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INCOME TAX ALLOCATION: THE CONTINUING CONTROVERSY IN HISTORICAL PERSPECTIVE

Abstract: The appropriate means of accounting for income taxes on financial statements has been among the most hotly debated and frequently recycled issues of the past 50 years. This retrospective account begins with the issuance of the first professional standards during the 1930s and 1940s, and illustrates how theoretical arguments, developed in professional and academic journals during the 1950s, were subsequently recycled and revised during later decades. The problems that led to reconsideration of the deferred tax issue by both the APB during the 1960s and the FASB during the 1980s and 1990s are discussed, as are the solutions offered by these standard setters.

INTRODUCTION

The appropriate means of accounting for income taxes on financial statements has been among the most hotly debated and frequently recycled issues of the past 50 years. The Committee on Accounting Procedure (CAP), the Accounting Principles Board (APB), and the Financial Accounting Standards Board (FASB) have all addressed the issue. Nevertheless, critics of FASB's most recent approach [Rosenfield, 1990; Defliese, 1991] provided evidence that agreement about the best solution to this problem is still lacking. This retrospective account of the ongoing debate is based on an examination of professional standards, research reports, and articles in leading academic and professional journals. General developments in accounting theory and the standards-setting process serve as a backdrop for examining accounting for income taxes. The paper attempts

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to provide readers with an understanding of how the accounting issues and authoritative literature have evolved, thereby providing a basis for understanding current requirements.

A broader perspective is taken in this paper than in other recent histories of tax accounting, which have focused solely on the development of professional standards [Rayburn, 1986; Plunkett and Turner, 1988; Johnson, 1993]. It serves to update earlier works that considered the development of both theory and practice [Black, 1966; Nurnberg, 1971; Beresford et al., 1983]. The paper focuses on the debate about the extent to which income tax allocation is appropriate and which method should be applied. Aspects of the topic that are beyond its scope include discounting of deferred taxes and the information content of tax deferrals. Based upon a review of the literature, the authors focus on those writers who introduced or distilled the prevailing theory or presented cogent discussions of the issues. The chronological organization of the paper is based on the periods during which CAP, the APB, and FASB respectively were in existence.

THE CAP ERA (1936-1959)

Income taxes became a permanent part of the federal tax system with the passage of the Corporation Tax Law in 1909 and the ratification of the Sixteenth Amendment to the Constitution in 1913. However, the main source of tax revenues prior to World War II was local property taxes. During the World War II period (1939-1945), income taxes gained in importance because of an increase in the marginal corporate income tax rate from 19% to 38% [Sommerfeld and Easton, 1987, pp. 168-170]. Following World War II, there was an economic expansion and an increase in the number of shareholders. Measures such as earnings per share gained in importance, which led to pressures for more comparable income numbers [Carey, 1970, pp. 58-59]. The emphasis on the measurement of income tax expense reflected the general concern with income measurement during this era [Bailey, 1948, pp. 10-14; Shield, 1957, p. 53].

CAP had been formed in 1936 and was expanded and given the authority to issue pronouncements in 1938 [Davidson and Anderson, 1987, p. 116]. Its first pronouncements were issued in 1939, including one addressing an early tax allocation issue. This issue arose in the 1930s when a decline in long-term interest rates led many companies to refund bond issues. In

computing taxable income, firms deducted the unamortized discount and redemption premium on the bonds refunded. For financial reporting (book) purposes, these amounts were often charged directly to retained earnings or amortized over the remaining life of the original issue, practices that made reporting the associated tax benefit in book income seem inappropriate.

In ARB No. 2 (1939) and ARB No. 18 (1942), CAP recommended that bond discounts written off to retained earnings be reduced by the related tax savings, although the preferable treatment was to amortize the discount, reduced by the tax savings, over the original life of the bonds. The first approach is *intraperiod* tax allocation, the second *interperiod* tax allocation.

Another concern of accountants was the nature of the debit that offset the credit to taxes payable. Carey [1944, p. 425], the managing editor of the *Journal of Accountancy* and a noted chronicler of accounting history, questioned whether income taxes were an expense or a distribution of profits, and published a symposium [1944] on this issue. As Nurnberg [1971, pp. 8-14] later noted, viewing taxes as an expense was consistent with proprietary theory while considering them a distribution of earnings reflected entity theory. From the viewpoint of the proprietor, taxes, like interest, would be considered an expense necessary to achieve profitable operations. However, entity theory views both equity investors and creditors as suppliers of capital, and taxes, like interest, would be considered a distribution of income.

ARB No. 23: CAP concluded that income taxes were an expense in ARB No. 23 (1944), thus adopting the proprietary perspective. This viewpoint subsequently became widely accepted [Shield, 1957, p. 53]. ARB No. 23 recommended tax allocation to maintain a proportional relationship between tax expense and pretax financial reporting income when material and extraordinary differences between taxable income and financial statement income existed. Interperiod allocation was considered appropriate if an item was recognized in different periods on the tax return and financial statements, while intraperiod allocation was applicable when a taxable gain or loss was credited or charged directly to equity. ARB No. 23 passed with 18 assenting and 3 dissenting votes. One point of dissension was the requirement to apply an allocation method that presented accounts on a hypothetical rather than a factual basis.

According to ARB No. 23, interperiod tax allocation was considered appropriate when accelerated amortization on

defense facilities was allowed for tax purposes during World War II; when tax was likely to be paid in the future because of profit recognized currently from an installment sale or long-term contract; or when cash payments were deducted for taxes, but were not treated as an expense for book purposes. Allocation was not considered necessary when timing differences were expected to recur regularly over a comparatively long time period. Thus, CAP initially supported partial allocation, an approach in which only the tax effects of certain nonrecurring material timing differences were allocated. (In contrast, comprehensive allocation would allocate the tax effects of all timing differences.)

ARB No. 23 suggested the use of different accounts to record tax allocation and different tax rates to measure the amount. The tax effect of a depreciation timing difference might be recognized by debiting tax expense and crediting the depreciable asset, which would then be accounted for on a net-of-tax basis. Alternately, depreciation expense could be debited and an "appropriate reserve or other account" credited. Measurement of the deferred tax effect might be based either on the current tax reduction or on the estimated amount of tax payable in the future when the timing difference would reverse. Also addressed in ARB No. 23 was accounting for the tax benefit resulting from a loss carryback, which would be recognized in income during the loss year, or a carryforward, which would be recognized in the period realized.

