Deferred Income Taxes: A Financial Windfall?

Richard A. Epraves

Ephraim P. Smith

Deferred Income Taxes

A Financial Windfall?

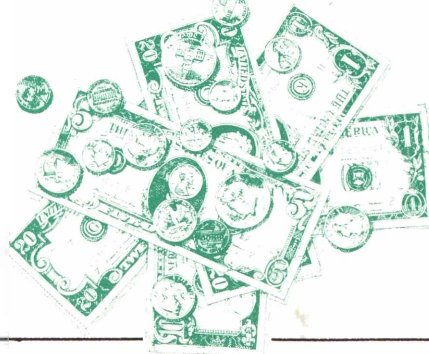
By Richard A. Epaves and Ephraim P. Smith

The long-awaited statement on accounting for income taxes was released by the Financial Accounting Standards Board (FASB) in December 1987. The FASB had released an exposure draft concerning accounting for income taxes in September 1986. Fifty days later, the Tax Reform Act of 1986 was passed decreasing the nominal corporate tax rate by approximately one-fourth, from 46% to 34%. Some of the changes in detail between the exposure draft and the final statement are:

1. The effective date has been changed from December 15, 1987, to December 15, 1988.
2. The exemptions from tax allocation allowed by APB Opinion 23 were originally suspended and later reinstated.
3. The requirement to allocate income tax expense on the exercise of stock option plans was reversed.
4. The transition accounting for the tax effects of prior purchase business combinations has been changed.

To provide an inventory of the implications and controversies surrounding accounting for income taxes is beyond the scope of this article; however, notation of a few items may help give a sense of place to the existing literature. Rayburn [1987] criticized the position taken in the exposure draft to not discount deferred taxes, and Nurnberg [1987] challenged the non-prospective nature of the suggested transition adjustment. The objections of Rayburn and Nurnberg also apply to SFAS No. 96. This article does not resolve the above controversies; rather it provides an analysis which will give contour and perspective to the discussion by measuring the combined impact on net income of the adoption of SFAS No. 96 and the decrease of corporate marginal tax rates.

At the time of adoption of SFAS No. 96, many large companies will reduce deferred income tax liabilities by a significant amount and adjust retained earnings accordingly. In other companies, however, this transfer to equity from the reduction of the liability will be made through the income statement as a cumulative effect. If the cumulative effect method of reporting is selected, the transition amount may be reported in **any** fiscal year presented in the financial statements after the publication of SFAS No. 96 (December 1987). Although the standard is officially effective for fiscal years beginning after December 15, 1988, earlier adoption is **encouraged** [SFAS No. 96, para. 32]. If an entity chooses to adopt the standard in a year prior to a year presented in the financial statements, the beginning balance of retained earnings of the earliest year presented is adjusted for the transition amount.



Major Provisions of SFAS No. 96

Change from Deferred to Liability Method. Formerly, generally accepted accounting principles (GAAP) required the deferred method of accounting for income taxes. Under that method, the deferred income tax liability was computed with the tax rate in existence when timing differences arose. The liability was not adjusted to reflect subsequent changes in the tax rate.

SFAS No. 96 prescribes the liability method. Under this method, the deferred income tax liability is adjusted to reflect the tax rates expected to be in effect when timing differences reverse. Whenever tax rates change, the deferred income tax liability is adjusted.

Purchase Business Combinations. Although SFAS No. 96 changes the accounting for the tax effects of differences between the tax bases of assets and liabilities and the values assigned in a purchase business combination, the provisions of the new standard generally do not affect net income. The net-of-tax approach required by APB Opinion 16 is replaced by the liability method, thereby recognizing deferred tax assets and/or liabilities. In substance, the provisions covering purchase business combinations result in a gross rather than a net-of-tax presentation in the financial statements. Since "the liability method (rather than the net-of-tax approach) in a purchase business combination by itself would not change net income" [E&W, 1986], it is not necessary to consider the business combination provisions in the analysis which follows.

