net deferred tax liabilities are always recognized when the originating events occur; potential net deferred tax

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assets, except for carrybacks, are never recognized when the originating events occur. That asymmetry is an algebraic consequence of the model. With all other taxable net income held to zero, reversal of net temporary credits always creates pro forma future taxable income and therefore a pro forma future cash outflow for taxes payable — a pro forma tax liability. Reversal of net temporary debits always creates a pro forma future tax loss and therefore no pro forma future cash inflow from a tax refund — no pro forma tax asset.

The trouble with that approach, in his view, is that the ultimate tax consequences of events are determined by total taxable income or loss and not by the small fraction of the total, reversing temporary differences, admitted by the model. There is no inherent correlation between the pro forma tax consequences recognized by the model and the actual tax consequences later determined by the tax return. The amounts recognized by the model are not designed to be best estimates of future cash flows; they are the result of a formula that ignores the most strategic event, taxable income.

Mr. Mosso agrees that accounting should not anticipate future events, no matter how probable, if those events have no direct cause and effect linkage to past events under the terms of a contract or, in this instance, a statute. For example, he would not permit anticipation of probable purchases of equipment that would create future originating depreciation differences sufficient to offset future reversals of past depreciation differences, a form of partial allocation. That is because there is no necessary relationship between future equipment purchases and the tax consequences of past depreciation differences. Future purchases will contribute to taxable income or loss in future years, but they will not by themselves determine the tax consequences of past book-tax differences.

Future taxable income, on the other hand, is linked firmly by statute to past book-tax differences; it is the sole determinant of the ultimate tax effects of originating differences. Mr. Mosso believes that it must be factored into the recognition model if the tax consequences of current events are to be measured on a best estimate basis. It must be anticipated if net tax assets other than carrybacks are to be measured at all.

The model in this Statement rests on a view of what is and what is not "inherently assumed" by financial statements. It admits future taxable income to the extent of reversing differences because future recovery and settlement of the reported amounts of assets and liabilities is said to be inherently assumed. It omits other future income because that is not inherently assumed. Thus, for purposes of deferred tax recognition the effect is to assume zero future accounting income, or breakeven. Mr. Mosso believes a better view is that amounts recorded on the historical cost basis are required to be estimates of *minimum* expected recovery and *maximum* expected settlement. Breakeven is neither assumed nor expected. In fact, the minimum-maximum notion suggests a general expectation of positive net income. Whether positive or negative, however, the key word is *expected.* Accrual accounting is concerned with the *expected* cash consequences of events (Concepts Statement 6, paragraph 141). Whatever is relevant to assessing expectations about the future cash consequences of an event must be part of an accrual accounting recognition model.

The design of the recognition model prescribed by this Statement, by recognizing net tax liabilities but not net tax assets, embodies the conservatism convention known as "anticipate no profits but anticipate all losses." That extreme form of conservatism was firmly rejected by the

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Board in Concepts Statement 2, "Conservatism in financial reporting should no longer connote deliberate, consistent understatement of net assets and profits" (Concepts Statement 2, paragraph 93).

Mr. Mosso would recognize tax assets at the time the originating events occur if realization were probable. Conversely, he would not recognize tax liabilities if settlement were not probable. He believes that is the only conclusion that is consistent with the Board's conceptual framework. He disagrees with the conceptual analysis in paragraphs 103-116 of the Statement. Requiring a probability, or realizability, test would require some estimation or presumption about future taxable income other than reversing temporary differences. That would necessarily be somewhat arbitrary or subjective, but it would eliminate the need for scheduling reversals of temporary differences and applying tax strategies in the formulized way required by this Statement for the purpose of maximizing deferred debit recognition. Mr. Mosso believes his approach would be simpler and have better ability to predict future cash flows.

Mr. Mosso dissents also because this Statement does not require discounting and, related to that, it continues the "indefinite reversal" exceptions permitted by Opinion 23. Without discounting, financial statements do not show the benefit of tax deferral or the burden of tax prepayment when those events occur; financial statements look as though the world is indifferent about when taxes are paid. Without discounting, the comparability of financial statements is impaired between enterprises and between time periods because a dollar of shorter term tax deferral is made to look the same as a dollar of longer term deferral even though their economic values differ vastly. Without discounting, recognizing Opinion 23 differences would have grossly overstated the amount of tax liabilities and that was a factor in the Board's decision to continue those anomalous exceptions to deferred tax recognition.

Mr. Northrop dissents from this Statement primarily because of its limitation on the recognition of deferred tax assets. That limitation results in not fully achieving the principal objective of comprehensive tax allocation and creates significant implementation complexities.

In Mr. Northrop's view, the principal objective of comprehensive tax allocation is to recognize the probable income tax consequences of transactions in the same year those transactions are recognized in the financial statements. This Statement requires recognition of the benefits of temporary differences that result in net deductible amounts in future years only to the extent that those amounts offset deferred tax liabilities or that tax refunds are available. Thus, the most likely tax consequences of certain transactions, such as accruals for deferred compensation (particularly for those payable in the distant future), may not be recognized in the same year that the transactions are recognized. That lack of recognition distorts the effective tax rate reflected in the statement of earnings both for the year the transactions occur and for the year when the tax benefits are realized. During the interim period, liabilities are overstated or assets are understated.

In Mr. Northrop's view, the event sufficient for recognition of a deferred tax asset is the recognition in the financial statements of the transaction that will result in a probable future tax benefit. He believes that view is consistent with the definitions in Concepts Statement 6 of an asset (paragraph 25) and of accrual accounting (paragraph 139) and the goal of accrual accounting (paragraph 145).

In his view, the complexities of implementing this Statement go beyond those that result

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from the complexities of the tax law. In order to determine whether temporary differences will result in net deductible amounts, this Statement requires scheduling of the amounts and timing of their reversal. The complexity is further increased by the additional requirement to devise hypothetical tax strategies that are not intended to be implemented, but are developed for accounting purposes only. Those required strategies relax the otherwise rigid limitation of recognition of deferred tax assets by hypothesizing future events that would maximize their recognition by accelerating or delaying the year of recovery of an asset or settlement of a liability. In his view, a Statement should not require that recognition of deferred tax assets be accomplished through complex indirect methods when, in many cases, it could be accomplished directly. The requirement for scheduling would be significantly reduced and the requirement for devising tax strategies would be unnecessary given different criteria for the recognition of deferred tax assets.

In Mr. Northrop's view, the consequences of the limitation on recognizing deferred tax assets may be less relevant financial statements for users prepared at a higher than necessary cost for reporting enterprises.

Members of the Financial Accounting Standards Board:

Dennis R. Beresford, *Chairman*
Victor H. Brown
Raymond C. Lauver
James J. Leisenring
David Mosso
C. Arthur Northrop
Robert J. Swieringa

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Appendix A

APPLICATION OF THE STANDARDS TO SPECIFIC ASPECTS OF ACCOUNTING FOR INCOME TAXES

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Appendix A: APPLICATION OF THE STANDARDS TO SPECIFIC ASPECTS OF ACCOUNTING FOR INCOME TAXES

Introduction

37. This appendix provides additional discussion and examples that illustrate application of the standards to specific aspects of accounting for income taxes. This appendix constitutes an integral part of the requirements of this Statement.

Recognition of a Deferred Tax Liability or Asset

Deferred Tax Liability

38. A liability is recognized for the deferred tax consequences of temporary differences that will result in *net* taxable amounts in future years. Provisions in the tax law may permit or require that net deductions in a particular year offset net taxable amounts in certain earlier or later years.[13] On that basis, determination of the net taxable or deductible amount in each future year is as follows:

a. Deductible amounts in future years offset amounts that become taxable in the same future years.
b. Loss carryback of net deductions for a particular future year offsets net taxable amounts in certain preceding years.
c. Loss carryforward of net deductions for a particular future year offsets net taxable amounts in certain succeeding years.

A deferred tax liability is recognized for the aggregate amount of income taxes payable on net taxable amounts in each future year.

The following example illustrates offsetting. 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 reported 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

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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 amount	—	—	—	(1,300)	—
	300	300	300	(1,000)	300
Loss carryback	(300)	(300)	(300)	900	—
Loss carryforward	—	—	—	100	(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.

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.

Deferred Tax Asset

39. Tax deductions provide a tax benefit only by offsetting amounts that are taxable. Temporary differences sometimes will result in deductible amounts that either exceed or cannot offset (based on loss carryback and carryforward provisions in the tax law) taxable amounts in past or future years. A net deferred tax asset is recognized for the deferred tax consequences of net deductible amounts in future years only to the extent that a tax benefit could 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 net deductible amounts in future years are, in substance, the same as operating loss carryforwards.

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

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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 loss carryforward	$ —	$ —	$ —	$ (100)	$ —

The $2,000 deductible amount in year 4:

a. Offsets (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.

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.

Offset of Taxable and Deductible Amounts

40. The tax law determines whether temporary differences that will result in taxable and deductible amounts in future years may be offset against each other. For example, if the tax law provides that capital losses are deductible only to the extent of capital gains, temporary differences that will result in future deductions in the form of capital losses cannot be offset

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against temporary differences that will result in future ordinary income for purposes of determining net taxable amounts in future years.

Pattern of Taxable or Deductible Amounts

41. The particular years in which most temporary differences will result in taxable or deductible amounts is determined by reference to the timing of the recovery of the related asset or settlement of the related liability and may require estimates. An example is an estimated liability for product warranties that is settled over a period of several years. The annual amount of tax deductions resulting from settlement of that liability during each of those years has to be estimated. A second example is a temporary difference between the tax basis and the reported amount of inventory for which cost for financial reporting is determined on a last-in, first-out (LIFO) basis. A LIFO inventory difference will result in taxable or deductible amounts when the reported amount of that inventory is recovered. Future recovery of the reported amount of inventory is a future event that is inherently assumed in the statement of financial position for the current year—future purchases or production of inventory are not. The reported amount of LIFO inventory would be recoverable next year if inventory is estimated to "turn over" at least once a year. If so, a temporary difference for LIFO inventory would be considered to be taxable or deductible next year. The temporary difference for the excess of cash surrender value of life insurance over premiums paid is a third example.

42. For some assets or liabilities, temporary differences may accumulate over several years and then eliminate over several years. That pattern is common for depreciable assets. Future temporary differences for existing depreciable assets (in use at the end of the current year) are considered in determining the future years in which existing temporary differences result in *net* taxable or deductible amounts. Consideration of future originating differences may affect:

a. Measurement of deferred taxes when enacted tax rates differ for different years
b. Recognition of a tax benefit for other temporary differences that will result in deductible amounts in future years
c. Classification of deferred tax liabilities or assets in a statement of financial position.

The following example illustrates those effects. The assumptions are as follows:

a. Year 1, the current year, is an enterprise's first year of operations.
b. The enacted tax rates are 40 percent for year 1, 35 percent for year 2, and 30 percent for year 3 and thereafter.
c. For the current year, the enterprise has pretax financial income of $700, taxable income of $500, and taxes currently payable of $200 ($500 at 40 percent).

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d. Temporary differences at the end of the current year are as follows:

Installment sale difference (taxable in year 2)	$300
Depreciation difference	100
Estimated expenses (deductible in year 7)	(200)
Net temporary difference	$200

e. Future recovery of the enterprise's depreciable assets (in assumed annual amounts equal to depreciation expense for financial reporting) is estimated to result in the following pattern of temporary differences: $900 of deductible amounts in year 2, and taxable amounts of $600 in year 3 and $400 in year 4.

Accrual of deferred taxes for the existing temporary differences is as follows:

	Current Year	Future Years Year 2	Year 3	Year 4	Year 7
Taxable income	$ 500	$ —	$ —	$ —	$ —
Temporary differences:					
Installment sale	—	300	—	—	—
Depreciation	—	(900)	600	400	—
Estimated expenses	—	—	—	—	(200)
	$ 500	(600)	600	400	(200)
Loss carryback	(500)	500	—	(200)	200
Loss carryforward	—	100	(100)	—	—
	$(500)	$ —	$ 500	$ 200	$ —
Enacted tax rate	40%	35%	30%	30%	30%
Deferred tax liability (asset):					
Current	$(200)				
Noncurrent			$ 150	$ 60	

The enterprise's total tax expense for the current year is $210 (current tax expense of $200 plus deferred tax expense of $10), that is, 30 percent of the enterprise's $700 of pretax income.

Temporary Differences for Foreign Assets and Liabilities

43. After a change in exchange rates, temporary differences attributable to an enterprise's foreign assets and liabilities result from two sources. One source is temporary differences between the foreign currency carrying amount and the foreign currency tax basis of those assets and liabilities. The other source is temporary differences that arise when the reporting currency

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(not the foreign currency) is the functional currency and certain assets and liabilities are remeasured from the foreign currency into the reporting currency using historical exchange rates. After a change in exchange rates, there will be a temporary difference between (a) the current foreign currency equivalent of the historical cost as measured in the reporting currency and (b) the foreign currency tax basis of those assets and liabilities. Those temporary differences (regardless of source) will result in taxable or deductible amounts on the foreign tax return in future years.

The following example illustrates temporary differences attributable to foreign depreciable assets when the U.S. dollar is the functional currency. The assumptions are as follows:

a. A foreign subsidiary purchases depreciable assets for FC1,000 at the beginning of year 1 when FC1 = $1.
b. The foreign currency unamortized historical cost of those assets is FC900 and FC800 at the end of years 1 and 2, respectively. Remeasured at the historical exchange rate of FC1 = $1, the U.S. dollar unamortized historical cost of those assets is $900 and $800 at the end of years 1 and 2, respectively. Future recovery of the U.S. dollar unamortized historical cost is assumed.
c. Depreciation of those assets is accelerated for foreign tax purposes, and the foreign tax basis of those assets is FC700 and FC400 at the end of years 1 and 2, respectively.
d. The exchange rate is FC1 = $1.20 and FC1 = $1.40 at the end of years 1 and 2, respectively.
e. The foreign income tax rate is 40 percent for all years.
f. There are no other temporary differences.

	End of Year 1		End of Year 2	
	FC	$	FC	$
U.S. dollar unamortized historical cost of assets		900		800
Foreign currency revenues necessary to recover U.S. dollar cost*	750		571	
Foreign tax basis	700		400	
Foreign temporary difference	50		171	
Deferred foreign tax liability	20		68	
U.S. dollar equivalent of the deferred foreign tax liability †		24		95

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*$900 ÷ $1.20, and $800 ÷ $1.40, respectively

†FC20 x $1.20, and FC68 x $1.40, respectively

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44. When the reporting currency (not the foreign currency) is the functional currency, remeasurement of an enterprise's deferred foreign tax liability or asset after a change in the

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exchange rate will result in a transaction gain or loss that is recognized currently in determining net income. When the foreign currency is the functional currency, translation of an enterprise's foreign assets and liabilities will result in a translation adjustment that is not included currently in determining net income. Statement 52 requires disclosure of the aggregate transaction gain or loss included in determining net income but does not specify how to display that transaction gain or loss (or its components) for financial reporting. Accordingly, a transaction gain or loss that results from remeasuring a deferred foreign tax liability or asset may be included in the reported amount of deferred tax benefit or expense if that presentation is considered to be more useful. If reported in that manner, that transaction gain or loss is still included in the aggregate transaction gain or loss for the period to be disclosed as required by Statement 52.

In the example following paragraph 43, one alternative for financial reporting in year 2 is to report $71 of deferred tax expense for the net change ($95 - $24) in the U.S. dollar equivalent of the deferred foreign tax liability. The other alternative for financial reporting is to exclude the transaction loss from the amount reported as deferred tax expense. Computation of the two components of the $71 net change in the U.S. dollar equivalent of the deferred foreign tax liability is as follows:

Deferred tax expense:		
The net change (FC48) in the deferred foreign tax liability multiplied by the average exchange rate (assumed to be FC1 = $1.30)		$62
Transaction loss:		
Beginning balance of the deferred foreign tax liability (FC20) multiplied by the change ($.20) in the exchange rate during the year (from $1.20 to $1.40)	$4	
The net change (FC48) in the deferred foreign tax liability multiplied by the difference ($.10) between the average and ending exchange rate ($1.30 and $1.40, respectively)	5	9
		$71

Measurement of a Deferred Tax Liability or Asset

45. A deferred tax liability or asset is computed at the date of the financial statements by applying the provisions in the tax law to measure the deferred tax consequences of temporary differences that will result in net taxable or deductible amounts in each future year. Measurements are based on elections that are expected to be made for tax purposes in future years. Enacted changes in tax laws and rates that are scheduled for a particular future year (or years) are used to measure a liability for the deferred tax consequences of net taxable amounts that will arise in that year (or years). Tax laws and rates for the current year are used if no changes have been enacted for future years. An asset for the deferred tax consequences of net deductible amounts in future years is measured using tax laws and rates for the current or a prior

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year, that is, the year for which a refund could be realized based on loss carryback provisions in the tax law.

The following example illustrates measurement of the amount of taxes payable in each future year as the result of the deferred tax consequences of temporary differences. At the end of year 1, future recovery of the reported amount of an enterprise's installment receivables will result in taxable amounts totaling $240,000 in years 2-4. Also, a $20,000 liability for estimated expenses has been recognized in the financial statements in year 1, and those expenses will be deductible for tax purposes in year 4 when the liability is expected to be paid. Those temporary differences are estimated to result in net taxable amounts in future years as presented below.

	Year 2	Year 3	Year 4
Taxable amounts	$70,000	$110,000	$60,000
Deductible amount	—	—	(20,000)
Net taxable amounts	$70,000	$110,000	$40,000

This example assumes that the enacted tax rates for years 2-4 are 20 percent for the first $50,000 of taxable income, 30 percent for the next $50,000, and 40 percent for taxable income over $100,000. The liability for deferred tax consequences is measured as follows:

	Year 2	Year 3	Year 4
20 percent tax on first $50,000	$10,000	$10,000	$8,000
30 percent tax on next $50,000	6,000	15,000	—
40 percent tax on over $100,000	—	4,000	—
	$16,000	$29,000	$8,000

A deferred tax liability is recognized for $53,000 (the total of the taxes payable for years 2-4) at the end of year 1. (Paragraph 63 discusses factors and circumstances that would permit a single calculation using an estimated average tax rate.)

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46. A deferred tax liability is measured using tax rates applicable to capital gains, ordinary income, and so forth, based on the expected type of net taxable amounts in future years. For example, evidence based on all facts and circumstances should determine whether a liability for the tax consequences of the equity in the earnings of an investee should be measured as a capital gain or as a dividend. Another example is measurement of a liability for differences between the reported amount and tax basis of depreciable assets. The deferred tax consequences are measured at a capital gains rate if it is expected that the assets will be sold and that the temporary differences will result in amounts taxed as a capital gain. The tax rate for ordinary income is used if recovery will be by use of the assets. A consistent policy of selling a particular type of asset midway through its economic life, together with an accounting policy that estimates salvage values and determines depreciation on the same basis, would provide the basis for an

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estimate that recovery will be by sale.

Comprehensive Alternative Tax Systems

47. A tax law may require that more than one comprehensive method or system be used to determine an enterprise's potential tax liability, with the higher (or possibly, lower) outcome of the calculations determining the actual tax liability. For example, the current U.S. Internal Revenue Code requires a corporation to calculate its potential federal income tax liability using both the "regular tax" system and an "alternative minimum tax" (AMT) system, with the corporation's actual income tax liability for the year being the greater of the two. If alternative systems exist, they should be used to measure an enterprise's deferred tax asset or liability in a manner consistent with the tax law. After giving consideration to any interaction between the two systems, such as the U.S. alternative minimum tax credit, that enterprise's deferred tax asset or liability is recognized based on the results of the two calculations for each future year. Accordingly, under existing U.S. tax law, a U.S. enterprise uses both the regular tax system and the alternative minimum tax system for each future period to determine the deferred tax consequences of its current and past activities.

48. Because of different recognition or measurement provisions, existing temporary differences may be recognized or measured differently under each of the two tax systems, or a temporary difference may exist for only one system. The pattern (timing and amount) in which an existing temporary difference will result in a future taxable or deductible amount may also be different. However, in applying each system, the same assumptions or tax strategies are used to measure or recognize the deferred tax consequences of temporary differences that exist under both systems. For example, if it is assumed that an asset will be sold in two years, that same assumption is used for each system.