As practitioners recorded tax allocation in different accounts and measured deferred taxes using different rates, three dominant allocation approaches evolved — the net-of-tax, liability (or asset-liability), and deferred methods. In the net-of-tax method, deferred taxes were treated as a valuation allowance offsetting the related asset or liability on the balance sheet. On the income statement, the adjustment might be either to tax expense or to the revenue or expense related to the timing difference, and the amount could be computed using either the current or a future tax rate.

Under both the liability and deferred methods, deferred taxes appear in a separate balance sheet account with the tax expense adjusted on the income statement. The deferred method considers the deferred tax account to be a deferred charge or credit, measured based on tax rates in effect when timing differences originated. Under the asset-liability method, the deferred tax account is considered an asset or liability measured by the tax rates expected to be in effect when differ-

ences reversed. Each of these viewpoints had its proponents in a debate that would be waged for decades to come. In the discussion that follows, support for the liability versus the deferred method is inferred if restatement of the deferred tax account for changes in tax rates is recommended.

Subsequent Professional Standards: The SEC, under Chief Accountant William Werntz (who served in this position from 1938 until 1947), initially opposed interperiod tax allocation. Accounting Series Release (ASR) No. 53 (1945) argued that, in most cases, the tax provision should reflect only the taxes actually payable for the current period. Despite the SEC's position, CAP continued to support interperiod tax allocation in ARB No. 27 (1946) and ARB No. 42 (1952), which recommended recognition of deferred taxes when the tax code allowed accelerated depreciation for emergency facilities during World War II and the Korean War. CAP permitted the net-of-tax treatment, but the preferred approach was to debit tax expense and credit a separate deferred tax account on the balance sheet.

In 1953, ARB No. 23 was revised for inclusion in ARB No. 43 (as Chapter 10B), and CAP added the suggestion that the current tax rate might be appropriate in some situations and an estimated future tax rate in others. Also, if tax allocation was not practicable, a disclosure was considered sufficient.

When the 1954 Internal Revenue Code allowed use of accelerated depreciation methods, many companies had significant recurring timing differences for the first time. CAP's response in ARB No. 44 (1954) was that "deferred income taxes need not be recognized in the accounts unless it is reasonably certain that the reduction in taxes during the earlier years of use of the declining-balance method for tax purposes is merely a deferment of income taxes until a relatively few years later, and then only if the amounts are clearly material" [ARB No. 44, par. 4]. Thus, tax allocation was not required for depreciation differences that were related to normal additions and replacements or ones that had an indefinite duration. Blough [1955, p. 68], at that time director of research for the AICPA, noted that CAP advocated partial allocation because, otherwise, firms replacing or expanding plant assets would build up a deferred tax liability that would not be reduced until a period of contraction or liquidation. (Blough had served as the SEC's first chief accountant in 1935 and would later serve on the APB during 1959-1964.)

Although the SEC had not officially rescinded or revised ASR No. 53, it began to require tax allocation for certain regis-

trants that used accelerated depreciation methods for tax purposes and straight-line depreciation for book purposes. Barr [1958, pp. 29-30], who served as the SEC's chief accountant from 1956 until 1972, noted that allocation was needed in some cases to avoid making the income statement seriously misleading. Subsequently, CAP changed its position and advocated comprehensive allocation for depreciation differences when ARB No. 44 was revised in 1958.

ARB No. 44 (revised) continued to allow flexibility in recognizing deferred taxes on the balance sheet, with either a separate deferred tax account or the net-of-tax approach considered acceptable. According to Rayburn [1986, p. 95], some accountants believed that ARB No. 44 (revised) permitted deferred taxes to be classified as earned surplus. To prevent this practice, CAP issued a letter clarifying that the deferred tax account was:

> . . . to be shown in the balance sheet as a liability or a deferred credit. . . . [It] should not at the same time result in a credit to earned surplus or to any other account included in the stockholders' equity section of the balance sheet [AICPA, 1959a].

CAP continued its support of interperiod tax allocation in ARB No. 51 (1959b), which required a parent company to recognize taxes on the undistributed earnings of subsidiaries included in consolidated income unless the earnings were likely to be distributed in a tax-free liquidation or to be invested permanently by the subsidiary. Thus, an exception to comprehensive allocation was created based on an indefinite reversal criterion.

Accounting Theory Develops: Deferred taxes were increasingly reported on financial statements during the 1950s. Consequently, articles in academic and professional journals proliferated on the appropriate means of accounting for income taxes. By the end of the decade, the arguments for partial versus comprehensive allocation, as well as for use of the net-of-tax, deferred, and liability methods, had been well-formulated. As Graham [1959, p. 14], a member of CAP, noted, "almost everything that can be said about income tax allocation has already been said — by someone." Exhibit 1 illustrates how the arguments already extant in Graham's day were recycled and refined during subsequent decades.

EXHIBIT 1
Representative Proponents of Different Tax Allocation Approaches

	the CAP era (1936-1959)	the APB era (1959-1973)	the FASB era (1973-present)
NO ALLOCATION	Hill [1957] Johns [1958] Davidson [1958]	Johnson [1961] Miller [1962] * Fremgen [1963] Drinkwater & Edwards [1965]	Rosenfield & Dent [1983]
PARTIAL ALLOCATION **	Powell [1959]		Wheeler & Galliart [1974] Nair & Weygandt [1981] Chaney & Jeter [1989]
NET-OF-TAX METHOD	Dohr [1959]	Drake [1962] Raby & Neubig [1963] Bierman [1963]	Bierman & Dyckman [1974] Defliese [1983]
DEFERRED METHOD	MacPherson [1954] Shield [1957] *** Graham [1959]	Hicks [1963]	Rosenfield [1990]
LIABILITY METHOD **	Moonitz [1957] *** Sands [1959]	Nurnberg [1969]	Nurnberg [1987]
DEFERRED TAXES AS EQUITY		Jaedicke & Nelson [1960] Keller [1962]	
COMBINED METHODS		Trumbell [1963] Grady [1964] Perry [1966] Black [1966]	Gilles [1976] Graul & Lemke [1976] Schwartz [1981] Arthur Andersen & Co. [1983] Wyatt et al. [1984] Kissinger [1986] Bierman [1990]

* Also considered comprehensive allocation acceptable.
** Most proponents of partial allocation favored its application using the liability method.
*** Support for either the liability or deferred method might be inferred.