Items Previously Exempt from Deferred Tax Accounting. SFAS No. 96 requires disclosure of items previously exempt from deferred tax accounting under the provisions of APB Opinion 23. Those items for which disclosure is now required include undistributed earnings of subsidiaries, savings and loan bad debt reserves, life insurance policyholders' surplus accounts, and reserve funds of U.S. steamship enterprises. However, this requirement of SFAS No. 96 is ignored in the following analysis since disclosure does not affect reported net income.

Deferred Tax Debits. The new standard also modifies the recognition of certain deferred tax assets. Many deferred tax assets can still be recognized to the extent that their

reversal coincides with the reversal of deferred tax liabilities. For the companies analyzed in this study, it was impractical or impossible to separate deferred tax debits from credits or to identify reversal patterns since this type of disclosure formerly was not required by GAAP. Consequently, the potential effects of deferred tax assets were not available and therefore are not used in estimating the impact on net income in the analysis which follows.

. . . companies could make the transition adjustment in any year presented in the financial statements issued after the standard's release date in December 1987.

Alternate Methods of Making the Transition Adjustment. The new standard gives a number of options for recording the transition adjustment. If a company elects to adopt the new standard in a year presented in the financial statements, the cumulative effect adjustment is made to net income in the adoption year. A company choosing to apply the new standard to a year not presented in the financial statements adjusts the beginning balance of retained earnings by the transition amount and restates subsequent years presented. These options under the new standard mean that some companies will show the transition adjustment as a cumulative effect in the income statement of one of the years presented, and others will show the adjustment as a prior period adjustment.

Because it is impossible to know how many companies will show the transition adjustment as a cumulative effect or as a prior period adjustment during the transition period, the following analysis assumes that all will use the cumulative effect method. This assumption permits the determination of a standard against which to measure the impact of the transition adjustments on net income.

Methodology

Nurnberg [1987] argued that the transition adjustment should, to some extent, be recognized prospectively. He noted the potentially dramatic impact on earnings of the cumulative effect prescribed by the exposure draft. Rayburn [1987] argued that deferred taxes should be discounted and projected a hypothetical example over ten years to illustrate his point. Earlier, Stepp [1985] had made a similar projection, but he concluded that discounting was inappropriate. This study quantifies the effect on net income noted by Nurnberg on a sample of actual companies. Deferred taxes are not discounted, which is consistent with the position taken in SFAS No. 96.

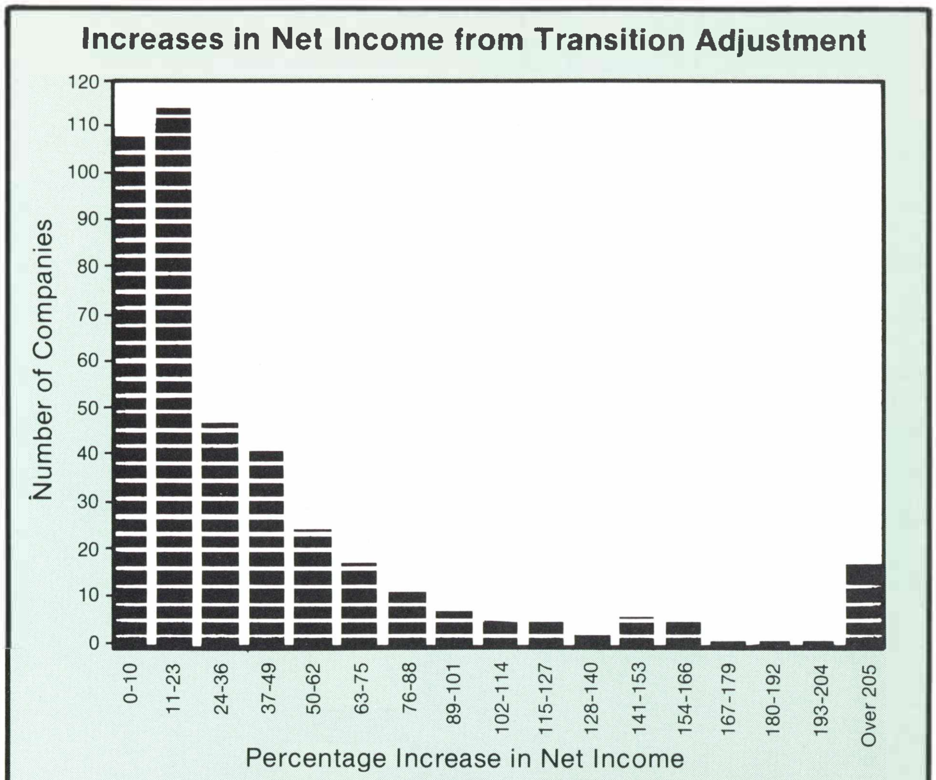
The authors analyzed the financial statements of the companies on the Fortune 500 list for 1985. Complications created by the graduated corporate tax rates were avoided by using those companies where the marginal tax rates approximated 46% before the transition adjustment.

