Statement of Financial Accounting Standards No. 109

FAS109 Status Page
FAS109 Summary

Accounting for Income Taxes

February 1992

Financial Accounting Standards Board
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CONTENTS

FAS 109: Accounting for Income Taxes

FAS 109 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 FASB Statement No. 96, *Accounting for Income Taxes,* and amends or supersedes other accounting pronouncements listed in Appendix D.

Objectives of Accounting for Income Taxes

The objectives of accounting for income taxes are to recognize (a) the amount of taxes payable or refundable for the current year and (b) deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an enterprise's financial statements or tax returns.

Basic Principles of Accounting for Income Taxes

The following basic principles are applied in accounting for income taxes at the date of the financial statements:

a. A current tax liability or asset is recognized for the estimated taxes payable or refundable on tax returns for the current year.
b. A deferred tax liability or asset is recognized for the estimated future tax effects attributable to temporary differences and carryforwards.
c. The measurement of current and deferred tax liabilities and assets is based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated.
d. The measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized.

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 income and pretax financial income for a year and (b) the tax bases of assets or liabilities and their reported amounts in financial statements.

APB Opinion No. 11, *Accounting for Income Taxes, 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.

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. A deferred tax liability or asset represents the increase or decrease in taxes payable or refundable in future years as a result of temporary differences and carryforwards at the end of the current year.

Deferred Tax Liabilities

A deferred tax liability is recognized for temporary differences that will result in 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 all of the gain on the installment sale will be included in the determination of taxable income in future years. 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.

Deferred Tax Assets

A deferred tax asset is recognized for temporary differences that will result in deductible amounts in future years and for carryforwards. For example, a temporary difference is created between the reported amount and the tax basis of a liability for estimated expenses if, for tax purposes, those estimated expenses are not deductible until a future year. Settlement of that liability will result in tax deductions in future years, and a deferred tax asset is recognized in the current year for the reduction in taxes payable in future years. A valuation allowance is recognized if, based on the weight of available evidence, it is *more likely than not* that some portion or all of the deferred tax asset will not be realized.

Measurement of a Deferred Tax Liability or Asset

This Statement establishes procedures to (a) measure deferred tax liabilities and assets using a tax rate convention and (b) assess whether a valuation allowance should be established for deferred tax assets. Enacted tax laws and rates are considered in determining the applicable tax rate and in assessing the need for a valuation allowance.

All available evidence, both positive and negative, is considered to determine whether, based on the weight of that evidence, a valuation allowance is needed for some portion or all of a deferred tax asset. Judgment must be used in considering the relative impact of negative and positive evidence. The weight given to the potential effect of negative and positive evidence should be commensurate with the extent to which it can be objectively verified. The more negative evidence that exists (a) the more positive evidence is necessary and (b) the more difficult it is to support a conclusion that a valuation allowance is not needed.

Changes in Tax Laws or Rates

This Statement requires that deferred tax liabilities and assets be adjusted in the period of enactment for the effect of an enacted change in tax laws or rates. The effect is included in income from continuing operations.

Effective Date

This Statement is effective for fiscal years beginning after December 15, 1992. 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.

2. FASB Statement No. 96, *Accounting for Income Taxes,* which was issued in December 1987, superseded APB Opinion No. 11, *Accounting for Income Taxes.* The effective date of Statement 96 was delayed to fiscal years that begin after December 15, 1992. In March 1989, the Board began consideration of requests to amend Statement 96 to (a) change the criteria for recognition and measurement of deferred tax assets and various other requirements of Statement 96 and (b) reduce complexity. This Statement is the result of that reconsideration.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Scope

3. 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 Statement 96 and supersedes or amends other accounting pronouncements listed in Appendix D.

4. 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 [2] 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.

5. This Statement does not address:

a. The basic methods 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. Accounting for income taxes in interim periods (other than the criteria for recognition of tax benefits and the effect of enacted changes in tax laws or rates and changes in valuation allowances. (APB Opinion No. 28, *Interim Financial Reporting,* and other accounting pronouncements address that subject.)

Objectives and Basic Principles

6. One objective of accounting for income taxes is to recognize the amount of taxes payable or refundable for the current year. A second objective is to recognize **deferred tax liabilities and assets** for the future **tax consequences** of events [3] that have been recognized in an enterprise's financial statements or tax returns.

7. Ideally, the second objective might be stated more specifically to recognize the *expected* future tax consequences of events that have been recognized in the financial statements or tax

returns. However, that objective is realistically constrained because (a) the tax payment or refund that results from a particular tax return is a joint result of all the items included in that return, (b) taxes that will be paid or refunded in future years are the joint result of events of the current or prior years and events of future years, and (c) information available about the future is limited. As a result, attribution of taxes to individual items and events is arbitrary and, except in the simplest situations, requires estimates and approximations.

8. To implement the objectives in light of those constraints, the following basic principles (the only exceptions are identified in paragraph 9) are applied in accounting for income taxes at the date of the financial statements:

a. A current tax liability or asset is recognized for the estimated taxes payable or refundable on tax returns for the current year.
b. A deferred tax liability or asset is recognized for the estimated future tax effects attributable to **temporary differences** and carryforwards.
c. The measurement of current and deferred tax liabilities and assets is based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated.
d. The measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized.

9. The only exceptions in applying those basic principles are that this Statement:

a. Continues certain exceptions to the requirements for recognition of deferred taxes for the areas addressed by APB Opinion No. 23, *Accounting for Income Taxes—Special Areas,* as amended by this Statement (paragraphs 31-34)
b. Provides special transitional procedures for temporary differences related to deposits in statutory reserve funds by U.S. steamship enterprises (paragraph 32)
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* (paragraphs 256-258)
d. Prohibits recognition of a deferred tax liability or asset related to goodwill (or the portion thereof) for which amortization is not deductible for tax purposes (paragraph 30)
e. Does not amend Accounting Research Bulletin No. 51, *Consolidated Financial Statements,* for income taxes paid on intercompany profits on assets remaining within the group, and prohibits recognition of a deferred tax asset for the difference between the tax basis of the assets in the buyer's tax jurisdiction and their cost as reported in the consolidated financial statements
f. Prohibits recognition of a deferred tax liability or asset for differences related to assets and liabilities that, under FASB Statement No. 52, *Foreign Currency Translation,* are remeasured from the local currency into the functional currency using historical exchange rates and that result from (1) changes in exchange rates or (2) indexing for tax purposes.

Temporary Differences

10. **Income taxes currently payable**[4] for a particular year usually include the tax consequences of most events that are recognized in the financial statements for that year. However, because tax laws and financial accounting standards differ in their recognition and measurement of assets, liabilities, equity, revenues, expenses, gains, and losses, differences arise between:

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.

11. 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. Based on 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(s) when the reported amounts of assets are recovered and the reported amounts of liabilities are settled. 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.*[5] 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. *An increase in the tax basis of assets because of indexing whenever the local currency is the functional currency.* 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 local currency historical cost of the asset will be less than the remaining tax basis of the asset, and the difference will be tax deductible when the asset is recovered.

h. *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.

12. Examples (a)-(d) in paragraph 11 illustrate 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 pretax 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)-(h) in paragraph 11 illustrate other events that create differences between the tax basis of an asset or liability and its reported amount in the financial statements. For all eight 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.

13. This Statement refers collectively to the types of differences illustrated by those eight examples and to the ones described in paragraph 15 as *temporary differences.* Temporary differences that will result in taxable amounts in future years when the related asset or liability is recovered or settled are often referred to in this Statement as **taxable temporary differences** (examples (a), (d), and (e) in paragraph 11 are taxable temporary differences). Likewise, temporary differences that will result in deductible amounts in future years are often referred to as **deductible temporary differences** (examples (b), (c), (f), and (g) in paragraph 11 are deductible temporary differences). Business combinations accounted for by the purchase method (example (h)) may give rise to both taxable and deductible temporary differences.

14. Certain basis differences may not result in taxable or deductible amounts in future years when the related asset or liability for financial reporting is recovered or settled and, therefore, may not be temporary differences for which a deferred tax liability or asset is recognized. One example under current U.S. tax law is the excess of cash surrender value of life insurance over premiums paid. That excess is a temporary difference if the cash surrender value is expected to be recovered by surrendering the policy, but is not a temporary difference if the asset is expected to be recovered without tax consequence upon the death of the insured (there will be no taxable amount if the insurance policy is held until the death of the insured).

15. Some temporary differences are deferred taxable income or tax deductions and have balances only on the income tax balance sheet and therefore cannot be identified with a particular asset or liability for financial reporting. That occurs, for example, when a long-term contract 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 and are deferred and deducted in a later year for tax purposes. 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.

Recognition and Measurement

16. An enterprise shall recognize a deferred tax liability or asset for all temporary differences[6] and operating loss and tax credit carryforwards in accordance with the provisions of paragraph 17. **Deferred tax expense or benefit** is the change during the year in an enterprise's deferred tax liabilities and assets.[7] For deferred tax liabilities and assets acquired in a purchase business combination during the year, it is the change since the combination date. Total income tax expense or benefit for the year is the sum of deferred tax expense or benefit and income taxes currently payable or refundable.

Annual Computation of Deferred Tax Liabilities and Assets

17. Deferred taxes shall be determined separately for each tax-paying component (an individual entity or group of entities that is consolidated for tax purposes) in each tax jurisdiction. That determination includes the following procedures:

a. Identify (1) the types and amounts of existing temporary differences and (2) the nature and amount of each type of operating loss and tax credit carryforward and the remaining length of the carryforward period
b. Measure the total deferred tax liability for taxable temporary differences using the applicable tax rate (paragraph 18)
c. Measure the total deferred tax asset for deductible temporary differences and operating loss carryforwards using the applicable tax rate
d. Measure deferred tax assets for each type of tax credit carryforward
e. Reduce deferred tax assets 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.

18. The objective is to measure a deferred tax liability or asset using the enacted tax rate(s) expected to apply to taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized. Under current U.S. federal tax law, if taxable income exceeds a specified amount, all taxable income is taxed, in substance, at a single flat tax rate. That tax rate shall be used for measurement of a deferred tax liability or asset by enterprises for which graduated tax rates are not a significant factor. Enterprises for which graduated tax rates are a significant factor shall measure a deferred tax liability or asset using the average graduated tax rate applicable to the amount of estimated annual taxable income in the periods in which the deferred tax liability or asset is estimated to be settled or realized (paragraph 236). Other provisions of enacted tax laws should be considered when determining the tax rate to apply to certain types of temporary differences and carryforwards (for example, the tax law may provide for different tax rates on ordinary income and capital gains). If there is a phased-in change in tax rates, determination of the applicable tax rate requires knowledge about when deferred tax liabilities and assets will be settled and realized.

19. In the U.S. federal tax jurisdiction, the applicable tax rate is the regular tax rate, and a deferred tax asset is recognized for alternative minimum tax credit carryforwards in accordance with the provisions of paragraph 17(d) and (e) of this Statement. If alternative tax systems exist in jurisdictions other than the U.S. federal jurisdiction, the applicable tax rate is determined in a manner consistent with the tax law after giving consideration to any interaction (that is, a mechanism similar to the U.S. alternative minimum tax credit) between the two systems.

20. All available evidence, both positive and negative, should be considered to determine whether, based on the weight of that evidence, a valuation allowance is needed. Information about an enterprise's current financial position and its results of operations for the current and preceding years ordinarily is readily available. That historical information is supplemented by all currently available information about future years. Sometimes, however, historical information may not be available (for example, start-up operations) or it may not be as relevant (for example, if there has been a significant, recent change in circumstances) and special attention is required.

21. Future realization of the tax benefit of an existing deductible temporary difference or carryforward ultimately depends on the existence of sufficient taxable income of the appropriate character (for example, ordinary income or capital gain) within the carryback, carryforward period available under the tax law. The following four possible sources of taxable income may be available under the tax law to realize a tax benefit for deductible temporary differences and carryforwards:

a. Future reversals of existing taxable temporary differences
b. Future taxable income exclusive of reversing temporary differences and carryforwards
c. Taxable income in prior carryback year(s) if carryback is permitted under the tax law
d. **Tax-planning strategies** (paragraph 22) that would, if necessary, be implemented to, for

example:
(1) Accelerate taxable amounts to utilize expiring carryforwards
(2) Change the character of taxable or deductible amounts from ordinary income or loss to capital gain or loss
(3) Switch from tax-exempt to taxable investments.

Evidence available about each of those possible sources of taxable income will vary for different tax jurisdictions and, possibly, from year to year. To the extent evidence about one or more sources of taxable income is sufficient to support a conclusion that a valuation allowance is not necessary, other sources need not be considered. Consideration of each source is required, however, to determine the amount of the valuation allowance that is recognized for deferred tax assets.

22. In some circumstances, there are actions (including elections for tax purposes) that (a) are prudent and feasible, (b) an enterprise ordinarily might not take, but would take to prevent an operating loss or tax credit carryforward from expiring unused, and (c) would result in realization of deferred tax assets. This Statement refers to those actions as *tax-planning strategies.* An enterprise shall consider tax-planning strategies in determining the amount of valuation allowance required. Significant expenses to implement a tax-planning strategy or any significant losses that would be recognized if that strategy were implemented (net of any recognizable tax benefits associated with those expenses or losses) shall be included in the valuation allowance. Refer to paragraphs 246-251 for additional guidance.

23. Forming a conclusion that a valuation allowance is not needed is difficult when there is negative evidence such as cumulative losses in recent years. Other examples of negative evidence include (but are not limited to) the following:

a. A history of operating loss or tax credit carryforwards expiring unused
b. Losses expected in early future years (by a presently profitable entity)
c. Unsettled circumstances that, if unfavorably resolved, would adversely affect future operations and profit levels on a continuing basis in future years
d. A carryback, carryforward period that is so brief that it would limit realization of tax benefits if (1) a significant deductible temporary difference is expected to reverse in a single year or (2) the enterprise operates in a traditionally cyclical business.

24. Examples (not prerequisites) of positive evidence that might support a conclusion that a valuation allowance is not needed when there is negative evidence include (but are not limited to) the following:

a. Existing contracts or firm sales backlog that will produce more than enough taxable income to realize the deferred tax asset based on existing sales prices and cost structures
b. An excess of appreciated asset value over the tax basis of the entity's net assets in an amount sufficient to realize the deferred tax asset

c. A strong earnings history exclusive of the loss that created the future deductible amount (tax loss carryforward or deductible temporary difference) coupled with evidence indicating that the loss (for example, an unusual, infrequent, or extraordinary item) is an aberration rather than a continuing condition.

25. An enterprise must use judgment in considering the relative impact of negative and positive evidence. The weight given to the potential effect of negative and positive evidence should be commensurate with the extent to which it can be objectively verified. The more negative evidence that exists (a) the more positive evidence is necessary and (b) the more difficult it is to support a conclusion that a valuation allowance is not needed for some portion or all of the deferred tax asset.

A Change in the Valuation Allowance

26. The effect of a change in the beginning-of-the-year balance of a valuation allowance that results from a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in future years ordinarily shall be included in income from continuing operations. The only exceptions are the initial recognition (that is, by elimination of the valuation allowance) of certain tax benefits that are allocated as required by paragraph 30 and paragraph 36 (items (c) and (e)-(g)). The effect of other changes in the balance of a valuation allowance are allocated among continuing operations and items other than continuing operations as required by paragraph 35.

An Enacted Change in Tax Laws or Rates

27. Deferred tax liabilities and assets shall be adjusted for the effect of a change in tax laws or rates. The effect shall be included in income from continuing operations for the period that includes the enactment date.

A Change in the Tax Status of an Enterprise

28. An enterprise's tax status may change from nontaxable to taxable or from taxable to nontaxable. An example is a change from a partnership to a corporation and vice versa. A deferred tax liability or asset 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. In either case, the effect of (a) an election for a voluntary change in tax status is recognized on the approval date or on the filing date if approval is not necessary and (b) a change in tax status that results from a change in tax law is recognized on the enactment date. The effect of recognizing or eliminating the deferred tax liability or asset shall be included in income from continuing operations.

Regulated Enterprises

29. 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, as a result of an action by a regulator, 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 is 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 for which a deferred tax liability or asset shall be recognized.

Business Combinations

30. 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 the portion of goodwill for which amortization is not deductible for tax purposes, unallocated "negative goodwill," leveraged leases, and acquired Opinion 23 differences [8]) recognized in a purchase business combination (refer to paragraphs 259-272 for additional guidance). If a valuation allowance is recognized for the deferred tax asset for an acquired entity's deductible temporary differences or operating loss or tax credit carryforwards at the acquisition date, the tax benefits for those items that are first recognized (that is, by elimination of that valuation allowance) in financial statements after the acquisition date shall be applied (a) first to reduce to zero any goodwill related to the acquisition, (b) second to reduce to zero other noncurrent intangible assets related to the acquisition, and (c) third to reduce income tax expense.

Opinion 23 and U.S. Steamship Enterprise Temporary Differences

31. A deferred tax liability is not recognized for the following types of temporary differences unless it becomes apparent that those temporary differences will reverse in the foreseeable future:

a. An excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary or a foreign corporate joint venture as defined in APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock,* that is essentially permanent in duration
b. Undistributed earnings of a domestic subsidiary or a domestic corporate joint venture that is essentially permanent in duration that arose in fiscal years beginning on or before December 15, 1992 [9]

c. "Bad debt reserves" for tax purposes of U.S. savings and loan associations (and other "qualified" thrift lenders) that arose in tax years beginning before December 31, 1987 (that is, the base-year amount)
d. "Policyholders' surplus" of stock life insurance companies that arose in fiscal years beginning on or before December 15, 1992.

The indefinite reversal criterion in Opinion 23 shall not be applied to analogous types of temporary differences.

32. A deferred tax liability shall be recognized for the following types of taxable temporary differences:

a. An excess of the amount for financial reporting over the tax basis of an investment in a domestic subsidiary that arises in fiscal years beginning after December 15, 1992
b. An excess of the amount for financial reporting over the tax basis of an investment in a 50-percent-or-less-owned investee except as provided in paragraph 31(a) and (b) for a corporate joint venture that is essentially permanent in duration
c. "Bad debt reserves" for tax purposes of U.S. savings and loan associations (and other "qualified" thrift lenders) that arise in tax years beginning after December 31, 1987 (that is, amounts in excess of the base-year amount).

The tax effects of temporary differences related to deposits in statutory reserve funds by U.S. steamship enterprises that arose in fiscal years beginning on or before December 15, 1992 and that were not previously recognized shall be recognized when those temporary differences reverse or in their entirety at the beginning of the fiscal year for which this Statement is first applied.

33. Whether an excess of the amount for financial reporting over the tax basis of an investment in a more-than-50-percent-owned domestic subsidiary is a taxable temporary difference must be assessed. It is not a taxable temporary difference if the tax law provides a means by which the reported amount of that investment can be recovered tax-free and the enterprise expects that it will ultimately use that means. For example, under current U.S. federal tax law:

a. An enterprise may elect to determine taxable gain or loss on the liquidation of an 80-percent-or-more-owned subsidiary by reference to the tax basis of the subsidiary's net assets rather than by reference to the parent company's tax basis for the stock of that subsidiary.
b. An enterprise may execute a statutory merger whereby a subsidiary is merged into the parent company, the minority shareholders receive stock of the parent, the subsidiary's stock is cancelled, and no taxable gain or loss results if the continuity of ownership, continuity of business enterprise, and certain other requirements of the tax law are met.