Two articles that appeared in 1957 laid out many of the basic theoretical concepts and concerns. Moonitz, an academic who would later serve the AICPA as director of accounting research and as a member of the APB, distinguished between permanent differences and timing differences. Permanent differences do not create a tax measurement problem since they impact either taxable income or financial reporting income, but not both. However, for timing differences, Moonitz [1957, p. 177] advocated matching to let "the tax follow the income." Four different types of timing differences were identified by both Moonitz [1957] and Shield [1957]. Shield [1957], a practitioner, dichotomized these differences based on whether they had a past or a future tax impact. In the current paper, transactions with a past tax impact are designated as tax earlier-book later (TEBL) differences, while those with a future tax impact are designated as book earlier-tax later (BETL) differences. Ex-

hibit 2, adapted from Shield [1957, p. 60], illustrates these four types of timing differences.

EXHIBIT 2
Four Types of Timing Differences

	Tax Earlier - Book Later (TEBL)	Book Earlier - Tax Later (BETL)
REVENUES	**EXAMPLE: REVENUE RECEIVED IN ADVANCE** DEFERRED TAX *DEBIT* BALANCE	**EXAMPLE: INSTALLMENT SALE** DEFERRED TAX *CREDIT* BALANCE
EXPENSES	**EXAMPLE: DEPRECIATION** DEFERRED TAX *CREDIT* BALANCE	**EXAMPLE: WARRANTY EXPENSE** DEFERRED TAX *DEBIT* BALANCE

TEBL revenues arise when recognition in taxable income precedes recognition in book income, as when revenue is received in advance. The tax paid on the revenue is debited to a deferred tax account. Later, when the revenue is reported for financial reporting purposes, the deferred tax debit is reduced and tax expense is increased. TEBL expenses arise when recognition in taxable income precedes recognition in book income, as when tax depreciation is more accelerated than book depreciation, or when a capitalized expenditure is treated as an expense for tax purposes. When these costs are deducted for tax purposes, the tax reduction gives rise to a deferred tax credit. Later, as the expense is recognized for financial reporting purposes, the deferred tax credit is decreased and tax expense reduced.

BETL revenues are recognized in book income before taxable income, as when an installment sale is recognized on the accrual basis for book purposes and on the cash basis for tax purposes, or when a long-term contract is accounted for using the percentage-of-completion method for book purposes and the completed-contract method for tax purposes. When revenue is recognized on the books, the related tax expense is also recognized, with a corresponding credit to deferred taxes. As the revenue is reported in taxable income, taxes payable increases and the deferred tax credit decreases. BETL expenses are recognized in book income earlier than taxable income, as when estimated expenses (for product warranties, deferred compensation, uncollectible accounts, etc.) are recognized on the

accrual basis for financial reporting and the cash basis for tax purposes. Tax expense is reduced when the estimated expense is accrued in book income, resulting in a deferred tax debit. When the costs are paid, taxes payable and the deferred tax account are both reduced.

Differences between the four types of timing differences were acknowledged. Moonitz [1957, p. 182] argued that accruing a deferred tax credit was not as important in the TEBL expense case as in the BETL revenue case because "the revenue in the second case has not yet been reported for tax purposes, whereas the deduction in the earlier case has already been taken."

Although Moonitz advocated measuring deferred taxes in all four cases using current tax rates, he acknowledged the uncertainty introduced into the measurement because future taxable income and future tax rates were unknown. Shield [1957, p. 60] similarly noted a measurement difference between the TEBL and BETL cases: "In situations of past tax impact the amount of the tax impact has been definitely established. . . . In situations of future tax impact the amount can only be estimated."

The propriety of recognizing the future tax benefit associated with a BETL expense was also a concern. Shield [1957, p. 57] argued for recognition only if a possible future tax loss could be offset against taxable income during the two-year carryback period. He did not consider recognition appropriate if realization of the tax benefit was contingent upon subsequent earnings.

Various viewpoints on the nature of deferred taxes were voiced. Some accountants opposed interperiod tax allocation, arguing that calculating tax expense based on book income "produces a meaningless figure not descriptive of any past, current, or future applications of funds" [Hill, 1957, p. 358]. Because deferred taxes did not really represent amounts currently payable to, or receivable from, another entity, some accountants argued that deferred taxes should be considered deferred credits rather than liabilities or equities. According to Graham [1959, p. 23], deferred taxes "should be interpreted as the deferment to future periods of a credit to income tax expense rather than as the deferment of the payment of a tax liability. Under this concept questions relating to the existence of future taxable income and to future tax rates are irrelevant." MacPherson [1954, p. 358], another advocate of the deferred method who was director of research for the Canadian Insti-

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tute of Chartered Accountants, noted that accelerated tax depreciation would not lead to a future tax liability if "tax rates are reduced, or there is no taxable income in later years, or the increase in taxes is indefinitely postponed by continued expansion of investment in depreciable assets, or the business is not continued as a going concern."

Some accountants considered the liability method preferable to the deferred method because the creation of deferred charges and credits "denies one of the fundamental premises of accounting, that assets minus liabilities equals ownership equity" [Sands, 1959, p. 588]. The net-of-tax approach also had it adherents. Dohr [1959, p. 20], a former AICPA director of research then in academe, considered it the most "simple, straightforward, factual and understandable" approach. Powell [1959, p. 27] characterized the net-of tax approach as an attempt:

> to find a basis of realism in both the income statement and the balance sheet . . . within the framework of existing concepts. . . . Tax deductibility gives value to an asset. . . . The fair value of an asset whose cost is not tax-deductible is less than the fair value of an otherwise identical asset whose cost is tax-deductible.