The following example illustrates measurement of the amount of deferred taxes payable in each future year for an enterprise when two comprehensive tax systems must be used to determine the enterprise's tax liability. For purposes of this example, it is assumed that the enterprise is a U.S. enterprise and that the tax liability is determined based on the Tax Reform Act of 1986. However, for ease of illustration, a 35 percent tax rate for regular taxable income is assumed for all years. Additional assumptions are as follows:

a. Year 1, the current year, is the enterprise's first year of operations.
b. The enterprise has tax exempt income of $1,300 from municipal bonds (nonpreference) in the current year.
c. U.S. tax law provides that the book income adjustment, a feature of the alternative minimum tax system, will be replaced by an adjustment for "adjusted current earnings" (ACE), and that change is assumed to occur in year 5.
d. Depreciable assets that cost $1,000 were acquired in the middle of the current year and will be depreciated as follows:

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	Financial Reporting	Regular Tax	AMT	ACE
Year 1	$ 100	$ 200	$ 150	$
Year 2	200	320	255	
Year 3	200	192	178	
Year 4	200	115	167	
Year 5	200	115	167	125
Year 6	100	58	83	125
	$1,000	$1,000	$1,000	$250

e. Financial income and income taxes currently payable for the current year are as follows:

Regular tax calculation:	
Pretax financial income	$ 2,000
Municipal bond income	(1,300)
Depreciation difference	(100)
Regular taxable income	$ 600
Regular tax (35 percent)	$ 210
AMT calculation:	
Regular taxable income	$ 600
Depreciation adjustment	50
Tentative AMT income (tentative AMTI)	650
Book income adjustment	
[50 percent of ($2,000 – $650)][14]	675
AMT income (AMTI)	$ 1,325
Tentative minimum tax (TMT) (20 percent)	$ 265
Income taxes currently payable	$ 265

The enterprise's current tax liability will be $265, the higher of the regular tax and the AMT calculations. Within certain limitations, the tax law permits the excess of the TMT over the regular tax ($55 in this example) to be carried forward and used as a credit against the regular tax in future years. However, the AMT credit can only be carried forward and cannot be used to reduce a future year's regular tax below the TMT for that future year.

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At the end of the current year (year 1), a liability for the deferred tax consequences of depreciation differences is calculated as follows (amounts are rounded to the nearest dollar):

	Carryback to Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Regular tax calculation:						
Taxable (deductible) amounts	$ —	$(120)	$ 8	$ 85	$ 85	$ 42
Loss carryback	(120)	120	—	—	—	—
Regular taxable amounts	$(120)	$ —	$ 8	$ 85	$ 85	$ 42
Regular tax (35 percent)	$ (42)	$ —	$ 3	$ 30	$ 30	$ 15
AMT calculation:						
Regular taxable amounts before loss carryback and carryforward	$ —	$(120)	$ 8	$ 85	$ 85	$ 42
AMT depreciation adjustment	—	65	14	(52)	(52)	(25)
Tentative AMTI	—	(55)	22	33	33	17
Book income adjustment	—	28	—	—		
ACE adjustment[15]					32	(32)
AMTI before loss carryback	—	(27)	22	33	65	(15)
Loss carryback	(27)	27	(15)	—	—	15
AMTI	$ (27)	$ —	$ 7	$ 33	$ 65	$ —
TMT (20 percent)	$ (5)	$ —	$ 1	$ 7	$ 13	$ —
Higher of regular tax or AMT	$ (5)	$ —	$ 3	$ 30	$ 30	$ 15
AMT credit carryforward applied	—	—	2	23	17	15
Deferred tax liability of $16	$ (5)	$ —	$ 1	$ 7	$ 13	$ —
AMT credit carryforward:						
Beginning of year	$ 55	$ 92	$ 92	$ 90	$ 67	$ 50
Add (deduct)	37	—	(2)	(23)	(17)	(15)
End of year	$ 92	$ 92	$ 90	$ 67	$ 50	$ 35

Loss carryback to year 1 results in a $42 reduction in regular tax, a $5 reduction in TMT, and a $37 increase ($42 - $5) in AMT credit carryforward so that the carryforward amount becomes $92 at the end of year 1.

The enterprise's total tax expense for the current year will be $281 (current tax expense of $265 plus deferred tax expense of $16).

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Operating Loss and Tax Credit Carryforwards and Carrybacks

Recognition of a Tax Benefit for Carrybacks

49. An operating loss (and certain deductible items that are subject to limitations) and some tax credits arising but not utilized in the current year may be carried back for refund of taxes paid in prior years or carried forward to reduce taxes payable in future years. An asset is recognized for the amount of taxes paid in prior years that is refundable by carryback of an operating loss or unused tax credits of the current year.

Recognition of a Tax Benefit for Carryforwards

50. An operating loss or tax credit carryforward is recognized as a reduction of a deferred tax liability for temporary differences that will result in taxable amounts during the operating loss or tax credit[16] carryforward period. Carryforward amounts from prior years are available (subject to limitations in the tax law) to reduce a deferred tax liability for temporary differences that arise in the current year. Provisions in the tax law that limit utilization of an operating loss or tax credits are applied in determining the amount by which a deferred tax liability is reduced. The tax benefit of an operating loss or tax credit carryforward that cannot be recognized as a reduction of a deferred tax liability is not recognized as an asset regardless of the probability that the enterprise will generate taxable financial income in future years.

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 years 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

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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
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.

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51. An operating loss or tax credit carryforward from a prior year may sometimes reduce taxable income and taxes payable that are attributable to certain revenues or gains that the tax law requires be included in taxable income for the year that cash is received. For financial reporting, however, there may have been no revenue or gain and a liability is recognized for the cash received. Future sacrifices to settle the liability will result in deductible amounts in future

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years. Under those circumstances, a tax benefit is not recognized for the reduction in taxable income and taxes payable from utilization of the operating loss or tax credit carryforward. In effect, the operating loss or tax credit carryforward has been replaced by temporary differences that will result in deductible amounts when a liability is settled in future years. The requirements for recognition of a tax benefit for those future tax deductions and for operating loss carryforwards are the same.

The following example illustrates the interaction of loss carryforwards and temporary differences that will result in net deductible amounts in future years. The assumptions are as follows:

a. The financial loss and the loss reported on the tax return for an enterprise's first year of operations are the same.
b. In year 2, a gain of $2,500 from a transaction that is a sale for tax purposes but a sale and leaseback for financial reporting is the only difference between pretax financial income and taxable income.

		Financial Income	Taxable Income
Year 1:	Income (loss) from operations	$(4,000)	$(4,000)
Year 2:	Income (loss) from operations	$ —	$ —
	Taxable gain on sale		2,500
	Taxable income before loss carryforward		2,500
	Loss carryforward from year 1		(4,000)
	Taxable income		$ —

The $4,000 operating loss carryforward at the end of year 1 is reduced to $1,500 at the end of year 2 since $2,500 of it is utilized to reduce taxable income. The $2,500 reduction in the loss carryforward becomes $2,500 of future tax deductions that will occur when lease payments are made. The enterprise has no deferred tax liability to be offset by those future tax deductions, and the future tax deductions cannot be realized by loss carryback because no taxes have been paid. A tax asset is not recognized at the end of year 2 for either the $2,500 of future tax deductions or the remaining $1,500 of operating loss carryforward.

Reporting the Tax Benefit of Operating Loss Carryforwards or Carrybacks

52. Except as noted in paragraphs 23 and 54, the manner of reporting the tax benefit of an operating loss carryforward or carryback is determined by the source of the income or loss in the current year and not by the source of the operating loss carryforward or taxes paid in a prior year. Thus, for example, the tax benefit of an operating loss carryforward reduces income tax expense from continuing operations if realization of the tax benefit results from income from continuing operations. Likewise, that tax benefit is reported as an extraordinary item if

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realization of the tax benefit results from an extraordinary gain.

Carryforwards for Tax Purposes and for Financial Reporting

53. An operating loss carryforward for tax purposes is an excess of tax deductions over gross income during a year that may be carried forward to reduce taxable income in future years. If there is an operating loss carryforward for tax purposes, an operating loss carryforward for financial reporting is the amount for tax purposes (a) reduced by the amount that offsets temporary differences that will result in net taxable amounts during the carryforward period and (b) increased by the amount of temporary differences that will result in net tax deductions for which a tax benefit has not been recognized in the financial statements. If there is no operating loss carryforward for tax purposes, an operating loss carryforward for financial reporting is the amount of temporary differences that will result in net tax deductions for which a tax benefit has not been recognized in the financial statements.

The following example illustrates an operating loss carryforward for financial reporting when a tax loss carryforward is reduced by temporary differences that will result in taxable amounts during the carryforward period. Year 1 is the first year of operations. The enterprise's only temporary differences are depreciation differences.

	Years 1-3	**Year 4**
Pretax financial income (loss)	$ 400	$(600)
Depreciation differences	(80)	(20)
Taxable income (loss)	320	(620)
Loss carryback for tax purposes	(320)	320
Loss carryforward for tax purposes	$ —	$(300)

Loss carryforward for tax purposes	$(300)
Loss applied to offset depreciation differences ($80 + $20)	100
Loss carryforward for financial reporting	$(200)

The following example illustrates an operating loss carryforward for financial reporting when a tax loss carryforward is increased by temporary differences that will result in net tax deductions for which a tax benefit has not been recognized in the financial statements. Year 1 is the first year of operations. The enterprise's only temporary differences are warranty expense differences that will result in deductible amounts in future years.

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	Years 1-3	Year 4
Pretax financial income (loss)	$ 400	$(800)
Warranty expense differences	80	20
Taxable income (loss)	480	(780)
Loss carryback for tax purposes	(480)	480
Loss carryforward for tax purposes	$ —	$(300)

Loss carryforward for tax purposes	$(300)
Warranty expense differences ($80 + $20)	(100)
Loss carryforward for financial reporting	$(400)

The following example illustrates an operating loss carryforward for financial reporting when there is no operating loss carryforward for tax purposes. Year 1 is the first year of operations. At the end of year 3, a $1,000 liability for estimated expenses has been recognized in the financial statements, and those expenses will be deductible for tax purposes in year 4 when the liability is expected to be paid. That temporary difference is the enterprise's only temporary difference.

	Years 1-2	Year 3
Pretax financial income (loss)	$ 400	$ (800)
Estimated expenses	—	1,000
Taxable income	$ 400	$ 200

Total temporary differences	$(1,000)
Temporary differences for which a tax benefit is recognized based on recoverability by loss carryback	600
Loss carryforward for financial reporting	$ (400)

Quasi Reorganizations

54. The tax benefit of an operating loss or tax credit carryforward for financial reporting as of the date of a quasi reorganization as defined and contemplated (involving write-offs directly to contributed capital) in ARB No. 43, Chapter 7, "Capital Accounts," is reported as a direct addition to contributed capital if the tax benefits are recognized in subsequent years. Some quasi reorganizations involve only the elimination of a deficit in retained earnings by a concurrent reduction in contributed capital. For that type of reorganization, subsequent recognition of the tax benefit of a prior operating loss or tax credit carryforward for financial reporting is reported as required by paragraph 52 and then reclassified from retained earnings to contributed capital. Regardless of whether the reorganization is labeled as a quasi reorganization, if prior losses were charged directly to contributed capital, the subsequent recognition of a tax benefit for a prior operating loss or tax credit carryforward for financial reporting is reported as a direct addition to

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contributed capital.

Tax-Planning Strategies

55. The basic principles underlying the requirements of this Statement distinguish between two types of future events. One type of future event results in taxable or deductible amounts (in future years) that are attributable to temporary differences existing at the end of the current year. The deferred tax consequences of temporary differences are recognized in the current year as described in paragraph 14. The other type of future event results in taxable or deductible amounts that are attributable to generating profits or incurring losses that will be reported in financial statements in future years. The future tax consequences of generating profits or incurring losses in future years are not recognized in the current year (paragraph 15).

56. Tax-planning strategies, as that term is used in this Statement, apply exclusively to the first type of future event, that is, recovery of assets and settlement of liabilities in future years. Tax-planning strategies that anticipate the tax consequences of earning income or incurring losses in future years are prohibited for purposes of recognition or measurement of a tax liability or asset under the requirements of this Statement.

57. The deferred tax consequences of temporary differences sometimes will be affected by the particular future years in which those temporary differences result in taxable or deductible amounts. For example, an operating loss carryforward that expires in year 10 will offset taxable amounts arising from collections of an installment sale receivable through year 10, but not in year 11 or later. Tax-planning strategies for purposes of the recognition and measurement requirements of this Statement apply to actions that the management of an enterprise would take, if necessary, to affect the particular years in which temporary differences result in taxable or deductible amounts so as to minimize taxes. Those actions would accelerate or delay the recovery of an asset or the settlement of a liability.

58. Tax-planning strategies cannot disregard assumptions that are critical to determining the reported amount of an asset or liability. For example, assume that there is a temporary difference related to land. Also assume that the current market value of that land is significantly less than its reported amount in the financial statements. The reported amount of that land might not be reduced if the enterprise intends to hold the land for at least five years and if the market value of that land is expected to at least equal its reported amount by the end of five years. If the reported amount of that land is not reduced, a tax-planning strategy related to the temporary difference to sell that land in two years would not meet the criteria of this Statement if the sale of that land after only two years would result in a significant loss.

59. Tax-planning strategies may be relevant for recognizing a tax benefit for an operating loss or tax credit carryforward. A tax benefit for a carryforward is recognized only to the extent that a deferred tax liability is reduced. A carryforward amount does not reduce a deferred tax liability for temporary differences that will result in taxable amounts in years beyond the

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carryforward period. A tax-planning strategy, however, might be to accelerate taxable amounts to years before the carryforward period expires. Examples that might meet the criteria (paragraph 19) of this Statement include:

a. A sale and leaseback of plant or equipment would accelerate taxable amounts for a difference between the tax basis and the reported amount of the plant or equipment. (The sales price is assumed to equal the remaining balance of the reported amount of the plant or equipment at the sale date and, on that basis, would result in a taxable amount that is equal to the remaining balance of the temporary difference at that date.)
b. A sale of installment sale receivables would accelerate taxable amounts for the gains on the installment sales. (The sales price is assumed to equal the remaining balance of the reported amount of the receivables at the sale date and, on that basis, would result in a taxable amount equal to the remaining balance of the temporary difference at that date.)

60. Tax-planning strategies may be relevant for recognizing a tax benefit for temporary differences that will result in net deductible amounts in future years. A tax benefit is recognized only to the extent that those net deductible amounts offset taxable amounts in other years based on loss carryback and carryforward provisions in the tax law. Carryback of net deductible amounts cannot offset taxable amounts for years prior to the carryback period. A tax-planning strategy, however, might be to accelerate the deductible amounts to an earlier future year. Examples that might meet the criteria (paragraph 19) of this Statement include:

a. An annual payment that is larger than an enterprise's usual annual payment to reduce a long-term pension obligation (recognized as a liability in the financial statements) might accelerate a tax deduction for pension expense to an earlier year than would otherwise have occurred.
b. Disposal of obsolete inventory that is reported at net realizable value in the financial statements would accelerate a tax deduction for the amount by which the tax basis exceeds the net realizable value of the inventory.
c. Sale of loans at their reported amount (that is, net of an allowance for bad debts) might accelerate a tax deduction for the allowance for bad debts.

61. Consideration of tax-planning strategies is not elective. Strategies that meet the two criteria (paragraph 19) for tax-planning strategies are to be reflected in the recognition and measurement of a deferred tax liability or asset.

Aggregate Calculation of a Deferred Tax Liability or Asset

62. Calculation of the deferred tax consequences of temporary differences will require information about the particular future years in which temporary differences will result in taxable or deductible amounts because of:

a. The requirements for offsetting and for recognition of an asset for the deferred tax benefit of

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net deductible amounts in future years

b. The requirements for recognition of a tax benefit for operating loss and tax credit carryforwards
c. The requirement for measurements based on enacted tax rates or laws for each future year whenever (1) enacted changes in the tax law or rate will be phased in over more than one year or (2) graduated tax rates based on the amount of taxable income in a particular year are a significant factor
d. Classification of deferred tax assets and liabilities as current or noncurrent in a statement of financial position.

For (a) - (c) above, overall estimates for time spans of several years or calculations on an exception basis are permitted if an enterprise can:

a. Identify any significantly large net deductible amounts that do not qualify for recognition of a tax benefit based on the recognition requirements of this Statement
b. Determine whether net taxable amounts are at least sufficient to utilize an operating loss or tax credit carryforward before the carryforward period expires
c. Estimate the net taxable or deductible amounts arising in the years of a phased-in change in tax law or rate. (The tax accrual for all taxable or deductible amounts arising in years after the phase-in is based on the new law or rate.)

63. A deferred tax liability is measured as if net taxable amounts arising from temporary differences will be the only net taxable amounts in future years. If tax rates are graduated according to the amount of taxable income, those graduated tax rates are used to measure the amount of income taxes payable in each future year. For some enterprises, the deferred tax liability may be so large that there will be no significant difference if it is computed by applying the highest tax rate to the aggregate net taxable amount that will arise in all future years. For other enterprises, the net amounts that will become taxable in individual future years may seldom or never exceed the level of income subject to tax at the maximum rate. Those enterprises are permitted to make aggregate calculations using an estimated average tax rate at which the aggregate net taxable amount would be subject to taxation in various future years provided that care and judgment are applied to identify and deal with unusual situations, for example, an unusually large amount that will become taxable in a single future year.

Regulated Enterprises

64. Paragraph 9 of Statement 71 requires a regulated enterprise that applies Statement 71 to capitalize an incurred cost that would otherwise be charged to expense if the following criteria are met:

a. It is probable that future revenue in an amount at least equal to the capitalized cost will result from inclusion of that cost in allowable costs for rate-making purposes.
b. Based on available evidence, the future revenue will be provided to permit recovery of the

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previously incurred cost rather than to provide for expected levels of similar future costs.

If the income taxes that result from recording a deferred tax liability in accordance with this Statement meet those criteria, an asset is recognized for those income taxes when the deferred tax liability is recognized. That asset and the deferred tax liability are not offset for general-purpose financial reporting; rather, each is displayed separately.

The following example illustrates recognition of an asset for the probable future revenue to recover future income taxes related to the deferred tax liability for the equity component of the allowance for funds used during construction (AFUDC). The assumptions are as follows:

a During year 1, the first year of operations, total construction costs for financial reporting and tax purposes are $400,000 (exclusive of AFUDC).
b. The enacted tax rate is 34 percent for all future years.
c. AFUDC (consisting entirely of the equity component) is $26,000. The asset for probable future revenue to recover the related income taxes is calculated as follows:

34 percent of ($26,000 + A) = A (where A equals the asset for probable future revenue)

A = $13,394

At the end of year 1, the related accounts are as follows:

Construction in progress	$426,000
Probable future revenue	$ 13,394
Deferred tax liability [34 percent of ($26,000 + $13,394)]	$ 13,394

The following example illustrates adjustment of a deferred tax liability for an enacted change in tax rates. The assumptions are the same as for the example above except that a change in the tax rate from 34 percent to 30 percent is enacted on the first day of year 2. As of the first day of year 2, the related accounts are adjusted so that the balances are as follows:

Construction in progress	$426,000
Probable future revenue	$ 11,143
Deferred tax liability [30 percent of ($26,000 + $11,143)]	$ 11,143

The following example illustrates adjustment of a deferred tax liability for an enacted change in tax rates when that deferred tax liability represents amounts already collected from

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customers for the future payment of income taxes. In that case, there would be no asset for "probable future revenue." The assumptions are as follows:

a. Amounts at the end of year 1, the current year, are as follows:

Construction in progress for financial reporting	$400,000
Tax basis of construction in progress	$300,000
Deferred tax liability (34 percent of $100,000)	$ 34,000

b. A change in the tax rate from 34 percent to 30 percent is enacted on the first day of year 2. As a result of the reduction in tax rates, it is probable that $4,000 of the $34,000 (previously collected from customers for the future payment of income taxes) will be refunded to customers, together with the tax benefit of that refund, through a future rate reduction. The liability for the future rate reduction to refund a portion of the deferred taxes previously collected from customers is calculated as follows:

$4,000 + 30 percent of L = L (where L equals the probable future reduction in revenue)

L = $5,714

As of the first day of year 2, the related accounts are adjusted so that the balances are as follows:

Construction in progress	$400,000
Probable reduction in future revenue	$ 5,714
Deferred tax liability [30 percent of ($100,000 - $5,714)]	$ 28,286

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Leveraged Leases

65. This Statement does not change (a) the pattern of recognition for the after-tax income for leveraged leases as required by Statement 13 or (b) the allocation of the purchase price in a purchase business combination to acquired leverage leases as required by Interpretation 21. Deferred tax credits attributable to a leveraged lease are reduced for both the tax benefits of (a) other temporary differences that will result in net deductible amounts and (b) operating loss and tax credit carryforwards that offset taxable amounts (paragraph 38) from future recovery of the net investment in the leveraged lease. However, to the extent that the amount of deferred tax credits for a leveraged lease as determined by Statement 13 differs from the amount of the deferred tax liability related to the leveraged lease that would otherwise result from applying the requirements of this Statement, that difference is preserved and is not offset by the deferred tax consequences of other temporary differences or by the tax benefit of operating loss or tax credit carryforwards. Interpretation 21 requires that the tax effect of any difference between the assigned value and the tax basis of a leveraged lease at the date of a business combination not be accounted for as a deferred tax credit. This Statement does not change that requirement. Any tax effects included in unearned and deferred income as required by Interpretation 21 are not offset by the deferred tax of other temporary differences or by the tax benefit of operating loss or tax credit carryforwards. However, deferred tax credits that arise after the date of a business combination are accounted for in the same manner as described above for leveraged leases that were not acquired in a purchase business combination.