Some elections for tax purposes are available only if the parent company owns a specified percentage of the subsidiary's stock. The parent company sometimes may own less than that specified percentage, and the price per share to acquire a minority interest may significantly exceed the per share equivalent of the amount reported as minority interest in the consolidated financial statements. In those circumstances, the excess of the amount for financial reporting over the tax basis of the parent's investment in the subsidiary is not a taxable temporary difference if settlement of the minority interest is expected to occur at the point in time when settlement would not result in a significant cost. That could occur, for example, toward the end of the life of the subsidiary, after it has recovered and settled most of its assets and liabilities, respectively. The fair value of the minority interest ordinarily will approximately equal its percentage of the subsidiary's net assets if those net assets consist primarily of cash.

34. A deferred tax asset shall be recognized for an excess of the tax basis over the amount for financial reporting of an investment in a subsidiary or corporate joint venture that is essentially permanent in duration only if it is apparent that the temporary difference will reverse in the foreseeable future. The need for a valuation allowance for that deferred tax asset and other deferred tax assets related to Opinion 23 temporary differences (for example, a deferred tax asset for foreign tax credit carryforwards or for a savings and loan association's bad-debt reserve for financial reporting) shall be assessed. Paragraph 21 identifies four sources of taxable income to be considered in determining the need for and amount of a valuation allowance for those and other deferred tax assets. One source is future reversals of temporary differences. Future reversals of taxable differences for which a deferred tax liability has not been recognized based on the exceptions cited in paragraph 31, however, shall not be considered. Another source is future taxable income exclusive of reversing temporary differences and carryforwards. Future distributions of future earnings of a subsidiary or corporate joint venture, however, shall not be considered except to the extent that a deferred tax liability has been recognized for existing undistributed earnings or earnings have been remitted in the past.

Intraperiod Tax Allocation

35. Income tax expense or benefit for the year shall be allocated among continuing operations, discontinued operations, extraordinary items, and items charged or credited directly to shareholders' equity (paragraph 36). The amount allocated to continuing operations is the tax effect of the pretax income or loss from continuing operations that occurred during the year, plus or minus income tax effects of (a) changes in circumstances that cause a change in judgment about the realization of deferred tax assets in future years (paragraph 26), (b) changes in tax laws or rates (paragraph 27), (c) changes in tax status (paragraph 28), and (d) tax-deductible dividends paid to shareholders (except as set forth in paragraph 36 for dividends paid on unallocated shares held by an employee stock ownership plan [ESOP] or any other stock compensation arrangement). The remainder is allocated to items other than continuing operations in accordance with the provisions of paragraph 38.

36. The tax effects of the following items occurring during the year are charged or credited

directly to related components of shareholders' equity:

a. Adjustments of the opening balance of retained earnings for certain changes in accounting principles or a correction of an error
b. **Gains and losses included in comprehensive income but excluded from net income** (for example, translation adjustments under Statement 52 and changes in the carrying amount of marketable securities under FASB Statement No. 12, *Accounting for Certain Marketable Securities*)
c. An increase or decrease in contributed capital (for example, deductible expenditures reported as a reduction of the proceeds from issuing capital stock)
d. An increase in the tax basis of assets acquired in a taxable business combination accounted for as a pooling of interests and for which a tax benefit is recognized at the date of the business combination
e. 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*)
f. Dividends that are paid on unallocated shares held by an ESOP and that are charged to retained earnings
g. Deductible temporary differences and carryforwards that existed at the date of a quasi reorganization (except as set forth in paragraph 39).

37. The tax benefit of an operating loss carryforward or carryback (other than those carryforwards referred to at the end of this paragraph) shall be reported in the same manner as the source of the income or loss in the current year and not in the same manner as (a) the source of the operating loss carryforward or taxes paid in a prior year or (b) the source of expected future income that will result in realization of a deferred tax asset for an operating loss carryforward from the current year. The only exceptions are as follows:

a. Tax effects of deductible temporary differences and carryforwards that existed at the date of a purchase business combination and for which a tax benefit is initially recognized in subsequent years in accordance with the provisions of paragraph 30
b. Tax effects of deductible temporary differences and carryforwards that are allocated to shareholders' equity in accordance with the provisions of paragraph 36 (items (c) and (e)-(g)).

38. If there is only one item other than continuing operations, the portion of income tax expense or benefit for the year that remains after the allocation to continuing operations is allocated to that item. If there are two or more items other than continuing operations, the amount that remains after the allocation to continuing operations shall be allocated among those other items in proportion to their individual effects on income tax expense or benefit for the year. When there are two or more items other than continuing operations, the sum of the separately calculated, individual effects of each item sometimes may not equal the amount of income tax expense or benefit for the year that remains after the allocation to continuing operations. In

those circumstances, the procedures to allocate the remaining amount to items other than continuing operations are as follows:

a. Determine the effect on income tax expense or benefit for the year of the total net loss for all net loss items
b. Apportion the tax benefit determined in (a) ratably to each net loss item
c. Determine the amount that remains, that is, the difference between (1) the amount to be allocated to all items other than continuing operations and (2) the amount allocated to all net loss items
d. Apportion the tax expense determined in (c) ratably to each net gain item.

Refer to paragraphs 273-276 for additional guidance.

Certain Quasi Reorganizations

39. The tax benefits of deductible temporary differences and carryforwards as of the date of a quasi reorganization as defined and contemplated in ARB No. 43, Chapter 7, "Capital Accounts," ordinarily are reported as a direct addition to contributed capital if the tax benefits are recognized in subsequent years. The only exception is for enterprises that have previously both adopted Statement 96 and effected a quasi reorganization that involves only the elimination of a deficit in retained earnings by a concurrent reduction in contributed capital prior to adopting this Statement. For those enterprises, subsequent recognition of the tax benefit of prior deductible temporary differences and carryforwards is included in income and reported as required by paragraph 37 (without regard to the referenced exceptions) and then reclassified from retained earnings to contributed capital. Those enterprises should disclose (a) the date of the quasi reorganization, (b) the manner of reporting the tax benefits and that it differs from present accounting requirements for other enterprises and (c) the effect of those tax benefits on income from continuing operations, income before extraordinary items, and on net income (and on related per share amounts).

Separate Financial Statements of a Subsidiary

40. The consolidated amount of current and deferred tax expense for a group that files a consolidated tax return shall be allocated among the members of the group when those members issue separate financial statements. This Statement does not require a single allocation method. The method adopted, however, shall be systematic, rational, and consistent with the broad principles established by this Statement. A method that allocates current and deferred taxes to members of the group by applying this Statement to each member as if it were a separate taxpayer [10] meets those criteria. Examples of methods that are not consistent with the broad principles established by this Statement include:

a. A method that allocates only current taxes payable to a member of the group that has taxable temporary differences

b. A method that allocates deferred taxes to a member of the group using a method fundamentally different from the asset and liability method described in this Statement (for example, the Opinion 11 deferred method)
c. A method that allocates no current or deferred tax expense to a member of the group that has taxable income because the consolidated group has no current or deferred tax expense.

Certain disclosures are also required (paragraph 49).

Financial Statement Presentation

41. In a classified statement of financial position, an enterprise shall separate deferred tax liabilities and assets into a current amount and a noncurrent amount. Deferred tax liabilities and assets shall be classified as current or noncurrent based on the classification of the related asset or liability for financial reporting. A deferred tax liability or asset that is not related to an asset or liability for financial reporting (paragraph 15), including deferred tax assets related to carryforwards, shall be classified according to the expected reversal date of the temporary difference pursuant to FASB Statement No. 37, *Balance Sheet Classification of Deferred Income Taxes*. The valuation allowance for a particular tax jurisdiction shall be allocated between current and noncurrent deferred tax assets for that tax jurisdiction on a pro rata basis.

42. For a particular tax-paying component of an enterprise and within a particular tax jurisdiction, (a) all current deferred tax liabilities and assets shall be offset and presented as a single amount and (b) all noncurrent deferred tax liabilities and assets shall be offset and presented as a single amount. However, an enterprise shall not offset deferred tax liabilities and assets attributable to different tax-paying components of the enterprise or to different tax jurisdictions.

Financial Statement Disclosure

43. The components of the net deferred tax liability or asset recognized in an enterprise's statement of financial position shall be disclosed as follows:

a. The total of all deferred tax liabilities measured in procedure (b) of paragraph 17
b. The total of all deferred tax assets measured in procedures (c) and (d) of paragraph 17
c. The total valuation allowance recognized for deferred tax assets determined in procedure (e) of paragraph 17.

The net change during the year in the total valuation allowance also shall be disclosed. A **public enterprise** shall disclose the approximate tax effect of each type of temporary difference and carryforward that gives rise to a significant portion of deferred tax liabilities and deferred tax assets (before allocation of valuation allowances). A **nonpublic enterprise** shall disclose the types of significant temporary differences and carryforwards but may omit disclosure of the tax effects of each type. 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.

44. The following information shall be disclosed whenever a deferred tax liability is not recognized because of the exceptions to comprehensive recognition of deferred taxes for any of the areas addressed by Opinion 23 (as amended by this Statement) 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 temporary differences related to investments in foreign subsidiaries and foreign corporate joint ventures that are essentially permanent in duration if determination of that liability is practicable or a statement that determination is not practicable
d. The amount of the deferred tax liability for temporary differences other than those in (c) above (that is, undistributed domestic earnings, the bad-debt reserve for tax purposes of a U.S. savings and loan association or other qualified thrift lender, the policyholders' surplus of a life insurance enterprise, and the statutory reserve funds of a U.S. steamship enterprise) that is not recognized in accordance with the provisions of paragraphs 31 and 32.

45. 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:

a. **Current tax expense or benefit**
b. Deferred tax expense or benefit (exclusive of the effects of other components listed 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. Tax expense that results from allocating certain tax benefits either directly to contributed capital or to reduce goodwill or other noncurrent intangible assets of an acquired entity
g. Adjustments of a deferred tax liability or asset for enacted changes in tax laws or rates or a change in the tax status of the enterprise
h. Adjustments of the beginning-of-the-year balance of a valuation allowance because of a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in future years.

46. The amount of income tax expense or benefit allocated to continuing operations and the amounts separately allocated to other items (in accordance with the provisions of paragraphs 35-39) shall be disclosed for each year for which those items are presented.

47. A public enterprise shall disclose a reconciliation using percentages or dollar amounts of (a) the reported amount of income tax expense attributable to continuing operations for the year to (b) 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. If not otherwise evident from the disclosures required by this paragraph and paragraphs 43-46, all enterprises shall disclose the nature and effect of any other significant matters affecting comparability of information for all periods presented.

48. An enterprise shall disclose (a) the amounts and expiration dates of operating loss and tax credit carryforwards for tax purposes and (b) any portion of the valuation allowance for deferred tax assets for which subsequently recognized tax benefits will be allocated to reduce goodwill or other noncurrent intangible assets of an acquired entity or directly to contributed capital (paragraphs 30 and 36).

49. An entity that is a member of a group that files a consolidated tax return shall disclose in its separately issued financial statements:

a. The aggregate 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 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.

Effective Date and Transition

50. This Statement shall be effective for fiscal years beginning after December 15, 1992. Earlier application is encouraged. Financial statements for any number of consecutive 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 (that is, if the Statement is adopted prior to the effective date and during an interim period other than the first interim period, all prior interim periods of that fiscal year shall be restated). Application of the requirements for recognition of a deferred tax liability or asset for a restated interim or annual period shall be based on the facts and circumstances as they existed at that prior date and without the benefit of hindsight.

51. The effect of initially applying this Statement 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 (APB Opinion No. 20, *Accounting Changes,* paragraph 20) except for initially

recognized tax benefits of the type required by this Statement to be excluded from comprehensive income. 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 shareholders' equity for the earliest year presented shall be adjusted for the effect of the restatement as of that date. Paragraph 30 addresses the manner of reporting acquired tax benefits initially recognized subsequent to a business combination and paragraph 36 identifies five items ((c)-(g)) for which tax benefits are excluded from comprehensive income and allocated directly to contributed capital or retained earnings. Pro forma effects of retroactive application (Opinion 20, paragraph 21) are not required if statements of earnings presented for prior years are not restated.

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

a. The effect, if any, of adopting this Statement on pretax income from continuing operations (for example, the effect of adjustments for prior purchase business combinations and for regulated enterprises) 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 net income (and on related per share amounts) for each year for which restated financial statements are presented.

Prior Business Combinations

53. 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.

54. For a purchase business combination consummated prior to the beginning of the year for which this Statement is first applied, any balance remaining as of that date for goodwill or negative goodwill shall not be adjusted to equal the amount it would be if financial statements for the year of the combination and subsequent years were restated. However, except for leveraged leases and except as provided in paragraph 55, (a) remaining balances as of the date of initially applying this Statement for assets and liabilities acquired in that combination shall be adjusted from their net-of-tax amounts to their pretax amounts and (b) any differences between those adjusted remaining balances and their tax bases are temporary differences. 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 applied.

55. If, for a particular business combination, determination of the adjustment for any or all of the assets and liabilities referred to in paragraph 54 is impracticable, either because the necessary information is no longer available or because the cost to develop that information is excessive, none of the remaining balances of any assets and liabilities acquired in that combination shall be adjusted to pretax amounts, that is, all remaining amounts that were originally assigned on a

net-of-tax basis pursuant to paragraph 89 of Opinion 16 shall not be adjusted. Any differences between those unadjusted 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 applied.

56. The net effect of the adjustments required by paragraphs 54 and 55 shall be included in the effect of initially applying this Statement and reported in accordance with the provisions of paragraph 51.

Assets of Regulated Enterprises Reported on a Net-of-Tax or After-Tax Basis

57. Some regulated enterprises that apply Statement 71 have accounted for certain components of construction in progress on either a net-of-tax or after-tax basis, or both. Upon initial application of this Statement, those enterprises shall make appropriate adjustments required by this Statement to account for the net-of-tax and after-tax components of construction in progress as if the requirements of this Statement were applied to that construction in progress in all prior years. Except as provided in paragraph 58, the reported amount of plant in service at the beginning of the year for which this Statement is first applied shall be similarly adjusted.

58. If determination of the adjustment to plant in service referred to in paragraph 57 is impracticable, either because the necessary information is no longer available or because the cost to develop that information is excessive, 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, as a result of an action by a regulator, 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.

59. The net effect of the adjustments required by paragraphs 57 and 58 shall be included in the effect of initially applying this Statement and reported in accordance with the provisions of paragraph 51.

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

This Statement was adopted by the unanimous vote of the six members of the Financial Accounting Standards Board:

Dennis R. Beresford, *Chairman*
Joseph V. Anania
Victor H. Brown
James J. Leisenring
A. Clarence Sampson
Robert J. Swieringa

Appendix A

BASIS FOR CONCLUSIONS

CONTENTS

Appendix A: BASIS FOR CONCLUSIONS

Introduction

60. 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.

61. 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 are deferred and will affect taxable income in future years. Events that have **deferred tax consequences** give rise to temporary differences. Paragraphs 10-15 discuss examples of temporary differences and describe how they originate and how they result in taxable or deductible amounts in future years.

62. The basic accounting issues about the effects of income taxes to be recognized in the financial statements for a period are as follows:

a. Whether the effects of income taxes recognized in the financial statements should be:
   (1) The amount of taxes payable for the period as determined by the tax return
   (2) The above plus the effect of all (comprehensive recognition) or at least some (partial recognition) temporary differences
   (3) The above plus the future tax benefit of operating loss and tax credit carryforwards
b. If recognized, whether the tax effects of temporary differences are:
   (1) Tax assets or liabilities to be recovered or settled in the future (the asset and liability approach)
   (2) Reductions in related assets and liabilities (the net-of-tax approach)
   (3) Deferred charges or deferred credits (the deferred approach)
   (4) A combination of the above based on the nature of the temporary differences
c. Whether measurement of the tax effects of temporary differences should be:
   (1) The incremental effect in the current year or the incremental effect in future years
   (2) Discounted
d. Whether deferred tax calculations are too complex, burdensome, and costly for:
   (1) Private and small public enterprises
   (2) All enterprises.

Conclusions on Basic Issues

63. The Board concluded that the financial statements should reflect the current and deferred

tax consequences of all events [11] that have been recognized in the financial statements or tax returns. The Board believes that the asset and liability approach to accounting for income taxes is most consistent with the definitions in FASB Concepts Statement No. 6, *Elements of Financial Statements,* and with other parts of the conceptual framework. It 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.

64. The Board concluded that a current tax liability or asset should be recognized for taxes payable or refundable for the current year, and that a deferred tax liability or asset should be recognized for the deferred tax consequences of temporary differences and operating loss or tax credit carryforwards. The Board's reasons for rejecting partial or no recognition of deferred taxes are explained in paragraphs 200-205, and the reasons for rejecting the net-of-tax, deferred, and combination approaches are explained in paragraphs 206-222.

65. The Board believes that it would be desirable to measure a deferred tax liability or asset as the incremental effect on future cash flows for income taxes that will result from existing temporary differences and carryforwards. As a practical matter, however, the Board notes that the information needed for precise predictions about the future is not available. The Board concluded that certain simplifying assumptions and procedures are necessary.

66. Under the requirements of this Statement:

a. The enacted tax rate(s) expected to apply to taxable income in future years is used to measure:
   (1) The total deferred tax liability for taxable temporary differences
   (2) The total deferred tax asset for deductible temporary differences and operating loss carryforwards.
b. The total deferred tax asset is reduced by a valuation allowance if it is more likely than not that some portion or all of the asset will not be realized.
c. Deferred tax liabilities and assets are not discounted.

67. Measurement of current and deferred tax liabilities and assets is based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated. Calculations may often be complicated, but the Board believes that most of those complications are primarily attributable to applying the complexities in the tax law to complex business transactions. The Board concluded that complexities in the tax law do not justify different accounting for income taxes depending on an enterprise's size or ownership.

Benefits and Costs

68. The Board follows certain precepts, including the precept to promulgate standards only when the expected benefits of the resulting information exceed the perceived costs. The Board strives to determine that a proposed standard will fill a significant need and that the costs

imposed to meet that standard, as compared with other alternatives, are justified in relation to the overall benefits of the resulting information.

69. Accounting for income taxes is a pervasive subject that affects most enterprises. Income taxes must be computed for complex business transactions within the context of voluminous, complicated, and constantly changing tax laws, rules, and regulations. Accounting requirements add additional complexities.

70. Opinion 11 was issued in 1967. Criticisms and concerns set forth in the accounting literature and in letters to the Board that requested reconsideration of Opinion 11 focused both on the complexity of the accounting requirements and on the relevance of the results of applying the requirements.

71. Numerous accounting 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.

72. Criticisms and concerns also focused on the effect of applying Opinion 11 on the statement of financial position and on the increasing amounts 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 shareholders' equity, and they also added the provision for deferred taxes back to earnings. Others did not. Uncertainty about the nature of those amounts created confusion for users.

73. Statement 96 was issued in December 1987. After it was issued, the Board received numerous requests to amend Statement 96. Those requests primarily focused on (a) changing the restrictive Statement 96 requirements for recognition of deferred tax assets to permit, in more instances, recognition of tax benefits that are expected to be realized and (b) reducing the complexity of scheduling the future reversals of temporary differences and considering hypothetical tax-planning strategies. The Board carefully considered the criticisms and concerns about the complexity of the requirements of Statement 96 and the understandability of the results of applying those requirements.