However, Powell, a member of CAP and later the first chair of the APB, did not personally support the net-of-tax approach because it would base the carrying value of a depreciable asset on the profitability of the firm. He generally opposed interperiod tax allocation except when needed to avoid an obvious distortion of income, as would occur in the case of a material, nonrecurring BETL revenue.

The argument against allocation in the depreciation case based on the indefinite reversal of aggregate depreciation differences for a static or growing firm was developed by Davidson [1958], an academic who would later debate the income tax issue as a member of the APB, and Hill [1957]. Graham [1959] rejected this argument because, taken to its logical conclusion, it would imply that a firm need not recognize any liabilities since maturing liabilities would always be replaced by new ones.

THE APB ERA (1959-1973)

CAP has been criticized for taking a piecemeal approach to setting accounting principles, with specific topics considered only as the need arose [Carey, 1970, p. 18]. Its pronouncements

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on accounting for income taxes are illustrative of that approach. Specific issues were addressed in a number of different ARBs, which bore little relationship to each other and led to a variety of interpretations in practice. Furthermore, many of the ARBs were phrased to allow for exceptions, with firms free to deviate from CAP's recommendations when departure could be justified [Carey, 1970, pp. 87-88].

As a result, there was "pressure for reasonable comparability of earnings . . . from the SEC, the universities, the analysts, the press, and from within the profession itself" [Carey, 1970, p. 80]. Jennings [1958], then president of the AICPA, responded to the calls for comparability by proposing an accounting research organization that would examine basic assumptions and identify generally accepted accounting principles. Subsequently, the AICPA replaced CAP with the APB and its semi-autonomous Accounting Research Division (ARD) in 1959. The expectation was that accounting principles issued by the APB would be based on the studies done by the ARD [Carey, 1970, p. 94].

Income taxes was the subject of APB Opinion No. 1 (1962). It extended the requirements of ARB No. 44 (revised) to timing differences arising when shorter depreciable lives were permitted for tax purposes. Under Chief Accountant Barr, the SEC formally advocated comprehensive tax allocation in ASR No. 85 (1960), which called for the recognition of deferred taxes whenever costs were deducted for tax purposes more quickly than for book purposes. The SEC permitted either a debit to tax expense and a credit to a non-equity balance sheet account, or a debit to depreciation expense and a credit to accumulated depreciation.

Continued Theoretical Controversy: As Exhibit 1 illustrates, academics recycled and refined the arguments advanced in earlier years during the 1960s. Miller [1962], an academic who served on both CAP and the APB, considered both the non-allocation and comprehensive allocation positions supportable and concluded that the inability to reach a solution to the deferred tax problem resulted from a lack of agreement on basic theoretical issues. The view of deferred tax credits as a source of government investment in the firm was advanced by Jaedicke and Nelson [1960] and Keller [1962]. This was an atypical investment, however, since "there is no expectation of interest or dividend payments" [Keller, 1962, p. 64].

Drake [1962] and Bierman [1963] opted for the net-of-tax method in the depreciation case and initiated a discussion of the relationship between tax allocation and present value depre-

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ciation. Raby and Neubig [1963, p. 568] believed "the underlying problem is the difference between the tax basis of an asset and its accounting basis" and considered the net-of-tax method appropriate for all situations in which an asset had a different basis for book and tax purposes.

Johnson [1961] opposed allocation since deferred tax credits were neither liabilities nor equity. Fremgen [1963] and Drinkwater and Edwards [1965] also opposed interperiod tax allocation, arguing that the matching principle should not be applied to taxes, a view reminiscent of the entity theorists' position that income taxes were not an expense. Hicks [1963], however, found support for income tax allocation based on the matching and going-concern concepts. He favored the deferred method, arguing that providing deferred taxes based on originating period tax rates was appropriate since tax allocation was a process of deferring a current tax reduction to future years rather than a process of providing for a future tax liability. Nurnberg [1969] argued that the deferred method was an aberration of the liability method because the basic accounting equation did not acknowledge the existence of miscellaneous deferred credits and charges. He favored classifying deferred taxes as liabilities and assets on the balance sheet but measuring them using the tax rate in the originating period.

Combined Approaches To Deferred Tax Accounting: During the 1960s and subsequent decades, several combined approaches to deferred tax accounting were proposed. Exhibit 3 expands upon Exhibit 1 by describing the methods advocated by proponents of the various combined approaches. Trumbell [1963, p. 47], an academic, considered the sources of deferred tax credits and concluded that a liability exists in the installment sales case but not in the depreciation case. With regard to BETL revenues, he reasoned that taxable revenue would result from the collection of receivables already recognized. However, with TEBL expenses, taxable revenue would only result from a future disposition of depreciable assets. Thus, the event creating the liability has already occurred with installment sales, but not with depreciation.

When the 1964 tax act reduced the basic corporate tax rate (from 52% to 50% for 1964 and to 48% thereafter), the issue of adjusting deferred tax balances for changes in tax rates was rekindled. Grady [1964, p. 26], the AICPA director of research, concluded that only deferred tax balances related to BETL expenses should be restated for rate changes because they "may

EXHIBIT 3
Combined Approaches

PROPONENTS	METHODS ADVOCATED	
Trumbell [1963] Bierman [1991]	ASSET-LIABILITY *BETL REVENUES* *	NET-OF-TAX *DEPRECIATION*
Grady [1964]	ASSET-LIABILITY *BETL EXPENSES*	DEFERRED *ALL OTHER TIMING DIFFERENCES*
Perry [1966] Gilles [1976] Arthur Andersen & Co. [1983] 2nd rule Wyatt et al. [1984]	ASSET-LIABILITY *BETL DIFFERENCES*	NET-OF-TAX *TEBL DIFFERENCES* *
Black [1966]	ASSET-LIABILITY *DEFERRED TAX CREDITS*	DEFERRED *DEFERRED TAX DEBITS*
Graul & Lemke [1976]	ASSET-LIABILITY *ADMINISTRATIVE DIFFERENCES*	EQUITY *ECONOMIC INCENTIVES*
Schwartz [1981]	ASSET-LIABILITY *SHORT-TERM DIFFERENCES*	EQUITY *LONG-TERM DIFFERENCES*
Arthur Andersen & Co. [1983] 1st rule	ASSET-LIABILITY *NO RELATED BALANCE SHEET ACCOUNT*	NET-OF-TAX *RELATED BALANCE SHEET ACCOUNT*
Beresford et al. [1983] These authors described, but did not advocate, this approach.	ASSET-LIABILITY *BETL DIFFERENCES*	DEFERRED *TEBL DIFFERENCES*
Kissinger [1986]	ASSET-LIABILITY *REVENUES*	NET-OF-TAX *EXPENSES*

*Acronyms used: BETL stands for book-earlier tax-later and TEBL for tax-earlier book-later.

not cover long periods, do not necessarily involve repetitive transactions, may be susceptible of fairly accurate estimates, and the tax effect represents an estimate of future effect rather than being currently determinable." This conclusion apparently ignored the fact that some firms might accrue bad debt or warranty expense repetitively but report installment sales on an isolated basis.