The following example illustrates integration of the results of income tax accounting for leveraged leases with the other results of accounting for income taxes as required by this Statement.

a. At the end of year 1, the current year, an enterprise has two temporary differences. One temporary difference is for a $120,000 estimated liability for warranty expense that will result in a tax deduction in year 5 when the liability is expected to be paid. The enterprise has no operating loss or tax credit carryforwards.
b. The other temporary difference is for a leveraged lease that was entered into in a prior year. During year 1, the enacted tax rate for year 2 and thereafter changed from 40 percent to 35 percent. After adjusting for the change in estimated total net income from the lease as a result of the change in tax rates as required by Statement 13, the components of the investment in the leveraged lease at the end of year 1 are as follows:

Net rentals receivable plus residual value less unearned pretax income		$150,000
Reduced by:		
Deferred ITC	$ 9,000	
Deferred tax credits	39,000	48,000

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Net investment in leveraged lease for financial reporting	$102,000

c. The tax basis of the investment in the leveraged lease at the end of year 1 is $41,000. The amount of the deferred tax liability for that leveraged lease that would otherwise result from the requirements of this Statement is determined as follows:

Net rentals receivable plus residual value less unearned pretax income	$150,000
Temporary difference for deferred ITC	9,000
	141,000
Tax basis of leveraged lease	41,000
Temporary difference	$100,000
Deferred tax liability (35 percent)	$ 35,000

d. Loss carryback (to year 2) and loss carryforward (to year 20) of the $120,000 tax deduction for warranty expense in year 5 would offset the $100,000 of taxable amounts resulting from future recovery of the net investment in the leveraged lease over the remainder of the lease term.
e. At the end of year 1, a $35,000 deferred tax benefit is recognized for the reduction in deferred tax credits attributable to the leveraged lease from $39,000 (the amount determined as required by Statement 13) to $4,000 (the difference, not available for offset, between the $39,000 of deferred tax credits as determined by Statement 13 and the $35,000 deferred tax liability as determined by this Statement) as a result of the $120,000 temporary difference for accrued warranty expense.

Business Combinations

Nontaxable Business Combinations

66. This Statement requires that a liability or asset be recognized for the deferred tax consequences of differences between the assigned values and the tax bases of the assets and liabilities recognized in a business combination accounted for as a purchase under Opinion 16. A deferred tax liability or asset is not recognized for a difference between the reported amount and the tax basis of goodwill, unallocated "negative" goodwill, and leveraged leases (paragraph 65).

The following example illustrates recognition and measurement of a deferred tax liability in a nontaxable business combination. The assumptions are as follows:

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a. The enacted tax rate is 40 percent for all future years.
b. An enterprise is acquired for $20,000 and the enterprise has no leveraged leases.
c. The tax basis of the net assets acquired is $5,000, and the assigned value (other than goodwill) is $12,000. Future recovery of the assets and settlement of the liabilities at their assigned values will result in taxable and deductible amounts that can be offset against each other.

The amounts recorded to account for the purchase transaction would be as follows:

Assigned value of the net assets (other than goodwill) acquired	$12,000
Liability for deferred tax consequences [40 percent of the $7,000 net taxable amounts ($12,000 - $5,000) that will arise upon recovery of the assigned value of those net assets]	(2,800)
Goodwill	10,800
Purchase price of the acquired enterprise	$20,000

Taxable Business Combinations

67. In a taxable business combination, the purchase price is assigned to the assets and liabilities recognized for tax purposes as well as for financial reporting. However, the amounts assigned to particular assets and liabilities may differ for financial reporting and tax purposes. A liability or asset is recognized for the deferred tax consequences of those temporary differences in accordance with the recognition and measurement requirements of this Statement. For example, a portion of the amount of goodwill for financial reporting may be allocated to some other asset for tax purposes, and amortization of that other asset may be deductible for tax purposes. Recognized benefits for those tax deductions should be applied to reduce to zero any goodwill and other noncurrent intangible assets related to the acquisition, after which any additional recognized benefits for those tax deductions should be applied to reduce income tax expense.

The following example illustrates recognition and measurement of the deferred tax consequences of temporary differences in a taxable business combination. The assumptions are as follows:

a. The enacted tax rate is 40 percent for all future years.
b. An enterprise is acquired for $20,000, and the enterprise has no leveraged leases.
c. The net assets (other than goodwill) acquired have a tax basis of $20,000 and an assigned value of $12,000, that is, there are $8,000 of temporary differences that will result in deductible amounts in future years.

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d. As of the acquisition date (1) the acquiring enterprise has a liability for the deferred tax consequences of temporary differences that will result in $30,000 of net taxable amounts in future years and (2) the acquired $8,000 of temporary differences ($20,000 - $12,000) will result in deductible amounts in the same future years.

The amounts recorded to account for the purchase transaction are as follows:

Assigned value of the net assets (other than goodwill) acquired	$12,000
Reduction of acquiring enterprise's deferred tax liability (40 percent of $8,000)	3,200
Goodwill	4,800
Purchase price of the acquired enterprise	$20,000

Carryforwards—Purchase Method

68. Accounting for a business combination should reflect any provisions in the tax law that permit or restrict the use of either of the combining enterprises' operating loss or tax credit carryforwards to reduce taxable income or taxes payable attributable to the other enterprise subsequent to the business combination. If permitted by tax law or by tax elections (for example, the election to file a consolidated tax return) that are expected to be adopted by the combined enterprise,[17] an operating loss or tax credit carryforward for financial reporting of either combining enterprise is recognized as a reduction of a deferred tax liability of the other as of the acquisition date, thereby either reducing goodwill or noncurrent assets (except long-term investments in marketable securities) of the acquired enterprise or creating or increasing negative goodwill.

The following example illustrates recognition of a loss carryforward in a nontaxable business combination. The assumptions are as follows:

a. The enacted tax rate is 40 percent for all future years.
b. The purchase price is $20,000. The tax basis of the identified net assets acquired is $5,000, and the assigned value is $12,000, that is, there are $7,000 of temporary differences that will result in taxable amounts in future years. The acquired enterprise also has a $16,000 operating loss carryforward which, under the tax law, may be used by the acquiring enterprise in the consolidated tax return.
c. The acquiring enterprise has a liability for the deferred tax consequences of temporary differences that will result in $30,000 of net taxable amounts in future years.
d. All temporary differences of the acquired and acquiring enterprises will result in taxable amounts before the end of the acquired enterprise's loss carryforward period.

The $16,000 operating loss carryforward will offset:

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a. The $7,000 of net taxable amounts that will result from future recovery of the assigned value of the acquired net assets
b. Another $9,000 of net taxable amounts attributable to the acquiring enterprise's deferred tax liability.

The amounts recorded to account for the purchase transaction are as follows:

Assigned value of the identified net assets acquired	$12,000
Reduction of acquiring enterprise's deferred tax liability (40 percent of $9,000)	3,600
Goodwill	4,400
Purchase price of the acquired enterprise	$20,000

Carryforwards—Pooling-of-Interests Method

69. The separate financial statements of combining enterprises for prior periods are restated on a combined basis when a business combination is accounted for by the pooling-of-interests method. For restatement of periods prior to the combination date, a combining enterprise's operating loss carryforward does not offset the other enterprise's taxable income because consolidated tax returns cannot be filed for those periods. If consolidated tax returns are expected to be filed (refer to footnote 17) subsequent to the combination date, however, one combining enterprise's operating loss carryforward in a prior period reduces the other enterprise's deferred tax liability in the loss and subsequent periods to the extent that (a) the temporary differences will result in taxable amounts subsequent to the combination date and (b) the loss carryforward can reduce those taxable amounts based on provisions of the tax law. That tax benefit is recognized as part of the adjustment to restate financial statements on a combined basis for prior periods. The same requirements apply to tax credit carryforwards and to temporary differences that will result in net deductible amounts in future years.

70. A taxable business combination may sometimes be accounted for by the pooling-of-interests method. The increase in the tax basis of the net assets acquired results in temporary differences. A deferred tax liability or asset is recognized and measured for those temporary differences the same as for other temporary differences. As of the combination date, recognizable tax benefits attributable to the increase in tax basis are allocated to contributed capital. Tax benefits attributable to the increase in tax basis that become recognizable after the combination date are reported as a reduction of income tax expense.

Subsequent Recognition of Carryforward Benefits

71. If not recognized at the acquisition date, the tax benefits of an acquired enterprise's operating loss or tax credit carryforward for financial reporting are recognized in financial statements for the subsequent year(s) when those carryforward amounts reduce either a deferred tax liability or taxes payable on the tax return (except as noted in paragraph 51). The recognized

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benefit is:

a. First applied to reduce to zero any goodwill and other noncurrent intangible assets related to the acquisition
b. Next recognized as a reduction of income tax expense.

Additional amounts of operating loss or tax credit carryforward for financial reporting may arise after the acquisition date and before recognition of the tax benefit of amounts existing at the acquisition date. Tax benefits are recognized in later years as follows:

a. The tax benefit of amounts existing at the acquisition date is first applied to reduce goodwill and other noncurrent intangible assets to zero. Any additional tax benefit reduces income tax expense.
b. The tax benefit of amounts arising after the acquisition date is recognized as a reduction of income tax expense.

Whether a tax benefit recognized in later years is attributable to an amount (for example, an operating loss carryforward) existing at or arising after the acquisition date is determined for financial reporting by provisions in the tax law that identify the sequence in which those amounts are utilized for tax purposes. If not determinable by provisions in the tax law, a tax benefit recognized for financial reporting is prorated between a reduction of (a) goodwill and other noncurrent intangible assets and (b) income tax expense.

The following example illustrates recognition of tax benefits subsequent to a business combination. The assumptions are as follows:

a. A nontaxable business combination occurs on the first day of year 1, and the purchase transaction is accounted for as follows:

	Assigned Values	Tax Basis
Net assets acquired	$5,000	$6,000
Goodwill*	1,500	
Purchase price	$6,500	

*There are no other noncurrent intangible assets.

b. The $1,000 excess of tax basis over the assigned value of identified net assets acquired does not meet the criteria for recognition of a deferred tax asset.
c. The only difference between pretax financial and taxable income (amortization of goodwill is disregarded for this example) for years 1-2 is a $1,000 loss for tax purposes

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from disposal of the acquired identified net assets at amounts equal to their $5,000 assigned value on the acquisition date.

		Financial Income	Taxable Income
Year 1:	Loss from operations	$(3,000)	$(3,000)
	Disposal of acquired identified net assets		(1,000)
	Loss carryforward (no taxes paid in prior years)		$(4,000)
Year 2:	Income from operations	$ 2,500	$ 2,500
	Loss carryforward		(4,000)
	Taxable income		$ —

Assuming a 40 percent tax rate, the consolidated statement of earnings would include the following amounts attributable to the acquired enterprise:

	Year 1	Year 2
Pretax income (loss)	$(3,000)	$2,500
Income tax expense	—	250
Net income (loss)	$(3,000)	$2,250

The $4,000 loss carryforward at the end of year 1 has two components. One component (25 percent) is $1,000 attributable to the excess of tax basis over the assigned value of the identified net assets acquired at the date of the business combination. The other component (75 percent) is $3,000 attributable to losses occurring after the business combination. Provisions in the tax law do not distinguish between those two components, and the component that is utilized first for tax purposes is indeterminable. In year 2, therefore, the $1,000 tax benefit ($2,500 at 40 percent) is prorated so that goodwill is reduced $250 (25 percent of $1,000) and tax expense is reduced $750 (75 percent of $1,000). Because $250 of the tax benefit reduces goodwill, $250 of tax expense is reported in year 2.

Financial and taxable income for year 3 are as follows:

	Financial Income	Taxable Income
Income from operations	$1,500	$1,500
Loss carryforward		(1,500)
Taxable income		$ —

The consolidated statement of earnings would be as follows:

Pretax income	$1,500
Income tax expense	150
Net income	$1,350

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The $600 benefit of the operating loss carryforward ($1,500 at 40 percent) is prorated so that goodwill is reduced $150 (25 percent of $600) and tax expense is reduced $450 (75 percent of $600). Because $150 of the tax benefit reduces goodwill, $150 of tax expense is reported in year 3.

The Tax Basis of the Stock of an Acquired Enterprise

72. An acquiring enterprise's tax basis of the stock of an acquired enterprise may exceed the tax basis of the net assets of the acquired enterprise. That excess will result in a deductible amount in a future year if the acquired enterprise is sold or liquidated. Prior to sale or liquidation, that potential tax benefit does not meet the recognition requirements of this Statement whenever a deferred tax liability is not recognized for that acquired enterprise's Opinion 23 differences or deposits in statutory reserve funds by U.S. steamship enterprises. (In those circumstances, that potential tax benefit is included in the computation of the unrecognized deferred tax liability that is disclosed for those items.) Otherwise, the recognition requirements would be met to the extent that the deductible amount reduces a deferred tax liability for temporary differences that do not result in taxable amounts until the acquired enterprise is sold or liquidated. For example, it would reduce the acquiring enterprise's deferred tax liability for the temporary difference related to a gain recognized after the acquisition date as a result of the acquired enterprise's sale of stock (a minority interest) to a third party at a price per share that exceeds the per share carrying amount (prior to the sale) of the acquiring enterprise's investment in the acquired enterprise.

Classification in a Statement of Financial Position

73. A deferred tax liability or asset is classified in two categories—the current amount and the noncurrent amount—in a classified statement of financial position.

The following example illustrates classification in a statement of financial position at the end of year 1 if temporary differences will result in a net deductible amount in year 2. The enterprise has no taxable income for year 1, the first year of operations. Therefore, the net deductible amount does not provide a realizable tax benefit in year 2. Instead, it provides a recognizable tax benefit based on loss carryforward to reduce a noncurrent deferred tax liability. The tax rate is 40 percent for all years.

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	Temporary Differences	Future Years Year 2	Year 3
Liability for warranties	$(500)	$(500)	$ —
Installment receivables	800	—	800
	$ 300	$(500)	$800
Classification:			
Current deferred tax asset	$ —		
Noncurrent deferred tax liability ($300 at 40 percent)	120		
	$ 120		

The following example illustrates classification in a statement of financial position at the end of year 1 if temporary differences will result in a net deductible amount in year 3 and a tax benefit for those differences is recognizable based on loss carryback to offset a net taxable amount for other temporary differences in year 2. The enterprise has no taxable income for year 1, the first year of operations. The tax rate is 40 percent for all years.

	Temporary Differences	Future Years Year 2	Year 3
Liability for warranties	$(500)	$ —	$(500)
Installment receivables	800	800	—
	$ 300	$800	$(500)
Classification:			
Current deferred tax liability ($800 at 40 percent)	$ 320		
Noncurrent deferred tax asset ($500 at 40 percent)	$(200)		
	$ 120		

The following example illustrates classification in a statement of financial position at the end of year 1 if one type of an enterprise's temporary differences is attributable to an asset (for example, a liquor inventory) that is classified as current based on a three-year operating cycle and the types of temporary differences addressed in paragraph 42 are not present. The enterprise has no taxable income for year 1, the first year of operations. The tax rate is 40 percent for all years.

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	Temporary Differences	Future Years		
		Year 2	Year 3	Year 4
Liability for warranties	$ (500)	$(500)	$ —	$ —
Installment receivables	800	—	800	—
Liquor inventory	700	—	—	700
	$1,000	$(500)	$800	$700

Classification:	
Current deferred tax liability ($700 at 40 percent)	$ 280
Noncurrent deferred tax liability ($300 at 40 percent)	120
	$ 400

Allocation of Income Tax Expense between Pretax Income from Continuing Operations and Other Items

74. The amount of income tax expense or benefit allocated to continuing operations (in addition to adjustments for changes in tax status and tax laws or rates) is the tax consequences of the pretax income or loss from continuing operations exclusive of any other category of items (for example, extraordinary items) that occurred during the year. The amount allocated to a category of items other than continuing operations is the incremental effect on income taxes that results from that category of items. When allocated to two or more categories of items other than continuing operations, the sum of the incremental tax effects of each category of items sometimes may not equal the incremental tax effect of all categories of items because of, for example, a **statutory limitation** on the utilization of tax credits. In those circumstances, the procedures to allocate the incremental tax effects to categories of items other than continuing operations are as follows:

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

The procedure for allocating income taxes to each item within each category of items is similar to the procedure described above.

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

a. The enterprise's pretax financial income and taxable income are the same.

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b. The enterprise's loss from continuing operations is $500, and a loss carryback would give rise to a $100 refund of taxes paid on the $250 of taxable income during the carryback years.
c. The enterprise also has an extraordinary gain of $900.
d. The tax rate is 40 percent, and income taxes currently payable are $160 on $400 of taxable income.

Income tax expense is allocated between the pretax loss from operations and the extraordinary gain as follows:

Total income tax expense	$ 160
Tax consequences associated with the loss from operations	(100)
Incremental tax consequences attributable to the extraordinary gain	$ 260

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

The incremental effect on income taxes that results from all categories of items other than

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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 limitation)	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.

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 comprises a single item. If any

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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.

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75. Stockholders' equity is charged or credited for the income tax effects of (a) adjustments of the opening balance of retained earnings for a change in accounting principles or correction of an error, (b) gains and losses recognized in comprehensive income but excluded from net income, (c) an increase or decrease in contributed capital (for example, expenditures reported as a reduction of the proceeds from issuing capital stock), and (d) expenses for employee stock options recognized differently for financial reporting and tax purposes (refer to paragraph 17 of APB Opinion No. 25, *Accounting for Stock Issued to Employees*). An income tax benefit for the tax deductibility of dividends paid to stockholders is recognized as a reduction of income tax expense and is not credited directly to stockholders' equity.

The following example illustrates the allocation of income taxes directly to stockholders' equity.

a. A foreign subsidiary has earnings of FC600 for year 2. Its net assets (and unremitted earnings) are FC1,000 and FC1,600 at the end of years 1 and 2, respectively.
b. The foreign currency is the functional currency. For year 2, translated amounts are as follows:

	Foreign Currency	**Exchange Rate**	**Dollars**
Unremitted earnings, beginning of year	1,000	FC1 = $1.20	1,200
Earnings for the year	600	FC1 = $1.10	660
Unremitted earnings, end of year	1,600	FC1 = $1.00	1,600

c. A $260 translation adjustment ($1,200 + $660 - $1,600) is charged to the cumulative translation adjustment account in stockholders' equity for year 2.
d. The U.S. parent expects that all of the foreign subsidiary's unremitted earnings will be remitted in the foreseeable future, and under Opinion 23, a deferred U.S. tax liability is recognized for those unremitted earnings.
e. The U.S. parent accrues the deferred tax liability at a 20 percent tax rate (that is, net of foreign tax credits, foreign tax credit carryforwards, and so forth). An analysis of the net investment in the foreign subsidiary and the related deferred tax liability for year 2 is as follows:

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	Net Investment	Deferred Tax Liability
Balances, beginning of year	$1,200	$240
Earnings and related taxes	660	132
Translation adjustment and related taxes	(260)	(52)
Balances, end of year	$1,600	$320

f. For year 2, $132 of deferred taxes are charged against earnings, and $52 of deferred taxes are credited directly to the cumulative translation adjustment account in stockholders' equity.

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Appendix B

BASIS FOR CONCLUSIONS

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Appendix B: BASIS FOR CONCLUSIONS

Introduction

76. This appendix summarizes considerations that members of the Board deemed significant in reaching the conclusions in this Statement. It includes reasons for accepting certain views and rejecting others. Individual Board members gave greater weight to some factors than to others.

Conclusions on Basic Issues

77. The Board believes that the effects of income taxes recognized in financial statements should be the current and deferred tax consequences, as measured by the provisions of enacted tax laws, of all events [18] that have been recognized in the financial statements. Other events not yet recognized in the financial statements may affect the eventual tax consequences of some events that have been recognized in the financial statements. But that change in tax consequences would be a result of those other later events, and the Board believes that the tax consequences of an event should not be recognized until that event is recognized in the financial statements. Therefore, the Board concluded that the amount of income taxes recognized in financial statements should be determined (a) by applying the provisions of enacted tax laws to all events that have been recognized in the financial statements and (b) without regard to other events not yet recognized in the financial statements.