74. This Statement is the result of a comprehensive reconsideration of Opinion 11, Statement 96, and other related authoritative pronouncements. The Board believes that the requirements of this Statement produce results that are understandable and relevant. The Board also believes that the requirements are less complex than those of either Opinion 11 or Statement 96. Practical decisions, such as eliminating the proposal in the June 1991 FASB Exposure Draft, *Accounting*

for Income Taxes, to recognize deferred taxes for certain temporary differences that are not timing differences, may reduce the cost and complexity of computing deferred taxes for many enterprises. Application of judgment to assess whether a valuation allowance is needed for deferred tax assets may sometimes be complex, but that complexity is the unavoidable result of the need for an informed decision about the effect of income taxes on an enterprise's financial position and results of operations.

A Deferred Tax Liability for Taxable Temporary Differences

75. The Board considered whether the deferred tax consequences of taxable temporary differences are a liability. Liabilities are defined in paragraph 35 of Concepts Statement 6 as "probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events" (footnote references omitted).

76. The first characteristic of a liability is that 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" (Concepts Statement 6, paragraph 36). Taxes are a legal obligation imposed by a government, and an obligation for the deferred tax consequences of taxable temporary differences stems from the requirements of the tax law.

77. A government levies taxes on net taxable income. Temporary differences will become taxable amounts in future years, thereby increasing taxable income and taxes payable, upon recovery or settlement of the recognized and reported amounts of an enterprise's assets or liabilities.

78. The second characteristic of a liability is that "the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice" (Concepts Statement 6, paragraph 36). An enterprise might be able to delay the future reversal of taxable temporary differences by delaying the events that give rise to those reversals, for example, by delaying the recovery of related assets or the settlement of related liabilities. A contention that those temporary differences will never result in taxable amounts, however, would contradict the accounting assumption inherent in the statement of financial position that the reported amounts of assets and liabilities will be recovered and settled, respectively; thereby making that statement internally inconsistent. For that reason, the Board concluded that the only question is when, not whether, temporary differences will result in taxable amounts in future years.

79. The third characteristic of a liability is that "the transaction or other event obligating the entity has already happened" (Concepts Statement 6, paragraph 36). Deferred tax liabilities result from the same past events that create taxable temporary differences.

A Deferred Tax Asset for Deductible Temporary Differences and Carryforwards

80. The Board considered whether the deferred tax consequences of deductible temporary differences and carryforwards are an asset. Assets are defined in paragraph 25 of Concepts Statement 6 as "probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events" (footnote reference omitted).

81. The first characteristic of an asset is that it "embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows" (Concepts Statement 6, paragraph 26). Deductible temporary differences and carryforwards at the end of the current year that reduce taxable income and taxes payable in future years contribute indirectly to future net cash inflows. Alternatively, if loss carryback is permitted by the tax law, deductible temporary differences at the end of the current year that increase taxes refundable in future years contribute directly to future net cash inflows. In both circumstances, the first characteristic of an asset is met.

82. The second characteristic of an asset is that "a particular entity can obtain the benefit and control others' access to it" (Concepts Statement 6, paragraph 26). To the extent permitted by tax law, an enterprise has the ability to obtain the benefit that may result from existing deductible temporary differences and carryforwards by reducing taxes payable either for future years or for the current or preceding years by carryback refund. The enterprise has an exclusive right to that future benefit and therefore can control others' access to it.

83. The third characteristic of an asset is that "the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred" (Concepts Statement 6, paragraph 26). The Board's conclusion in Statement 96 was that the critical past event is earning the income that permits realization of the benefit. Prior to earning income, deductible temporary differences and carryforwards were considered to be future tax benefits that are not yet recognizable in the financial statements.

84. The Statement 96 requirements for recognition of the tax benefit of deductible temporary differences and carryforwards were criticized by the Board's constituents. Many constituents stated that Statement 96 sometimes produced results that were not understandable or relevant. Some constituents were particularly concerned about the nonrecognition of tax benefits that are expected to be realized.

85. Upon reconsidering the requirements of Statement 96, the Board decided that the critical recognition event is the event that gives rise to deductible temporary differences and carryforwards. The Exposure Draft proposed, and most respondents agreed, that that event is the event that gives the enterprise a right to or control over the future tax benefits. Once that event has occurred, those tax benefits are recognizable in the financial statements.

86. A tax benefit will be realized, however, only if there is sufficient taxable income in

particular future years. The existence or absence of future taxable income is critical to measurement of the amount of tax benefit that is recognized for deductible temporary differences and carryforwards at the end of the current year. The Board concluded that earning taxable income in future years (a) is the event that confirms the existence of a recognizable tax benefit at the end of the current year and (b) is not the prerequisite event that must occur before a tax benefit may be recognized as was the case under the requirements of Statement 96.

The Asset and Liability Approach to Accounting for Income Taxes

87. In concept, a deferred tax liability or asset represents the increase or decrease in taxes payable or refundable in future years as a result of temporary differences and carryforwards at the end of the current year. That concept is an incremental concept. A literal application of that concept would require measurement of:

a. The amount of taxes that *will* be payable or refundable in future years *inclusive* of reversing temporary differences and carryforwards
b. The amount of taxes that *would* be payable or refundable in future years *exclusive* of reversing temporary differences and carryforwards.

The incremental tax effect is the difference between those measurements.

88. As a practical matter, the Board believes that determination of the incremental difference between all future income tax cash flows with and without reversing temporary differences and carryforwards is impossible except in the simplest situations. For that reason, the Board decided to establish procedures (a) to measure deferred tax liabilities and assets using a tax rate convention and then (b) to assess whether a valuation allowance should be established for deferred tax assets.

Measurement

89. The Exposure Draft proposed that deferred tax liabilities and assets should be measured using the enacted tax rate expected to apply to the *last* dollars of taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized. Some respondents to the Exposure Draft disagreed. In their view, that approach would often overstate deferred tax liabilities and assets for enterprises for which graduated tax rates are a significant factor. For example, if the highest graduated tax rate is for taxable income in excess of $1,000, that tax rate would be the tax rate for measurement of deferred taxes if future annual taxable income is expected to be $1,001. However, lower graduated tax rates would actually apply to all but the last dollar of annual reversals of temporary differences in future years. For that reason, the Board decided to adopt the average graduated tax rate approach required by this Statement for enterprises for which graduated tax rates are a significant factor.

90. A few respondents to the Exposure Draft suggested measurement of deferred taxes using

the lower alternative minimum tax (AMT) rate if an enterprise currently is an AMT taxpayer and expects to "always" be an AMT taxpayer. The Board believes that no one can predict whether an enterprise will always be an AMT taxpayer. Furthermore, it would be counterintuitive if the addition of AMT provisions to the tax law were to have the effect of reducing the amount of an enterprise's income tax expense for financial reporting, given that the provisions of AMT may be either neutral or adverse but never beneficial to an enterprise. It also would be counterintuitive to assume that an enterprise would permit its AMT credit carryforward to expire unused at the end of the life of the enterprise, which would have to occur if that enterprise was "always" an AMT taxpayer.

91. The Board concluded that all enterprises should measure deferred taxes for temporary differences using regular tax rates and assess the need for a valuation allowance for an AMT credit carryforward deferred tax asset using the guidance in this Statement. Otherwise, an enterprise's deferred tax liability could be understated for either of two reasons:

a. It could be understated if the enterprise currently is an AMT taxpayer because of temporary differences. Temporary differences reverse and, over the entire life of the enterprise, cumulative income will be taxed at regular tax rates.
b. It could be understated if the enterprise currently is an AMT taxpayer because of preference items but does not have enough AMT credit carryforward to reduce its deferred tax liability from the amount of regular tax on regular tax temporary differences to the amount of tentative minimum tax (TMT) on AMT temporary differences. In those circumstances, measurement of the deferred tax liability using AMT rates would anticipate the tax benefit of future special deductions, such as statutory depletion, which have not yet been earned.

Realizability of Deferred Tax Assets

92. The Board considered two basic approaches to the measurement of deferred tax assets. Under one approach, the "affirmative judgment" approach, a deferred tax asset is recognized for deductible temporary differences and carryforwards if, based on an affirmative judgment, that asset will be realized. Under the other approach, the "impairment" approach, a deferred tax asset is recognized for deductible temporary differences and carryforwards *unless* that asset is deemed to be impaired.

93. The Board also considered whether the criterion for either (a) future realization of the asset (under the affirmative judgment approach) or (b) impairment of the asset should be (1) "probable," (2) "more likely than not," or (3) something else.

94. Concepts Statement 6 defines assets and liabilities, in part, as *probable* future economic benefits and *probable* future sacrifices of economic benefits, respectively. But footnotes 18 and 21 explain that probable refers to "that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved" and is not used "in a specific accounting or technical sense (such as that in FASB Statement No. 5, *Accounting for Contingencies,* par. 3)."

95. For purposes of measurement of a deferred tax asset, the Board rejected *probable* as that term is used in Statement 5. The limited amount of information available about the future contributes to the following results of using that criterion in conjunction with each basic approach:

a. *Affirmative judgment approach.* A deferred tax asset would be recognized if it is probable that the asset *will* be realized. The problem is that recognition of a deferred tax asset that is *expected* to be realized is prohibited when the likelihood of realizing that asset is considered to be less than probable. The Board believes that result is unacceptable.
b. *Impairment approach.* A deferred tax asset would be recognized unless it is probable that the asset *will* not be realized. The problem is that recognition of a deferred tax asset that is not expected to be realized is nevertheless required when the likelihood of not realizing that asset is considered to be less than probable. The Board believes that result also is unacceptable.

96. The Board believes that the criterion required for measurement of a deferred tax asset should be one that produces accounting results that come closest to the expected outcome, that is, realization or nonrealization of the deferred tax asset in future years. For that reason, the Board selected *more likely than not* as the criterion for measurement of a deferred tax asset. Based on that criterion, (a) recognition of a deferred tax asset that is expected to be realized is required, and (b) recognition of a deferred tax asset that is not expected to be realized is prohibited.

97. The Board intends *more likely than no*t to mean a level of likelihood that is more than 50 percent. Selection of more likely than not as the criterion for measurement of a deferred tax asset is intended to virtually eliminate any distinction between the impairment and affirmative judgment approaches. In practice, there should be no substantive difference between the accounting results of either:

a. Recognition of a deferred tax asset if the likelihood of realizing the future tax benefit is more than 50 percent (the affirmative judgment approach)
b. Recognition of a deferred tax asset unless the likelihood of not realizing the future tax benefit is more than 50 percent (the impairment approach).

98. The Board acknowledges that future realization of a tax benefit sometimes will be expected for a portion but not all of a deferred tax asset, and that the dividing line between the two portions may be unclear. In those circumstances, application of judgment based on a careful assessment of all available evidence is required to determine the portion of a deferred tax asset for which it is more likely than not a tax benefit will not be realized. Most respondents to the Exposure Draft supported the impairment approach based on the criterion of more likely than not and believed that the guidance for exercise of judgment as provided in paragraphs 20-25 is sufficient.

Cumulative Losses in Recent Years

99. The Board considered whether there should be different requirements for recognition of a deferred tax asset for (a) deductible temporary differences and (b) tax loss carryforwards. The Board believes that, in substance, both are the same—both are amounts deductible on tax returns in future years. For example, a decision about whether to fund accrued pension costs currently will determine whether an enterprise has a tax loss carryforward or a deductible temporary difference if that enterprise otherwise has zero taxable income in the current year. The Board concluded that there should not be different requirements for recognition of a deferred tax asset for deductible temporary differences and tax loss carryforwards.

100. The Board also considered whether the criterion for recognition of a deferred tax asset should be at a higher level such as *assured beyond a reasonable doubt* when there is a cumulative pretax loss for financial reporting for the current and two preceding years. The rationale for that sort of requirement would be that cumulative losses in recent years is significant negative evidence about an enterprise's profitability that creates significant uncertainty about an enterprise's ability to earn taxable income and realize tax benefits in future years. When that condition exists, a more restrictive criterion for recognition of a deferred tax asset might be warranted to offset potential undue optimism concerning an enterprise's future profitability.

101. The Board is concerned, however, about the numerous implementation issues that would arise in applying a three-year cumulative loss test or some other similar test on a taxable entity by entity basis within consolidated financial statements. Implementation issues would include matters such as intercompany transactions, foreign operations, and business combinations accounted for by the purchase method. Numerous and detailed implementation rules for a three-year cumulative loss test would significantly increase the complexity of understanding and applying the requirements of this Statement.

102. The Board also is concerned about the effect on earnings when an enterprise moves into or out of a three-year cumulative loss status. When an enterprise moves into a three-year cumulative loss status, the assured beyond a reasonable doubt criterion ordinarily would (a) prohibit recognition of a tax benefit for the current year loss and (b) require recognition of a valuation allowance for deferred tax assets originally recognized in prior years. In those circumstances, deferred tax expense from elimination of the deferred tax asset would be added to a pretax loss to produce a larger net loss. Similarly, when an enterprise moves out of a three-year cumulative loss status, the more likely than not criterion might remove the need for a valuation allowance. In those circumstances, a deferred tax benefit from reinstatement of the deferred tax asset would be added to pretax income to produce a larger net income.

103. The Board believes that the more likely than not criterion required by this Statement is capable of appropriately dealing with all forms of negative evidence, including cumulative losses in recent years. That criterion requires positive evidence of sufficient quality and quantity to

counteract negative evidence in order to support a conclusion that, based on the weight of *all* available evidence, a valuation allowance is not needed. A cumulative loss in recent years is a significant piece of negative evidence that is difficult to overcome. For that reason, the Board concluded that a more restrictive criterion such as assured beyond a reasonable doubt is not necessary.

Tax-Planning Strategies

104. Statement 96 prohibited anticipation of taxable income expected to be earned in future years for purposes of recognizing a tax benefit for deductible temporary differences and carryforwards at the end of the current year. Within the bounds of that constraint, however, Statement 96 required consideration of tax-planning strategies that maximize the amount of tax benefits recognizable in the current year. As a result, an enterprise was required to identify and recognize the effect of strategies that the enterprise did not expect to implement if it expected to be profitable in future years. Many of the Board's constituents believed that requirement for "hypothetical" strategies was complex and confusing.

105. This Statement requires consideration of future taxable income and other available evidence when assessing the need for a valuation allowance. Various assumptions and strategies (including elections for tax purposes) are implicit in estimates of expected future taxable income. The Board concluded that it should not try to establish detailed criteria and other rules and requirements for those types of assumptions and strategies.

106. A tax-planning strategy, as that term is used in this Statement, is a possible source of taxable income that must be considered only in determining the amount of valuation allowance required. It is an action that an enterprise ordinarily might not implement but would implement, if necessary, to realize a tax benefit for an operating loss or tax credit carryforward before it expires. The existence of a tax-planning strategy demonstrates that a valuation allowance is not needed for some portion or all of a deferred tax asset.

107. A tax-planning strategy must be prudent and feasible. 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. Implementation of the tax-planning strategy must be primarily within the control of management but need not be within the unilateral control of management.

108. Statement 96 prohibited any tax-planning strategy that is expected to result in a significant cost. That requirement was consistent with the Statement 96 requirement to not anticipate any future events that are not inherently assumed in the financial statements. That requirement is not consistent, however, with this Statement's requirement to assess all available evidence to determine whether a valuation allowance is needed.

109. The Board concluded that tax-planning strategies that are expected to result in a significant cost should not be prohibited. The tax benefit recognized as a result of a tax-planning strategy, however, should be net of any significant expenses to implement that tax-planning

strategy or any significant losses that would be recognized if that tax-planning strategy is implemented. The Board believes that it would be inappropriate to recognize a tax benefit in the current year and postpone recognition of any expenses or losses necessary to generate that tax benefit to a later year.

Change in Valuation Allowance

110. Some respondents to the Exposure Draft proposed that the current-year tax effect of a change in the valuation allowance for a deferred tax asset related to prior-year losses or expenses that were charged direct to equity pursuant to Statement 12, 52, or FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises,* also should be allocated direct to equity rather than to continuing operations. In effect, those respondents recommend a current-year correction of the after-tax amount of those losses or expenses originally reported in a prior year. But no respondent recommended current-year corrections of the after-tax amount of prior-year extraordinary gains or prior-year gains that were credited direct to equity. That situation could arise, for example, if the current-year loss from continuing operations (a) offsets a deferred tax liability for a prior-year Statement 52 hedging gain or (b) results in a refund of taxes paid on a prior-year extraordinary gain.

111. The Board believes that there is no conceptual basis to require current-year corrections for the after-tax amount of prior-year losses or expenses while not requiring the same treatment of prior-year gains. Furthermore, current-year corrections of the after-tax amount of both gains and losses that occurred in prior years would be very complex. For those reasons, the Board decided that this Statement should retain the proposals in the Exposure Draft.

Changes in Tax Law and Tax Status

112. 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, that is, in the year that a change in tax law or rate is enacted or a change in tax status is approved. As a result of the change, deferred tax consequences become larger or smaller. Conceptually, it could be argued that an enterprise should anticipate the tax effect of an expected future change in tax law or rate or a change in tax status on its deferred tax liability or asset at the end of the current year. The Board believes, however, that recognition of those tax consequences in the year that a change occurs permits a more reliable measurement of the economic effects of an enacted change in tax law or rate or a change in the tax status of an enterprise.

113. Some respondents to the Exposure Draft proposed that the tax effect of an enacted change in tax rates on temporary differences related to a prior-year gain or loss that was reported as an extraordinary item, discontinued operations, or an item of comprehensive income excluded from net income should be reported in the same manner as that gain or loss was reported in the prior year. The Board concluded that it should not require reporting portions of the tax effect of an enacted change in tax rates (or a change in a valuation allowance as discussed above) as extraordinary items, and so forth, to remeasure in the current year the after-tax amount of gains

and losses that occurred and were reported in prior years. The Board decided that the entire tax effect of a change in enacted tax rates should be allocated to continuing operations in order to avoid the sometimes complex problems of tracing back to events of prior years in conjunction with:

a. Many different types of temporary differences
b. Incremental tax rates (used for intraperiod allocation) that may be different from statutory tax rates
c. Operating loss and tax credit carrybacks and carryforwards.

Temporary Differences That Are Not Timing Differences

114. This Statement, and Statement 96 before it, requires recognition of a deferred tax liability or asset for temporary differences that are not timing differences under Opinion 11. Some of the Board's constituents objected to that requirement of Statement 96 for three particular types of temporary differences because of a perceived "conflict of concepts" with some other authoritative accounting pronouncement. The three types of differences and the perceived conflict of concepts for each are as follows:

a. *Deferred ITC.* Under Opinion 2, ITC is deferred and amortized over the life of the related asset, but Statement 96 required immediate recognition of a deferred tax asset for the difference between the book and tax basis of the related asset that results from deferral of ITC.
b. *Foreign nonmonetary assets.* Under Statement 52, exchange gains and losses are not recognized for foreign nonmonetary assets when the U.S. dollar is the functional currency, but Statement 96 required recognition of a deferred tax liability or asset for the difference between the book and tax basis of the related nonmonetary asset that results from a change in exchange rates.
c. *Intercompany sale of inventory or other assets.* Under ARB 51, taxes paid on intercompany profits are deferred, but Statement 96 required recognition of a deferred tax asset for the difference between the book and tax basis of the related asset that results from an intercompany sale.