Perry [1966, pp. 29-30], a practitioner, clarified and extended the distinction between TEBL and BETL transactions and related it to the use of different tax rates and different balance sheet accounts. He reasoned that taxable revenues or expenses would result when BETL differences reversed, so the related deferred taxes should be reported as liabilities or assets. For TEBL differences, he reasoned that revenues taxed currently do not result in a tax receivable nor do expenses deducted currently produce a tax payable. Since they did not qualify as assets and liabilities in their own right, Perry considered the deferred taxes attributable to TEBL differences to be valuation allowances under the net-of-tax method. Further, he believed that reporting depreciable assets on a net-of-tax basis would prevent the erroneous conclusion that deferred taxes were a source of government investment in the firm. Perry [1966, pp. 29] argued that, on the contrary, "the failure to use accelerated methods in computing depreciation deductions is equivalent to making an interest-free loan *to the government*."

Standards and Studies Preceding APB Opinion No. 11: Use of the net-of-tax method was curtailed when APB Opinion No. 6 (1965, par. 23) restricted the allowable methods:

> Provisions for deferred income taxes may be computed either (a) at the tax rate for the period in which the provision is made (the so-called 'deferred credit' approach) or (b) at the tax rate which it is estimated will apply in the future (the so-called 'liability' approach).

The SEC was putting increasing pressure on the APB to move towards greater uniformity in financial reporting during the mid-1960s. Before the APB could resolve the income tax issue, the SEC took limited action to narrow differences in reporting practices [Carey, 1970, pp. 130-135]. In ASR No. 102 (1965), the SEC required deferred taxes related to installment sales receivables to be classified as liabilities.

Black's Accounting Research Study No. 9 set the stage for the APB's deliberation of the deferred tax issue. Black [1966, p.

5], an academic, noted that continuing disagreement about the appropriate method of accounting for deferred taxes stemmed from the diverse interpretations of the ARBs. CAP had not made it clear whether tax allocation should be applied to all or only to some timing differences, and the ARBs provided support for more than one method of allocating taxes. As part of Black's study, Steiner [1961], a practitioner, reviewed the treatment of deferred taxes in almost 400 annual reports and concluded that tax allocation was often handled in an unclear manner with confusing terminology.

Black [1966] took as a given that taxes were an expense to be allocated. He examined the arguments for and against the three basic approaches, as well as the combined methods of Grady [1964] and Perry [1966]. He rejected the indefinite postponement idea used to defend partial allocation and concluded that interperiod allocation should be applied comprehensively. He found the net-of-tax method unacceptable and advocated a combination approach in which the liability method was applied to deferred tax credits and the deferred method was applied to deferred tax debits. Thus, both Black [1966] and Perry [1966] concluded that BETL revenues resulted in deferred tax liabilities to be measured using future rates. Black also concluded that depreciation timing differences resulted in liabilities to be measured based on future tax rates, while BETL expenses resulted in current tax payments to be measured using current rates. In contrast, Perry [1966] argued that BETL expenses led to future tax savings, which would be measured using future tax rates, while TEBL expenses led to current tax savings, which would be measured using current rates.

APB Opinion No. 11 and Subsequent Opinions: The text of APB Opinion No. 11 (1967) made no mention of any combined approach, although a discussion of the three basic methods of accounting for deferred taxes was included. Defliese [1991, p. 90], a member of the APB at the time the income tax issue was considered, recalled that the APB was "hopelessly split on which rationale to apply to tax allocation." (Defliese had earlier chaired CAP and would go on to chair the APB in its final years.) APB Opinion No. 11 passed with 14 assenting votes and 6 opposing votes. Opponents cited the requirement for comprehensive rather than partial allocation as their primary concern. According to Arthur Andersen [1983, chap. II, p. 11], many APB members preferred the net-of-tax and liability methods, but there was insufficient support for either method to obtain the

necessary two-thirds vote. The deferred method was selected as a practical compromise. As Perry [1981, pp. 25-26] noted, the deferred method:

> does not require deferred tax charges and credits to be deemed receivables and payables [and thus] . . . has the practical advantage of not requiring assumptions as to future taxes, does not require adjustments of prior deferred tax balances when tax rates change . . . and avoids the issue of the need for discounting. . . . Finally, the effects of applying interperiod tax allocation are more simply presented by showing deferred taxes as separate items in the financial statements than by showing them net-of-tax.

APB Opinion No. 11 allowed some flexibility in computing the tax effect of timing differences. Under the gross change method, the tax rate in effect when a difference originated was applied upon reversal as well. Under the net change method, the current year's tax rate was applied to both originating and reversing differences.

APB Opinion No. 11 required classification of deferred taxes on the balance sheet based on the current or noncurrent status of the related asset or liability. It addressed the recognition of deferred tax debits only with respect to net operating losses. The tax benefit of a net operating loss carryback, which could be realized by a refund of taxes previously paid, would be recognized in the loss year. The tax benefit of a net operating loss carryforward would only be recognized if realization was assured beyond any reasonable doubt. Hence, recognition was generally deferred until realization occurred.