Sixteen of the companies on the Fortune 500 list had been merged or were cooperatives. Both merged companies and cooperatives were excluded from the analysis because necessary information was either not available or not complete for 1985.

Special care was taken to insure that the deferred income tax liability did not include other liabilities and deferrals. An examination of the descriptive support for each company disclosed that a "clean" deferred income tax liability could not be obtained or did not exist for 71 companies, and these companies were excluded. A total of 87 companies were excluded, leaving 413 usable financial statements for analysis.

The new standard requires that the deferred income tax liability be adjusted for changes in the tax rate. Since the standard encourages early adoption, companies could make the transition adjustment in any year presented in the financial statements issued after the standard's release date in December 1987. The following analysis assumes adoption of the new standard at the time the income tax rate changed from 46% to 34%. (This assumption minimizes the effect of differing fiscal years.) The combination of the adoption of the new standard and the new tax rate of 34% may force 12/46 of the deferred income tax liability to be recognized during the transition period.

The 1985 financial statements of the 413 companies were used as a base. The 1985 deferred income tax liability was assumed to be the beginning balance of the liability for the transition fiscal year. The transition year net income was assumed to be the same as the net income indicated in the 1985 financial statements, plus the transition adjustment. Thus, the increases in net income noted in the following analysis are solely the result of the transition adjustment.



Analysis

Aggregate Impact. The percentage increase in net income attributable to the cumulative effect was computed for each company. The pattern of potential impact on net income is dramatic in many respects. Although the median potential increase in net income is 23% for the 413 companies, the mean increase is 79%. This difference in the median and mean indicates a positively skewed distribution. The case could be made that a median increase of 23% in net income, although more than trivial, is not dramatically significant. However, the 79% mean increase does have ominous implications. While only half of the companies will have net income increased by more than 23%, the range of the increases of these companies will be much greater than the 0-23% range of the companies in the other half.

A closer examination of the skewness towards the right of the distribution reveals some interesting characteristics. For instance, net income is projected to increase 50% or more for 25% of the companies in the sample; and for 11% of the companies, net income is projected to more than double.

The foregoing observations indicate that users of financial statements must be wary of any analysis involving net income during the transition period. SFAS No. 96 permits companies to show the transition adjustment either as a cumulative effect in net income or as an adjustment to retained earnings.