115. The Board reconsidered whether to require recognition of deferred taxes for each of those three types of differences. The Board's reasons for continuing the requirement for deferred ITC and eliminating the requirement for foreign nonmonetary assets and intercompany sales are discussed below.

Deferred Investment Tax Credit

116. The requirements for accounting for investment tax credits are contained in Opinions 2 and 4. In Opinion 2, the Accounting Principles Board (APB) concluded that:

a. The investment tax credit reduces the cost of the related asset, and for that reason, it should be deferred and amortized over the productive life of the related asset.

b. Display of the deferral in the statement of financial position as a reduction of the cost of the asset ordinarily is preferable.

c. Display of the deferral as deferred income is 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 concluded that:

(1) The essential nature of the investment tax credit is that it reduces the cost of the related asset, and the method of accounting for it in Opinion 2 is preferable.

(2) The flow-through method to account for the investment tax credit is also acceptable.

117. Accounting for an investment tax credit as required by Opinion 2 reduces the cost of the asset to less than its tax basis. The excess of tax basis over cost for financial reporting will be deductible in future years when the asset is recovered. Deferred tax accounting for that temporary difference 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 subsequently amortized over the life of the asset. The Board concluded that accounting for this temporary difference (a) is consistent with the basic principles of the Board's asset and liability approach to accounting for deferred *income taxes* and (b) is not a change in the deferred method of accounting for *investment tax credits* under Opinion 2.

Foreign Nonmonetary Assets

118. Statement 52 requires use of the U.S. dollar to measure the cost of foreign nonmonetary assets such as inventory, land, and depreciable assets when the U.S. dollar is the functional currency.[12] When exchange rates change, the amount of foreign currency revenues needed to recover the U.S. dollar cost of those assets also changes—but the foreign currency tax basis of those assets does not change. After a change in exchange rates, there will be a difference between (a) the amount of foreign currency needed to recover the U.S. dollar cost of those assets and (b) the foreign currency tax basis of those assets. Some believe that deferred taxes for those differences should be recognized in the period in which exchange rates change.

119. Under Statement 96, that difference between the foreign currency equivalent of the U.S. dollar cost and the foreign tax basis of nonmonetary assets is accounted for as a temporary difference. Although that difference technically meets the definition of a temporary difference, the Board concluded that the substance of accounting for it as such is to recognize deferred taxes on exchange gains and losses that are not recognized under Statement 52. The Board decided to resolve that conflict between the requirements of Statements 96 and 52 by prohibiting recognition of deferred taxes for those differences. The Board believes that decision will significantly reduce complexity by eliminating cross-currency (U.S. dollar cost versus foreign tax basis) computations of deferred taxes for those differences.

120. The Board also considered indexing of foreign nonmonetary assets for tax purposes (to counter the effects of inflation) when the U.S. dollar is the functional currency. In most countries, indexing is "too little, too late." As a result, at least in part, of the Board's decision about Statement 52 differences discussed above, however, a comparison of indexed tax basis to local currency historical cost ordinarily would indicate an excess of tax over book basis and a potential deferred tax asset—a counterintuitive result in highly inflationary economies. For that reason, the Board decided to prohibit deferred tax accounting for differences that result from indexing for tax purposes whenever the U.S. dollar is the functional currency for a foreign entity.

Intercompany Transfers of Assets

121. An intercompany transfer of assets such as the sale of inventory or depreciable assets between tax jurisdictions is a taxable event that establishes a new tax basis for those assets in the buyer's tax jurisdiction. The new tax basis of those assets is deductible on the buyer's tax return when the cost of those assets as reported in the consolidated financial statements is recovered.

122. Paragraph 17 of ARB 51 requires deferral of income taxes paid by the seller on intercompany profits on assets remaining within the consolidated group. Under Statement 96, however, the tax paid by the seller is charged to expense, and a deferred tax asset is potentially recognizable for the excess of the buyer's tax basis over the cost of the assets as reported in the consolidated financial statements. As a result, under Statement 96, a tax benefit or tax expense attributable to transferred inventory may be recognized in a period before that inventory is sold to an unrelated third party.

123. This Statement changes that requirement of Statement 96. Some argued that the Board's conclusion to recognize a deferred tax asset for the seller's tax payments and to not recognize a deferred tax asset for the buyer's deductible temporary difference reflects a deferred approach that is inconsistent with the asset and liability approach to accounting for income taxes. An intercompany sale of inventory between tax jurisdictions changes the tax basis of the inventory and thereby creates a temporary difference that will result in tax deductions on the buyer's tax return when the cost of the inventory as reported in the consolidated financial statements is recovered. In this view, those deferred tax consequences should be recognized in the year they occur (usually the year of the intercompany sale) and not in the year that the inventory is sold to an unrelated third party.

124. The Board concluded that although the excess of the buyer's tax basis over the cost of transferred assets as reported in the consolidated financial statements technically meets the definition of a temporary difference, the substance of accounting for it as such is to recognize income taxes related to intercompany gains that are not recognized under ARB 51. The Board decided to resolve that conflict between the requirements of Statement 96 and ARB 51 by prohibiting recognition of a deferred tax asset in the buyer's tax jurisdiction for those differences. As a result, ARB 51 is unchanged, and the income taxes paid by the seller including the tax

effect, in the seller's tax jurisdiction, of any reversing temporary differences as a result of that intercompany sale are deferred. The Board believes that that decision together with the decisions for Statement 52 and certain Opinion 23 differences should eliminate the need for complex cross-currency deferred tax computations for most enterprises.

Regulated Enterprises

125. When Statement 71 was issued, accounting for income taxes was a project on the Board's agenda, and the Board decided not to change regulated enterprises' accounting for income taxes until that project was completed. The general standards of accounting for the effects of regulation set forth 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 an 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 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 set forth in Statement 71.

Leveraged Leases

126. The Board acknowledges that the accounting for income taxes related to leveraged leases set forth in 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 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:

(1) The accounting for a leveraged lease requires recognition of deferred tax credits.
(2) The requirements of this Statement limit the recognition of a tax benefit for deductible temporary differences and carryforwards not related to the leveraged lease.
(3) 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 of recognizing the tax effect of an enacted change in tax rates.

Business Combinations

127. 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 nondeductible goodwill and leveraged leases) recognized in a purchase business combination.

128. 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 that reflect the 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.

129. Paragraph 89 of Opinion 16 stated 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 income taxes." The Board believes that the net result is the same whether amounts assigned to the individual assets acquired and liabilities assumed 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.

130. Paragraph 89 of Opinion 16 also stated 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 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.

131. Goodwill is recognized in a business combination accounted for as a purchase if the purchase price exceeds the assigned value of the identifiable net assets acquired. Conceptually, a

deferred tax liability or asset always should be recognized for the deferred tax consequences of a difference between the reported amount and the tax basis of goodwill. The requirements of this Statement differ, however, depending on whether amortization of goodwill is deductible for tax purposes. In tax jurisdictions where amortization of goodwill is not deductible, the Board believes that adjusting goodwill by an amount equal to the deferred tax liability or asset for the deferred tax consequences of recovering goodwill would not provide information that is particularly relevant. Furthermore, the computation of that adjustment often is very complex. For those reasons, the Board decided that a deferred tax liability or asset should not be recognized for goodwill temporary differences if amortization is not deductible.

132. Amortization of goodwill is deductible in certain tax jurisdictions. Nonrecognition of a deferred tax liability or asset would result in an uneven effective tax rate for financial reporting if the annual amount of amortization is different for financial reporting and tax purposes. For that reason, the Board concluded that a deferred tax liability or asset should be recognized for goodwill temporary differences in those tax jurisdictions.

133. Goodwill is not the only type of intangible asset for which amortization is not deductible in certain tax jurisdictions. The Board considered whether the exception to comprehensive recognition of deferred taxes that pertains to temporary differences related to goodwill should be extended to temporary differences related to other types of intangible assets. The Board decided that the exception should not be extended. Goodwill is a residual. It is the excess of purchase price over the assigned values of the identifiable net assets acquired. Other types of intangibles are not residuals. One reason for not recognizing deferred taxes related to goodwill is to avoid the gross-up of both sides of the statement of financial position that occurs because goodwill and the related deferred tax liability are mutually dependent on each other. That relationship does not exist for other types of intangible assets.

134. The other reason for not recognizing deferred taxes related to nondeductible goodwill is complexity. That complexity does not exist for other types of intangible assets. Furthermore, if amounts assigned to intangible assets, depreciable assets, or other types of assets acquired in a business combination exceed the tax basis of those assets, that excess will be taxable when those assets are recovered. The Board concluded that a deferred tax liability should be recognized for those taxable temporary differences regardless of whether the related assets are intangible assets or some other type of assets.

135. 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 any tax benefits recognizable by either enterprise as a result of the business combination should be included in accounting for the business combination. Goodwill is reduced, thereby reducing the annual charge to income for amortization of goodwill in subsequent years.

136. An acquired enterprise's deductible temporary differences and carryforwards are not included in measuring a purchase transaction if the criteria for recognition of tax benefits are not met. The Board decided against retroactive restatement of the purchase transaction and results of operations for intervening years if the criteria for recognition of tax benefits are met in subsequent periods. Recognition of a tax benefit in subsequent years is a consequence of either (a) earning income or (b) some other significant change in circumstances that causes a change in judgment about the need for a valuation allowance in those subsequent years. For that reason, the Board decided that (1) tax benefits should be accounted for in financial statements for the year in which the criteria for recognition of tax benefits are met, (2) the tax benefits should be applied first to reduce goodwill to zero and then to reduce other noncurrent intangible assets acquired in that business combination to zero, and (3) any additional tax benefits should be recognized as a reduction of income tax expense.

137. The Board decided that any noncurrent intangible assets other than goodwill should be reduced to zero before reducing income tax expense for acquired tax benefits that are recognized after the acquisition date for two reasons. One reason is that some of the Board's constituents were concerned that the opportunity to reduce income tax expense in future years for a portion of acquired tax benefits might sometimes influence purchase price allocations for business combinations. If amounts allocated to other noncurrent assets are increased, goodwill is reduced, thereby increasing the portion of acquired tax benefits that could reduce income tax expense in future years. Moreover, reliable fair values are sometimes difficult to obtain for noncurrent assets, particularly intangible assets. For those reasons, the Board concluded that both goodwill and other noncurrent intangible assets should be reduced to zero before the tax benefit of acquired deductible temporary differences and carryforwards are recognized as a reduction of income tax expense in future years.

138. Paragraph 72 of Statement 96 and the proposals in the Exposure Draft that preceded this Statement would have required, in certain limited circumstances, recognition of a tax benefit for the excess of an acquiring enterprise's tax basis of the stock of an acquired enterprise over the tax basis of the net assets of the acquired enterprise. The Board decided to eliminate that requirement because of changes in the U.S. federal tax law and the complexity of determining whether that requirement would be applicable in other tax jurisdictions.

Intraperiod Tax Allocation

139. 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. Under Statement 96, the amount of tax expense or benefit allocated to continuing operations was determined without regard to any items that are reported apart from income or loss from continuing operations. Items reported apart from continuing operations were viewed as incremental, and their tax consequences were not considered in determining the amount of tax expense or benefit to be allocated to continuing operations.

140. This Statement, however, requires consideration of the tax consequences of events for which consideration was prohibited under Statement 96. Under this Statement, for example, taxable income expected in future years is considered for measurement of a deferred tax asset for the carryforward of a current-year loss from continuing operations. For that reason, the Board believes that it is also appropriate to consider an extraordinary gain in the current year for purposes of allocating a tax benefit to a current-year loss from continuing operations. The Board concluded that all items (for example, extraordinary items, discontinued operations, and so forth) should be considered for purposes of determining the amount of tax benefit that results from a loss from continuing operations and that should be allocated to continuing operations.

141. The Board concluded that the tax benefit of a loss or tax credit carryforward, if not recognized when the item arose, is not an extraordinary item when subsequently recognized because the tax benefit is neither unusual in nature nor infrequent in occurrence. That tax benefit results from both (a) earning income in the current year or the expectation of earning income in a future year and (b) incurring a loss in a prior year. The Board also considered whether the tax benefit should be reported in the same manner as the prior-year loss that gave rise to the carryforward. The Board decided that reporting the benefit of a loss or tax credit carryforward based on the event that occurred in the prior year would (1) produce less understandable results and (2) create the sometimes complex problem of tracing back to events of prior years.

142. The Board concluded that 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.

143. 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. Because that difference between the exercise price and the fair value of the stock is not presently recognized as compensation expense in the financial statements, the Board believes that reporting the related tax benefit as a reduction of income tax expense would not be appropriate. Pending completion of the Board's project on accounting for employee stock options, the Board decided to make no changes to the requirements of Opinion 25 for reporting the tax effects of stock compensation plans.

144. The requirements of this Statement for reporting the tax benefit of tax-deductible dividends paid on allocated shares (that is, shares already earned by employees) of an employee stock ownership plan (ESOP) are the same as the requirements of Statement 96 for tax-deductible dividends paid to other shareholders. The Board also believes that the requirements of this Statement for tax-deductible dividends paid on shares held by an ESOP but not yet earned by employees are consistent with the requirements of Statement 96 and Opinion 25. An ESOP and a stock option plan are analogous. Both are compensatory arrangements and

both sometimes result in tax deductions for amounts that are not presently recognized as compensation expense in the financial statements under existing generally accepted accounting principles. The tax benefits of both are reported as a credit to shareholders' equity.

145. The Board believes that a tax deduction received for the payment of dividends (exclusive of dividends paid on unallocated shares held by an ESOP) represents, in substance, 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 directly to shareholders' equity. A tax benefit should not be recognized, however, for tax deductions or favorable tax rates attributable to future dividends of undistributed 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 that unrecognized deferred tax liability for disclosure purposes.

146. The Board reconsidered the Statement 96 requirements for reporting tax benefits after a quasi reorganization. Statement 96 had different requirements for (a) quasi reorganizations that are only an elimination of a deficit in retained earnings by a concurrent reduction in contributed capital and (b) other quasi reorganizations. The Board concluded that after any quasi reorganization, including those that are only a deficit reclassification, the enterprise's accounting should be substantially similar to that appropriate for a new enterprise. The income reported by a new enterprise would not include tax benefits attributable to deductible temporary differences and carryforwards that arose prior to its organization date. Therefore, those tax benefits should be reported as a direct addition to contributed capital when recognized subsequent to the date of the quasi reorganization.

147. The Board is aware, however, that some enterprises effected a quasi reorganization that involved only a deficit reclassification and adopted Statement 96 based, at least in part, on reliance on the requirements for the manner of reporting those tax benefits under Statement 96. For that reason, although some noted that other changes to more restrictive requirements than Statement 96 have not received special treatment in this Statement and that this exception is inconsistent with other requirements of this Statement, the Board concluded that it is appropriate to provide an exception for those enterprises.

148. Statement 96 required and the Exposure Draft proposed that interest and penalties assessed on income tax deficiencies should not be reported as income tax expense. Some respondents cited the difficulty of separating the total accrual for an income tax "cushion" between taxes, interest, and penalties. Some financial statement users stated a preference for excluding interest on income tax deficiencies from other types of interest expense. Upon reconsideration, the Board decided to eliminate that proposed requirement.

Classification in a Statement of Financial Position

149. Statement 96 required that the current portion of a deferred tax liability or asset should be the deferred tax consequences of temporary differences that will result in taxable or deductible

amounts during the following year or operating cycle if longer than one year. Some of the Board's constituents believe that requirement increased complexity because it required a detailed analysis to determine the amount of next year's reversing temporary differences. For that reason, the Board considered two alternatives to the requirements of Statement 96. One alternative was to classify all deferred taxes as noncurrent. The other was to continue the requirements of Opinion 11 and Statement 37 and to allocate a valuation allowance between current and noncurrent deferred tax assets on a pro rata basis.

150. Some prefer the requirements of Statement 96. They believe that those requirements are consistent with the overall objective of and reinforce the concepts underlying an asset and liability approach to accounting for income taxes. Furthermore, application of those requirements would produce the information needed to determine the current and noncurrent portions of a valuation allowance so that allocation on a pro rata basis would be unnecessary. They also believe that most enterprises would spend very little time and effort on classification of deferred taxes because classification is not a significant issue for those enterprises. When classification is a significant issue, they believe any additional time and effort is entirely appropriate.

151. The first alternative, classify all deferred taxes as noncurrent, was not adopted because the Board believes that a deferred tax liability or asset should be classified as current or noncurrent in a classified statement of financial position. An inappropriate current ratio would result from noncurrent classification of the deferred tax consequences of temporary differences related to current assets and liabilities. The results of applying that alternative would be confusing for the users of financial statements.

152. The Board concluded, and most respondents to the Exposure Draft agreed, that the requirements for classification of deferred taxes in a classified statement of financial position should be the same as under Opinion 11 and Statement 37. The Board also concluded that a valuation allowance should be allocated on a pro rata basis. The reasons for those conclusion are:

a. The results from applying that alternative ordinarily should not be significantly different from the results from applying the requirements of Statement 96.
b. The requirements of that alternative are easier to understand and apply.
c. That alternative does not create the impression that detailed scheduling is required for situations in which it otherwise could be avoided.

153. The Board considered whether deferred tax assets and liabilities should be offset or presented separately. The Board decided to permit offset of deferred tax liabilities and assets for the same tax jurisdiction for purposes of presentation in the statement of financial position to avoid the detailed analyses necessary to determine whether reversing taxable and deductible temporary differences offset each other on a particular future tax return or in carryback or carryforward years. However, the Board decided to prohibit offset of deferred tax liabilities and

assets attributable to different tax jurisdictions. Detailed analyses are not necessary to determine, for example, that a tax asset for German income taxes does not offset a tax liability for French income taxes.

Disclosures

154. 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 significant incremental costs.

155. Some respondents to the Exposure Draft recommended disclosure of additional information that might enable financial statement users to estimate the potential future effect of a change in tax laws or rates for each tax jurisdiction in which an enterprise has significant operations. The Board decided that this would require too much detail. In response to a similar recommendation by users of financial statements, however, the Board decided that a public enterprise should disclose the approximate total tax effect (not the separate tax effect for each tax jurisdiction) for each type of temporary difference and carryforward that gives rise to a significant portion of the enterprise's deferred tax liabilities and assets. The Board believes that this summarized information is useful and that it does not impose significant additional costs. This Statement also requires disclosure of the effect of enacted changes in tax laws or rates.

156. Some respondents to the Exposure Draft stated that disclosure of the amount of an enterprise's total deferred tax liabilities, deferred tax assets, and valuation allowances is of little value and potentially misleading. It might be misleading, for example, to continue to disclose a deferred tax asset and valuation allowance of equal amounts for a loss carryforward after operations are permanently terminated in a particular tax jurisdiction. The Board believes that it need not and should not develop detailed guidance for when to cease disclosure of the existence of a worthless asset. Some financial statement users, on the other hand, stated that disclosure of the total liability, asset, and valuation allowance as proposed in the Exposure Draft is essential for gaining some insight regarding management's decisions and changes in decisions about recognition of deferred tax assets. Other respondents recommended significant additional disclosures such as the extent to which net deferred tax assets are dependent on (a) future taxable income exclusive of reversing temporary differences or even (b) *each* of the four sources of taxable income cited in paragraph 21. After reconsideration, the Board concluded that disclosure of the total amounts as proposed in the Exposure Draft is an appropriate level of disclosure.