78. The tax consequences of most events affect taxable income for the year the events are recognized in the financial statements. The tax consequences of some events, however, are deferred. Temporary differences result from events that have deferred tax consequences. Paragraphs 9-13 discuss examples of temporary differences and describe how they originate and how they result in taxable or deductible amounts in later years. Most temporary differences will result in taxable or deductible amounts in future years when the reported amount of an asset or liability for financial reporting is recovered or settled.[19] Ordinarily, no other future event is required.

79. In the Board's view, 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. The Board believes that assumption creates a requirement under accrual accounting to recognize the deferred tax consequences of temporary differences, that is, the amount of income taxes (as measured by the provisions of enacted tax laws) that would be payable or refundable when the reported amounts of assets and liabilities are recovered and settled, respectively.

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80. The Board believes that this Statement should not address criteria for initial or continued recognition of assets or liabilities other than tax liabilities and assets. This Statement accepts whatever methods or procedures that are followed in determining the amount of other assets and liabilities. For example, this Statement does not address the issue of valuation allowances or write-downs for impairment of depreciable or other long-lived assets. Once the amounts of other assets and liabilities for financial reporting are determined, however, the Board believes that a fundamental accounting assumption inherent in the statement of financial position is that those amounts will be recovered and settled, respectively.

81. The amount actually recovered for an asset or paid to settle a liability in a subsequent year may be different from the reported amount of the asset or liability in the current year, and that difference may have tax consequences. The Board concluded that those tax consequences should be recognized in the subsequent year in which the gain or loss from recovery or settlement of the asset or liability (or from an adjustment of the reported amount of the asset or liability) is recognized.

82. Under the current accounting model, earning income and incurring losses or expenses in future years are events that are neither assumed nor recognized in financial statements for the current year. Those events are recognized in financial statements for the future years in which the income is earned or the losses and expenses are incurred. The Board concluded that the tax consequences of those future events should be recognized in future years and should not be anticipated for purposes of recognizing and measuring a deferred tax liability or asset in the current year.

A Deferred Tax Liability for Temporary Differences

83. The Board considered whether the deferred tax consequences of temporary differences that will result in *net* taxable amounts in future years are a liability. FASB Concepts Statement No. 6, *Elements of Financial Statements,* defines a liability and states that it "has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other 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" (paragraph 36).

84. The first characteristic of a liability requires a present duty or responsibility—an obligation—to one or more entities. Taxes are a legal obligation imposed by the government, and an obligation for the deferred tax consequences of temporary differences stems from the requirements of the tax law.

85. The first characteristic of a liability also requires settlement by probable future transfer or use of assets. The government levies taxes on net taxable income. Temporary differences will become taxable amounts in future years as a result of events whose occurrence is already inherently assumed in an enterprise's statement of financial position for the current year, namely,

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recovery or settlement of the recognized and reported amounts of an enterprise's assets or liabilities. No other future events need occur. Temporary differences will result in taxable amounts without regard to other possible future events such as earning financial income in future years. The Board concluded that the deferred tax consequences of temporary differences represent a probable future transfer or use of assets.

86. Losses or expenses that might be incurred in future years would offset net taxable amounts that result from temporary differences at the end of the current year. However, losses or expenses that might be incurred in future years (a) have not yet occurred and (b) are not inherently assumed in financial statements for the current year. The Board concluded that the future tax consequences of incurring losses or expenses in future years should not be anticipated to avoid recognizing a present obligation in the current year.

87. The first characteristic of a liability also requires settlement of the obligation (a) at a specified or determinable date, (b) on occurrence of a specified event, or (c) on demand. Settlement of a deferred tax liability will result from events specified by the tax law (item (b) above)—events whose occurrence is inherently assumed in the statement of financial position for the current year. Thus, the Board concluded that the deferred tax consequences of temporary differences (that is, net taxable amounts in future years) possess the first characteristic of a liability.

88. The second characteristic of a liability is that the obligation leaves the enterprise with little or no discretion to avoid the future sacrifice. Governments prescribe rules and regulations for (a) the taxation of revenues and the deduction of expenses, including the timing thereof, and (b) how to compute and when to pay the resulting tax. The deferred tax consequences of presently existing temporary differences are not yet payable to the government, but based on government rules and regulations, taxes will be payable when those differences result in net taxable amounts in future years. An enterprise might be able to delay settlement of the tax obligation by delaying the events that give rise to taxable amounts for tax purposes, for example, by delaying the recovery of an asset or the settlement of a liability. However, a contention that those events will never occur would contradict accounting assumptions inherent in the statement of financial position and thereby make that financial statement internally inconsistent. For that reason, the Board 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.

89. The third characteristic of a liability is that the obligating event has already happened—it is a past event. The past events that give rise to a deferred tax obligation are the same past events that create temporary differences. The Board 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.

Exceptions to Recognition of Deferred Tax Liabilities

90. The September 1986 FASB Exposure Draft, *Accounting for Income Taxes,* proposed a

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requirement to recognize the deferred tax liability for the areas addressed by Opinion 23 and for deposits in statutory reserve funds by U.S. steamship enterprises. Opinion 23 does not require recognition of deferred taxes for certain temporary differences because the taxpayer can control the timing of the events that result in taxable amounts in future years. However, Opinion 11 required recognition of deferred taxes for other temporary differences for which the taxpayer also could control the timing of the events that result in taxable amounts in future years. The Board believes that inconsistency is not appropriate and the proposal in the Exposure Draft would have eliminated it.

91. The Board continues to view the Exposure Draft's proposal as consistent with the Board's decision to reject partial recognition of deferred taxes depending on whether the cumulative balance of all temporary differences (or of particular recurring differences such as depreciation) is expected to continue to increase. The latter approach views future purchases of depreciable assets, for example, as a means to control the taxation of aggregate depreciation differences. Similarly, the ability to control the payment of dividends is viewed as a means to control the taxation of income attributable to subsidiaries that are not included in the parent's consolidated tax return. Management's ability to determine the particular future year(s) in which a deferred tax liability will be settled, however, does not eliminate the existence of that liability at the end of the current year.

92. Net earnings and shareholders' equity represent the shareholders' residual ownership interest in an enterprise's net earnings and net assets, respectively. Not recognizing a liability for the deferred tax consequences to a parent company as a result of a subsidiary's earnings implies that a portion of the parent's investment in the subsidiary will not be recovered. If that is the case, income (and the related income taxes) should be recognized only when dividends are received. If the earnings are consolidated and recognized on a current basis, however, taxes payable by a parent company upon recovery of a subsidiary's unremitted earnings represent a claim by the government that ranks ahead of the shareholders' residual ownership interest. To the extent of that prior claim by the government, shareholders are precluded from an ownership interest in a portion of an enterprise's earnings. Amounts payable to the government are not earnings or shareholders' equity. The Board continues to believe that there is a recognizable liability for the deferred tax consequences of a subsidiary's unremitted earnings. Similar considerations pertain to the bad debt reserves of a savings and loan association, the policyholders' surplus of a stock life insurance enterprise, and deposits in statutory reserve funds of U.S. steamship enterprises. The government has a claim (a right to collect taxes) that precludes shareholders from ever realizing a portion of the enterprise's net assets. The year in which the taxes will be paid may be uncertain, but the government's prior claim is not. A tax obligation is not a component of shareholders' equity.

93. The Exposure Draft also proposed recognition of the deferred tax liability for deposits in statutory reserve funds of U.S. steamship enterprises. The Board views anticipated tax deductions for deposits to capital construction funds in future years by steamship enterprises as analogous to anticipated tax deductions for the depreciation of depreciable assets that are

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expected to be acquired in future years by other types of enterprises. Both types of events are expected to result in tax deductions in future years, but neither event has occurred or is inherently assumed in preparing financial statements for the current year. The Board continues to believe that there is a recognizable liability for the deferred tax consequences of those reserve funds.

94. The Board considered whether payment of income taxes for the Opinion 23 and steamship enterprise temporary differences might be a *contingency* as that term is used in FASB Statement No. 5, *Accounting for Contingencies.* The Board concluded that there is no uncertainty that a tax obligation has been incurred for those temporary differences. The amount of the government's claim will never revert to the benefit of the shareholders unless there is a change in the tax law. The possibility of a change in the tax law in some future year is not an *uncertainty* as that term is used in Statement 5.

95. Many respondents to the Exposure Draft disagreed with the proposal to recognize the deferred tax liability for Opinion 23 differences and statutory reserve funds of U.S. steamship enterprises. In their view, the deferred tax liability for those temporary differences should not be recognized because the duration of some of those liabilities is very long and the Board has not addressed the issue of whether deferred tax liabilities and assets should be discounted. Some respondents expressed the view that if unremitted earnings are permanently reinvested, there is no tax liability to the parent company. Other respondents expressed the view that determination of the deferred tax liability for unremitted foreign earnings would require exceedingly complex calculations.

96. The Board continues to believe that the deferred tax liability for those temporary differences should be recognized. However, after considering respondents' views, the Board decided that, at this time, it would continue the exception to comprehensive recognition of deferred taxes for those temporary differences. Individual Board members support that decision to various degrees and for various reasons that include the following:

a. The complexity of measuring the deferred tax liability for foreign unremitted earnings and the reliability of the results
b. The need for Board members to compromise in order to improve other aspects of accounting for income taxes
c. The omission of discounting which, if concluded to be appropriate, would significantly reduce the magnitude of the deferred tax liability for those temporary differences.

Recognition of a deferred tax liability for analogous types of temporary differences is required.

A Deferred Tax Asset for Temporary Differences

97. The Board considered whether the deferred tax consequences of temporary differences that result in deductible amounts in future years are assets. Concepts Statement 6 defines an asset and states that it "has three essential characteristics: (a) it embodies a probable future

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benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred" (paragraph 26).

98. The first characteristic of an asset requires a capacity to contribute directly or indirectly to future net cash inflows. Temporary differences that result in deductible amounts that offset taxable amounts from other temporary differences (that is, reduce a deferred tax liability) contribute indirectly to future net cash inflows. This Statement recognizes that tax benefit by reducing a deferred tax liability.

99. The Board also considered whether the deferred tax consequences of temporary differences that will result in *net* deductible amounts (that is, deductible amounts that do not reduce a deferred tax liability) in future years have a capacity to contribute to future net cash inflows. The Board concluded that the tax law determines the existence and the amount of a tax benefit for temporary differences that will result in net deductible amounts in future years. The tax law for a particular tax jurisdiction may or may not provide for carryback of losses to offset taxable income in preceding years. If permitted by tax law, a future benefit is assured to the extent that net deductible amounts in future years would result in a refund of taxes paid in the current or preceding years. In those circumstances, the first characteristic of an asset is met.

100. Earning financial income in future years might generate taxable income that would be offset by net deductible amounts that result from temporary differences at the end of the current year. However, earning financial income in future years (a) has not yet occurred and (b) is not inherently assumed in financial statements for the current year. Therefore, the Board believes that the tax consequences of earning financial income in future years should not be anticipated in the current year. The Board concluded that a deferred tax asset should not be recognized for temporary differences that result in net deductible amounts that cannot result in a refund of taxes paid in the current or preceding years.

101. The second characteristic of an asset requires control. An enterprise has the ability to obtain the benefit of net deductible amounts in future years if the tax law permits loss carryback and if taxes were paid during the loss carryback period. The enterprise has an exclusive right to that benefit and therefore can control others' access to it. The Board concluded that in those circumstances the second characteristic of an asset is met.

102. The third characteristic of an asset is that the event giving rise to the future benefit has already happened—it is a past event. Temporary differences result from past events. Those past events create a potential future benefit for temporary differences that will result in net deductible amounts in future years. Deductible amounts can only provide a benefit, however, by offsetting taxable amounts and reducing taxes otherwise paid or payable. Therefore, the Board decided that the event that creates a temporary difference is not in itself the single past event that is sufficient to meet the third characteristic of an asset. One other "past event" is required: the

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enterprise must have earned taxable income and paid taxes in the current or prior years—taxes paid that could be recovered by loss carryback when temporary differences result in net deductible amounts in future years. If not recoverable by loss carryback, the Board concluded that the past event needed to recognize an asset is earning income that will be taxable in future years. Prior to earning income, temporary differences that will result in net deductible amounts are a potential future benefit but are not a recognizable asset.

A Deferred Tax Asset for Future Events

103. Some respondents to the Exposure Draft expressed the view (a) that the event that creates a temporary difference or an operating loss or tax credit carryforward for tax purposes is the *single* "past event" that is sufficient to recognize a tax asset or liability and (b) that recognition of a tax asset should be determined based on the probability of earning income in future years. In their view:

a. The Board's requirements for recognition of a tax asset are more stringent than the requirements for recognition of other assets (for example, trade receivables) and are more like a liquidation approach than a going-concern approach to accounting for income taxes.
b. A profitable enterprise should not be precluded from recognizing a deferred tax asset for temporary differences that will result in net deductible amounts that do not reduce taxes otherwise paid or payable.

Other respondents who share those views regarding temporary differences that will result in net deductible amounts, however, accept not recognizing a tax benefit for a *tax* loss carryforward that does not reduce a deferred tax liability. Their rationale is that an enterprise with a tax loss carryforward is usually in financial difficulty and, in those circumstances, future realization of a tax benefit is less probable.

104. The Board believes that the differences between (a) the future collection of cash that settles a recognized trade receivable and (b) the future earning of income that permits realization of a tax benefit for a temporary difference or a loss carryforward preclude any analogy between those two types of future events. Prior to collecting a trade receivable, all of the sufficient "past events," such as producing a product, selling the product, and establishing an appropriate reserve for uncollectible amounts have occurred. Prior to realization of a tax benefit for a temporary difference or loss carryforward, a significant and critical "past event"—earning income that increases total assets, net assets, and shareholders' equity—has not yet occurred. The Board believes that collecting a trade receivable and earning future income are not analogous future events.

105. This Statement requires recognition of the deferred tax consequences for the full recovery of the *reported amount* of an enterprise's assets and the full settlement at the *reported amount* of its liabilities. The Board believes that requirement does not constitute a liquidation approach to accounting for deferred taxes. Anticipation of income that might be earned in future years is not permitted for purposes of recognition of a tax asset. The Board believes that earning income in

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future years is not inherently assumed by either the going-concern principle or the basis on which financial statements presently are prepared.

106. This Statement limits the recognition of tax benefits based on offsetting, that is, offsetting temporary differences that will result in deductible amounts against taxable amounts that will result from other temporary differences. For example, assuming three-year carryback and no qualifying tax-planning strategy, an enterprise cannot recognize a tax benefit for estimated expenses that are not deductible until the related liability is settled if settlement will occur four years after any other temporary differences will result in taxable amounts. The Board believes that result is appropriate (regardless of an enterprise's past or anticipated future profitability) for the following reasons:

a. The liability for those estimated expenses is an obligation of the enterprise (all necessary past events have occurred), and recognition of that liability does not depend on the past or anticipated future profitability of the enterprise.
b. Whether the enterprise receives a tax deduction for those expenses depends on whether the liability is settled.
c. Whether the enterprise realizes a tax benefit for that tax deduction, however, depends entirely on earning income in future years—a necessary past event that has not yet occurred.

The Board believes that (a) recognition of a liability for an obligation incurred in the current year and (b) recognition of a tax benefit for the tax deductions that will result from the future settlement of that liability are separate issues. Recognition of the liability for estimated expenses is not the single past event that is needed to recognize a deferred tax asset for that temporary difference. It is a necessary, *but not sufficient,* past event.

107. This Statement limits the recognition of a *net* deferred tax asset to the amount of taxes that could be recovered by a refund of taxes paid for the current or a prior year. A net deferred tax asset cannot be recognized if an enterprise has not paid taxes (during the current or carryback years) or if the tax law does not permit loss carryback. The Board believes that result is appropriate for all enterprises regardless of the past or expected future profitability of an enterprise. For example, assume that:

a. A lessor receives an advance payment of next year's rent and pays a tax in the current year for that future rental income.
b. The lessor refunds that lease payment to the lessee early in the next year, and the tax law in that jurisdiction does not permit loss carryback.

The lessor's tax payment in the current year does not result in a prepaid tax. Next year, the lessor will be entitled to a tax deduction for refunding the lease payment, but under the tax law, the tax benefit of that deduction is zero unless it offsets income earned from other sources next year. The Board believes that the temporary difference at the end of the current year, in substance, is the same as a tax loss carryforward.

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108. The Board believes that the requirements for recognition of tax benefits should be the same for (a) tax loss carryforwards and (b) temporary differences that will result in deductible amounts in future years. In substance, both are the same—both are amounts deductible on tax returns in future years. For example, a decision on whether to fund accrued pension costs currently will determine whether an enterprise has a tax loss carryforward or a temporary difference if that enterprise otherwise has zero taxable income in the current year.

109. The Board believes that the probability of future events should be equally applicable or not applicable to the recognition of deferred tax assets *and* deferred tax liabilities. For example, if one enterprise's only temporary difference is from an installment sale and another enterprise's only temporary difference is from warranty expense, the results would be as follows:

	Current	**Future Years**	
	Year	**Year 2**	**Year 3**
Financial income (loss)	$ 800	$ —	$ —
Installment sale difference	(800)	400	400
Taxable income (loss)	$ —	$ 400	$ 400
Tax payable (40 percent)	$ —	$ 160	$ 160
Financial income (loss)	$(900)	$ —	$ —
Warranty expense difference	900	(450)	(450)
Taxable income (loss)	$ —	$(450)	$(450)
Tax benefit (no tax paid in prior years)	$ —	$ —	$ —

Taxes payable for the $800 installment sale difference at the end of the current year could be eliminated by incurring a loss in year 2 or 3—but that necessary future event has not yet occurred. A tax benefit for the $900 warranty expense difference at the end of the current year could be realized by earning a profit in year 2 or 3—but that necessary future event has not yet occurred. This Statement prohibits anticipation of the future tax effects of either incurring losses or earning profits in future years.

110. The results illustrated in paragraph 109 are sometimes described as asymmetrical because the deferred tax liability (installment sale difference) is recognized and the potential tax benefit (warranty expense difference) is not. 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 illustrated in paragraph 109 above are *symmetrical* with the tax law—they are *representationally faithful,* a quality called for in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information.*

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111. The Board believes that, under the current accounting model, the only conceptual alternative to the position taken in this Statement would be to anticipate the future tax effects of both (a) incurring losses and (b) earning income for purposes of recognition of both (1) deferred tax liabilities and (2) deferred tax assets. Most respondents to the Exposure Draft favor recognition of deferred tax liabilities regardless of the probability of future losses or future originating temporary differences—they favor "comprehensive tax allocation" and they oppose "partial tax allocation." The Board believes that there is no conceptual justification for (a) recognition of a deferred tax liability regardless of the probability of future losses and (b) recognition of a deferred tax asset based on the probability of future income.

The Tax Consequences of Earning Financial Income or Incurring Losses or Expenses in Future Years

112. In arriving at its conclusions on the basic issues, the Board considered various examples of future events. One was an enterprise that incurs a major loss from a storm early in year 2 and before the enterprise issues financial statements for year 1. The loss is not covered by insurance, and government assistance is not available. As a result of the storm, the loss for year 2 is virtually certain to exceed the income earned in year 1 and the prior years included in the loss carryback period for tax purposes. The enterprise will receive a refund of taxes paid for the three preceding years.

113. In year 1, should the enterprise's financial statement recognize the tax benefit that results from the storm loss early in year 2? The Board concluded that the tax benefit of the storm loss in year 2 should not be recognized in the financial statements for year 1. The storm loss is not recognized in the financial statements for year 1 and, therefore, the tax consequences of that loss should not be recognized in year 1. Both should be recognized in the financial statements for year 2 when the storm actually occurs.

114. Another example discussed by the Board was about an enterprise that realized a large gain from a transaction that is conceived and executed early in year 2 and before the enterprise issues financial statements for year 1. As a result of the gain from the transaction early in year 2, income for all of year 2 is virtually certain to exceed the enterprise's operating loss carryforward at the end of year 1.

115. Should financial statements for year 1 recognize a tax benefit for the amount of income taxes that will not be paid on income earned in year 2? The Board believes that the tax benefit should not be recognized in year 1. The Board can see no reason for anticipating the tax consequences of a gain in year 2 if there is an operating loss carryforward, and not anticipating the tax consequences of a gain in year 2 if there is no operating loss carryforward. If there is no operating loss carryforward, the financial statements for year 1 would not recognize a liability for the amount of taxes payable as a result of the gain in year 2. The Board concluded that the gain and the tax benefit realized as a result of that gain both should be recognized in the financial

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statements for year 2.