APB Opinion No. 11 considered several transactions leading to book-tax differences that might not reverse for an indefinite future period because the taxpayer controlled the events that would result in future taxable amounts (e.g., the undistributed earnings of subsidiaries, an issue that had been addressed in ARB No. 51). Ultimately, the Board decided not to modify ARB No. 51 and deferred any conclusion on the other indefinite reversal cases. Subsequently, APB Opinion No. 23 [1972a] required recognition of deferred taxes for several such cases (including the undistributed earnings of subsidiaries), but nevertheless permitted an exception to tax allocation when differences were not expected to reverse for an indefinite future period. APB Opinion No. 24 [1972b] required tax allocation for earnings from equity method investees.

THE FASB ERA (1973 TO PRESENT)

APB Opinion No. 11 effectively narrowed the areas of difference in accounting for income taxes. However, despite the progress towards consistency made in this and other areas, the APB continued to be the subject of criticism. "Few APB pronouncements escaped opposition from some corporations or industry groups" [Carey, 1970, p. 124]. Based on the recommendations of the Wheat Study Group, the AICPA replaced the APB with FASB in 1973. During the same year, the SEC issued ASR No. 149, requiring registrants to improve disclosure of the components of income tax expense, the causes of timing differences, and the items reconciling the difference between the effective and statutory tax rates.

New Combination Approaches: During the FASB era, academicians continued to voice support for partial allocation [Wheeler and Galliart, 1974], the net-of-tax method [Bierman and Dyckman, 1974], and Perry's combined approach [Gilles, 1976]. Several new combination approaches to accounting for income taxes were proposed as well. Graul and Lemke [1976] distinguished between timing differences intended to create an economic policy incentive (e.g., accelerated depreciation) and those developed as a matter of administrative convenience (e.g., taxing revenues and expenses when cash flows occurred). The tax effects of differences resulting from economic policy incentives were deemed a constructive source of funds that would be credited to equity, while those resulting from policies based on administrative convenience would be accounted for using the liability method. Schwartz [1981] argued that the tax effects of long-term timing differences whose reversal was indefinite, such as depreciation, should be considered interest-free loans from the government, while the tax effects of short-term differences, such as installment sales, should be considered liabilities. Kissinger [1986] advocated the asset-liability method for the two revenue cases and the net-of-tax method for the two expense cases.

Arthur Andersen & Co. [1983, chap. III, p. 24] found that the "apparent desire for a single exclusive theory is an unnecessary and unwarranted limitation" on accounting for income taxes. They supported a combined approach based on either of two rules. The first rule would apply the net-of-tax method to those differences related to a particular asset or liability and the liability method to those timing differences unrelated to a spe-

cific balance sheet account. The second rule represented Perry's [1966] approach. Ernst & Whinney partners, Beresford et al. [1983, p. 65], reported that a variant on Perry's approach, in which the deferred method was applied to TEBL differences and the asset-liability method to BETL differences, was considered "more acceptable to those who object to the net-of-tax approach under any circumstances."

Thus, accountants continued to recognize that all timing differences were not the same. Exhibit 3 illustrates that although each combined proposal was based on a different rationale, all but three led to the conclusion that a liability results in the installment sales case, but not in the depreciation case. (Grady [1964], Black [1966], and Arthur Andersen's [1983] first rule are the exceptions.) Moonitz [1957] and Trumbell [1963] had previously distinguished between the installment sales case, in which the event triggering the liability had already occurred, and the depreciation case, in which it had not.

The Legacy of APB Opinion No. 11: In FASB's early years, various pronouncements amended or clarified the application of APB Opinion No. 11. SFAS No. 9 [1975] extended interperiod allocation to intangible development costs of oil and gas companies. In 1976, the SEC's Staff Accounting Bulletin (SAB) No. 8 (restated in SAB No. 40, topic 5C) conservatively recommended recording deferred tax charges only if it was likely that a future tax benefit would result. FASB Interpretation No. 22 [1978] limited the applicability of the indefinite reversal concept to the specific items mentioned in APB Opinion No. 23, but SFAS No. 31 [1979] extended the concept to a U.K. tax deduction. SFAS No. 37 [1980] amended APB Opinion No. 11 by requiring that deferred taxes unrelated to a specific asset or liability be classified according to the expected reversal date.

Over time, concerns with APB Opinion No. 11 mounted. Based on a review of professional standards and 1975 annual reports, Ditkoff [1977, p. 79] concluded that:

> financial tax accounting is now a bewildering amalgam of theoretical anomalies, inconsistencies and specious assumptions. On most contemporary financial statements . . . the current tax liability, which is the single verifiable income tax consequence of the period's operations, cannot be determined.

Widespread disagreement on the part of financial analysts as to the character of deferred tax balances was reported

[Wheeler and Galliart, 1974, p. 135; Arthur Andersen & Co., 1983, chap. IV]. At the same time, deferred tax credits were growing on firms' balance sheets and becoming increasingly material in relation to assets and equity [Davidson et al., 1977, 1984; Beresford, 1982; Skekel and Fazzi, 1984].

Critics maintained that professional pronouncements in this area were difficult to comprehend, internally inconsistent, and subject to different interpretations [Beresford et al., 1983, p. 3]. Furthermore, APB Opinion 11 was inconsistent with recently adopted U.K. and international accounting standards that permitted partial allocation and a choice of alternative methods. Some accountants believed that Statement of Financial Accounting Concepts (SFAC) No. 3 (1980), which excluded deferred charges and credits from its definitions of balance sheet assets and liabilities, ruled out deferred tax accounting. FASB responded that "both the liability method and the net-of-tax method are compatible with the definitions in this Statement. Only the deferred method that is prescribed by APB Opinion No. 11 . . . does not fit the definitions" [SFAC No. 3, par. 163-164].

According to Beresford [1982], the issue that finally forced FASB to reconsider deferred tax accounting was the introduction of the Accelerated Cost Recovery System (ACRS) as part of the 1981 tax act. At that time Beresford, who would chair FASB between 1987 and 1997, was chair of the AICPA's Accounting Standards Executive Committee (AcSEC). Under ACRS, the recovery period for most depreciable assets was between 3 and 15 years. This shortened period meant that companies that had previously used the same depreciation method for book and tax purposes could no longer do so and would have to provide deferred taxes on depreciation timing differences. The 1981 tax act also extended the carryforward period for net operating losses to 15 years, affecting the likelihood that carryforward benefits could be realized.