157. The Board considered and rejected a requirement for disclosure of the future maturities of a long-term deferred tax liability or asset. Disclosure of future maturities would require all enterprises with deferred tax liabilities or assets to analyze the distribution of taxable and deductible amounts among particular future years.

158. This Statement requires certain disclosures for an unrecognized 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. Those disclosure requirements are a result of the Board's decision to continue, in certain circumstances, the exception to comprehensive recognition of deferred taxes for those temporary differences.

159. This Statement does not prescribe a single method for recognition and measurement of income taxes in the separately issued financial statements of an entity that is a member of a group that files a consolidated tax return. It does, however, require certain criteria for the allocation method adopted (paragraph 40) and certain disclosures (paragraph 49) that previously were not required under Opinion 11 about the accounting for income taxes by such an entity. Some would have preferred to not require criteria for the allocation method because generally accepted accounting principles normally rely on disclosures under FASB Statement No. 57, *Related Party Disclosures,* and do not specify accounting requirements for related party transactions. The Board concluded, however, that those requirements are necessary (a) because an entity's reported results of operations and financial position can be significantly affected by those related-party transactions and (b) to obtain reported results that are closer to those that would be reported if the entity were an independent enterprise.

Effective Date and Transition

160. The Board considered and rejected a solely prospective application of the accounting standards required by this Statement. Continued recognition of deferred tax assets or liabilities computed under Opinion 11 or Statement 96 is inconsistent with the Board's present 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.

161. The Exposure Draft proposed disclosure of the effect of adopting this Statement for the year of adoption if financial statements for the prior year are not restated. Some respondents to the Exposure Draft stated that the cost to develop that information would exceed the benefit of providing it. Two sets of deferred tax computations would be required for the year of adoption—one under the requirements of this Statement and another under the requirements of either Statement 96 or Opinion 11.

162. Upon reconsideration, the Board decided that it should not require two sets of deferred tax computations for a single year. However, this Statement does require disclosure of either (a) the current-year effect on pretax income (from adjustments for prior year business combinations and regulated enterprises) if prior-year financial statements are not restated or (b) the prior-year effect of restatement if prior-year financial statements are restated. Some users of financial statements study changes in the trend of pretax income, and the disclosure required in (a) above will identify the current-year impact on that trend as a result of adopting this Statement. The Board believes that the disclosures required in (b) above should not require excessive cost because that information already will have been developed as a result of restating prior-year financial statements.

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

164. For similar reasons, the Board decided that the initial and subsequent accounting for purchase business combinations consummated in years prior to the year for which this Statement is first applied should not be restated.

165. For those purchase business combinations, the Board also considered whether to require adjustment of the remaining balances of assets (except for leveraged leases) and liabilities to pretax rather than net-of-tax amounts and recognition of a deferred tax liability or asset for the related temporary differences. The Board understands that for some prior business combinations, determination of those adjustments is impracticable, either because the necessary information is no longer available or because the cost to develop that information is excessive.

166. Statement 96 prohibited those adjustments in all instances. The purpose of that requirement was to eliminate the lack of comparability between the financial statements of enterprises that could and could not compute those adjustments. In reconsidering Statement 96, however, the Board decided to require those adjustments, if practicable, so that statements of financial position and statements of earnings will be more useful and representationally faithful (for both display and measurement) in future years. The Exposure Draft description of impracticable as involving "prohibitive" costs was changed to "excessive" costs to clarify that this is intended to be a "reasonable hurdle."

167. If determination of those adjustments is impracticable for a particular business combination, this Statement requires (except for leveraged leases) that 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. For that calculation, the only information required for transition is the amounts of an enterprise's assets and liabilities for financial reporting and for tax purposes. That information should be available.

168. 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 information needed for plant that is already in service, however, might not be available. Upon initial

application of this Statement, the reported amount of plant in service is adjusted to the amount that would have resulted from applying this Statement in all prior years, if practicable. Otherwise, any difference between the reported amount and the tax basis of plant in service is accounted for as the temporary difference.

Exceptions to Comprehensive Recognition of Deferred Taxes

Opinion 23 and U.S. Steamship Enterprise Temporary Differences

169. Under Opinion 11 and Statement 96, there were certain exceptions to comprehensive recognition of deferred tax liabilities. A deferred tax liability was not recognized for the areas addressed by Opinion 23 and for deposits in statutory reserve funds by U.S. steamship enterprises. At the time of issuing Statement 96, the Board concluded that those temporary differences give rise to a recognizable deferred tax liability. However, the Board decided to continue those exceptions because of (a) the complexity of measuring the deferred tax liability for foreign undistributed earnings, (b) the need to compromise, and (c) the omission of discounting.

170. In reconsidering the requirements of Statement 96, the Board reconsidered whether the Opinion 23 and U.S. steamship enterprise temporary differences give rise to a recognizable deferred tax liability. The Board concluded that those temporary differences give rise to a recognizable deferred tax liability. Opinion 23 required partial recognition of deferred taxes—an approach to accounting for income taxes that the Board has rejected. The underlying rationale for Opinion 23 is based on an enterprise's ability and intent to control the timing of the events that cause temporary differences to reverse and result in taxable amounts in future years. The Board concluded that management's ability to determine the particular future year(s) in which a deferred tax liability will be settled does not eliminate the existence of that liability at the end of the current year.

171. Not recognizing a liability for the deferred tax consequences of Opinion 23 and U.S. steamship enterprise temporary differences overstates the shareholders' residual ownership interest in an enterprise's net earnings and net assets. The government has a claim (a right to collect taxes) that precludes shareholders from ever realizing a portion of the enterprise's net assets. A tax obligation is not a component of shareholders' equity.

172. The Board considered whether payment of income taxes for the Opinion 23 and U.S. steamship enterprise temporary differences might be a contingency as that term is used in Statement 5. 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.

173. Complexity was one reason Statement 96 did not require recognition of a deferred tax liability for Opinion 23 and U.S. steamship enterprise temporary differences. Information received from constituents has convinced the Board that calculation of a deferred tax liability for undistributed foreign earnings that are or will be invested in a foreign entity indefinitely may sometimes be extremely complex. The hypothetical nature of those calculations introduces significant implementation issues and other complexities that occur less frequently in calculations of a deferred tax liability for an *expected* remittance of earnings from a foreign entity. For that reason, the Exposure Draft proposed to not require recognition of a deferred tax liability for undistributed earnings that are or will be invested in a foreign entity indefinitely. Based on respondents' concerns about complexity, however, the Board decided to extend that exception for foreign undistributed earnings to include the entire amount of a temporary difference between the book and tax basis of an investment in a foreign subsidiary or foreign corporate joint venture that is essentially permanent in duration regardless of the underlying reason(s) for that temporary difference.

174. A deferred tax liability is recognized for exempted taxable temporary differences if those temporary differences will reverse in the foreseeable future, and the Board decided that the same criterion should apply for recognition of a deferred tax asset for an excess of tax over the book basis of an investment in a foreign or domestic subsidiary or corporate joint venture that is essentially permanent in duration. The Exposure Draft proposed to prohibit recognition of a deferred tax asset for foreign tax credit carryforwards in excess of the amount by which those credits reduce the deferred tax liability recognized for undistributed foreign earnings and other foreign source income. Many respondents to the Exposure Draft objected to that limitation. After considering respondents' views, the Board decided to modify that limitation to permit recognition of the entire deferred tax asset so long as its future realization does not depend on either past or future Opinion 23 items (for example, undistributed earnings) for which a deferred tax liability either has not or will not be recognized.

175. Statement 96 required, in certain circumstances, disclosure of the amount of withholding taxes that would be payable upon remittance of foreign earnings. Payment of withholding taxes may be avoided in many foreign jurisdictions if the parent's investment in the foreign entity is recovered by some means other than dividends, for example, by sale of the stock of that foreign entity. For that reason, the Board decided to eliminate the Statement 96 requirement for disclosure of withholding taxes.

176. The need to compromise was the second reason cited in Statement 96 for not requiring recognition of a deferred tax liability for Opinion 23 temporary differences. The Statement 96 requirements for recognition of deferred tax assets created the overriding reason for the need to compromise. The requirements of this Statement result in the recognition of deferred tax assets that could not be recognized under the requirements of Statement 96.

177. The omission of discounting was the third reason cited in Statement 96. This Statement

prohibits discounting either deferred tax assets or deferred tax liabilities. The Board acknowledges that some of the types of deductible temporary differences that potentially give rise to the largest deferred tax assets are related to estimated liabilities (for example, other postretirement benefits) that are already discounted amounts. The Board notes, however, that an undiscounted deferred tax asset will sometimes be recognized for operating loss and tax credit carryforwards that may not be realized for up to 15 years into the future. Furthermore, discounting would usually require scheduling the reversals of temporary differences in future years.

178. Paragraph 2 of FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises,* states that "the Board intends future change [in practice] to occur in the gradual, evolutionary way that has characterized past change." Thus, evolutionary change may have to be slower in some areas than in others. The Board concluded that, in this area, recognition of a deferred tax liability for all Opinion 23 and U.S. steamship enterprise temporary differences should not be required at this time. That requirement would be too great a change from present practice under either Opinion 11 or Statement 96. The Board also concluded that recognition of a deferred tax liability for those temporary differences on a prospective basis as required by this Statement is an evolutionary change in practice that results in a significant improvement in financial reporting.

179. The Board considered the cost and complexity that would result from recognition of a deferred tax liability for Opinion 23 and U.S. steamship enterprise temporary differences on a prospective basis. The Board concluded that, except for temporary differences between the book and tax basis of investments in foreign subsidiaries and foreign corporate joint ventures, any increase in cost or complexity as a result of that requirement would be minimal. For that reason, the Board decided to require recognition of a deferred tax liability for those temporary differences on a prospective basis.

180. Over the years, as a result of changes in the tax law, the particular tax benefits that gave rise to Opinion 23 temporary differences have been reduced for savings and loan associations (and other qualified thrift lenders) and have been eliminated for life insurance companies. Thus, eliminating those exceptions on a prospective basis should not have a significant effect for many of those enterprises. The tax law for recapture of a savings and loan association's bad-debt reserve for tax purposes changed for tax years beginning after December 31, 1987 and, for that reason, the Board chose that date for prospective recognition of a deferred tax liability for this type of temporary difference. The Exposure Draft proposed a limitation on recognition of a deferred tax asset for a savings and loan association's bad-debt reserve for financial reporting. Respondents disagreed because the effect of that limitation sometimes would be, in substance, the same as recognizing a deferred tax liability for tax bad-debt reserves that arose prior to tax years beginning after December 31, 1987. The Board decided to eliminate that limitation.

181. The Board sees little similarity between Opinion 23 differences and U.S. steamship enterprise differences. Opinion 23 differences reverse in indefinite future periods. U.S.

steamship enterprise differences reverse in predictable future periods and, in substance, are no different from depreciation differences for which recognition of deferred taxes is required. For those reasons, the Exposure Draft proposed to eliminate the exception for U.S. steamship enterprises on a prospective basis. After consideration of responses to the Exposure Draft, however, the Board decided that recognition of the entire deferred tax liability for those temporary differences that exist at the beginning of the year for which this Statement is first applied also should be permitted.

182. A few respondents to the Exposure Draft proposed extending the Opinion 23 exception to comprehensive recognition of deferred taxes to certain analogous types of temporary differences, such as LIFO inventory temporary differences. The Board's reasons for concluding that Opinion 23 temporary differences give rise to a recognizable deferred tax liability equally apply to analogous types of temporary differences. The Board concluded that nonrecognition of a deferred tax liability for analogous types of temporary differences should be prohibited.

Tax Holidays

183. The Board considered whether a deferred tax asset ever should be recognized for the expected future reduction in taxes payable during a tax holiday. In most tax jurisdictions that have tax holidays, the tax holiday is "generally available" to any enterprise (within a class of enterprises) that chooses to avail itself of the holiday. The Board views that sort of exemption from taxation for a class of enterprises as creating a nontaxable status (somewhat analogous to S-corporation status under U.S. federal tax law) for which a deferred tax asset should not be recognized.

184. Some tax jurisdiction(s) may have a "unique" type of tax holiday that is *controlled* by the enterprise that qualifies for it (that is, a tax holiday that is not generally available to any enterprise within a class of enterprises that chooses to avail itself of the holiday). In those circumstances, conceptually, a deferred tax asset might be recognizable so long as (a) the enterprise has done whatever is necessary to qualify for the holiday and (b) the deferred tax asset recognized is net of the incremental cost of special requirements for future performance under the tax holiday agreement. The Board decided to prohibit recognition of a deferred tax asset for *any* tax holiday because of the practical problems in (1) distinguishing "unique" tax holidays (if any exist) for which recognition of a deferred tax asset might be appropriate from "generally available" tax holidays and (2) measuring the deferred tax asset.

The Incremental Effect of Future Losses

185. Conceptually, under an incremental approach, the tax consequences of tax losses expected in future years would be anticipated for purposes of:

a. Nonrecognition of a deferred tax liability for taxable temporary differences if there will be no future sacrifice because of future tax losses that otherwise would expire unused
b. Recognition of a deferred tax asset for the carryback refund of taxes paid for the current or a

prior year because of future tax losses that otherwise would expire unused.

Nevertheless, the Board decided to prohibit anticipation of the tax consequences of future tax losses. That decision reduces the complexity of understanding and applying the requirements of this Statement.

Private and Small Public Enterprises

186. 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 enterprise perspective were rather evenly divided on this issue.

187. 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 that many of 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.

188. 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.

189. The Board believes that the disclosure requirements of this Statement generally do not create significant new complexities or significant incremental costs. Paragraph 47 generally requires a numerical reconciliation between the reported amount of income tax expense and the amount that would result from applying domestic federal statutory tax rates. 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. Similarly, paragraph 43 requires that nonpublic enterprises disclose the types of temporary differences, but not the tax effect of each, that give rise to significant portions of deferred tax liabilities and assets. 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 between the disclosures required by this Statement for public enterprises and the disclosures required for nonpublic enterprises.

Interim Financial Reporting

190. 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 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 asset and liability approach to accounting for income taxes for annual periods, however, is a discrete approach that measures a deferred tax liability or asset at a particular time.

191. 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.

192. In certain circumstances, Opinion 28 prohibits recognition of tax benefits unless future realization is assured beyond a reasonable doubt. That provision in Opinion 28 creates a conflict with the accounting requirements to be applied at the end of the year for annual reporting, and the Board decided to eliminate that provision.

193. 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 that is attributable to losses in prior years is expected 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.

194. Measurements of a deferred tax liability or asset for annual reporting are subject to change when enacted tax laws or rates change. Likewise, a valuation allowance is subject to change when a change in circumstances causes a change in judgment about the realizability of the related deferred tax asset in *future* years. For interim reporting, the Board believes that the effects of those changes should be recognized as of the enactment date for a change in tax law or rate or as of the date of a change in circumstances for a change in valuation allowance 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. Thus, in effect, there is a catch-up adjustment for the cumulative effect as of the date of the change. The effect of changes in tax laws or rates and changes in judgment about the need for a valuation allowance on income or losses for future

interim periods, however, is reflected by an adjustment of the estimated annual effective tax rate for the remainder of the year.

195. 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 the 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 that enactment of tax legislation is a discrete event and that the effects should be recognized in the period of enactment. 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

196. An issue in the 1983 Discussion Memorandum that preceded Statement 96 was the basic method for recognition of investment tax credits in financial 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 income as a reduction of tax expense of the year that taxes payable are reduced.)

197. 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.[13] As a result, the conclusions of the 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.

Discounting

198. Another issue in the 1983 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.

199. 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. If deferred income taxes were discounted, however, a detailed analysis of the future reversals of temporary differences would be routinely required and a frequent criticism of Statement 96 was the need for scheduling.

Proposals for Partial or No Recognition of Deferred Taxes That Were Rejected

Taxes Payable As Determined by the Tax Return

200. Some respondents to 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.
e. All other approaches to accounting for income taxes are too complex.

201. 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.

202. 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. 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.

Partial Recognition of Deferred Taxes

203. Some respondents to 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 is that since the cumulative amount of differences does not reverse, no future tax payment will arise, and a deferred tax liability should not be recognized.

204. The Board does not agree. 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.

205. 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 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.

Methods of Accounting for Income Taxes That Were Rejected

206. The Discussion Memorandum identified four basic approaches to accounting 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

207. 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.

208. 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, capital gains).

209. 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 208 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.

210. A criticism of the deferred method is its failure to recognize the consequences of an enacted change in tax laws 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.

211. 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 amount of depreciable assets reported in the financial statements 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.

212. 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 include:

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.
d. Alternative minimum tax.

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.

213. 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 Net-of-Tax Approach to Accounting for Income Taxes

214. 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.

215. 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:

	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 use of the equipment, and the annual expiration of each of those components are as follows:

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

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

216. 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.

217. 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.

218. 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

219. 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.

220. 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.

221. 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.

222. 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 deferred tax liabilities or assets. 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.

Appendix B

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

CONTENTS

Paragraph Numbers

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

Introduction

223. This appendix provides additional discussion and examples [14] that illustrate application of the standards to specific aspects of accounting for income taxes.

Recognition of Deferred Tax Assets and Deferred Tax Liabilities

224. A deferred tax liability is recognized for all taxable temporary differences,[15] and a deferred tax asset is recognized for all deductible temporary differences and operating loss and tax credit carryforwards. A valuation allowance is recognized if it is more likely than not that some portion or all of the deferred tax asset will not be realized.

225. The following example illustrates recognition of deferred tax assets and liabilities. At the end of year 3 (the current year), an enterprise has $2,400 of deductible temporary differences and $1,500 of taxable temporary differences.

A deferred tax liability is recognized at the end of year 3 for the $1,500 of taxable temporary differences, and deferred tax asset is recognized for the $2,400 of deductible temporary differences. All available evidence, both positive and negative, is considered to determine whether, based on the weight of that evidence, a valuation allowance is needed for some portion or all of the deferred tax asset. If evidence about one or more sources of taxable income (refer to paragraph 21) is sufficient to support a conclusion that a valuation allowance is not needed, other sources of taxable income need not be considered. For example, if the weight of available evidence indicates that taxable income will exceed $2,400 in each future year, a conclusion that no valuation allowance is needed can be reached without considering the pattern and timing of the reversal of the temporary differences, the existence of qualifying tax-planning strategies, and so forth.

Similarly, if the deductible temporary differences will reverse within the next 3 years and taxable income in the current year exceeds $2,400, nothing needs to be known about future taxable income exclusive of reversing temporary differences because the deferred tax asset could be realized by carryback to the current year. A valuation allowance is needed, however, if the weight of available evidence indicates that some portion or all of the $2,400 of tax deductions from future reversals of the deductible temporary differences will not be realized by offsetting:

a. The $1,500 of taxable temporary differences and $900 of future taxable income exclusive of reversing temporary differences

b. $2,400 of future taxable income exclusive of reversing temporary differences
c. $2,400 of taxable income in the current or prior years by loss carryback to those years
d. $2,400 of taxable income in one or more of the circumstances described above and as a result of a qualifying tax-planning strategy (refer to paragraphs 246-251).