116. In summary, the Board concluded that the tax consequences of incurring losses or expenses (the storm loss in paragraph 112) or earning income (the gain in paragraph 114) in future years should not be anticipated and recognized in financial statements for the current year (paragraph 15). On that basis, tax deductions for losses or expenses not yet incurred are not anticipated for purposes of eliminating a deferred tax liability. Similarly, taxable amounts for income not yet earned are not anticipated for purposes of recognizing a tax asset for temporary differences or for an operating loss or tax credit carryforward.

The Asset and Liability Approach to Accounting for Income Taxes

117. The Board believes the asset and liability approach to accounting for income taxes is most consistent with the definitions in Concepts Statement 6 and other parts of the conceptual framework. The Board also believes that the asset and liability approach produces the most useful and understandable information and that it is no more complex than any other approach to accounting for income taxes. Most respondents to the Exposure Draft favored an asset and liability approach to accounting for income taxes.

Recognition and Measurement

118. A deferred tax liability or asset represents the amount of taxes payable or recoverable in future years as a result of temporary differences at the end of the current year. The Board believes that the amount of those taxes payable or recoverable in future years is best measured based on (a) the tax laws and rates applicable to those future years, (b) the types of taxable or deductible amounts that will result in those future years, and (c) the elections and options that are expected to be made for tax purposes in future years. Paragraph 17 describes procedures that apply those recognition and measurement principles to compute the amount of a deferred tax liability or asset at the end of the current year. The Board believes that application of those procedures (including various estimates discussed in paragraphs 62 and 63) provides an understandable and reliable measure of taxes payable or recoverable in future years based on events that have already occurred or that are inherently assumed in an enterprise's statement of financial position for the current year.

119. Some temporary differences (primarily those related to depreciable assets) accumulate over several years and then eliminate over several years. For example, assume that an enterprise acquires $1,500 of depreciable assets at the beginning of year 1 and that depreciation of those assets for tax purposes and for financial reporting will be as follows:

	Year 1	Year 2	Year 3	Year 4	Year 5
Financial depreciation	$ 300	$ 300	$ 300	$300	$300
Tax deductions	375	570	555	—	—
Annual difference	$ (75)	$(270)	$(255)	$300	$300

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Based on the first-in, first-out assumption that was proposed in the Exposure Draft, the $75 temporary difference at the end of year 1 would be considered to result in a taxable amount in year 4 and not in year 2. It would not result in a taxable amount in year 2 because future recovery of those depreciable assets and accelerated tax deductions will result in net deductible amounts in years 2 and 3. In effect, the *incidence* of those net deductible amounts in years 2 and 3 determines that the $75 temporary difference will result in a taxable amount in year 4. As proposed in the Exposure Draft, however, the *amount* of those deductions in years 2 and 3 would not have been considered for purposes of determining the future years in which other temporary differences will result in net taxable or deductible amounts. For example, if that enterprise (above) had one other type of temporary difference at the end of year 1—a $525 installment sale temporary difference that will result in taxable amounts in years 2 and 3—the pattern of taxable amounts in future years under the proposals in the Exposure Draft would have been as follows:

Temporary	Current	Future Taxable Amounts			
Differences	**Year**	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Installment receivables	$525	$270	$255	$—	$ —
Depreciable assets	75	—	—	75	—
Net taxable amounts	$600	$270	$255	$75	$ —

The Board decided to change from the Exposure Draft proposal so that both the incidence and the amount of future temporary differences for existing depreciable assets are considered in determining the future years in which other existing temporary differences result in net taxable or deductible amounts. Based on that decision, the pattern of net taxable amounts in future years for the example above is as follows:

Temporary	Current	Future Taxable Amounts			
Differences	**Year**	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Installment receivables	$525	$270	$255	$ —	$ —
Depreciable assets	75	(270)	(255)	300	300
Net taxable amounts	$600	$ —	$ —	$300	$300

The Board believes that consideration of the incidence but not the amount of future temporary differences from recovery of existing assets would be inconsistent. In the example above, taxable amounts (from recovery of installment receivables) are offset by deductible amounts (from recovery of depreciable assets) in years 2 and 3, and there are no net taxable amounts until years 4 and 5. The Board believes that result better reflects what would be reported on tax returns for future years before considering any profits and losses that might occur in future years.

120. Paragraph 20 requires that a deferred tax liability or asset be adjusted for the effect of a change in tax law or rate and that the effect be included in income from continuing operations for

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the period including the enactment date. Paragraph 21 requires adjustment of a deferred tax liability or asset to reflect a change in the tax status of an enterprise. In the Board's opinion, a change in tax law or rate or a change in the tax status of an enterprise is an event that has economic consequences for an enterprise in the year that the change occurs. As a result of the change, deferred tax consequences become larger or smaller. The enterprise's financial condition improves if it owes a smaller amount or if it would receive a larger refund. Financial condition weakens if the enterprise owes more or if it would receive a smaller refund. The Board concluded that those tax consequences should be recognized in the year that a change occurs in order for the financial statements to reflect the economic effects of an enacted change in tax law or rate or a change in the tax status of an enterprise.

Tax-Planning Strategies

121. The Board decided that tax-planning strategies should be taken into account for purposes of recognition and measurement of a deferred tax liability or asset in certain instances. Most strategies accelerate the recovery of assets or settlement of liabilities to increase the tax benefit of tax deductions and tax credits. The Board decided that those strategies are consistent with the basic principle that recovery and settlement of the reported amounts of assets and liabilities are events that are inherently assumed in the statement of financial position for the current year and should be reflected in determining a deferred tax liability or asset. Strategies that anticipate earning financial income or incurring financial losses or expenses in future years do not meet the requirements of this Statement.

122. The Board believes that accelerating the recovery and settlement of the reported amounts of assets and liabilities are actions that management ordinarily would reasonably be expected to take to reduce the amount of taxes payable or to increase a tax benefit in future years. The Board concluded that the strategy must be one that management has the ability to implement and intends to implement unless the need to do so is eliminated in future years. Management would not actually have to apply the strategy if, for example, income earned in a following year utilizes the entire amount of an operating loss or tax credit carryforward from the current year.

123. The Board concluded that a tax-planning strategy should meet two criteria. First, the strategy should require only prudent and feasible actions over which management has discretion and control. If an action is not prudent, management probably would not do it. If an action is not feasible, management does not have the ability to do it. Without discretion and control, management cannot unilaterally employ a particular strategy. The Board concluded that if an enterprise could not or would not implement a strategy, that strategy should not qualify for purposes of recognition and measurement of a deferred tax liability or asset.

124. The second criterion is that a strategy should not give rise to a significant cost to the enterprise. For example, a strategy to accelerate recovery of the reported amount of an asset that involves incurring four dollars of legal expense for every five dollars of tax savings might be a prudent and reasonable action for management to take. Nevertheless, the strategy would not

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meet the second criterion because the costs of implementing a tax strategy must be of a minor, incidental nature. Otherwise, the strategy anticipates "significant" future events that are not inherent in financial accounting assumptions for the current year. Future events that are not inherently assumed in financial statements for the current year are not anticipated under the recognition requirements of this Statement.

125. The Exposure Draft also proposed that a strategy should not contradict the assumptions inherent in (a) the measurement bases of existing assets and liabilities or (b) their classification in the statement of financial position. Upon reconsideration, the Board decided to eliminate that criterion because part (a) of that criterion is not needed and part (b) of that criterion would have prohibited some strategies that should be permitted. The Board believes that part (a) is not needed because the other criteria result in prohibiting strategies that contradict assumptions inherent in the measurement bases of existing assets and liabilities. Part (b) of the criterion would have prohibited strategies that contradict assumptions inherent in the classification of assets and liabilities in the statement of financial position. For example, a sale (for tax purposes) and leaseback under a capital lease (accounted for as a financing arrangement for financial reporting) to accelerate recovery of depreciable assets (*solely* for tax purposes) would have been a permitted strategy. A sale and leaseback under an operating lease or an outright sale would not have been permitted strategies. In the Board's opinion, each of those strategies to accelerate the recovery of depreciable assets should be permitted *provided* that the other criteria for a qualifying strategy are met.

Regulated Enterprises

126. When Statement 71 was issued, this project on accounting for income taxes was on the Board's agenda, and the Board decided not to change regulated enterprises' accounting for income taxes until this Statement was issued. The general standards of accounting for the effects of regulation contained in Statement 71 require recognition of a deferred tax liability or asset for the tax consequences of temporary differences because a regulator cannot relieve a regulated enterprise of a liability or asset that was not created by rate actions of the regulator. Those general standards require (a) recognition of a new asset when a deferred tax liability is recognized if it is probable that future revenue will be provided for the payment of those deferred tax liabilities, and (b) recognition of a new liability when a deferred tax asset is recognized if it is probable that a future reduction in revenue will result when that deferred tax asset is realized. The Board concluded that this Statement should be applied to regulated enterprises consistent with the general standards of accounting for the effects of regulation as set forth in Statement 71.

Leveraged Leases

127. The Board acknowledges that the accounting for income taxes related to leveraged leases as required by Statement 13 and Interpretation 21 is not consistent with the requirements of this Statement. However, the Board concluded that it should not change the accounting for income taxes related to leveraged leases without considering the need to change leveraged lease accounting, and decided not to reopen the subject of leveraged lease accounting as part of this

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project. Therefore, this Statement does not change the requirements of Statement 13 or Interpretation 21. The Board also considered whether there should be any integration of (a) the results of accounting for income taxes related to leveraged leases with (b) the other results of accounting for income taxes as required by this Statement. Integration is an issue when all of the following exist:

a. The accounting for a leveraged lease requires recognition of deferred tax credits.
b. The requirements of this Statement limit the recognition of a tax benefit for temporary differences (not related to the leveraged lease) that result in net deductible amounts or for an operating loss or tax credit carryforward.
c. Unrecognized tax benefits in (b) could offset taxable amounts that result from future recovery of the net investment in the leveraged lease.

The Board concluded that, in those circumstances, integration should be required. However, consistent with the decision not to change leveraged lease accounting, the Board decided that integration should not override any results that are unique to income tax accounting for leveraged leases, for example, the manner for recognizing the tax effect of an enacted change in tax rates.

Business Combinations

128. Values are assigned to identified assets and liabilities when a business combination is accounted for as a purchase. The assigned values frequently will be different from the tax bases of those assets and liabilities. The Board concluded that a liability or asset should be recognized for the deferred tax consequences of differences between the assigned values and the tax bases of the assets and liabilities (other than goodwill and leveraged leases) recognized in a purchase business combination.

129. The Board considered and rejected the approach that assigns net-of-tax values to those assets and liabilities. That approach mixes the normal amounts of expenses and revenues with their tax effects and thereby confuses the relationship between various items on the statement of earnings in subsequent years. For example, the relationship between sales and cost of sales is affected if cost of sales includes amounts attributable to net-of-tax values assigned to acquired inventory or depreciable assets. Likewise, the relationship between pretax income from continuing operations and income tax expense is affected to the extent that pretax income from continuing operations includes any net-of-tax amounts.

130. The Board believes that if, for example, the reported amount of depreciable assets exceeds their tax basis, the excess should be treated similarly regardless of whether the difference arose from a business combination or from accelerated depreciation for tax purposes. Different events may give rise to the difference, but the tax consequences of the difference are the same. In either case, recovery of the reported amount of depreciable assets will result in taxable amounts in future years.

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131. Some respondents to the Exposure Draft cited the statement in paragraph 89 of Opinion 16 that "the fair value of an asset to an acquirer is less than its market or appraisal value if all or a portion of the market or appraisal value is not deductible for taxes." Those respondents then questioned how to determine the amounts to be assigned to the individual assets acquired and liabilities assumed if those amounts are not net-of-tax. The Board believes that the net result is the same whether assigned amounts are pretax or net-of-tax. For example, assume (a) that the pretax market or appraisal value of depreciable assets acquired in a purchase business combination is $1,000, (b) that the tax basis of those assets is zero, and (c) that the enacted tax rate is 40 percent for all years. If net-of-tax, the assigned value of those assets would be $600. If pretax, the assigned value of those assets would be $1,000, and there would be a $400 deferred tax liability. Under either approach, the net result of allocating the purchase price is the same. The Board concluded that the amounts assigned to assets and liabilities in a purchase business combination should not be net of any related deferred tax liability or asset.

132. Paragraph 89 of Opinion 16 also states that "the impact of tax effects on amounts assigned to individual assets and liabilities depends on numerous factors, including imminence or delay of realization of the asset value and the possible timing of tax consequences." That sentence has been interpreted to permit discounting the deferred tax effects of differences between the assigned amounts and the tax bases of the assets and liabilities in a purchase business combination. The issue of discounting a deferred tax liability or asset, however, has been excluded from the scope of this project. The Board decided that until the conceptual and implementation issues related to discounting deferred tax liabilities and assets are addressed, discounting deferred tax assets or liabilities should be prohibited for temporary differences (except for leveraged leases) related to business combinations as it is for other temporary differences.

133. Goodwill is recognized in a business combination accounted for as a purchase if the purchase price exceeds the assigned value of the net assets acquired. Conceptually, a liability should be recognized for the deferred tax consequences of the difference between the reported amount and the tax basis of goodwill if recovery of the reported amount of goodwill will give rise to taxable amounts in future years. However, the Board believes that increasing goodwill by an amount equal to the liability for the deferred tax consequences of recovering goodwill would not provide information that is particularly relevant. The Board decided that a liability should not be recognized for the deferred tax consequences of recovering goodwill.

134. The tax law may permit operating loss or tax credit carryforwards of the acquiring or the acquired enterprise to reduce future taxable income or taxes payable attributable to the other enterprise if consolidated tax returns are filed subsequent to the acquisition. In those circumstances, the Board decided that accounting for the business combination should recognize the acquiring or acquired enterprise's carryforwards as a reduction of the other enterprise's deferred tax liability. Goodwill is reduced, thereby reducing the annual charge to income for amortization of goodwill in subsequent years. The alternative is that the operating loss or tax credit carryforward would be recognized as a reduction of the deferred tax liability immediately

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after the acquisition. On that basis, the reduction in the deferred tax liability for an acquiring enterprise's carryforwards would reduce deferred tax expense and thereby increase net income. The ability to utilize the operating loss or tax credit carryforward, however, is a factor that is known by the acquiring enterprise when the terms of the purchase transaction are set. The Board believes that factor is properly includable in measuring the purchase transaction and the tax benefit is not income immediately subsequent to the business combination.

135. An acquired enterprise's operating loss carryforward is not included in measuring a purchase transaction if the carryforward does not reduce a deferred tax liability. The Board decided against retroactive restatement of the purchase transaction and results of operations for intervening years if the criteria for recognition of a loss carryforward are met in subsequent periods. The Board believes that realization of a tax benefit in subsequent years is, in part, a consequence of earning financial income in those subsequent years. For that reason, the Board decided that (a) tax benefits should be accounted for in financial statements for the year that the Board's recognition criteria (paragraph 39) are met, (b) benefits should first reduce goodwill and other noncurrent intangible assets to zero, and (c) any additional benefits should be recognized as income. The Board's conclusions for an operating loss carryforward also apply to the tax benefit of a tax credit carryforward and an excess of tax basis over the assigned value of net assets acquired. The Board believes that the accounting for all three types of tax benefits should be the same.

136. The Exposure Draft proposed that only goodwill would be reduced to zero before reducing income tax expense for the tax benefit of an acquired operating loss or tax credit carryforward that is recognized after the acquisition date. Some respondents to the Exposure Draft, however, were concerned that the opportunity to reduce income tax expense in future years for a portion of the tax benefit of acquired carryforwards might sometimes influence purchase price allocations for business combinations. Those respondents noted that if amounts allocated to noncurrent assets are increased, goodwill is reduced thereby increasing the portion of tax benefits for acquired carryforwards that could reduce income tax expense in future years. In considering those comments, the Board was influenced by the fact that reliable fair values are sometimes difficult to obtain for noncurrent assets, particularly intangible assets. The Board concluded that both goodwill and other noncurrent intangible assets should be reduced to zero before the tax benefit of an acquired carryforward is recognized as a reduction of income tax expense in future years.

Allocation of Income Tax Expense between Pretax Income from Continuing Operations and Other Items

137. The amount of tax expense (or benefit) for the year is allocated between pretax income (or loss) from continuing operations and other items that gave rise to the tax expense (or benefit). Tax expense (or benefit) allocated to continuing operations should be the tax consequences of the income (or loss) from continuing operations without regard to any items that are reported apart from income (or loss) from continuing operations. The Board believes that a primary focus on the tax consequences of income (or loss) from continuing operations is appropriate. Business

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activities that are expected to continue in the future are of the greatest interest to most people. Other events may have significant effects, but those events are still usually incidental to an enterprise's primary operations. For this reason, tax expense (or benefit) allocated to items other than income (or loss) from continuing operations should be the increase or decrease in tax expense (or benefit) as a result of those items. Because events reported apart from continuing operations are viewed as incremental items, the related tax effects are deemed to be incremental.

138. The Board concluded that the tax benefit of a loss or tax credit carryforward is not an extraordinary item because the tax benefit is neither unusual in nature nor infrequent in occurrence. The tax benefit of a loss carryforward results from both (a) earning income in the current year and (b) incurring a loss in a prior year. The Exposure Draft proposed that the tax benefit should be reported in the same manner as the prior year loss that gave rise to the carryforward. Upon reconsideration, however, the Board decided that reporting the benefit of a loss or tax credit carryforward based on the event that occurred in the current year (a) produces more understandable results and (b) avoids the sometimes complex problem of tracing back to events of prior years.

139. The amount of income taxes allocated to the beginning balance of retained earnings for a change in accounting principles should be measured as if the newly adopted accounting principles had been followed in prior years. If prior years are restated for a change in accounting principles or for a correction of an error, the related tax consequences also should be restated for those prior years.

140. The Board believes that the tax consequences of an event that increases or decreases contributed capital should be allocated directly to contributed capital. A tax deduction may be received for the difference between the exercise price of employee stock options and the fair value of the stock at the date of exercise, and that difference between the exercise price and the fair value of the stock is not recognized in the financial statements under existing generally accepted accounting principles. The Exposure Draft proposed that the related tax benefit should reduce income tax expense and should not be allocated to stockholders' equity primarily because there is no corresponding adjustment to contributed capital. After reconsidering that proposal in the Exposure Draft, the Board decided to make no changes to the requirements of Opinion 25 for reporting the tax effects of stock compensation plans pending completion of the Board's project on accounting for employee stock options.

141. A tax deduction may also be received for the payment of dividends to stockholders. Dividends are a distribution of earnings. The Board believes that, in substance, a tax deduction for the payment of dividends represents an exemption from taxation of an equivalent amount of earnings. For that reason, the Board concluded that the tax benefit should be recognized as a reduction of tax expense and should not be allocated to stockholders' equity. A tax benefit should not be recognized, however, for tax deductions (or favorable tax rates) attributable to future dividends of unremitted earnings for which a deferred tax liability has not been recognized under the requirements of Opinion 23. (Favorable tax treatment would be reflected in measuring

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that unrecognized deferred tax liability for disclosure purposes.)

Classification in a Statement of Financial Position

142. The Board believes that a deferred tax liability or asset should be classified as current or noncurrent in a classified statement of financial position. The Exposure Draft proposed that the current portion should be only the deferred tax consequences of temporary differences that will result in taxable or deductible amounts during the following year. Upon reconsideration of that proposal, however, the Board concluded that that approach could result in an inappropriate current ratio when assets or liabilities are classified for financial reporting as current because of an operating cycle that is longer than one year. For example, an inappropriate current ratio could result if a deferred tax liability related to inventory is classified as noncurrent and that inventory is classified as current because of a three-year operating cycle. Likewise, if a deferred tax liability related to a long-term contract (paragraph 12) is classified as noncurrent and contract-related assets are classified as current because of a three-year operating cycle, the resulting current ratio would be overstated. As a result, the Board concluded that the current portion of a deferred tax liability or asset should also include the deferred tax consequences of temporary differences related to assets or liabilities that are classified as current because of an operating cycle that is longer than one year.

143. Some respondents to the Exposure Draft proposed that there should be no current deferred tax liability if probable purchases of depreciable assets or other events next year are expected to result in no net cash outflow for deferred taxes. The Board reconsidered the reversal pattern of depreciation differences (paragraph 119) and decided that both the incidence and the amount of future originating depreciation differences from recovery of *existing* depreciable assets should be considered in determining the future years in which other temporary differences result in *net* taxable amounts. However, the Board reaffirmed its earlier decision that the tax consequences of events that are not inherently assumed in financial statements at the end of the current year (for example, future purchases of depreciable assets) should not be anticipated as a basis for denying the existence of a current deferred tax liability at the end of the current year. Some respondents to the Exposure Draft also proposed offsetting deferred tax liabilities and assets attributable to different tax jurisdictions. The Board believes that such offsetting would be inconsistent with other standards that preclude offsetting assets and liabilities unless a right of setoff exists. A right of setoff normally does not exist for income taxes, for example, there is no right of setoff for a tax asset for German income taxes and a tax liability for French income taxes.