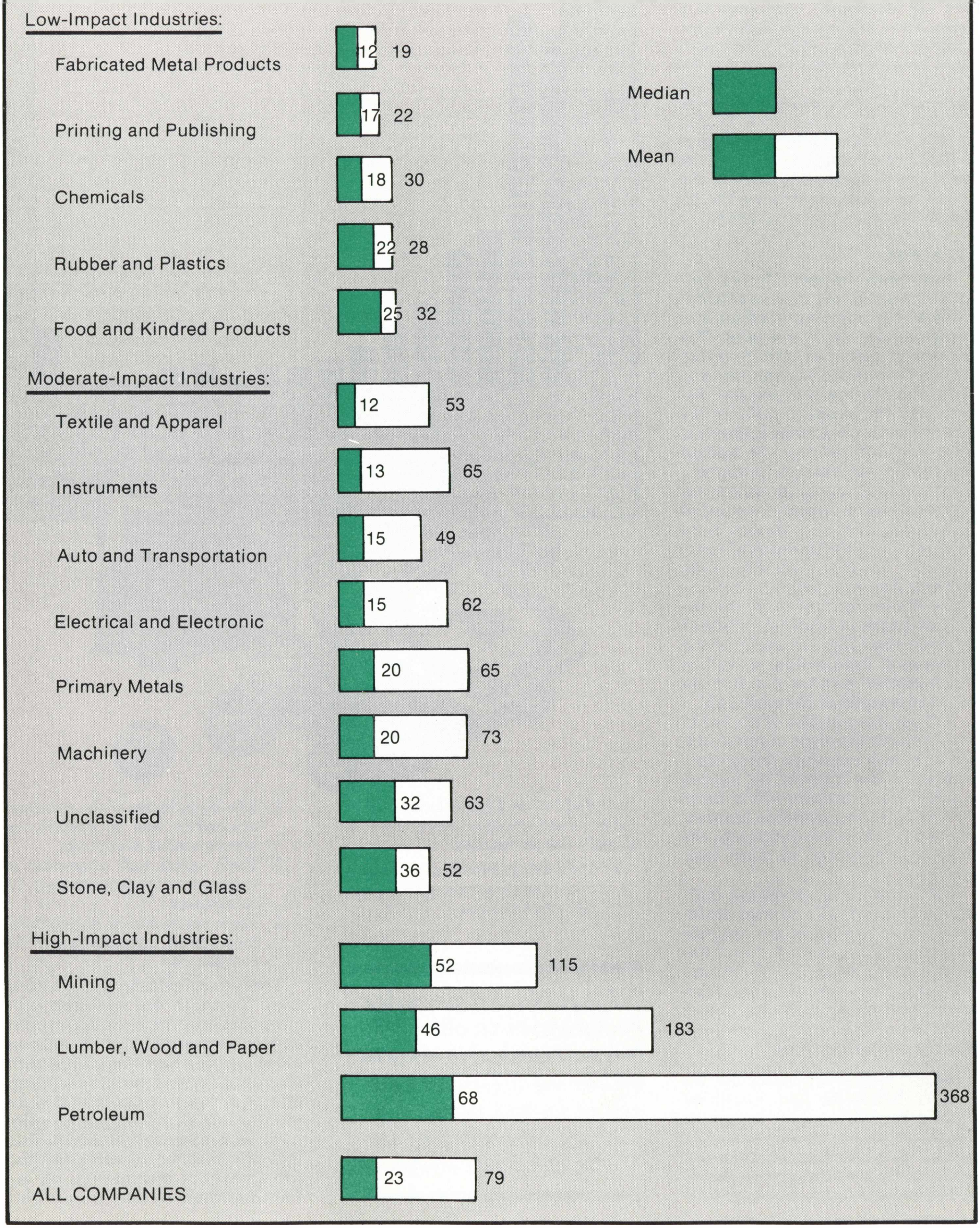
Industry Specific Analysis. To identify industries that would be significantly affected by the provisions of SFAS No. 96, aggregate net income data are further analyzed after the 413 companies were classified by industry groups using Standard Industrial Classification (SIC) codes. Four criteria were used to classify the companies:

1. Industry groups had to contain continuous series within the SIC code system.
2. The boundaries of the continuous series had to encompass homogeneous groupings.
3. Each series had to contain a minimum of approximately 10 companies.
4. Each series could not contain more than approximately 50 companies.

SFAS No. 96 permits companies to show the transition adjustment either as a cumulative effect in net income or as an adjustment to retained earnings.

The sixteen industry groups were then placed in one of three sub-classifications. The three sub-classifications were established in order to bring together industry groups with similar patterns of median and mean effects on net income. It should be noted that in all industry groups, the mean value exceeds the median. This indicates that for all industries the distribution of increases in net income has a definite skew to the right.

Percentage Increase in Median and Mean Net Income by Impact Groups



Low-Impact Industries. Five industries representing 148 of the 413 companies fall into the low-impact classification: fabricated metal products, printing and publishing, chemicals, rubber and plastic, and food and kindred products. The median percentage increase in net income ranges from 12% to 25%, while the mean increase in net income ranges from 19% to 32%.