To the extent that evidence about one or more sources of taxable income is sufficient to eliminate any need for a valuation allowance, other sources need not be considered. Detailed forecasts, projections, or other types of analyses [16] are unnecessary if expected future taxable income is more than sufficient to realize a tax benefit. Detailed analyses are not necessary, for example, if the enterprise earned $500 of taxable income in each of years 1-3 and there is no evidence to suggest it will not continue to earn that level of taxable income in future years. That level of future taxable income is more than sufficient to realize the tax benefit of $2,400 of tax deductions over a period of at least 19 years (the year(s) of the deductions, 3 carryback years, and 15 carryforward years) in the U.S. federal tax jurisdiction.

226. The following example illustrates recognition of a valuation allowance for a portion of a deferred tax asset in one year and a subsequent change in circumstances that requires adjustment of the valuation allowance at the end of the following year. The assumptions are as follows:

a. At the end of the current year (year 3), an enterprise's only temporary differences are deductible temporary differences in the amount of $900.
b. Pretax financial income, taxable income, and taxes paid for each of years 1-3 are all positive, but relatively negligible, amounts.
c. The enacted tax rate is 40 percent for all years.

A deferred tax asset in the amount of $360 ($900 at 40 percent) is recognized at the end of year 3. If management concludes, based on an assessment of all available evidence (refer to guidance in paragraphs 20-25), that it is more likely than not that future taxable income will not be sufficient to realize a tax benefit for $400 of the $900 of deductible temporary differences at the end of the current year, a $160 valuation allowance ($400 at 40 percent) is recognized at the end of year 3.

Assume that pretax financial income and taxable income for year 4 turn out to be as follows:

Pretax financial loss	$ (50)
Reversing deductible temporary differences	(300)
Loss carryforward for tax purposes	$(350)

The $50 pretax loss in year 4 is additional negative evidence that must be weighed against available positive evidence to determine the amount of valuation allowance necessary at the end of year 4. Deductible temporary differences and carryforwards at the end of year 4 are as follows:

Loss carryforward from year 4 for tax purposes (see above)	$350
Unreversed deductible temporary differences ($900 - $300)	600
	$950

The $360 deferred tax asset recognized at the end of year 3 is increased to $380 ($950 at 40 percent) at the end of year 4. Based on an assessment of all evidence available at the end of year 4, management concludes that it is more likely than not that $240 of the deferred tax asset will not be realized and, therefore, that a $240 valuation allowance is necessary. The $160 valuation allowance recognized at the end of year 3 is increased to $240 at the end of year 4. The $60 net effect of those 2 adjustments (the $80 increase in the valuation allowance less the $20 increase in the deferred tax asset) results in $60 of deferred tax expense that is recognized in year 4.

Offset of Taxable and Deductible Amounts

227. The tax law determines whether future reversals of temporary differences will result in taxable and deductible amounts that offset each other in future years. The tax law also determines the extent to which deductible temporary differences and carryforwards will offset the tax consequences of income that is expected to be earned in future years. For example, the tax law may provide that capital losses are deductible only to the extent of capital gains. In that case, a tax benefit is not recognized for temporary differences that will result in future deductions in the form of capital losses unless those deductions will offset either (a) other existing temporary differences that will result in future capital gains, (b) capital gains that are expected to occur in future years, or (c) capital gains of the current year or prior years if carryback (of those capital loss deductions from the future reversal years) is expected.

Pattern of Taxable or Deductible Amounts

228. The particular years in which temporary differences result in taxable or deductible amounts generally are determined by the timing of the recovery of the related asset or settlement of the related liability. However, there are exceptions to that general rule. For example, a temporary difference between the tax basis and the reported amount of inventory for which cost is determined on a LIFO basis does not reverse when present inventory is sold in future years if it is replaced by purchases or production of inventory in those same future years. A LIFO inventory temporary difference becomes taxable or deductible in the future year that inventory is liquidated and not replaced.

229. For some assets or liabilities, temporary differences may accumulate over several years and then reverse over several years. That pattern is common for depreciable assets. Future originating differences for existing depreciable assets and their subsequent reversals are a factor to be considered when assessing the likelihood of future taxable income (paragraph 21(b)) for realization of a tax benefit for existing deductible temporary differences and carryforwards.

Change in Deferred Foreign Tax Assets and Liabilities

230. 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 exchange rate will result in a transaction gain or loss that is recognized 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.

Special Deductions

231. Statement 96 amended FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies,* to require recognition of statutory depletion that would result from generating future revenues exactly equal to the amount of the related assets (that is, the assets subject to statutory depletion) to the extent that the statutory depletion offsets a deferred tax liability for taxable temporary differences attributable to those assets. This Statement eliminates that amendment of Statement 19. The Board concluded that, under the basic approach to recognition of deferred tax benefits required by this Statement, the necessary past event for recognition of the tax benefit of statutory depletion is producing oil, mining copper, and so forth (or its subsequent sale). The tax benefit of statutory depletion and other types of special deductions such as those for Blue Cross-Blue Shield and small life insurance companies in future years should not be anticipated for purposes of offsetting a deferred tax liability for taxable temporary differences at the end of the current year.

232. As required above, the tax benefit of special deductions ordinarily is recognized no earlier than the year in which those special deductions are deductible on the tax return. However, some portion of the future tax effects of special deductions are implicitly recognized in determining (a) the average graduated tax rate to be used for measuring deferred taxes when graduated tax rates are a significant factor and (b) the need for a valuation allowance for deferred tax assets. In those circumstances, implicit recognition is unavoidable because (1) those special deductions are one of the determinants of future taxable income and (2) future taxable income determines the average graduated tax rate and sometimes determines the need for a valuation allowance.

Measurement of Deferred Tax Liabilities and Assets

233. The tax rate that is used to measure deferred tax liabilities and deferred tax assets is the enacted tax rate(s) expected to apply to taxable income in the years that the liability is expected to be settled or the asset recovered. Measurements are based on elections (for example, an election for loss carryforward instead of carryback) that are expected to be made for tax purposes

in future years. Presently enacted changes in tax laws and rates that become effective for a particular future year or years must be considered when determining the tax rate to apply to temporary differences reversing 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 deductible temporary differences that are expected to be realized in future years through carryback of a future loss to the current or a prior year (or a liability for taxable temporary differences that are expected to reduce the refund claimed for the carryback of a future loss to the current or a prior year) is measured using tax laws and rates for the current or a prior year, that is, the year for which a refund is expected to be realized based on loss carryback provisions of the tax law.

234. The following example illustrates determination of the tax rate for measurement of a deferred tax liability for taxable temporary differences when there is a phased-in change in tax rates. At the end of year 3 (the current year), an enterprise has $2,400 of taxable temporary differences, which are expected to result in taxable amounts of approximately $800 on the future tax returns for each of years 4-6. Enacted tax rates are 35 percent for years 1-3, 40 percent for years 4-6, and 45 percent for year 7 and thereafter.

The tax rate that is used to measure the deferred tax liability for the $2,400 of taxable temporary differences differs depending on whether the tax effect of future reversals of those temporary differences is on taxes payable for years 1-3, years 4-6, or year 7 and thereafter. The tax rate for measurement of the deferred tax liability is 40 percent whenever taxable income is expected in years 4-6. If tax losses are expected in years 4-6, however, the tax rate is:

a. 35 percent if realization of a tax benefit for those tax losses in years 4-6 will be by loss carryback to years 1-3
b. 45 percent if realization of a tax benefit for those tax losses in years 4-6 will be by loss carryforward to year 7 and thereafter.

235. The following example illustrates determination of the tax rate for measurement of a deferred tax asset for deductible temporary differences when there is a change in tax rates. The assumptions are as follows:

a. Enacted tax rates are 30 percent for years 1-3 and 40 percent for year 4 and thereafter.
b. At the end of year 3 (the current year), an enterprise has $900 of deductible temporary differences, which are expected to result in tax deductions of approximately $300 on the future tax returns for each of years 4-6.

The tax rate is 40 percent if the enterprise expects to realize a tax benefit for the deductible temporary differences by offsetting taxable income earned in future years. Alternatively, the tax rate is 30 percent if the enterprise expects to realize a tax benefit for the deductible temporary differences by loss carryback refund.

Assume that (a) the enterprise recognizes a $360 ($900 at 40 percent) deferred tax asset to be realized by offsetting taxable income in future years and (b) taxable income and taxes payable in each of years 1-3 were $300 and $90, respectively. Realization of a tax benefit of at least $270 ($900 at 30 percent) is assured because carryback refunds totalling $270 may be realized even if no taxable income is earned in future years. Recognition of a valuation allowance for the other $90 ($360 - $270) of the deferred tax asset depends on management's assessment of whether, based on the weight of available evidence, a portion or all of the tax benefit of the $900 of deductible temporary differences will not be realized at 40 percent tax rates in future years.

Alternatively, if enacted tax rates are 40 percent for years 1-3 and 30 percent for year 4 and thereafter, measurement of the deferred tax asset at a 40 percent tax rate could only occur if tax losses are expected in future years 4-6.

236. The following example illustrates determination of the average graduated tax rate for measurement of deferred tax liabilities and assets by an enterprise for which graduated tax rates ordinarily are a significant factor. At the end of year 3 (the current year), an enterprise has $1,500 of taxable temporary differences and $900 of deductible temporary differences, which are expected to result in net taxable amounts of approximately $200 on the future tax returns for each of years 4-6. Enacted tax rates are 15 percent for the first $500 of taxable income, 25 percent for the next $500, and 40 percent for taxable income over $1,000. This example assumes that there is no income (for example, capital gains) subject to special tax rates.

The deferred tax liability and asset for those reversing taxable and deductible temporary differences in years 4-6 are measured using the average graduated tax rate for the estimated amount of annual taxable income in future years. Thus, the average graduated tax rate will differ depending on the expected level of annual taxable income (including reversing temporary differences) in years 4-6. The average tax rate will be:

a. 15 percent if the estimated annual level of taxable income in years 4-6 is $500 or less
b. 20 percent if the estimated annual level of taxable income in years 4-6 is $1,000
c. 30 percent if the estimated annual level of taxable income in years 4-6 is $2,000.

Temporary differences usually do not reverse in equal annual amounts as in the example above, and a different average graduated tax rate might apply to reversals in different future years. However, a detailed analysis to determine the net reversals of temporary differences in each future year usually is not warranted. It is not warranted because the other variable (that is, taxable income or losses exclusive of reversing temporary differences in each of those future years) for determination of the average graduated tax rate in each future year is no more than an estimate. For that reason, an aggregate calculation using a single estimated average graduated tax rate based on estimated average annual taxable income in future years is sufficient. Judgment is permitted, however, to deal with unusual situations, for example, an abnormally large temporary difference that will reverse in a single future year, or an abnormal level of taxable income that is expected for a single future year. The lowest graduated tax rate should be used whenever the estimated average graduated tax rate otherwise would be zero.

237. Deferred tax liabilities and assets are measured using enacted tax rates applicable to capital gains, ordinary income, and so forth, based on the expected type of taxable or deductible amounts in future years. For example, evidence based on all facts and circumstances should determine whether an investor's liability for the tax consequences of temporary differences related to its equity in the earnings of an investee should be measured using enacted tax rates applicable to a capital gain or a dividend. Computation of a deferred tax liability for undistributed earnings based on dividends should also reflect any related dividends received deductions or foreign tax credits, and taxes that would be withheld from the dividend.

Alternative Minimum Tax

238. Temporary differences such as depreciation differences are one reason why TMT may exceed regular tax. Temporary differences, however, ultimately reverse and, absent a significant amount of preference items, total taxes paid over the entire life of the enterprise will be based on the regular tax system. Preference items are another reason why TMT may exceed regular tax. If preference items are large enough, an enterprise could be subject, over its lifetime, to the AMT system; and the cumulative amount of AMT credit carryforwards would expire unused. No one can know beforehand which scenario will prevail because that determination can only be made after the fact. In the meantime, this Statement requires procedures that provide a practical solution to that problem.

239. Under the requirements of this Statement, an enterprise should:

a. Measure the total deferred tax liability and asset for regular tax temporary differences and carryforwards using the regular tax rate
b. Measure the total deferred tax asset for all AMT credit carryforward
c. Reduce the deferred tax asset for AMT credit carryforward by a valuation allowance if, based on the weight of available evidence, it is more likely than not that some portion or all of that deferred tax asset will not be realized.

Paragraph 21 identifies four sources of taxable income that should be considered in determining the need for and amount of a valuation allowance. No valuation allowance is necessary if the deferred tax asset for AMT credit carryforward can be realized:

1. Under paragraph 21(a), by reducing a deferred tax liability from the amount of regular tax on regular tax temporary differences to not less than the amount of TMT on AMT temporary differences
2. Under paragraph 21(b), by reducing taxes on future income from the amount of regular tax on regular taxable income to not less than the amount of TMT on AMT income
3. Under paragraph 21(c), by loss carryback
4. Under paragraph 21(d), by a tax-planning strategy such as switching from tax-exempt to taxable interest income.

Operating Loss and Tax Credit Carryforwards and Carrybacks

Recognition of a Tax Benefit for Carrybacks

240. An operating loss, 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. A receivable 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

241. A deferred tax asset is recognized for an operating loss or tax credit carryforward.[17] In assessing the need for a valuation allowance, provisions in the tax law that limit utilization of an operating loss or tax credit carryforward are applied in determining whether it is more likely than not that some portion or all of the deferred tax asset will not be realized by reduction of taxes payable on taxable income during the carryforward period.

242. The following example illustrates recognition of the tax benefit of an operating loss in the loss year and in subsequent carryforward years when a valuation allowance is necessary in the loss year. The assumptions are as follows:

a. The enacted tax rate is 40 percent for all years.
b. An operating loss occurs in year 5.
c. 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.
d. 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 (loss)	$2,000	$5,000	$(8,000)	$ 2,200	$ 7,000
Depreciation differences	(800)	(2,200)	(800)	(700)	(600)
Loss carryback	—	—	2,800	—	—
Loss carryforward	—	—	—	(6,000)	(4,500)
Taxable income (loss)	$1,200	$2,800	$(6,000)	$(4,500)	$ 1,900
Taxes payable (refundable)	$ 480	$1,120	$(1,120)	$ —	$ 760

e. At the end of year 5, profits are not expected in years 6 and 7 and later years, and it is concluded that a valuation allowance is necessary to the extent realization of the deferred tax asset for the operating loss carryforward depends on taxable income (exclusive of reversing temporary differences) in future years.

The deferred tax liability for the taxable temporary differences is calculated at the end of each year as follows:

	Year 1	Years 2-4	Year 5	Year 6	Year 7
Unreversed differences:					
Beginning amount	$ —	$ 800	$3,000	$3,800	$4,500
Additional amount	800	2,200	800	700	600
Total	$ 800	$3,000	$3,800	$4,500	$5,100
Deferred tax liability (40 percent)	$ 320	$1,200	$1,520	$1,800	$2,040

The deferred tax asset and related valuation allowance for the loss carryforward are calculated at the end of each year as follows:

	Year 1	Years 2-4	Year 5	Year 6	Year 7
Loss carryforward for tax purposes	$—	$—	$6,000	$4,500	$—
Deferred tax asset (40 percent)	$—	$—	$2,400	$1,800	$—
Valuation allowance equal to the amount by which the deferred tax asset exceeds the deferred tax liability	—	—	(880)	—	—
Net deferred tax asset	$—	$—	$1,520	$1,800	$—

Total tax expense for each period is as follows:

	Year 1	Years 2-4	Year 5	Year 6	Year 7
Deferred tax expense (benefit):					
Increase in deferred tax liability	$320	$ 880	$ 320	$ 280	$ 240
(Increase) decrease in net deferred tax asset	—	—	(1,520)	(280)	1,800
	320	880	(1,200)	—	2,040
Currently payable (refundable)	480	1,120	(1,120)	—	760
Total tax expense (benefit)	$800	$2,000	$(2,320)	$ —	$2,800

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. In addition, a $1,520 deferred tax liability is recognized for $3,800 of taxable temporary differences, and a $2,400 deferred tax asset is recognized for the $6,000 loss carryforward. However, based on the conclusion described in assumption (e), a valuation allowance is recognized for the amount by which that deferred tax asset exceeds the deferred tax liability.

In year 6, a portion of the deferred tax asset for the loss carryforward is realized because taxable income is earned in that year. The remaining balance of the deferred tax asset for the loss carryforward at the end of year 6 equals the deferred tax liability for the taxable temporary differences. A valuation allowance is not needed.

In year 7, the remaining balance of the loss carryforward is realized, and $760 of taxes are payable on net taxable income of $1,900. A $2,040 deferred tax liability is recognized for the $5,100 of taxable temporary differences.

243. An operating loss or tax credit carryforward from a prior year (for which the deferred tax asset was offset by a valuation allowance) 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 years. Under those circumstances, the reduction in taxable income and taxes payable from utilization of the operating loss or tax credit carryforward gives no cause for recognition of a tax benefit because, in effect, the operating loss or tax credit carryforward has been replaced by temporary differences that will result in deductible amounts when a nontax liability is settled in future years. The requirements for recognition of a tax benefit for deductible temporary differences and for operating loss carryforwards are the same, and the manner of reporting the eventual tax benefit recognized (that is, in income or as required by paragraph 37) is not affected by the intervening transaction reported for tax purposes.

244. 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 because $2,500 of it is used to reduce taxable income. The $2,500 reduction in the loss carryforward becomes $2,500 of deductible temporary differences that will reverse and result in future tax deductions when lease payments are made. The enterprise has no deferred tax liability to be offset by those future tax deductions, the future tax deductions cannot be realized by loss carryback because no taxes have been paid, and the enterprise has had pretax losses for financial reporting since inception. Unless positive evidence exists that is sufficient to overcome the negative evidence associated with those losses, a valuation allowance is recognized at the end of year 2 for the full amount of the deferred tax asset related to the $2,500 of deductible temporary differences and the remaining $1,500 of operating loss carryforward.

Reporting the Tax Benefit of Operating Loss Carryforwards or Carrybacks

245. Except as noted in paragraph 37, 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 (a) the source of the operating loss carryforward or taxes paid in a prior year or (b) the source of expected future income that will result in realization of a deferred tax asset for an operating loss carryforward from the current year. Deferred tax expense or benefit that results because a change in circumstances causes a change in judgment about the future realization of the tax benefit of an operating loss carryforward is allocated to continuing operations (refer to paragraph 26). Thus, for example:

a. The tax benefit of an operating loss carryforward that resulted from an extraordinary loss in a prior year and that is first recognized in the financial statements for the current year:
    (1) Is allocated to continuing operations if it offsets the current or deferred tax consequences of income from continuing operations
    (2) Is allocated to an extraordinary gain if it offsets the current or deferred tax consequences of that extraordinary gain
    (3) Is allocated to continuing operations if it results from a change in circumstances that causes a change in judgment about future realization of a tax benefit
b. The current or deferred tax benefit of a loss from continuing operations in the current year is allocated to continuing operations regardless of whether that loss offsets the current or deferred tax consequences of an extraordinary gain that:
    (1) Occurred in the current year
    (2) Occurred in a prior year (that is, if realization of the tax benefit will be by carryback refund)

(3) Is expected to occur in a future year.