SFAS No. 96: In 1982, FASB added accounting for income taxes to its agenda. The Board's deliberations were based on input that included an Ernst & Whinney Research Report by Beresford et al. [1983], an FASB Discussion Memorandum [1983b], and studies by Arthur Andersen & Co. [1983] and Coopers & Lybrand [1983]. As in earlier decades, various opinions on the optimum resolution of the deferred tax problem were offered in the literature. Rosenfield, director of the AICPA's Accounting Standards Division, and Dent, a former

AcSEC member [1983], argued for eliminating deferred taxes. Defliese [1983], the former APB chairman, favored the net-of-tax method. Academics Nair and Weygandt, the latter also a member of AcSEC [1981], opted for partial allocation and the liability method. Arthur Andersen partners, Wyatt et al. [1984], preferred Perry's combined approach, advocated in Arthur Andersen & Co. [1983].

Meanwhile, prior to the issuance of a new statement on income taxes, a number of FASB Technical Bulletins were issued to address accounting issues raised by provisions in the tax acts of 1978, 1981, 1982, 1984, and 1986. (These bulletins were later superseded by the new statement.) After its inception in 1984, FASB's Emerging Issues Task Force (EITF) was also called upon to address similar questions.

FASB [1986] eventually issued an Exposure Draft that supported comprehensive allocation under the asset-liability method. In the same year, corporate tax rates were reduced from 46% to 34%. As Nurnberg [1987] noted, a change to the liability method would require firms to reduce deferred tax credits to reflect the lower tax rates, with a corresponding increase in earnings. Not surprisingly, FASB's proposed change to the asset-liability approach found favor with the business community. In SFAS No. 96 [1987], FASB argued that this approach was consistent with the asset and liability definitions in the conceptual framework and would produce the most useful and understandable information. The choice of the asset-liability method reflected a shift "away from the matching concept and income statement focus under the deferred method to a balance sheet focus" [Wolk et al., 1989, p. 1]. As Parks [1988, p. 24] noted, "this conceptual preference for the balance sheet dovetails philosophically with the trend of other standards issued by the FASB in recent years."

FASB rejected the net-of-tax approach, citing the practical problem of determining the tax effect on each asset or liability and the difficulty in understanding an enterprise's overall tax situation. The deferred method was rejected as inconsistent with the conceptual framework asset and liability definitions. The combined approaches were also rejected, partly because use of the net-of-tax and deferred methods had been ruled out as single methods and partly because of the increased complexity and balance sheet confusion that might result [SFAS No. 96, par. 180-196].

SFAS No. 96 introduced the concept of temporary differences, which included not only APB Opinion No. 11 timing

differences (arising from recognition of revenues or expenses in different periods for tax and book purposes), but also other circumstances that would cause the tax basis and financial reporting basis of assets to differ. Such differences might arise when assets values were adjusted as a result of a business combination accounted for as a purchase or when a tax jurisdiction permitted assets to be indexed for inflation. In 1969, AICPA Accounting Interpretation 8 of Opinion No. 11 had concluded that permanent differences would result when assets had a different basis for accounting and tax purposes. However, SFAS No. 96 concluded that all basis differences were temporary. Thus, under SFAS No. 96, deferred tax liabilities or assets could result regardless of whether the item creating the difference was a BETL difference, a TEBL difference, or what some accountants would consider to be a permanent difference in depreciable basis.

FASB considered temporary differences to be either taxable differences, which would lead to deferred tax liabilities, or deductible differences, which would lead to deferred tax assets. SFAS No. 96 [par. 14] provided that "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." Thus, the tax benefits of deductible temporary differences and net operating loss carryforwards could be recognized only to the extent that they offset future reversals of taxable temporary differences or could be realized by carryback to offset taxable income of a prior year. The existence of future taxable income from other sources could not be assumed, and firms had to prepare hypothetical tax returns to schedule the year-by-year reversal of temporary differences. In a special report, FASB staff members provided guidance for determining the reversal pattern for specific temporary differences [Simpson et al.,1987].

SFAS No. 96 was adopted with five affirmative votes. The limitation on the recognition of deferred tax assets was the primary concern cited by the two dissenters. Businesses were also concerned about the lack of symmetry that resulted from recognizing all deferred tax liabilities but not all deferred tax assets. After the issuance of SFAS No. 96, the Board began receiving requests to change the criteria for recognition of deferred tax assets to anticipate the tax consequences of future income and to reduce the complexity of scheduling the future reversals of temporary differences [SFAS No. 109, par. 283].

Because of the controversy engendered by SFAS No. 96, its effective date was postponed by SFAS No. 100 (1988), SFAS No. 103 (1989), and SFAS No. 108 (1991) while FASB reconsidered the deferred tax issue.

Theoreticians Respond: Articles in professional journals described the application of SFAS No. 96 and criticized its complexities and its rigid and mechanical approach to deferred tax accounting [Parks, 1988; Knight et al., 1989]. Although SFAS No. 96 treated deferred tax assets differently than deferred tax liabilities, BETL and TEBL differences were not distinguished. Parks [1988, p. 28] noted that nonrecognition of deferred tax assets for TEBL revenues is counterintuitive:

> Because these assets represent deferred tax expenses that should be allocated to future periods to match the financial reporting of . . . income, realization of the assets isn't a relevant consideration. The FASB should have made a conceptual distinction between those deferred tax assets that require future taxable income for realization and those that represent a deferral of taxes paid currently.

Accounting academicians continued to suggest alternatives to FASB's asset-liability method, comprehensively applied as Exhibit 1 illustrates. Wolk et al. [1989, p. 1] complained that SFAS No. 96 "ignores an extensive body of empirical evidence which clearly indicates that permanent deferral of tax obligations occurs far more frequently than their payment." Chaney and Jeter [1989, p. 12] preferred partial allocation because "the deferred tax liability on the balance sheet would conform more closely to the definition specified by the FASB . . . of a *probable* future sacrifice of economic benefits." Bierman [1990, p. 45] noted that "the FASB implicitly assumes the use of the tax deduction is the critical event giving rise to a tax liability . . . [but] there is not a tax liability until the depreciable asset is converted by a sale transaction into cash or a receivable." He continued to prefer the net-of-tax method in the depreciation case, but acknowledged that a deferred tax liability should be recognized in the installment sales case. Defliese [1991, p. 90] also found that "the net-of-tax approach is easier to fit into the current conceptual framework." On the other hand, Rosenfield [1990, p. 100] preferred to live with the deferred method, despite its inconsistency with the conceptual framework, rather than to adopt the liability method, which "represents an at-

tempt to fit an income statement principle into . . . a balance sheet mold." Thus, the same arguments were again recycled in professional and academic journals, with no apparent consensus about the best method of accounting for income taxes.