Moderate-Impact Industries. The moderate-impact industries are textile and apparel; instruments, auto and transportation; electrical and electronics; primary metals; machinery; stone, clay, and glass; and unclassified. This classification includes the greatest number of companies, a total of 197. The pattern of median and mean values for the moderate-impact industries closely approximates the aggregate pattern for all 413 companies. The median percentage increase in net income ranges from 12% to 36%, while the mean increase in net income ranges from 49% to 73%. However, the mean values of each of the eight industries are slightly lower than the aggregate mean value (79% for all 413 companies). This demonstrates that the extreme mean values are concentrated in the high-impact industries classification.

High-Impact Industries. Three industries composed of 68 companies fall into the high-impact classification: mining; lumber, wood and paper; and petroleum. The median value of each of the three industries is at least double the median value for all 413 companies. The mean values of these three industries exceed the mean (79%) for all 413 companies by 45%, 231%, and 466%, respectively.

All financial ratios involving net income will be affected significantly for most companies. However, other ratios, such as the debt-equity ratio, will generally be only slightly affected. For example, only 5% of the companies will experience a change in the debt-equity ratio of more than 10%, and the effect upon this ratio in half of the companies will be less than 2%. The debt-equity ratio is only slightly affected because the expected transition adjustment is relatively small in relation to equity although it is relatively large in relation to net income.

Conclusion

The users of financial statements may be confronted with a significant numeric anomaly when SFAS No. 96 is adopted. Approximately 25% of America's leading companies could show net income levels at 50% above normal, and approximately 11% of these companies could show earnings at double the norm. Within the high-impact industries, half the companies could show net income at levels 50% above normal while 28% could show net income levels at double the norm.

Many users of financial information rely on aggregate data bases such as "Disclosure" or "Compustat." Since some companies would show the transition adjustment as a cumulative effect in one of the years presented and others as prior period adjustments, considerable confusion could result. The transition adjustment will most likely produce a significant numeric anomaly in financial reporting.

The anomaly may be obscured for a particular company because it can appear in any of the financial statements presented in 1988, 1989 or 1990. Also, it is possible that the management of some companies will take this opportunity to write off assets or to change another accounting principle using the transition adjustment as a cover.

The users of financial information must be particularly alert during the three-year transition period and should exercise special caution in the selection of data from the income statement, as the components of net income need to be closely scrutinized. The preparers of financial information, on the other hand, may find guidance during that time period in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information,* which contains the following advice:

> . . . Greater comparability of accounting information, which most people agree is a worthwhile aim, is not to be attained by making unlike things look alike any more than by making like things look different. The moral is that in seeking comparability, accountants must not disguise real differences nor create false differences . . . [SFAC No. 2, para. 119]. Ω

REFERENCES

Deloitte Haskins & Sells, *DH&S Review* (June 22, 1987), p. 4.

Ernst & Whinney, *Financial Reporting Developments: Accounting for Income Taxes — FASB Exposure Draft* (September 1986).

Financial Accounting Standards Board, *Statements of Financial Accounting Concepts 1-6* (New York: McGraw-Hill, 1986).

Financial Accounting Standards Board, *Proposed Statement of Financial Accounting Standards: Accounting for Income Taxes* (September 2, 1986).

Financial Accounting Standards Board, *Statement of Financial Accounting Standards No. 96: Accounting for Income Taxes* (December 1987).

Nurnberg, Hugo, "Changes in Tax Rates Under the Deferred and Liability Methods of Interperiod Tax Allocation," *Accounting Horizons* (September 1987), pp. 59-65.

Rayburn, Frank R., "Discounting of Deferred Income Taxes: An Argument for Reconsideration," *Accounting Horizons* (March 1987), pp. 43-49.

Stepp, James O., "Deferred Taxes: The Discounting Controversy," *Journal of Accountancy* (November 1985), pp. 98-108.

Richard A. Epaves, DBA, CPA, *is professor of accounting at Cleveland State University. He is a member of the AAA, AICPA, American Institute for Decision Sciences, and the Ohio Society of CPAs.*

Ephraim P. Smith, Ph.D., *is professor of accounting and dean of the College of Business Administration at Cleveland State University. He is a member of the AAA, American Institute for Decision Sciences, American Tax Association and Financial Management Association. Dean Smith is a member of the continuing accreditation and visitation committees of the American Assembly of Collegiate Schools of Business.*