Disclosures

144. The Board believes that the financial statement disclosures required by this Statement provide information that is useful in understanding the general effect of income taxes on a particular enterprise and that those disclosures can be prepared without encountering undue complexities or incremental costs. The Board considered whether to require disclosure of additional information that might enable financial statement users to estimate the effect of a

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change in tax law or rate on a particular enterprise. The Board decided that too much detail would be required. This Statement, however, does require disclosure of the effect of enacted changes in tax laws or rates.

145. The Board also considered and rejected a requirement for disclosure of the future maturities of a long-term deferred tax liability or asset. Paragraphs 62 and 63 discuss various ways that an enterprise might be able to avoid detailed computations for each future year in which temporary differences result in taxable or deductible amounts. Disclosure of future maturities would require all enterprises with deferred tax liabilities or assets to make those detailed computations. That disclosure would also require estimating the distribution of taxable and deductible amounts among particular future years. The Board decided not to require disclosure of future maturities.

146. The Exposure Draft proposed a requirement to recognize the deferred tax liability for temporary differences related to the areas addressed in Opinion 23 and deposits in statutory reserve funds by U.S. steamship enterprises but no special disclosure requirements related thereto. The disclosures required by paragraph 25 are a result of the Board's subsequent decision to continue the exception to comprehensive recognition of deferred taxes for those temporary differences.

147. This Statement does not prescribe requirements for recognition and measurement of income taxes in the separately issued financial statements of an enterprise that is part of a group that files a consolidated tax return. Paragraph 30, however, requires certain disclosures that previously were not required about the accounting for income taxes by such an enterprise. The Board believes that those disclosures are necessary because (a) an enterprise's reported results of operations and financial position can be significantly affected by those related-party transactions and (b) the reported results of operations and financial position often do not represent what would be reported if the enterprise was an independent entity.

Effective Date and Transition

148. The Board considered and rejected a solely prospective application of the accounting standards required by this Statement. Continued recognition of deferred tax credits and charges computed by the deferred method is inconsistent with the Board's decisions about the deferred tax consequences of temporary differences. Furthermore, the cost and complexity of maintaining two systems of accounting for income taxes would not be justified.

149. The Board believes that restatement of financial statements for prior years would be desirable to provide useful information about income taxes for purposes of comparing financial data after the effective date of this Statement with data presented for earlier years. The Board recognizes, however, that the procedures required by this Statement sometimes would differ significantly from procedures followed in previous years and that restatement could be particularly complex and time-consuming for some enterprises. In addition, restatement requires the availability of records or information that an enterprise may no longer have or that its past

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procedures did not require. Therefore, the Board decided that restatement should be permitted but not required.

150. For similar reasons, the Board decided that this Statement should not apply retroactively to purchase business combinations consummated in years prior to the year for which this Statement is first applied. Thus, whether a prior purchase business combination is remeasured depends on an enterprise's decision about restatement of financial statements for prior years. If financial statements for prior years are restated, all purchase business combinations that were consummated in those years are remeasured in accordance with the requirements of this Statement. Remeasurement is prohibited for purchase business combinations that were consummated in years for which this Statement is not applied.

151. For purchase business combinations consummated in prior years for which the financial statements are not restated, the Exposure Draft proposed that the remaining balances of assets and liabilities be adjusted to pretax rather than net-of-tax amounts and that a corresponding deferred tax liability or asset be recognized for the related temporary differences. Many respondents to the Exposure Draft stated either (a) that the information needed to determine those adjustments was not available or (b) that the cost to develop that information was prohibitive. Some respondents, however, stated that the necessary information was readily available to them and preferred the proposal in the Exposure Draft. Determining the transition requirements of a new accounting standard often requires an appropriate balance between conceptual and practical considerations, and the Board decided to change the proposal in the Exposure Draft.

152. For purchase business combinations consummated in prior years for which the financial statements are not restated, this Statement requires that except for leveraged leases any differences between the remaining balances of the assets and liabilities and their tax bases should be considered to be temporary differences and that a deferred tax liability or asset should be recognized for those temporary differences. The remaining balances of assets and liabilities that were originally recognized at net-of-tax amounts in prior purchase business combinations are not adjusted to pretax amounts. Thus, the only information required for transition is the amount of an enterprise's assets and liabilities for financial reporting and for tax purposes. That information should be available to all enterprises.

153. The Board considered whether to permit adjustment of net-of-tax balances of assets and liabilities to their pretax amounts (as proposed in the Exposure Draft) for enterprises that could do so and that chose to do so. This Statement permits two alternatives for initial application, however, and permitting another alternative could further increase the lack of comparability in future financial statements. Accordingly, adjustment of those remaining balances to pretax amounts is prohibited unless financial statements for prior years are restated, in which case, all purchase business combinations that were consummated in those years are remeasured in accordance with the requirements of this Statement.

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154. Similar considerations affected the Board's decisions about the method of transition for regulated enterprises. Upon initial application of this Statement, the reported amount of construction in progress is adjusted to the amount that would have resulted from applying this Statement to account for that construction in progress in all prior years. If construction is still in progress, the information needed to make that adjustment should be available. The necessary information for plant that is already in service, however, might not be available. Therefore, upon initial application of this Statement, any difference between the reported amount and the tax basis of plant in service is accounted for as a temporary difference, and the reported amount of plant in service is not adjusted to the amount that would have resulted from applying this Statement in all prior years.

Private and Small Public Enterprises

155. An issue in the August 1983 FASB Discussion Memorandum, *Accounting for Income Taxes*, is whether accounting requirements for income taxes should differ for private or small public enterprises. Most respondents to the Discussion Memorandum who addressed this issue opposed differential recognition or measurement. Respondents who could be identified as having a small business perspective were rather evenly divided on this issue.

156. A frequent criticism of Opinion 11 was that the accounting requirements were too complex, burdensome, and costly. If there were operating loss or tax credit carrybacks or carryforwards, the calculations were particularly complex. The Board believes that eliminating the Opinion 11 requirement for separate with-and-without calculations of the tax effects of individual or groups of similar timing differences reduces complexity.

157. Under the asset and liability approach required by this Statement, measurement of a deferred tax liability or asset is based on the provisions of the tax law. Calculations may often be complicated, but the Board believes those complications are primarily attributable to the tax law. Complexities in the tax law are applicable to small as well as to large enterprises. Those complexities must be dealt with for tax purposes regardless of what the accounting requirements might be. The Board believes that complexities in the tax law do not give rise to a need for different accounting requirements based on an enterprise's size or ownership.

158. The Board believes that accounting standards should establish requirements that result in accounting for similar transactions and circumstances similarly and for different transactions and circumstances differently. Different accounting standards for income taxes based on an enterprise's size or ownership would affect how financial statement amounts (for example, net income, total assets, and total liabilities) and relationships (for example, debt-to-equity ratio and times interest earned) are determined. The Board believes that the deferred tax consequences of temporary differences are recognizable liabilities or assets and nonrecognition of deferred taxes by some enterprises would deny the existence of deferred tax liabilities and assets. The Board believes that result would significantly reduce the credibility and usefulness of general-purpose external financial reporting.

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159. The Board believes that the disclosure requirements of this Statement generally do not create significant new complexities or incremental costs. Paragraph 28 requires a numerical reconciliation (using percentages or dollar amounts) between the reported amount of income tax expense attributable to continuing operations and the amount of income tax expense that would result from applying domestic federal statutory tax rates to pretax income from continuing operations. A numerical reconciliation was previously required only for public enterprises. The Board decided that nonpublic enterprises should disclose the reasons for significant differences but that a numerical reconciliation should not be required. In addition, the disclosures required when an enterprise's income is taxed directly to owners are applicable only for public enterprises. The Board decided that there should be no other differences in application of the disclosures required by this Statement.

Interim Financial Reporting

160. The accounting requirements of Opinion 28 are based on a view that each interim period is primarily an integral part of the annual period. 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. Opinion 28 rejects the discrete approach to interim reporting whereby the results of operations for each interim period would be determined as if the interim period were an annual period. The Board's liability approach to accounting for income taxes for annual periods, however, is a discrete approach. A deferred tax liability or asset is measured at a particular time. Expectations about earning income or incurring expenses or losses in future annual periods are disregarded.

161. The Board decided not to reopen the subject of interim accounting as part of this project and did not reconsider the general approach in Opinion 28 to accounting for income taxes in interim periods. As a result, most of the requirements in Opinion 28 remain unchanged. The Board concluded, however, that some changes were necessary because of the basic principles encompassed in this Statement.

162. For annual reporting, this Statement does not permit recognition of a deferred tax asset unless the benefit would be recoverable by a carryback to reduce taxes payable in the current or a prior year. Thus, a tax asset would not be recognized for a loss carryforward based on expectations of earning income in future *years.* However, the tax benefit of losses in early interim periods (loss carryback not possible) should be recognized if realization in subsequent *interim periods* of that year is assured beyond any reasonable doubt. That provision in Opinion 28 does not create a conflict with the accounting requirements to be applied at the end of the year for annual reporting, and the Board decided that a change in that provision was not required.

163. The Board considered whether assurance beyond any reasonable doubt should continue to be the criterion for recognition of tax benefits that will be realized in subsequent interim periods of the current year. A desire to avoid debating certain fundamental conclusions in

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Opinion 28 and to make as few changes as possible to interim accounting caused the Board to retain that criterion.

164. Under the requirements of this Statement for annual reporting, the tax benefit of an operating loss carryforward is not reported as an extraordinary item (unless realization of the carryforward results from an extraordinary gain). If realization of an operating loss carryforward (attributable to losses in prior years) is assured beyond any reasonable doubt because of estimated "ordinary" income in the current year, the operating loss carryforward is included in the computation of the estimated annual effective tax rate the same as, for example, tax credit carryforwards.

165. Measurements of a deferred tax liability or asset for annual reporting are subject to change when enacted tax laws or rates change. For interim reporting, the Board believes that the effects of those changes should be recognized as of the enactment date of the change in tax law or rate and should not be allocated to subsequent interim periods by an adjustment of the estimated annual effective tax rate for the remainder of the year.

166. Paragraph 13 of FASB Statement No. 16, *Prior Period Adjustments,* identifies four items for which the results of prior interim periods should be restated. One of them encompasses the effects of new retroactive tax legislation. Subsequent to the issuance of Statement 16, however, restatement of prior interim periods has not been adopted in Board pronouncements addressing the tax effects of 1979 U.K. tax legislation or the 1984 and 1986 U.S. tax legislation. Furthermore, that requirement of Statement 16 conflicts with the Board's decision in this project that enactment of tax legislation is a discrete event and that the effects should be recognized in the period of enactment. Accordingly, the Board decided to amend Statement 16 to prohibit restatement of prior interim periods for the enactment of new tax legislation.

Issues Removed from the Scope of This Project

Accounting for the Investment Tax Credit

167. An issue in the Discussion Memorandum is the basic method for recognition of investment tax credits in financial reporting income. The basic nature of the U.S. investment tax credit has been viewed in three different ways. Each view leads to different accounting for the investment tax credit. The three possibilities are that the investment tax credit:

a. Reduces the cost of the related asset (The investment tax credit is recognized in financial income as a reduction of depreciation over the productive life of the asset.)
b. Results in a liability because of the provision for recapture upon early disposal of the related asset (The investment tax credit is recognized in financial income as a reduction of tax expense for the years that the recapture periods lapse or ratably over the recapture period.)
c. Results in a reduction of tax expense. (The investment tax credit is recognized in financial

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income as a reduction of tax expense of the year that taxes payable are reduced.)

168. The Board believes that it would be desirable to have only one method to account for the investment tax credit. However, the Board decided not to address the issue of accounting for the investment tax credit for practical reasons, including the Revenue Act of 1971.[20] As a result, the conclusions of the Accounting Principles Board (APB) remain unchanged and both the deferral method (Opinion 2) and the flow-through method (Opinion 4) continue to be acceptable methods to account for the investment tax credit.

169. The APB addressed the basic nature of the investment tax credit and concluded that it is a reduction of the cost of the related asset. Opinion 2 requires deferral of the investment tax credit and its subsequent amortization over the productive life of the asset—not amortization over the recapture period. The APB concluded that the preferable display of the deferral in the statement of financial position is as a reduction of the cost of the asset and that the preferable display of the amortization is as a reduction of depreciation expense. However, display of the deferral as deferred income and display of the amortization as a reduction of tax expense are also permitted provided that the investment tax credit is accounted for as a reduction of the cost of the asset, that is, amortized over the productive life of the asset. In Opinion 4, the APB reaffirmed that the basic nature of the investment tax credit is a reduction of the cost of the asset and that the method of accounting in Opinion 2 is preferable. However, Opinion 4 also permits the flow-through method to account for the investment tax credit.

170. Deferral of investment tax credit and accounting for it as a reduction of the cost of the related asset results in a temporary difference. The cost of the asset for financial reporting is less than its tax basis. (The difference is the same even if the deferral of the investment tax credit is displayed as deferred income in the statement of financial position.) The amount of the difference will be deductible in future years as the cost of the asset is recovered. Deferred tax accounting for the temporary difference that results from deferral of the investment tax credit does not change the accounting for the investment tax credit required by Opinion 2. The entire amount of the investment tax credit is still deferred at the outset, and that entire deferral is still subsequently amortized over the life of the asset. The Board concluded that accounting for this temporary difference in the same manner as other temporary differences (a) is consistent with the basic principles of the Board's asset and liability approach to account for deferred *income taxes* and (b) is not a change in the method of accounting for deferred *investment tax credit* under Opinion 2.

Discounting

171. Another issue in the Discussion Memorandum was whether measurement of a deferred tax liability or asset should reflect the time value of money, that is, whether a deferred tax liability or asset should be determined on a present value or discounted basis. Most respondents to the Discussion Memorandum opposed discounting deferred income taxes.

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172. Conceptual issues, such as whether discounting income taxes is appropriate, and implementation issues associated with discounting income taxes are numerous and complex. Implementation issues include selection of the discount rate(s) and determination of the future years in which amounts will become taxable or deductible. The Board decided not to consider those issues at this time. Board members who favor that decision do so for a number of reasons. Some Board members oppose discounting because of the complexity that would be added to accounting for income taxes. Other Board members believe that discounting should be addressed in a broader context than just accounting for income taxes. As a result, discounting has been removed from the scope of this project. The Board has made no decision on when or in what context to address the issue of discounting as it pertains to accounting for income taxes.

Proposals for Partial or No Recognition of Deferred Tax Consequences That Were Rejected

Taxes Payable As Determined by the Tax Return

173. Some respondents to the Exposure Draft or the Discussion Memorandum advocated that income tax expense for financial reporting should be the amount of taxes payable for the year as determined by the tax return. The rationale most frequently cited to support that proposal is summarized as follows:

a. The tax return determines the legal liability for income taxes.
b. Taxes are levied on aggregate taxable income, and individual events are merely indistinguishable pieces of the overall determination of aggregate taxable income.
c. Any tax payments for future years will be solely a consequence of generating taxable income in those future years.
d. Notional tax calculations based on the recognition and measurement of events for financial reporting are not appropriate.

174. The Board believes that the tax consequences of an individual event are separable from aggregate taxable income. For example, if the gain on an installment sale is taxable, both the sale and the tax consequences of the gain on the sale should be recognized in financial income for the same year. The tax law may permit an election to include some or all of the gain in the determination of taxable income in future years. That election, however, only affects when and not whether the gain will be included in determining taxable income. The tax consequences arose at the time of the sale and result from the gain on the sale.

175. As the installment sale receivable is collected, pro rata amounts of the gain are included in determining taxable income. Reporting the uncollected balance of the receivable at its net realizable value in the statement of financial position reflects an assumption that the receivable will be recovered and, therefore, that the gain will become taxable. In the Board's view, not recognizing the deferred tax consequences in the year of the sale would directly contradict the

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assumption that the related receivable will be recovered. Recognition of the sale and the gain on the sale on an accrual basis requires concurrent recognition of the tax consequences of the gain on the sale. For example, commission expense attributable to the installment sale is recognized on an accrual basis even if the commissions are paid as the receivable is collected and, likewise, income tax expense should also be recognized on an accrual basis. To do otherwise would result in accounting for the sale and the gain on an accrual basis and the related tax consequences on a cash basis—a result that the Board believes is inconsistent and inappropriate.

176. Taxes payable in future years will be determined by the amount of taxable income generated in those years, and losses incurred in future years may offset taxable amounts that arise when the installment receivable is recovered. In the Board's opinion, that offset would be a tax consequence of incurring losses in future years. The tax consequences of future losses should be recognized when they are incurred in future years. Likewise, the tax consequences of current year events should be recognized when they occur in the current year.

Partial Recognition of Deferred Tax Consequences

177. Some respondents to the Exposure Draft or the Discussion Memorandum suggested that the tax consequences of some events may never be paid and, therefore, should not be recognized as a tax liability. They stated that the aggregate of all timing differences (or of timing differences for a particular type of recurring item such as depreciation) usually keeps getting larger because new originating differences more than offset reversing differences. Their view was that since the cumulative amount of differences does not reverse, no future tax payment will arise, and a tax liability should not be recognized.

178. The Board does not agree. The Board considered and rejected that proposal because it is based on anticipating tax deductions for expenses or losses that have not yet been incurred. Furthermore, the Board believes that a deferred tax liability will result in a future sacrifice even if the aggregate amount of temporary differences increases in future years.

179. Depreciation differences resulting from accelerated depreciation for tax purposes may be used as an example. The aggregate amount of depreciation differences may become larger in future years because of general price inflation, expansion of enterprise activities, or for other reasons. Nevertheless, the deferred tax consequences of a depreciation difference for a particular depreciable asset ordinarily will result in a sacrifice in future years. There will be a future sacrifice because an *individual* difference results in a taxable amount when revenue that recovers the reported amount of the depreciable asset exceeds its remaining tax basis. That taxable amount for a future year will result in a sacrifice in one of the following ways:

a. Increase taxable income and taxes payable if the enterprise earns net taxable income for that year
b. Reduce a tax loss and a loss carryback refund if the enterprise incurs a tax loss that offsets net taxable income of an earlier year
c. Reduce an operating loss carryforward, thereby increasing taxes payable if net taxable

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income is earned during the carryforward period.

The depreciation difference results in a future sacrifice in each of the three situations described above. The only circumstance in which there would be no future sacrifice is if, in situation (c) above, the enterprise does not pay taxes during the carryforward period and, in that case, avoidance of the future sacrifice is a result of incurring an operating loss in future years.

Methods of Accounting for Income Taxes That Were Rejected

180. The Discussion Memorandum identifies four basic approaches to account for income taxes. The conceptual nature of the resulting item in the statement of financial position is an important distinction among the four approaches. That item is viewed as:

a. A tax asset or liability under the asset and liability approach
b. A deferred credit or a deferred charge under the deferred approach
c. A reduction in related assets or liabilities under the net-of-tax approach
d. Either (b) or (c) above in combination with (a), depending on whether a difference between financial and taxable income results from an item that is recognized in financial income after or before it is included in determining taxable income.

This Statement requires the asset and liability approach to accounting for income taxes. The Board's reasons for rejecting the other approaches are discussed below.

The Deferred Approach to Accounting for Income Taxes

181. Opinion 11 required a deferred approach to accounting for income taxes. The objective was to match tax expense with related revenues and expenses for the year in which those revenues and expenses were recognized in pretax financial income. Differential calculations were used to measure the incremental effect on income tax expense resulting from either individual or groups of similar timing differences. Those calculations were based on either the gross change or the net change method. No adjustment was made to reflect changes in tax rates or laws in subsequent years. Deferred tax credits and charges in the statement of financial position represented the cumulative effect of interperiod tax allocation and were not receivables or payables.

182. The deferred method produces different results depending on whether the calculations are made by the gross change or the net change method in the following circumstances:

a. When tax rates change
b. When tax credits have statutory limitations
c. When an enterprise is significantly affected by graduated income tax rates
d. When originating timing differences affect one type of taxable income (for example, ordinary income) and the reversal affects a different type of taxable income (for example,

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capital gains).

183. Under the net change method, deferred tax balances may remain after the individual timing differences that gave rise to those balances have reversed if one of the situations described in paragraph 182 occurs. Those balances may continue to be reported in an enterprise's statement of financial position for as long as the particular type of timing difference exists. Those balances are not eliminated earlier than that because the objective of the deferred method is to measure the incremental effect on income tax expense as a result of timing differences in the year they originate; the objective is not to measure the cumulative amount of taxes payable or refundable when timing differences reverse in future years.