SFAS No. 109: The Exposure Draft preceding SFAS No. 109 [FASB, 1991a] was generally "viewed as a significant improvement over Statement 96" because it addressed the concerns about complexity and the limited recognition of deferred tax assets [Stepp and Petzing, 1991]. SFAS No. 109 [1992], adopted by a unanimous vote, ultimately superseded SFAS No. 96. It retained comprehensive allocation and the asset-liability method, but significantly relaxed the limitations on the recognition of deferred tax assets and the requirement for detailed scheduling of future taxable and deductible amounts. Under SFAS No. 109, an enterprise would measure the total deferred tax liability for taxable temporary differences and the total deferred tax asset for deductible temporary differences and for operating loss and tax credit carryforwards. Then, deferred tax assets would be reduced by a valuation allowance:

> if, based on the weight of available evidence, it is *more likely than not* (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets will not be realized. The valuation allowance should be sufficient to reduce the deferred tax asset to the amount that is more likely than not to be realized [SFAS No. 109, par. 17e].

Realization of a deferred tax asset would depend on the existence of sufficient taxable income during the carryback and carryforward periods. Unlike SFAS No. 96, SFAS No. 109 did not preclude consideration of sources of future taxable income other than reversals of existing temporary differences. Scheduling the reversal of taxable temporary differences would be unnecessary if a firm could provide positive evidence to support assumptions about future taxable income. Adequate positive evidence, such as a sales backlog, would be needed to justify the conclusion that a valuation allowance was not needed for a firm also having negative evidence, such as recent cumulative losses. Thus, SFAS 109 required firms to exercise considerable judgment in weighing the relative effects of positive and negative evidence, giving consideration to the objective verifiability of different types of evidence.

The objectives of SFAS No. 109 were to recognize the

amount of taxes payable or refundable for the year and the deferred tax assets and liabilities for the expected future tax consequences of events that had been recognized in a firm's tax returns or financial statements. Deferred tax assets and liabilities would be measured based on the enacted tax law and adjusted for the effect of a change in tax law or tax rates. Total income tax expense would be the sum of taxes currently payable or refundable plus deferred tax expense or the change during the year in the firm's deferred tax assets and liabilities.

For classification purposes, SFAS No. 109 reverted to the same rule used in APB Opinion No. 11. Deferred taxes were considered current or noncurrent based on the classification of the balance sheet account related to the temporary differences. Deferred tax amounts with no related balance sheet account would be classified based on the expected reversal date of the temporary differences. In contrast, SFAS No. 96 had required classification of all deferred taxes as current or noncurrent based on the scheduled reversal date.

SFAS No. 109 finally eliminated the exceptions to comprehensive allocation for the indefinite reversal situations from APB Opinion No. 23 on a prospective basis. Earlier, FASB [1986] had sought to eliminate these exceptions in the Exposure Draft preceding SFAS No. 96. However, constituents' comments caused the Board to modify its position at that time, and these exceptions had been allowed to continue in the final version of SFAS No. 96.

Subsequent to the issuance of SFAS No. 109, application questions were addressed in a special report by FASB staff members Perry and Simpson [1992]. (Perry had joined the FASB staff after retiring from public accounting.) Also, specific income tax accounting issues were addressed in a number of EITF abstracts, including several occasioned by provisions of the 1993 tax act.

With the controversy engendered by SFAS No. 96 finally quelled by the issuance of SFAS No. 109, the normative debate about the best tax allocation method to apply under U.S. GAAP waned. More recent articles in the professional journals have focused on applying the provisions of SFAS No. 109 [Read and Bartsch, 1992; Leahey, 1993; Petree et al., 1995] and evaluating its impact on subsequent accounting standards [Cocco et al., 1994; Munter and Ratcliffe, 1996]. Articles in academic journals have focused on deferred tax issues that can be investigated empirically [Gupta, 1995; Chandra and Ro, 1997]. This may reflect saturation with the income tax accounting issue after so

many decades of debate as well as current trends in academic and professional journals.

SUMMARY AND CONCLUSIONS

This paper serves to illustrate the ebb and flow of opinions on the "best" method of accounting for income taxes, given differences between taxable income and book income. The issue arose in the 1930s and 1940s as CAP began to promulgate professional standards to address the problem. During the 1950s, a debate was waged in professional and academic journals concerning the need for interperiod tax allocation, the extent to which it should be applied, and the best single method of applying it. In the 1960s, several combined approaches were discussed in the literature. The APB considered the income tax problem and issued Opinion No. 11. The 1970s brought new combined proposals and various amendments to that opinion. FASB reconsidered the problem during the 1980s and issued the ill-fated SFAS No. 96. During the 1990s, SFAS No. 96 was superseded by SFAS No. 109 and the debate about normative issues started to wane.

During these decades, the arguments for the various approaches to accounting for income taxes have been recycled with many accounting firms, rule-making bodies, and academic institutions represented in the discussion, but no particular group dominating the debate. A true consensus about the best method of accounting for income taxes does not seem to have evolved, probably due to the sheer variety of accounting alternatives available and the discrepancy between the theoretical consistency of allocation methods and the ease with which they can be applied in practice. Practicality within the constraints imposed by the conceptual framework appears to be the approach taken by the present standard setters.

Nevertheless, continued differences between taxable income and financial statement income guarantee that the issue will not go away. Future accounting standards and tax acts will raise issues about new book-tax differences, and the profession will be called upon to assess their impact on financial reporting. Whether the debate will be restricted to practical implementation questions or veer back towards broader theoretical questions remains to be seen.

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