Tax-Planning Strategies

246. Expectations about future taxable income incorporate numerous assumptions about actions, elections, and strategies to minimize income taxes in future years. For example, an enterprise may have a practice of deferring taxable income whenever possible by structuring sales to qualify as installment sales for tax purposes. Actions such as that are not *tax-planning strategies,* as that term is used in this Statement, because they are actions that management takes in the normal course of business. For purposes of applying the requirements of this Statement, a *tax-planning strategy* is an action that management ordinarily might not take but would take, if necessary, to realize a tax benefit for a carryforward before it expires. For example, a strategy to sell property and lease it back for the expressed purpose of generating taxable income to utilize a carryforward before it expires is not an action that management takes in the normal course of business. A qualifying tax-planning strategy is an action that:

a. *Is prudent and feasible.* Management must have the ability to implement the strategy and expect to do so unless the need is eliminated in future years. For example, management would not have to apply the strategy if income earned in a later year uses the entire amount of carryforward from the current year.
b. *An enterprise ordinarily might not take, but would take to prevent an operating loss or tax credit carryforward from expiring unused.* All of the various strategies that are expected to be employed for business or tax purposes other than utilization of carryforwards that would otherwise expire unused are, for purposes of this Statement, implicit in management's estimate of future taxable income and, therefore, are not tax-planning strategies as that term is used in this Statement.
c. *Would result in realization of deferred tax assets.* The effect of qualifying tax-planning strategies must be recognized in the determination of the amount of a valuation allowance. Tax-planning strategies need not be considered, however, if positive evidence available from other sources (refer to paragraph 21) is sufficient to support a conclusion that a valuation allowance is *not* necessary.

247. Tax-planning strategies may shift estimated future taxable income between future years. For example, assume that an enterprise has a $1,500 operating loss carryforward that expires at the end of next year and that its estimate of taxable income exclusive of the future reversal of existing temporary differences and carryforwards is approximately $1,000 per year for each of the next several years. That estimate is based, in part, on the enterprise's present practice of making sales on the installment basis and on provisions in the tax law that result in temporary deferral of gains on installment sales. A tax-planning strategy to increase taxable income next year and realize the full tax benefit of that operating loss carryforward might be to structure next year's sales in a manner that does not meet the tax rules to qualify as installment sales. Another strategy might be to change next year's depreciation procedures for tax purposes.

248. Tax-planning strategies also may shift the estimated pattern and timing of future reversals of temporary differences. For example, if an operating loss carryforward otherwise would expire unused at the end of next year, a tax-planning strategy to sell the enterprise's installment sale receivables next year would accelerate the future reversal of taxable temporary differences for the gains on those installment sales. In other circumstances, a tax-planning strategy to accelerate the future reversal of *deductible* temporary differences in time to offset taxable income that is expected in an early future year might be the only means to realize a tax benefit for those deductible temporary differences if they otherwise would reverse and provide no tax benefit in some later future year(s). Examples of actions that would accelerate the future reversal of deductible temporary differences 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) would accelerate a tax deduction for the allowance for bad debts.

249. A significant expense might need to be incurred to implement a particular tax-planning strategy, or a significant loss might need to be recognized as a result of implementing a particular tax-planning strategy. In either case, that expense or loss (net of any future tax benefit that would result from that expense or loss) reduces the amount of tax benefit that is recognized for the expected effect of a qualifying tax-planning strategy. For that purpose, the future effect of a differential in interest rates (for example, between the rate that would be earned on installment sale receivables and the rate that could be earned on an alternative investment if the tax-planning strategy is to sell those receivables to accelerate the future reversal of related taxable temporary differences) is not considered.

250. The following example illustrates recognition of a deferred tax asset based on the expected effect of a qualifying tax-planning strategy when a significant expense would be incurred to implement the strategy. The assumptions are as follows:

a. A $900 operating loss carryforward expires at the end of next year.
b. Based on historical results and the weight of other available evidence, the estimated level of taxable income exclusive of the future reversal of existing temporary differences and the operating loss carryforward next year is $100.
c. Taxable temporary differences in the amount of $1,200 ordinarily would result in taxable amounts of approximately $400 in each of the next 3 years.
d. There is a qualifying tax-planning strategy to accelerate the future reversal of all $1,200 of taxable temporary differences to next year.

e. Estimated legal and other expenses to implement that tax-planning strategy are $150.
f. The enacted tax rate is 40 percent for all years.

Without the tax-planning strategy, only $500 of the $900 operating loss carryforward could be realized next year by offsetting (a) $100 of taxable income exclusive of reversing temporary differences and (b) $400 of reversing taxable temporary differences. The other $400 of operating loss carryforward would expire unused at the end of next year. Therefore, the $360 deferred tax asset ($900 at 40 percent) would be offset by a $160 valuation allowance ($400 at 40 percent), and a $200 net deferred tax asset would be recognized for the operating loss carryforward.

With the tax-planning strategy, the $900 operating loss carryforward could be applied against $1,300 of taxable income next year ($100 of taxable income exclusive of reversing temporary differences and $1,200 of reversing taxable temporary differences). The $360 deferred tax asset is reduced by a $90 valuation allowance recognized for the net-of-tax expenses necessary to implement the tax-planning strategy. The amount of that valuation allowance is determined as follows:

Legal and other expenses to implement the tax-planning strategy	$150
Future tax benefit of those legal and other expenses—$150 at 40 percent	60
	$ 90

In summary, a $480 deferred tax liability is recognized for the $1,200 of taxable temporary differences, a $360 deferred tax asset is recognized for the $900 operating loss carryforward, and a $90 valuation allowance is recognized for the net-of-tax expenses of implementing the tax-planning strategy.

251. Under this Statement, the requirements for consideration of tax-planning strategies pertain only to the determination of a valuation allowance for a deferred tax asset. A deferred tax liability ordinarily is recognized for all taxable temporary differences. The only exceptions are identified in paragraph 9. Certain seemingly taxable temporary differences, however, may or may not result in taxable amounts when those differences reverse in future years. One example is an excess of cash surrender value of life insurance over premiums paid (paragraph 14). Another example is an excess of the book over the tax basis of an investment in a domestic subsidiary (paragraph 33). The determination of whether those differences are taxable temporary differences does not involve a tax-planning strategy as that term is used in this Statement.

Regulated Enterprises

252. 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 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.

253. 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 [18] 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

254. 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 in paragraph 253 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

255. 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 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 R) = R (where R equals the probable future reduction in revenue)

   R = $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

Leveraged Leases

256. This Statement does not change (a) the pattern of recognition of 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 leveraged leases as required by Interpretation 21. Integration of the results of income tax accounting for leveraged leases with the other results of accounting for income taxes under this Statement is required when deferred tax credits related to leveraged leases are the only source (refer to paragraph 21) for recognition of a tax benefit for deductible temporary differences and carryforwards not related to leveraged leases. A valuation allowance is not necessary if deductible temporary differences and carryforwards will offset taxable amounts 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 under 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 a source of taxable income for recognition of the tax benefit of deductible temporary differences and operating loss or tax credit carryforwards.

257. 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 consequences 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.

258. 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 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
Net investment in leveraged lease for financial reporting		$102,000

b. The other 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. Absent consideration of the deferred tax credits attributable to the leveraged lease, the weight of available evidence indicates that a valuation allowance is needed for the entire amount of the deferred tax asset related to that $120,000 deductible temporary difference.
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, the enterprise recognizes a $42,000 ($120,000 at 35 percent)deferred tax asset and a related $7,000 valuation allowance. The effect is to recognize a $35,000 net deferred tax benefit for the reduction in deferred tax credits attributable to the leveraged lease. Deferred tax credits attributable to the leveraged lease determined under the requirements of Statement 13 are $39,000. However, the deferred tax liability determined under the requirements of this Statement is only $35,000. The $4,000 difference is not available for offsetting.

Business Combinations

259. This Statement requires recognition of deferred tax liabilities and deferred tax assets (and related valuation allowances, if necessary) 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 or the portion thereof for which amortization is not deductible for tax purposes (paragraphs 262 and 263), unallocated "negative" goodwill, and leveraged leases (paragraphs 256-258). Acquired Opinion 23 differences are accounted for in accordance with the requirements of Opinion 23, as amended by this Statement (paragraphs 31-34).

Nontaxable Business Combinations

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

a. The enacted tax rate is 40 percent for all future years, and amortization of goodwill is not deductible for tax purposes.
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 $20,000 of taxable amounts and $13,000 of deductible amounts that can be offset against each other. Therefore, no valuation allowance is

necessary.

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

Assigned value of the net assets (other than goodwill) acquired	$12,000
Deferred tax liability for $20,000 of taxable temporary differences	(8,000)
Deferred tax asset for $13,000 of deductible temporary differences	5,200
Goodwill	10,800
Purchase price of the acquired enterprise	$20,000

Taxable Business Combinations

261. 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 deferred tax liability and asset are 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. If a valuation allowance is recognized for that deferred tax asset at the acquisition date, recognized benefits for those tax deductions after the acquisition date should be applied (a) first to reduce to zero any goodwill related to that acquisition, (b) second to reduce to zero other noncurrent intangible assets related to that acquisition, and (c) third to reduce income tax expense.

262. Amortization of goodwill is deductible for tax purposes in some tax jurisdictions. In those tax jurisdictions, the reported amount of goodwill and the tax basis of goodwill are each separated into two components as of the combination date for purposes of deferred tax calculations. The first component of each equals the lesser of (a) goodwill for financial reporting or (b) tax-deductible goodwill. The second component of each equals the remainder of each, that is, (1) the remainder, if any, of goodwill for financial reporting or (2) the remainder, if any, of tax-deductible goodwill. Any difference that arises between the book and tax basis of that first component of goodwill in future years is a temporary difference for which a deferred tax liability or asset is recognized based on the requirements of this Statement. No deferred taxes are recognized for the second component of goodwill. If that second component is an excess of tax-deductible goodwill over the reported amount of goodwill, the tax benefit for that excess is recognized when realized on the tax return, and that tax benefit is applied first to reduce to zero the goodwill related to that acquisition, second to reduce to zero other noncurrent intangible assets related to that acquisition, and third to reduce income tax expense.

263. The following example illustrates accounting for the tax consequences of goodwill when amortization of goodwill is deductible for tax purposes. The assumptions are as follows:

a. At the combination date, the reported amount and tax basis of goodwill are $600 and $800, respectively.
b. For tax purposes, amortization of goodwill will result in tax deductions of $400 in each of years 1 and 2. Those deductions result in a current tax benefit in years 1 and 2.
c. For financial reporting, amortization of goodwill is straight-line over years 1-4.
d. For purposes of simplification, the consequences of other temporary differences are ignored for years 1-4.
e. Income before amortization of goodwill and income taxes in each of years 1-4 is $1,000.
f. The tax rate is 40 percent for all years.

Income taxes payable for years 1-4 are:

	Year			
	1	**2**	**3**	**4**
Income before amortization of goodwill	$1,000	$1,000	$1,000	$1,000
Amortization of goodwill	400	400	—	—
Taxable income	$ 600	$ 600	$1,000	$1,000
Income taxes payable (40 percent)	$ 240	$ 240	$ 400	$ 400

At the combination date, goodwill is separated into two components as follows:

	Reported Amount	Tax Basis
First component	$600	$600
Second component	—	200
Total goodwill	$600	$800

A deferred tax liability is recognized at the end of years 1-3 for the excess of the reported amount over the tax basis of the first component of goodwill. A deferred tax asset is not recognized for the second component of goodwill; the tax benefit is allocated to reduce goodwill when realized on the tax returns for years 1 and 2.

The second component of goodwill is deductible $100 per year in years 1 and 2. Those tax deductions provide $40 ($100 at 40 percent) of tax benefits that are realized in years 1 and 2. Allocation of those realized tax benefits to reduce the first component of goodwill produces a deferred tax benefit by reducing the taxable temporary difference related to that component of goodwill. Thus, the total tax benefit allocated to reduce the first component of goodwill in each of years 1 and 2 is the sum of (a) the $40 realized tax benefit allocated to reduce goodwill and (b) the deferred tax benefit from reducing the deferred tax liability related to goodwill. That total tax benefit (TTB) is determined as follows:

TTB = realized tax benefit plus (tax rate times TTB)
TTB = $40 + (.40 x TTB)

TTB = $67

Goodwill for financial reporting for years 1-4 is:

	Year			
	1	2	3	4
Balance at beginning of year	$600	$383	$188	$ 94
Amortization:				
$600 ÷ 4 years	150			
$383 ÷ 3 years		128		
$188 ÷ 2 years			94	94
Total tax benefit allocated to reduce goodwill	67	67	—	—
Balance at end of year	$383	$188	$ 94	$ —

The deferred tax liability for the first component of goodwill and the related amount of deferred tax expense (benefit) for years 1-4 are:

	Year			
	1	2	3	4
Reported amount of goodwill at end of year	$383	$188	$ 94	$ —
Tax basis of goodwill (first component)	300	—	—	—
Taxable temporary difference	$ 83	$188	$ 94	$ —
Deferred tax liability:				
At end of year (40 percent)	$ 33	$ 75	$ 38	$ —
At beginning of year	—	33	75	38
Deferred tax expense (benefit) for the year	$ 33	$ 42	$(37)	$(38)

Income for financial reporting for years 1-4 is:

	Year			
	1	2	3	4
Income before amortization of goodwill and income taxes	$1,000	$1,000	$1,000	$1,000
Amortization of goodwill	150	128	94	94
Pretax income	850	872	906	906
Income tax expense (benefit):				
Current	240	240	400	400
Deferred	33	42	(37)	(38)
Benefit applied to reduce goodwill	67	67	—	—
Income tax expense	340	349	363	362

Net income	$ 510	$ 523	$ 543	$ 544

Carryforwards—Purchase Method

264. Accounting for a business combination should reflect any provisions in the tax law that restrict the future use of either of the combining enterprises' deductible temporary differences or carryforwards to reduce taxable income or taxes payable attributable to the other enterprise subsequent to the business combination. For example, the tax law may limit the use of the acquired enterprise's deductible temporary differences and carryforwards to subsequent taxable income of the acquired enterprise in a consolidated tax return for the combined enterprise. In that circumstance, or if the acquired enterprise will file a separate tax return, the need for a valuation allowance for some portion or all of the acquired enterprise's deferred tax assets for deductible temporary differences and carryforwards is assessed based on the acquired enterprise's *separate* past and expected future results of operations.

265. The following example illustrates (a) recognition of a deferred tax asset and the related valuation allowance for acquired deductible temporary differences at the date of a nontaxable business combination and in subsequent periods when (b) the tax law limits the use of an acquired enterprise's deductible temporary differences and carryforwards to subsequent taxable income of the acquired enterprise in a consolidated tax return. The assumptions are as follows:

a. The enacted tax rate is 40 percent for all future years.
b. The purchase price is $20,000, and the assigned value of the net assets acquired is also $20,000.
c. The tax basis of the net assets acquired is $60,000. The $40,000 ($60,000 - $20,000) of deductible temporary differences at the combination date is primarily attributable to an allowance for loan losses. Provisions in the tax law limit the use of those future tax deductions to subsequent taxable income of the acquired enterprise.
d. The acquired enterprise's actual pretax results for the two preceding years and the expected results for the year of the business combination are as follows:

Year 1	$(15,000)
Year 2	(10,000)
Year 3 to the combination date	(5,000)
Expected results for the remainder of year 3	(5,000)

e. Based on assessments of all evidence available at the date of the business combination in year 3 and at the end of year 3, management concludes that a valuation allowance is needed at both dates for the entire amount of the deferred tax asset related to the acquired deductible temporary differences.

The acquired enterprise's pretax financial income and taxable income for year 3 (after the business combination) and year 4 are as follows:

	Year 3	Year 4
Pretax financial income	$ 15,000	$10,000
Reversals of acquired deductible temporary differences	(15,000)	(10,000)
Taxable income	$ —	$ —

At the end of year 4, the remaining balance of acquired deductible temporary differences is $15,000 ($40,000 - $25,000). The deferred tax asset is $6,000 ($15,000 at 40 percent). Based on an assessment of all available evidence at the end of year 4, management concludes that no valuation allowance is needed for that $6,000 deferred tax asset. Elimination of the $6,000 valuation allowance results in a $6,000 deferred tax benefit that is reported as a reduction of deferred income tax expense because there is no goodwill or other noncurrent intangible assets related to the acquisition. For the same reason, tax benefits realized in years 3 and 4 attributable to reversals of acquired deductible temporary differences are reported as a zero current income tax expense. The consolidated statement of earnings would include the following amounts attributable to the acquired enterprise for year 3 (after the business combination) and year 4:

	Year 3	Year 4
Pretax financial income	$ 15,000	$10,000
Income tax expense (benefit):		
Current	—	—
Deferred	—	(6,000)
Net income	$15,000	$16,000

266. The tax law in some tax jurisdictions may permit the future use of either of the combining enterprises' deductible temporary differences or carryforwards to reduce taxable income or taxes payable attributable to the other enterprise subsequent to the business combination. If the combined enterprise expects to file a consolidated tax return, a deferred tax asset (net of a valuation allowance, if necessary) is recognized for deductible temporary differences or carryforwards of either combining enterprise based on an assessment of the *combined* enterprise's past and expected future results of operations as of the acquisition date. This either reduces goodwill or noncurrent assets (except long-term investments in marketable securities) of the acquired enterprise or creates or increases negative goodwill.

267. The following example illustrates (a) elimination of the need for a valuation allowance for the deferred tax asset for an acquired loss carryforward based on offset against taxable temporary differences of the acquiring enterprise in a nontaxable business combination when (b) the tax law permits use of an acquired enterprise's deductible temporary differences and carryforwards to reduce taxable income or taxes payable attributable to the acquiring enterprise in a consolidated tax return. 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 taxable temporary differences. 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 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.

In assessing the need for a valuation allowance, future taxable income exclusive of reversing temporary differences and carryforwards (paragraph 21(b)) need not be considered because the $16,000 operating loss carryforward will offset (a) the *acquired* enterprise's $7,000 of taxable temporary differences and (b) another $9,000 of the *acquiring* enterprise's taxable temporary differences. The amounts recorded to account for the purchase transaction are as follows:

Assigned value of the identified net assets acquired	$12,000
Deferred tax liability recognized for the acquired company's taxable temporary differences ($7,000 at 40 percent)	(2,800)
Deferred tax asset recognized for the acquired loss carryforward based on offset against the acquired company's taxable temporary differences ($7,000 at 40 percent)	2,800
Deferred tax asset recognized for the acquired loss carryforward based on offset against the acquiring company's taxable temporary differences ($9,000 at 40 percent)	3,600
Goodwill	4,400
Purchase price of the acquired enterprise	$20,000

Subsequent Recognition of Carryforward Benefits—Purchase Method

268. If a valuation allowance is recognized for some portion or all of an acquired enterprise's deferred tax asset for deductible temporary differences and operating loss or tax credit carryforwards at the acquisition date, tax benefits for those items recognized in financial statements for a subsequent year(s) are:

a. First applied to reduce to zero any goodwill related to the acquisition
b. Second applied to reduce to zero other noncurrent intangible assets related to the acquisition
c. Third applied to reduce income tax expense.

Additional amounts of deductible temporary differences and operating loss or tax credit carryforwards 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.