184. A criticism of the deferred method is its failure to recognize the consequences of an enacted change in tax law or rates. The use of accelerated depreciation for taxes and straight-line depreciation for financial reporting is sometimes cited by advocates of the deferred approach as an example illustrating why that approach is appropriate. Advocates of the deferred approach state that a realized tax benefit for accelerated depreciation deductions cannot change as a result of a change in future tax rates. Under the deferred method, the realized benefit is reported in the statement of financial position pending allocation to reduce income tax expense in future years when the depreciation differences reverse. Measured and reported in that manner, deferred tax credits and charges do not meet the Board's definition of liabilities and assets in Concepts Statement 6.

185. A realized tax benefit for accelerated depreciation does not subsequently change if tax rates change. Depreciation differences, however, affect income taxes in two years—once in the year they originate and once again in the year they reverse. Revenues received in later years that recover the reported amount (in the financial statements) of depreciable assets are taxable. Taxable income as determined by the tax return is larger in later years because depreciation deductions for tax purposes have been used up. Taxes payable on that increased amount of taxable income will be determined by enacted tax rates for the year(s) the depreciation differences reverse and not for the year(s) that they originated. In the Board's opinion, measurements using enacted future tax rates provide more relevant information.

186. Other situations are not satisfactorily dealt with under a deferred approach that focuses on the statement of earnings and timing differences between financial and taxable income. Examples are:

a. A business combination gives rise to differences between the assigned values and the tax bases of an acquired enterprise's assets and liabilities that are not "timing" differences.
b. Deferred amounts may be affected by a change in the tax law such as the 1979 U.K. tax legislation regarding stock relief or the 1984 U.S. Tax Reform Act regarding taxation of Domestic International Sales Corporations and stock life insurance companies.
c. Deferred amounts may be affected when an enterprise changes its tax status and becomes or ceases to be a taxable entity.

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On the other hand, under a deferred approach that focuses on the statement of earnings and timing differences between financial and taxable income, the Board can see no reason for not recognizing the tax effects of timing differences for the areas addressed by Opinion 23 and for deposits in statutory reserve funds by U.S. steamship enterprises.

187. Some respondents to the Discussion Memorandum criticized the complexity of multiple with-and-without calculations particularly when deferred tax credits are eliminated and reinstated because of operating loss and tax credit carrybacks and carryforwards. The Board believes that the complexities arise because the issues pertain to amounts, deferred tax credits and charges, that can be described only in terms of the procedures by which the amounts were computed. The complexity of accounting for the interaction of deferred taxes, carrybacks, and carryforwards is significantly reduced under this Statement. Complexity may be increased in other areas, but the Board believes that the results will be more understandable and useful.

The Net-of-Tax Approach to Accounting for Income Taxes

188. The net-of-tax approach accounts for the effects of taxability and deductibility on assets and liabilities as reductions of the reported amounts of those assets and liabilities. The amount of accounts receivable from installment sales, for example, is reduced for the taxability of the cash receipts in the future years in which the receivables are collected. Depreciable assets, on the other hand, are viewed as providing future benefits from tax deductions and from use of the assets to provide a product or service. The cost of depreciable assets is allocated between the cost of future tax benefits and the cost of future benefits from use of the assets. As the tax deductibility of the assets is used up, a portion of the cost of the assets is used up and the reported amount of the assets is reduced.

189. Allocations of the cost of depreciable assets between tax benefits and benefits from use of the assets are subjective. Advocates of the net-of-tax approach propose that the portion of the cost of depreciable assets allocated to future tax benefits should be the amount of the tax benefits. The remaining cost of the assets is allocated to the future benefits from use of the assets. That approach appears to allocate too much cost to tax benefits and too little cost to benefits from use of the asset, but there may not be a workable solution to the problem that provides a better answer. An example of applying the net-of-tax method when there are depreciable assets is presented below. Equipment that costs $1,000 has a 4-year life. The tax rate is 40 percent. Tax deductions and their tax benefit are as follows:

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	Tax Depreciation	Tax Benefit at 40 Percent
Year 1	$ 400	$160
Year 2	300	120
Year 3	200	80
Year 4	100	40
	$1,000	$400

Allocation of the cost of the equipment between the cost of future tax benefits and the cost of future benefits from the use of the equipment, and the annual expiration of each of those components are as follows:

	Cost of Tax Benefits	Cost of Operation Benefits	Annual Expiration
Year 1	$160	$150	$ 310
Year 2	120	150	270
Year 3	80	150	230
Year 4	40	150	190
	$400	$600	$1,000

The reported amount of the equipment is reduced by $310 the first year, an additional $270 the second year, and so forth

190. Straight-line depreciation for financial reporting would be $250 each year. In year 1, deferred tax expense would be $60 under either the deferred or the liability approach. An issue under the net-of-tax approach is whether the $310 expiration of the cost of depreciable assets in year 1 should be reported as $310 of depreciation or, alternatively, whether depreciation should be $250 and tax expense $60. The latter approach is recommended by most net-of-tax advocates. They cite some precedents for their approach and practical reasons why the other approach does not make sense. Nevertheless, application of the net-of-tax approach to depreciable assets is viewed as a cost allocation process.

191. Valuation accounts would be used to reduce assets and liabilities for the effects of their taxability or deductibility. The additional special procedures that are necessary to determine the amount of timing differences and their tax effects for each different asset or liability would be a practical problem. Another problem is that some timing differences cannot be identified with a specific asset or liability, for example, timing differences that result from (a) cash basis accounting for tax purposes and accrual accounting for financial reporting and (b) completed-contract accounting for tax purposes and percentage-of-completion accounting for financial reporting.

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192. Reporting an enterprise's assets and liabilities net of their tax effects would make it difficult to understand an enterprise's overall tax situation, and those tax effects would have to be combined in financial statement disclosures. Financial statement disclosures that refer to income taxes that become payable or refundable in future years, however, would appear to contradict the underlying net-of-tax accounting. The Board believes that if recovery of an asset or settlement of a liability will result in amounts that are taxable or deductible, that fact is better communicated by reporting a deferred tax liability or asset rather than by reducing other assets and liabilities.

A Combination of Approaches to Accounting for Income Taxes

193. The net-of-tax or the deferred approach is sometimes proposed in combination with the asset and liability approach. Advocates believe that timing differences for items not yet included in the tax return give rise to an estimated future sacrifice or benefit that is a liability or an asset. Settlement of the estimated tax liability or asset occurs when the item enters the tax return. If the item has already been included in the tax return, advocates believe that the tax sacrifice or benefit has already occurred and that the tax effects should be deferred or applied to reduce a related asset or liability until the timing difference reverses.

194. The Board rejected use of either the deferred or the net-of-tax approach in combination with the asset and liability approach for the same reasons that the deferred and net-of-tax approaches were rejected as a single overall approach. The Board believes that the deferred tax consequences of temporary differences are recognizable liabilities and assets regardless of whether the item that created the temporary difference was first recognized in financial income or first included in taxable income.

195. Any combination of methods increases complexity. All of an enterprise's timing differences would have to be analyzed and sorted into two different groups. Different tax calculation procedures would then have to be applied to each group. In some instances, a single type of timing difference might have to be analyzed and sorted into both groups. For example, depreciation for some classes of assets is sometimes faster for financial reporting than for tax purposes. The underlying rationale for a combination of approaches does not permit offsetting those depreciation differences against excess tax depreciation in the early years for other classes of depreciable assets.

196. Amounts reported in the statement of financial position under a combination of approaches would be confusing. The tax effects of some differences would be reported as liabilities or assets for deferred tax consequences. The tax effects of other differences would be reported as deferred tax credits or charges, or as reductions of other assets and liabilities. Some sort of financial statement disclosure of an enterprise's overall tax status would be required.

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Appendix C: BACKGROUND INFORMATION

197. This Statement is the result of a comprehensive reconsideration of Opinion 11 and related authoritative pronouncements. Criticisms and concerns set forth in the accounting literature and in letters to the Board requesting reconsideration of accounting for income taxes focused both on the complexity of the accounting requirements and on the meaningfulness of the results of applying the requirements. Opinion 11 was issued in 1967 and numerous pronouncements amended, interpreted, or supplemented Opinion 11 for areas that were not addressed or were not clear in that Opinion and for changes in the tax law. One criticism was that the various accounting requirements were inconsistent and that the results of applying them could only be described in terms of a mechanical process. Another criticism was that the time devoted to coping with the complexities and ambiguities of the requirements was not cost-beneficial when compared with the usefulness of the resulting information.

198. Criticisms and concerns also focused on the effect on the statement of financial position of applying Opinion 11 and the increasing amount of deferred tax credits reported by many enterprises. As measured and recognized under the requirements of Opinion 11, deferred tax credits and charges were not payables or receivables. Because those items were often considered to be only "bookkeeping" entries, some users of financial statements added deferred tax credits to stockholders' equity and they also added the charge for deferred taxes back to earnings. Others did not. Uncertainty about the nature of those amounts created confusion for users.

199. In January 1982, the Board added a project to its agenda to reconsider accounting for income taxes, and a task force was appointed to advise the Board during its deliberations on this project. An FASB Research Report, *Accounting for Income Taxes: A Review of Alternatives,* prepared by Ernst & Whinney, was published in July 1983. The report discusses the accounting and reporting alternatives advanced in the accounting literature on income taxes.

200. The Discussion Memorandum on accounting for income taxes was issued in August 1983, and more than 400 comment letters were received. The Board conducted a public hearing on the Discussion Memorandum in April 1984, and 43 organizations and individuals presented their views at the 3-day hearing. In May 1984, the FASB sponsored three regional meetings to obtain the views of preparers, users, and auditors associated with the financial statements of small companies.

201. Accounting for income taxes was addressed at 20 public Board meetings and at 2 public task force meetings and, in September 1986, the Board issued an Exposure Draft, *Accounting for Income Taxes.* It proposed an asset and liability approach to account for the effects of income taxes that result from an enterprise's activities during the current and preceding years. The Board received more than 400 comment letters in response to the Exposure Draft.

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202. In January 1987, the Board conducted a public hearing on the Exposure Draft. Fifty-one organizations and individuals presented their views at the 3-day hearing. Based on the information received in the comment letters and at the public hearing, the Board reconsidered its proposals in the Exposure Draft at 21 public Board meetings during 1987. Appendix B discusses the basis for the Board's conclusions, including reasons for changes made to the provisions of the 1986 Exposure Draft.

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Appendix D: AMENDMENTS TO EXISTING PRONOUNCEMENTS

203. This Statement supersedes the following pronouncements:

a. Accounting Research Bulletin No. 44 (Revised), *Declining-balance Depreciation*
b. APB Opinion No. 1, *New Depreciation Guidelines and Rules*
c. APB Opinion No. 11, *Accounting for Income Taxes* [21]
d. APB Opinion No. 24, *Accounting for Income Taxes—Investments in Common Stock Accounted for by the Equity Method (Other than Subsidiaries and Corporate Joint Ventures)*
e. FASB Statement No. 31, *Accounting for Tax Benefits Related to U.K. Tax Legislation concerning Stock Relief*
f. FASB Statement No. 37, *Balance Sheet Classification of Deferred Income Taxes*
g. AICPA Accounting Interpretations 4, "Change in Method of Accounting for Investment Credit," and 6, "Investment Credit in Consolidation," of APB Opinion No. 4, *Accounting for the "Investment Credit"*
h. AICPA Accounting Interpretations of APB Opinion No. 11, *Accounting for Income Taxes*
i. AICPA Unofficial Accounting Interpretations 13, "Subchapter S Corporations," and 16, "EPS for Extraordinary Items," of APB Opinion No. 15, *Computing Earnings per Share*
j. AICPA Accounting Interpretations of APB Opinion No. 23, *Accounting for Income Taxes—Special Areas*
k. FASB Interpretation No. 22, *Applicability of Indefinite Reversal Criteria to Timing Differences*
l. FASB Interpretation No. 25, *Accounting for an Unused Investment Tax Credit*
m. FASB Interpretation No. 29, *Reporting Tax Benefits Realized on Disposition of Investments in Certain Subsidiaries and Other Investees*
n. FASB Interpretation No. 32, *Application of Percentage Limitations in Recognizing Investment Tax Credit*
o. FASB Technical Bulletin No. 81-2, *Accounting for Unused Investment Tax Credits Acquired in a Business Combination Accounted for by the Purchase Method*
p. FASB Technical Bulletin No. 83-1, *Accounting for the Reduction in the Tax Basis of an Asset Caused by the Investment Tax Credit*
q. FASB Technical Bulletin No. 84-2, *Accounting for the Effects of the Tax Reform Act of 1984 on Deferred Income Taxes Relating to Domestic International Sales Corporations*
r. FASB Technical Bulletin No. 84-3, *Accounting for the Effects of the Tax Reform Act of 1984 on Deferred Income Taxes of Stock Life Insurance Enterprises*
s. FASB Technical Bulletin No. 86-1, *Accounting for Certain Effects of the Tax Reform Act of 1986*

204. Other pronouncements issued by the Accounting Principles Board and the Financial Accounting Standards Board refer to Opinion 11 or Opinion 24, or use the term *timing*

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differences as defined in Opinion 11. All such references appearing in paragraphs that establish standards or the scope of a pronouncement are hereby amended to refer instead to FASB Statement No. 96, *Accounting for Income Taxes,* or to use the term *temporary differences.*

205. This Statement amends the following pronouncements:

a. Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins.*

   The following is added to the end of paragraph 5 of Chapter 9C:

   > The declining-balance method is one that meets the requirements of being systematic and rational.[2] If the expected productivity or revenue-earning power of the asset is relatively greater during the earlier years of its life, or where maintenance charges tend to increase during later years, the declining-balance method may provide the most satisfactory allocation of cost. That conclusion also applies to other methods, including the sum-of-the-years'-digits method, that produce substantially similar results.
   >
   > [2]Accounting Terminology Bulletin No. 1, *Review and Resume,* paragraph 56.

   Paragraphs 11-13 of Chapter 9C are replaced by the following:

   > 11. Refer to FASB Statement No. 96, *Accounting for Income Taxes.*

   Paragraph 8 of Chapter 11B is deleted. Paragraph 11 of Chapter 15 is deleted.

b. Accounting Research Bulletin No. 51, *Consolidated Financial Statements.*

   Paragraph 17 is replaced by the following:

   > If income taxes have been paid on intercompany profits on assets remaining within the group, refer to FASB Statement No. 96, *Accounting for Income Taxes.*

c. APB Opinion No. 16, *Business Combinations.*

   The last sentence in paragraph 87 is replaced by the following:

   > The tax basis of an asset or liability shall not be a factor in determining its fair value.

   Paragraph 89 and the last sentence in paragraph 88 are deleted.

   The following sentence is added to the end of paragraph 88:

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> FASB Statement No. 96, *Accounting for Income Taxes,* paragraph 23, addresses accounting for the deferred tax consequences of the differences between the assigned values and the tax bases of assets and liabilities of an enterprise acquired in a purchase business combination.

d. APB Opinion No. 17, *Intangible Assets.* The last sentence in paragraph 30 is deleted.

e. APB Opinion No. 23, *Accounting for Income Taxes—Special Areas.* In paragraph 9, all words following equity method are deleted and replaced by *results in a temporary difference.* In the third sentence of paragraph 10, *for interperiod allocation of taxes* is deleted. Footnote 4 and the last three sentences of paragraph 10 are deleted.

   Paragraph 11 is replaced by the following:

   > Temporary differences attributable to losses of a subsidiary shall be accounted for in accordance with paragraph 39 of FASB Statement No. 96, *Accounting for Income Taxes.*

   The last sentence of paragraph 13 is replaced by the following:

   > If a parent company recognized a deferred tax liability for the temporary difference arising from its equity in undistributed earnings of a subsidiary and subsequently reduces its investment in the subsidiary through a taxable sale or other transaction, the amount of the temporary difference and the related deferred tax liability will change. An investment in common stock of an investee (other than a subsidiary or corporate joint venture) may change so that the investee becomes a subsidiary because the investor acquires additional common stock, the investee acquires or retires common stock, or other transactions that affect the investment. A temporary difference for the investor's share of the unremitted earnings of the investee prior to the date it becomes a subsidiary shall continue to be treated as a temporary difference for which a deferred tax liability shall continue to be recognized to the extent that dividends from the subsidiary do not exceed the parent company's share of the subsidiary's earnings subsequent to the date it became a subsidiary.

   Paragraph 14 is replaced by the following:

   > *Disclosure.* FASB Statement No. 96, *Accounting for Income Taxes,* specifies the requirements for financial statement disclosures.

   Footnote 6 is deleted. In paragraph 17, the reference to paragraph 11 is deleted. The first and second sentences in footnote 9 are deleted. Footnote 10 is deleted.

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Paragraph 24 is replaced by the following:

> *Disclosure.* Statement 96 specifies the requirements for financial statement disclosures.

f. APB Opinion No. 25, *Accounting for Stock Issued to Employees.* In the second sentence of paragraph 17, (APB Opinion No. 11, paragraphs 34 to 37) is replaced by *(FASB Statement No. 96, Accounting for Income Taxes).*

g. APB Opinion No. 28, *Interim Financial Reporting.* In footnote 2, *(see APB Opinion No. 11, paragraph 63)* is replaced by (*refer to FASB Statement No. 96, Accounting for Income Taxes,* paragraph 28). In the first sentence of paragraph 20, (1) *in subsequent interim periods* is added after *realization* and (2) *(paragraph 45 of APB Opinion No. 11)* is replaced by (The *term* assured beyond any reasonable doubt *as used in this Opinion has the same meaning as that term had in paragraph 45 of Opinion 11 and as discussed in paragraph 47 of that Opinion.*). In footnote 3, *as is provided for in annual periods in paragraph 45 of APB Opinion No. 11* is deleted.

   The last sentence in paragraph 20 is replaced by the following:

> The effects of new tax legislation shall not be recognized prior to enactment. The tax effect of a change in tax law or rates on taxes currently payable or refundable for the current year shall be reflected after the effective dates prescribed in the statutes in the computation of the annual effective tax rate beginning no earlier than the first interim period that includes the enactment date of the new legislation. The effect of a change in tax law or rates on a deferred tax liability or asset shall not be apportioned among interim periods through an adjustment of the annual effective tax rate. The tax effect of a change in tax law or rates on taxes payable or refundable for a prior year shall be recognized as of the enactment date of the change as tax expense (benefit) for the current year.

h. APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions.* In paragraph 7, *APB Opinion No. 11, Accounting for Income Taxes, paragraphs 45 and 61* is replaced by *FASB Statement No. 96, Accounting for Income Taxes, paragraph 52*.

i. AICPA Accounting Interpretations of APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock.* In the third sentence of the fifth paragraph of the interpretation section of Interpretation 1, *reduction in income tax expense* is replaced by *deferred tax asset (this is a temporary difference under FASB Statement No. 96, Accounting for Income Taxes).* The last two sentences of the fifth paragraph are deleted.

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j. AICPA Accounting Interpretations of APB Opinion No. 25, *Accounting for Stock Issued to Employees.* In the last sentence of the last paragraph, the reference to paragraph 89 of Opinion 16 is deleted.

k. FASB Statement No. 12, *Accounting for Certain Marketable Securities.* The last sentence of paragraph 22 is deleted.

l. FASB Statement No. 13, *Accounting for Leases.* In paragraph 47, *as prescribed in APB Opinion No. 11, "Accounting for Income Taxes," paragraphs 57, 59, and 64* is deleted.

m. FASB Statement No. 16, *Prior Period Adjustments.*

Paragraph 11 is replaced by the following:

> An item of profit and loss related to the correction of an error in the financial statements of a prior period[3] shall be accounted for and reported as a prior period adjustment[4] and excluded from the determination of net income for the current period.

Footnotes 3 and 4 are renumbered 4 and 3 respectively, and their positions are reversed. Footnote 5 is deleted. In the first sentence of paragraph 13 *(except for the effects of retroactive tax legislation)* is added after *taxes.* In the third sentence of paragraph 13, *new retroactive tax legislation or* is deleted.

n. FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies.* In paragraph 61, *by the deferred method, as described in APB Opinion No. 11, "Accounting for Income Taxes"* is replaced by *as described in FASB Statement No. 96, Accounting for Income Taxes.* In the first sentence of paragraph 62, (1) *not* is deleted and (2) (a) *only to the extent of statutory depletion that would result from generating revenues exactly equal to the amount of the related assets (that is, the assets subject to statutory depletion) as reported in the financial statements and (b) subject to any limitations (for example, total taxable income or taxable income from the property) prescribed by the tax law* is added to the end of the sentence. The second sentence is deleted. In the third sentence, (1) *Accordingly, the* is replaced by *The tax benefit of any additional* and (2) *accounted for as a permanent difference* is replaced by *recognized.*

o. FASB Statement No. 38, *Accounting for Preacquisition Contingencies of Purchased Enterprises.* In paragraph 2, the last sentence is deleted. In the first sentence of footnote 2, *Paragraph 49 of Opinion 11 and paragraph 88 of Opinion 16 (paragraphs 15 and 16 of this Statement) specify* is replaced by *FASB Statement No. 96, Accounting for Income Taxes, specifies.* The second and third sentences of footnote 2 are deleted.

p. FASB Statement No. 52, *Foreign Currency Translation.* In paragraph 48, *deferred income taxes and* is deleted from the table in both places.

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q. FASB Statement No. 57, *Related Party Disclosures.*

The following item is added to the end of paragraph 2:

> (e) the information required by paragraph 30 of FASB Statement No. 96, *Accounting for Income Taxes.*

r. FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises.*

Paragraph 55 is replaced by the following:

> Except as noted in paragraph 59, a deferred tax liability or asset shall be recognized for the deferred tax consequences of temporary differences in accordance with FASB Statement No. 96, *Accounting for Income Taxes.*

Paragraphs 56-58, 60(j), and footnote 8 are deleted.

Paragraph 60(i) is replaced by the following:

> Statement 96 specifies the requirements for financial statement disclosures about income taxes.

s. FASB Statement No. 69, *Disclosures about Oil and Gas Producing Activities.* In the second sentence of paragraph 26 and the second sentence of paragraph 30(c), *permanent differences and* is deleted and *deductions,* is inserted before *tax credits and allowances.* In paragraphs 40 and 41 of Appendix A, *permanent differences* is replaced by *tax deductions.*

t. FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation.*

Paragraph 18 is replaced by the following:

> A deferred tax liability or asset shall be recognized for the deferred tax consequences of temporary differences in accordance with FASB Statement No. 96, *Accounting for Income Taxes.*

Footnote 12 is deleted. In paragraph 46, (1) as *amended* is inserted after *Statement 16* and (2) *adjustments that result from realization of income tax benefits of preacquisition operating loss carryforwards of purchased subsidiaries* is deleted.

u. FASB Statement No. 89, *Financial Reporting and Changing Prices.* In paragraph 96, *Deferred income tax charges*[a]*—Offsets to prospective monetary liabilities* and *Deferred income tax credits*[a]*—Cash requirements will not vary materially due to changes in specific*

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prices are replaced by *Deferred tax assets* and *Deferred tax liabilities,* respectively.

v. FASB Statement No. 90, *Regulated Enterprises—Accounting for Abandonments and Disallowances of Plant Costs.*

The fifth and sixth sentences of paragraph 14 are replaced by the following:

> Under FASB Statement No. 96, *Accounting for Income Taxes,* the tax effects of temporary differences are measured based on enacted tax laws and rates and are recognized based on specified criteria.

w. FASB Interpretation No. 18, *Accounting for Income Taxes in Interim Periods.*

Paragraph 14 is replaced by the following:

> *Recognition of the tax benefit of a loss.* Paragraph 49 of FASB Statement No. 96, *Accounting for Income Taxes,* provides that a tax benefit is recognized for the amount of taxes paid in prior years that are refundable by carryback of a loss of the current year. Paragraph 20 of Opinion 28 (as amended by Statement 96) provides that a tax benefit is recognized for a loss that arises early in a fiscal year if realization in subsequent interim periods of that year is assured beyond any reasonable doubt. Paragraph 50 of Statement 96 provides that an asset is not recognized for a loss carryforward at the end of a fiscal year regardless of the probability that the enterprise will generate profits in future years. Those limitations shall be applied in determining the estimated tax benefit of an "ordinary" loss for the fiscal year, used to determine the estimated annual effective tax rate described in paragraph 8 above, and the year-to-date tax benefit of a loss.

In paragraph 15, the caption *Reversal of net deferred tax credits* is replaced by *Adjustment of a deferred tax liability.* In the first sentence, (1) *or its realization is not assured beyond any reasonable doubt* is deleted and (2) *existing deferred tax credits arising from timing differences shall be adjusted as required by paragraph 48 of APB Opinion No. 11* is replaced by *an existing deferred tax liability shall be adjusted as required by paragraph 50 of Statement 96.* The second sentence is deleted. Footnotes 9-13 are deleted.

Footnote 14 is replaced by the following:

> Upon subsequent realization of the tax benefits of the loss, a deferred tax liability is recognized pursuant to Statement 96 for any remaining temporary differences that were previously offset by that loss.

In paragraph 16, the references to *paragraph 52 of APB Opinion No. 11* are replaced by *paragraph 74 of Statement 96.* Footnote 18 is deleted.

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In the third sentence of paragraph 18, *by future taxable income that is virtually certain to occur soon enough to provide realization during the carryforward period, including anticipated 'ordinary' income for the current year expected to result from* is replaced by *if future taxable income from (ordinary) income during the current year is virtually certain based on.* In footnote 19, the reference to paragraph 47 of APB Opinion No. 11 is deleted.

The fourth sentence in paragraph 18 is replaced by the following:

> If the loss would reduce a deferred tax liability (paragraph 50 of Statement 96) and if all or a portion of the tax benefit of the loss is not realized and future realization in the current year is not assured beyond any reasonable doubt, refer to paragraph 15 above.

In the fifth sentence, *in the current year* is inserted after *future realization.*

Paragraph 20 is replaced by the following:

> Paragraph 52 of Statement 96 requires that the manner of reporting the tax benefit of an operating loss carryforward recognized in a subsequent year is determined by the source of the income in that year, that is, initially as a reduction of tax expense from continuing operations with any excess allocated to other categories including extraordinary items, discontinued operations, and so forth. That requirement also pertains to reporting the tax benefit of an operating loss carryforward in interim periods. The tax benefit of an operating loss carryforward from prior years shall be included in the effective tax rate computation if realization of the tax benefit as a result of "ordinary" income in the current year is assured beyond any reasonable doubt. Otherwise, the tax benefit shall be recognized in the manner described above in each interim period to the extent that income in the period and for the year to date is available to offset the operating loss carryforward.

Paragraph 23 is replaced by the following:

> Paragraph 20 of Opinion 28 (as amended by Statement 96) sets forth the requirements for recognition of the tax effects of a change in tax law or rates. That paragraph refers to effective dates prescribed in the statutes. Paragraph 24 describes the determination of when new legislation becomes effective.

In the assumed facts for the examples in Appendix C, references in paragraphs 41, 43, 48, 49, 65, and 68 to *permanent differences* are replaced by references to *events that do not have tax consequences.*

In the last subparagraph of paragraph 43, *or are expected to be assured of future realization beyond any reasonable doubt at year-end* is deleted. In the penultimate

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sentence of that subparagraph, *have been realized if timing differences were not present* is replaced by *reduce an existing deferred tax liability as required by paragraph 50 of Statement 96.*

The third sentence of paragraph 46 is replaced by the following:

> Established seasonal patterns assure the realization in the current year of the tax benefit of the year-to-date loss and of anticipated tax credits beyond any reasonable doubt.

The third sentence of paragraph 47 is replaced by the following:

> There is no established seasonal pattern and realization in the current year of (a) the tax benefit of the year-to-date loss and (b) the anticipated tax credits is not assured beyond any reasonable doubt.

In footnote*, *in the current year* is inserted between *realization* and *of*.

In the third subparagraph of paragraph 49, *If realization of the tax benefit of the loss and realization of tax credits were assured beyond any reasonable doubt* is replaced by *If there is a recognizable tax benefit for the loss and the tax credits pursuant to the requirements of Statement 96.*

The third sentence of paragraph 50 is replaced by the following:

> The full tax benefit of the anticipated "ordinary" loss and the anticipated tax credits will be realized by carryback.

In paragraph 51, the third and fourth sentences are replaced by the following:

> The full tax benefit of the anticipated "ordinary" loss and anticipated tax credits will be realized by carryback. The full tax benefit of the maximum year-to-date 'ordinary' loss can also be realized by carryback.

In the first sentence of paragraph 52, (1) *realization of, nor realization of,* and *assured beyond any reasonable doubt* are deleted, and (2) *or* is added directly before, and *recognizable pursuant to Statement 96* is added directly after, *anticipated tax credits were.*

In the second sentence of paragraph 53, *beyond any reasonable doubt* is deleted.

In the third sentence of paragraph 54, *beyond any reasonable doubt* is deleted.

In the second sentence of paragraph 55, *during the current year* is inserted after *future profits.*

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The third and fourth sentences of paragraph 55 are replaced by the following:

> Carryforward of the loss will reduce an existing deferred tax liability pursuant to paragraph 50 of Statement 96.

In the third sentence of paragraph 58, *in the current year* is inserted after *reasonable doubt.* In the fourth sentence, *assured beyond any reasonable doubt* is replaced by *recognizable.*

Paragraphs 59-61 and the heading *Using a Prior Year Operating Loss Carryforward* are deleted.

In the fifth sentence of paragraph 66, *in the current year* is inserted after *realization.*

Paragraph 70 and all references thereto are deleted.

x. FASB Interpretation No. 31, *Treatment of Stock Compensation Plans in EPS Computations.* In the last sentence of footnote 1, delete *as described in paragraph 36 of APB Opinion No. 11, Accounting for Income Taxes.*

y. FASB Technical Bulletin No. 79-9, *Accounting in Interim Periods for Changes in Income Tax Rates.* The last sentence in paragraph 3 is deleted.

z. FASB Technical Bulletin No. 79-16 (Revised), *Effect of a Change in Income Tax Rate on the Accounting for Leveraged Leases.* In paragraph 4, *paragraph 63 of APB Opinion No. 11, Accounting for Income Taxes* is replaced by *paragraph 28 of FASB Statement No. 96, Accounting for Income Taxes.*

aa. FASB Technical Bulletin No. 82-1, *Disclosure of the Sale or Purchase of Tax Benefits through Tax Leases.*

Paragraph 5 is replaced by the following:

> Paragraph 28 of FASB Statement No. 96, *Accounting for Income Taxes,* requires that (a) the reported amount of income tax expense attributable to continuing operations for the year be reconciled to the amount of tax expense that would result from applying domestic federal statutory tax rates to pretax income from continuing operations and (b) the estimated amount and the nature of each significant reconciling item be disclosed. Transactions involving the sale or purchase of tax benefits through tax leases may give rise to a significant reconciling item that should be disclosed pursuant to the requirements of Statement 96.

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bb. FASB Technical Bulletin No. 87-3, *Computation of a Loss on an Abandonment.* Paragraphs 9-11 and 13 and footnote 4 are deleted. The first sentence of paragraph 18 is deleted. Appendix A is deleted.

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Appendix E: GLOSSARY

206. This appendix contains definitions of certain terms or phrases used in this Statement.

Assumptions inherent in a statement of financial position prepared in accordance with generally accepted accounting principles

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.

Current tax expense or benefit

The amount of income taxes paid or payable (or refundable) for a year as determined by applying the provisions of the tax law to the taxable income or excess of deductions over revenues for that year.

Deferred tax asset

The amount of deferred tax consequences attributable to temporary differences that will result in net tax deductions in future years that could be recovered (based on loss carryback provisions in the tax law) by refund of taxes paid in the current or a prior year. Recognition and measurement of a deferred tax asset does not anticipate the tax consequences of financial income that might be earned in future years.

Deferred tax consequences

The future effects on income taxes as measured by the provisions of enacted tax laws resulting from temporary differences at the end of the current year, without regard to the effects of events not yet recognized or inherently assumed in the financial statements.

Deferred tax expense or benefit

The net change during the year in an enterprise's deferred tax liability or asset.

Deferred tax liability

The amount of deferred tax consequences attributable to temporary differences that will result in net taxable amounts in future years. The liability is the amount of taxes that would be payable on those net taxable amounts in future years based on the provisions of the tax law. Recognition and measurement of a deferred tax liability does not anticipate the tax consequences of losses or expenses that might be incurred in future years.

Event

A happening of consequence to an enterprise. The term encompasses both transactions and other events affecting an enterprise.

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Gains and losses included in comprehensive income but excluded from net income

Under present practice, this category includes certain changes in market values of investments in marketable equity securities classified as noncurrent assets, certain changes in market values of investments in industries having specialized accounting practices for marketable securities, adjustments from recognizing certain additional pension liabilities, and foreign currency translation adjustments. Future changes to generally accepted accounting principles may change what is included in this category.

Income taxes

Domestic and foreign federal (national), state, and local (including franchise) taxes based on income.

Income taxes currently payable (refundable)

Refer to **Current tax expense or benefit**.

Income tax expense (benefit)

The sum of current tax expense (benefit) and deferred tax expense (benefit).

Nonpublic enterprise

An enterprise other than one (a) whose debt or equity securities are traded in a public market, including those traded on a stock exchange or in the over-the-counter market (including securities quoted only locally or regionally), or (b) whose financial statements are filed with a regulatory agency in preparation for the sale of any class of securities.

Operating loss carryback or carryforward for tax purposes

An excess of tax deductions over gross income during a year that may be carried back or forward to reduce taxable income in other years. Different tax jurisdictions have different rules about whether an operating loss may be carried back or forward and the length of the carryback or carryforward period. The discussion and examples in this Statement assume that the tax law requires that an operating loss first be carried back for up to 3 years and then be carried forward for up to 15 years. As used in this Statement, this term is intended to also include carrybacks or carryforwards for individual deductions that exceed statutory limitations.

Operating loss carryforward for financial reporting

The amount of an operating loss carryforward for tax purposes (a) reduced by the amount that offsets temporary differences that will result in net taxable amounts during the carryforward period and (b) increased by the amount of temporary differences that will result in net tax deductions for which a tax benefit has not been recognized in the financial statements.

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Public enterprise

An enterprise (a) whose debt or equity securities are traded in a public market, including those traded on a stock exchange or in the over-the-counter market (including securities quoted only locally or regionally), or (b) whose financial statements are filed with a regulatory agency in preparation for the sale of any class of securities.

Statutory limitations

Provisions in the tax law that limit the amount by which certain deductions or tax credits are applied to reduce taxable income or income taxes payable.

Taxable income

The excess of taxable revenues over tax deductible expenses and exemptions for the year as defined by the governmental taxing authority.

Tax consequences

The effects on income taxes—current or deferred—of an event.

Tax credit carryback or carryforward for tax purposes

Tax credits that exceed statutory limitations that may be carried back or forward to reduce taxes payable in other years. Different tax jurisdictions have different rules regarding whether a tax credit may be carried back or forward and the length of the carryback or carryforward period.

Tax credit carryforward for financial reporting

The amount of a tax credit carryforward for tax purposes reduced by the amount recognized as a reduction of a deferred tax liability for temporary differences that will result in net taxable amounts during the tax credit carryforward period.

Tax-planning strategy

A transaction or series of transactions that meet certain criteria (paragraph 19) and that, if implemented, would affect the particular future years in which temporary differences result in taxable or deductible amounts. A tax-planning strategy (including elections for tax purposes that are required or permitted by the tax law) either reduces the amount of a deferred tax liability or increases the amount of a deferred tax asset that would otherwise be recognized.

Temporary difference

A difference between the tax basis of an asset or liability and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively. Paragraph 10 cites nine examples of temporary differences. Some temporary differences cannot be identified with a particular asset or liability for financial reporting (paragraph 12), but those temporary differences (a) result from events that have been recognized in the financial statements and (b) will result in taxable or deductible amounts in future

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years based on provisions in the tax law. Some events recognized in financial statements do not have tax consequences. Certain revenues are exempt from taxation and certain expenses are not deductible. Events that do not have tax consequences do not give rise to temporary differences.

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Footnotes

FAS96, Footnote 1--Words that appear in the glossary are set in **boldface type** the first time they appear.

FAS96, Footnote 2--References in this Statement to income taxes currently payable and (total) **income tax expense** are intended to include also **income taxes currently refundable** and (total) **income tax benefit,** respectively.

FAS96, Footnote 3--The term *enterprise* is used throughout this Statement because accounting for income taxes is primarily an issue for business enterprises. However, the requirements of this Statement apply to a not-for-profit organization's activities that are subject to income taxes.

FAS96, Footnote 4--The only exceptions in applying those basic principles are identified in paragraph 8.

FAS96, Footnote 5--Some events do not have tax consequences. Certain revenues are exempt from taxation and certain expenses are not deductible. In the United States, for example, interest earned on certain municipal obligations is not taxable and fines are not deductible.

FAS96, Footnote 6--References to **assumptions inherent in a statement of financial position prepared in accordance with generally accepted accounting principles** occur frequently in this Statement. That concept and its application have a significant effect on the accounting for the tax consequences of an event.

FAS96, Footnote 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.

FAS96, Footnote 8--The meaning of *temporary differences* in this Statement is different from the meaning of *timing differences* in Opinion 11. By definition, timing differences are differences between the periods in which transactions affect taxable income and the periods in which they enter into the determination of pretax accounting income. As such, timing differences are limited to the situations illustrated in examples (a)-(d) in paragraph 10 and exclude other differences such as the situations in examples (e)-(i) in paragraph 10. Temporary differences include all existing differences that will result in taxable or deductible amounts in future years.

FAS96, Footnote 9--Refer to paragraph 8. A deferred tax liability shall be recognized for the temporary differences addressed by Opinion 23 in accordance with the requirements of that Opinion, as amended. The indefinite reversal criterion of that Opinion applies only to the temporary differences addressed by Opinion 23 and to deposits in statutory reserve funds by U.S. steamship enterprises and shall not be applied to analogous types of temporary differences.

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FAS96, Footnote 10--Paragraph 44 addresses the manner of reporting the transaction gain or loss that is included in the net change in a deferred foreign tax liability or asset when the reporting currency is the functional currency.

FAS96, Footnote 11--Interest and penalties assessed on income tax deficiencies (underpayment or improper computation) shall not be reported as income tax expense.

FAS96, Footnote 12--The *consolidated amount* is the amount of current and deferred taxes reported in the consolidated financial statements for the group, or the amount that would be reported if such financial statements were prepared. The sum of the amounts allocated to members of the group (net of consolidation eliminations) shall equal the consolidated amount.

FAS96, Appendix A, Footnote 13--The discussion and examples in this appendix assume that the tax law requires offsetting net deductions in a particular year against net taxable amounts in the 3 preceding years and then in the 15 succeeding years. Assumptions in this appendix regarding the tax law are for illustrative purposes only. The enacted tax law for a particular tax jurisdiction should be used for recognition and measurement of a deferred tax liability or asset.

FAS96, Appendix A, Footnote 14—The book income adjustment is equal to one-half of the amount by which pretax financial income exceeds tentative AMTI. No book income adjustment is made in years in which tentative AMTI exceeds pretax financial income.

FAS96, Appendix A, Footnote 15--The ACE adjustment is equal to 75 percent of the difference between tentative AMTI and ACE. Unlike the book income adjustment, the ACE adjustment, subject to certain limitations, can result in deductible or taxable amounts. For purposes of this example, it is assumed that depreciation is the only reason for differences between pretax financial income, regular taxable income, tentative AMTI, and ACE.

The ACE adjustments for years 5 and 6 are calculated as follows:

	Year 5	**Year 6**
Regular taxable amounts	$ 85	$ 42
ACE depreciation adjustment	(10)	(67)
ACE	75	(25)
Tentative AMTI	33	17
ACE less tentative AMTI	$ 42	$ (42)
75 percent of difference	$ 32	$ (32)

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FAS96, Appendix A, Footnote 16--This requirement pertains to all ITC carryforwards regardless of whether the flow-through or deferral method is used to account for ITC.

FAS96, Appendix A, Footnote 17--If separate tax returns are expected to be filed, the accounting set forth in this paragraph and in paragraph 69 ordinarily would not apply. However, if a strategy to file consolidated tax returns for later years meets the criteria in paragraph 19, the effect of the strategy would be recognized in applying the accounting set forth in this paragraph and that in paragraph 69.

FAS96, Appendix B, Footnote 18--Refer to paragraph 8.

FAS96, Appendix B, Footnote 19--Some temporary differences cannot be identified with a particular asset or liability for financial reporting. Paragraph 12 discusses two examples. In both examples, the temporary difference results from an event that has been recognized in the financial statements, and based on the provisions of enacted tax laws, the temporary difference will result in taxable or deductible amounts in future years.

FAS96, Appendix B, Footnote 20--The Revenue Act of 1971 states that no particular method to account for investment tax credit shall be required in taxpayers' reports to any federal agency.

FAS96, Appendix D, Footnote 21--This Statement also supersedes those pronouncements or parts thereof that were explicitly superseded or effectively superseded by Opinion 11.

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