269. 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. Before considering any acquired deferred tax assets, the purchase transaction is summarized as follows:

	Assigned Value	Tax Basis
Net assets acquired	$5,000	$6,000
Excess of purchase price over the fair value of the net assets acquired*	1,500	
Purchase price	$6,500	

*There are no other noncurrent intangible assets.

b. The only difference between pretax financial income and taxable income (amortization of goodwill is disregarded for this example) for years 1-3 is a $1,000 loss for tax purposes in year 1 from disposal of the acquired identified net assets at amounts equal to their $5,000 assigned value on the acquisition date.

	Year 1	Year 2	Year 3
Pretax financial income (loss)	$(3,000)	$ 2,500	$ 1,500
Disposal of acquired identified net assets	(1,000)	—	—
Taxable income (loss) before loss carryforward	(4,000)	2,500	1,500
Loss carryforward (loss carryback not permitted)	4,000	(2,500)	(1,500)
Taxable income after loss carryforward	$ —	$ —	$ —

c. The tax rate is 40 percent for all years.

d. Based on an assessment of all available evidence, management reaches the following conclusions at the acquisition date and at the end of years 1 and 2:
   (1) At the acquisition date, the portion of the $1,000 of deductible temporary differences ($6,000 - $5,000) for which it is more likely than not that a tax benefit will not be realized is $500.
   (2) At the end of year 1, the portion of the $4,000 loss carryforward for which it is more likely than not that a tax benefit will not be realized is $1,750.
   (3) At the end of year 2, it is more likely than not that a tax benefit will be realized for all of the remaining $1,500 of loss carryforward.

At the acquisition date, a $400 ($1,000 at 40 percent) deferred tax asset and a $200 ($500 at 40 percent) valuation allowance are recognized. The $200 net tax benefit reduces the excess of purchase price over the fair value of the net assets acquired from $1,500 to $1,300. Thus, the amount of goodwill recognized at the acquisition date is $1,300.

During year 1, the $1,000 of net deductible temporary differences at the acquisition date reverse and are part of the $4,000 loss carryforward for tax purposes at the end of year 1. An analysis of the components of that $4,000 loss carryforward follows:

	Acquired Deductions	Loss in Year 1	Total
Tax loss carryforward	$1,000	$3,000	$4,000
Portion for which a tax benefit was recognized at the acquisition date	500	—	500
Remainder available for recognition of a tax benefit at the end of year 1	$ 500	$3,000	$3,500

Provisions in the tax law do not distinguish between those two components of the $3,500, and the component that is used first for tax purposes is indeterminable. However, the $500 of acquired deductions for which a tax benefit has not been recognized is one-seventh of the $3,500 total, and the $3,000 loss in year 1 is six-sevenths of the $3,500 total. The tax benefit of that $3,500 is prorated one-seventh to reduce goodwill and six-sevenths to reduce income tax expense when recognized in years 1 and 2.

At the end of year 1, a $1,600 ($4,000 at 40 percent) deferred tax asset and a $700 ($1,750 at 40 percent) valuation allowance are recognized. The tax benefit for the $700 increase in the net deferred tax asset (from $200 at the acquisition date to $900 at the end of year 1) is prorated as follows:

a. One-seventh or $100 to reduce goodwill
b. Six-sevenths or $600 to reduce tax expense.

During year 2, $1,000 ($2,500 at 40 percent) of the deferred tax asset recognized at the end of year 1 is realized. In addition, a tax benefit is recognized for the remaining $1,750 of future tax deductions by eliminating the $700 valuation allowance. That tax benefit is prorated $100 to reduce goodwill and $600 to reduce tax expense. The combined effect of the changes in the deferred tax asset and the related valuation allowance during year 2 is illustrated below:

	Deferred Tax Asset		Tax Expense
	Year 1	**Year 2**	**or (Benefit)**
Deferred tax asset	$1,600	$600	$1,000
Valuation allowance	(700)	—	(700)
	$ 900	$600	300
Portion of $700 tax benefit allocated to reduce goodwill			100
Deferred tax expense for year 2			$ 400

The $600 deferred tax asset at the end of year 2 is realized in year 3, resulting in $600 of deferred tax expense for year 3. The consolidated statement of earnings would include the following amounts attributable to the acquired enterprise:

	Year 1	Year 2	Year 3
Pretax financial income (loss)	$(3,000)	$2,500	$1,500
Net deferred tax expense (benefit)	(600)	400	600
Net income (loss)	$(2,400)	$2,100	$ 900

Carryforwards—Pooling-of-Interests Method

270. 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. However, provisions in the tax law may permit an operating loss carryforward of either of the combining enterprises to offset combined taxable income subsequent to the combination date.

271. If the combined enterprise expects to file consolidated tax returns, a deferred tax asset is recognized for either combining enterprise's operating loss carryforward in a prior period. A

valuation allowance is necessary to the extent it is more likely than not that a tax benefit will not be realized for that loss carryforward through offset of either (a) the other enterprise's deferred tax liability for taxable temporary differences that will reverse subsequent to the combination date or (b) combined taxable income subsequent to the combination date. Determined in that manner, the valuation allowance may be less than the sum of the valuation allowances in the separate financial statements of the combining enterprises prior to the combination date. 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 deductible temporary differences and tax credit carryforwards.

272. 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. The deferred tax consequences of those temporary differences are recognized and measured 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 (that is, by elimination of a valuation allowance) are reported as a reduction of income tax expense.

Intraperiod Tax Allocation

273. If there is only one item other than continuing operations, the portion of income tax expense or benefit for the year that remains after the allocation to continuing operations is allocated to that item. If there are two or more items other than continuing operations, the amount that remains after the allocation to continuing operations is allocated among those other items in proportion to their individual effects on income tax expense or benefit for the year.

274. 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.
b. The enterprise's ordinary loss from continuing operations is $500.
c. The enterprise also has an extraordinary gain of $900 that is a capital gain for tax purposes.
d. The tax rate is 40 percent on ordinary income and 30 percent on capital gains. Income taxes currently payable are $120 ($400 at 30 percent).

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

Total income tax expense	$ 120
Tax benefit allocated to the loss from operations	(150)
Incremental tax expense allocated to the extraordinary gain	$ 270

The effect of the $500 loss from continuing operations was to offset an equal amount of capital gains that otherwise would be taxed at a 30 percent tax rate. Thus, $150 ($500 at 30 percent) of tax benefit is allocated to continuing operations. The $270 incremental effect of the extraordinary gain is the difference between $120 of total tax expense and the $150 tax benefit from continuing operations.

275. The following example illustrates allocation of the tax benefit of a tax credit carryforward that is recognized as a deferred tax asset in the current year. The assumptions are as follows:

a. The enterprise's pretax financial income and taxable income are the same.
b. Pretax financial income for the year comprises $300 from continuing operations and $400 from an extraordinary gain.
c. The tax rate is 40 percent. Taxes payable for the year are zero because $330 of tax credits that arose in the current year more than offset the $280 of tax otherwise payable on $700 of taxable income.
d. A $50 deferred tax asset is recognized for the $50 ($330 - $280) tax credit carryforward. Based on the weight of available evidence, management concludes that no valuation allowance is necessary.

Income tax expense or benefit is allocated between pretax income from continuing operations and the extraordinary gain as follows:

Total income tax benefit		$ (50)
Tax expense (benefit) allocated to income from continuing operations:		
Tax (before tax credits) on $300 of taxable income at 40 percent	$ 120	
Tax credits	(330)	(210)
Tax expense allocated to the extraordinary gain		$160

Absent the extraordinary gain and assuming it was not the deciding factor in reaching a conclusion that a valuation allowance is not needed, the entire tax benefit of the $330 of tax credits would be allocated to continuing operations. The presence of the extraordinary gain does not change that allocation.

276. Income taxes are sometimes allocated directly to shareholders' equity. The following example illustrates the allocation of income taxes for translation adjustments under Statement 52 directly to shareholders' 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 shareholders' 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:

	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 shareholders' equity.

Appendix C: BACKGROUND INFORMATION

277. Opinion 11 was issued in 1967. Over the years that followed, it was the frequent subject of numerous criticisms and concerns that focused both on the complexity of the accounting requirements and on the meaningfulness of the results of applying the requirements.

278. 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.

279. 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.

280. 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.

281. 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.

282. FASB Statement No. 96, *Accounting for Income Taxes,* was issued in December 1987 and the FASB Special Report, *A Guide to Implementation of Statement 96 on Accounting for Income Taxes,* was issued in March 1989. As issued, Statement 96 was effective for financial statements for fiscal years beginning after December 15, 1988, but the effective date was deferred three times, the last of which was to fiscal years beginning after December 15, 1992.

283. After the issuance of Statement 96, the Board received (a) requests for about 20 different limited-scope amendments to that Statement, (b) requests to change the criteria for recognition and measurement of deferred tax assets to anticipate, in certain circumstances, the tax consequences of future income, and (c) requests to reduce the complexity of scheduling the future reversals of temporary differences and considering hypothetical tax-planning strategies. The Board considered the requests to amend Statement 96 at 41 public Board meetings and 3 Implementation Group meetings starting in March 1989.

284. In June 1991, the Board issued an Exposure Draft, *Accounting for Income Taxes.* The Exposure Draft retained the asset and liability approach for financial accounting and reporting for income taxes as in Statement 96, but reduced the complexity of the standard and changed the criteria for recognizing and measuring deferred tax assets. During the comment period for the Exposure Draft, a limited-scope field test of the proposals in the Exposure Draft was completed, and an FASB-prepared seminar that explained and analyzed the proposals was presented by Board and staff members at nine locations throughout the country.

285. The Board received more than 250 comment letters in response to the Exposure Draft. In October 1991, the Board held a 3-day public hearing on the Exposure Draft, and 25 organizations and individuals presented their views. Based on the information received in the comment letters and at the public hearing, the Board reconsidered its proposals in the Exposure

Draft at 12 public Board meetings. The basis for the Board's conclusions, including reasons for changes made to the provisions of the Exposure Draft, is set forth in Appendix A.

Appendix D: AMENDMENTS TO EXISTING PRONOUNCEMENTS

286. 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*
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. 96, *Accounting for Income Taxes*
g. FASB Statement No. 100, *Accounting for Income Taxes—Deferral of the Effective Date of FASB Statement No. 96*
h. FASB Statement No. 103, *Accounting for Income Taxes—Deferral of the Effective Date of FASB Statement No. 96*
i. FASB Statement No. 108, *Accounting for Income Taxes—Deferral of the Effective Date of FASB Statement No. 96*
j. 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"*
k. AICPA Accounting Interpretations of APB Opinion No. 11, *Accounting for Income Taxes*
l. AICPA Unofficial Accounting Interpretations 13, "Subchapter S Corporations," and 16, "EPS for Extraordinary Items," of APB Opinion No. 15, *Earnings per Share*
m. AICPA Accounting Interpretations of APB Opinion No. 23, *Accounting for Income Taxes—Special Areas*
n. FASB Interpretation No. 22, *Applicability of Indefinite Reversal Criteria to Timing Differences*
o. FASB Interpretation No. 25, *Accounting for an Unused Investment Tax Credit*
p. FASB Interpretation No. 29, *Reporting Tax Benefits Realized on Disposition of Investments in Certain Subsidiaries and Other Investees*
q. FASB Interpretation No. 32, *Application of Percentage Limitations in Recognizing Investment Tax Credit*
r. FASB Technical Bulletin No. 81-2, *Accounting for Unused Investment Tax Credits Acquired in a Business Combination Accounted for by the Purchase Method*
s. FASB Technical Bulletin No. 83-1, *Accounting for the Reduction in the Tax Basis of an Asset Caused by the Investment Tax Credit*
t. 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

u. 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*

v. FASB Technical Bulletin No. 86-1, *Accounting for Certain Effects of the Tax Reform Act of 1986.*

287. Other pronouncements issued by the Accounting Principles Board and the Financial Accounting Standards Board refer to Opinion 11, Opinion 24, or Statement 96 or use the term *timing 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. 109, *Accounting for Income Taxes,*[19] or to use the term *temporary differences.*

288. 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. 109, *Accounting for Income Taxes.*

Chapter 10B is deleted.

Paragraph 8 of Chapter 11B is deleted.

b. APB Opinion No. 2, *Accounting for the "Investment Credit."* Paragraph 16 is replaced by the following:

> An investment credit should be reflected in the financial statements to the extent it has been used as an offset against income taxes otherwise currently payable or to the extent its benefit is recognizable under the provisions of FASB Statement No. 109, *Accounting for Income Taxes.* Refer to paragraph 48 of Statement 109 for required

disclosures related to (a) tax credit carryforwards for tax purposes and (b) tax credit carryforwards for which a tax benefit has not been recognized for financial reporting.

c. APB Opinion No. 6, *Status of Accounting Research Bulletins.* Paragraphs 20-23 and footnotes 7 and 8 are deleted.

d. 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.

The last sentence in paragraph 88 is replaced by the following:

> FASB Statement No. 109, *Accounting for Income Taxes,* paragraph 30, 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.

Paragraph 89 is deleted.

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

f. 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.*

Paragraph 10 is replaced by the following:

> *Temporary Difference.* The Board believes it should be presumed that all undistributed earnings of a subsidiary will be transferred to the parent company. Accordingly, the undistributed earnings of a subsidiary included in consolidated income should be accounted for as a temporary difference unless the tax law provides a means by which the investment in a domestic subsidiary can be recovered tax free. However, for reasons described in FASB Statement No. 109, *Accounting for Income Taxes,* a deferred tax liability is not recognized for (a) an excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary that meets the criteria in paragraph 12 of this Opinion and (b) undistributed earnings of a domestic subsidiary that arose in fiscal years beginning on or before December 15, 1992 and that meet the criteria in paragraph 12 of this Opinion. The criteria in paragraph 12 of this Opinion do not apply to undistributed earnings of domestic subsidiaries that arise in fiscal years beginning after December 15, 1992, and a deferred tax liability shall be recognized if the undistributed earnings are a taxable temporary difference.

Footnotes 3 and 4 are deleted.

Paragraph 11 is replaced by the following:

> A deferred tax asset shall be recognized for an excess of the tax basis over the amount for financial reporting of an investment in a subsidiary in accordance with the requirements of paragraph 34 of Statement 109.

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

> If a parent company recognizes 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 affect the investment. A temporary difference for the investor's share of the undistributed 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.* Statement 109 specifies the requirements for financial statement disclosures.

Footnote 6 is deleted.

In the second sentence in paragraph 21, *permanent differences* is replaced with *events that do not have tax consequences.*

The first and second sentences of paragraph 23 are deleted.

The first and second sentences in footnote 9 are deleted.

The third sentence of paragraph 23 is replaced by the following:

> As described in Statement 109, a savings and loan association[9] should not provide deferred taxes on taxable temporary differences related to bad-debt reserves for tax purposes that arose in tax years beginning before December 31, 1987 (the base-year

amount).

Paragraph 24 is replaced by the following:

Disclosure. Statement 109 specifies the requirements for financial statement disclosures.

Footnote 10 is deleted.

g. APB Opinion No. 25, *Accounting for Stock Issued to Employees.* In the second sentence of paragraph 17, (1) *are timing differences* is replaced by *result in temporary differences* and (2) *(APB Opinion No. 11, paragraphs 34 to 37)* is deleted and *in accordance with the provisions of FASB Statement No. 109, Accounting for Income Taxes* is added to the end of that sentence.

h. 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. 109, Accounting for Income Taxes, paragraph 47).*

In the first sentence of paragraph 20, (1) *(in the event carryback of such losses is not possible)* is deleted and (2) *realization is assured beyond any reasonable doubt (paragraph 45 of APB Opinion No. 11)* is replaced by *the tax benefits are expected to be (a) realized during the year or (b) recognizable as a deferred tax asset at the end of the year in accordance with the provisions of Statement 109.* In the second and third sentences of paragraph 20, *assured beyond reasonable doubt* is replaced by *more likely than not.* 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 tax effect of a valuation allowance expected to be necessary for a deferred tax asset at the end of the year for originating deductible temporary differences and carryforwards during the year should be included in the effective tax rate. The effect of a change in the beginning-of-the-year balance of a valuation allowance as a result of a change in judgment about the realizability of the related deferred tax asset in future years shall not be apportioned among interim periods through an adjustment of the effective tax rate but shall be recognized in the interim period in which the change occurs. The effects of new tax legislation shall not be recognized prior to enactment. The tax effect of a change in tax laws 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 laws 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 laws 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.

i. 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. 109, Accounting for Income Taxes, paragraph 37.*

j. AICPA Accounting Interpretations of APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock.* In the fourth sentence of the fifth paragraph of the interpretation section of Interpretation 1, the second half of the sentence beginning with *; for example* is deleted.

k. 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.

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

m. 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.

n. 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.

o. 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. 109, Accounting for Income Taxes,*. In the first sentence of paragraph 62, *the amount of income taxes otherwise payable shall not be taken into account* is replaced by *taxable* *income in future years shall be considered in determining whether it is more likely than not that the tax benefits of deferred tax assets will not be realized.* The second sentence is deleted. In the third sentence, (1) *Accordingly, the* is replaced by *However, the tax benefit of the,* (2) *shall be accounted for as a permanent difference in* is replaced by *shall not be recognized until,* and (3) ; it *shall not be anticipated by recognizing interaction* is deleted.

p. FASB Statement No. 37, *Balance Sheet Classification of Deferred Income Taxes.* Paragraph 4 and the preceding caption and related footnotes are replaced by the following:

> 4. A temporary difference is related to an asset or liability if reduction* of the asset or liability causes the temporary difference to reverse. A deferred tax liability or asset for a temporary difference that is related to an asset or liability shall be classified as current or noncurrent based on the classification of the related asset or liability. A deferred tax liability or asset for a temporary difference not related to an asset or liability because (a) there is no associated asset or liability or (b) reduction of an associated asset or liability will not cause the temporary difference to reverse shall be classified based on the expected reversal date of the specific temporary difference. Such classification disregards any additional temporary differences that may arise and is based on the criteria used for classifying other assets and liabilities.
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> ---
>
> *As used here, the term *reduction* includes amortization, sale, or other realization of an asset and amortization, payment, or other satisfaction of a liability.

Paragraphs 17 and 18, the preceding caption, and footnote 1 are deleted.

In paragraph 19, the first and second references to *deferred income taxes* are replaced by *The deferred tax liability or asset and deferred tax liability or asset*, respectively.

In the illustration at the end of paragraph 20, *Accumulated Deferred Income Tax Debits Related to Accounting Change . . . $2,357,500* is replaced by *Deferred Tax Asset (40 percent is the enacted tax rate—no valuation allowance deemed necessary) . . . $2,050,000.*

In the first sentence of paragraph 21, *deferred income taxes do* is replaced by *deferred tax asset does.* In the second and third sentences, *deferred income tax debits* is replaced by *deferred tax asset.* At the end of the third sentence, *($261,944)* is replaced by *($227,778).*

In the second sentence of paragraph 22, *deferred income tax credits* is replaced by *temporary differences.* In the fourth and fifth sentences, *deferred income tax credits* is replaced by *deferred tax liability* and *deferred tax liabilities,* respectively.

In paragraphs 23-25, references to *deferred income tax credits* are changed to *deferred tax liability.* In the first sentence of paragraph 24, *do* is replaced by *does.*

Paragraphs 26-29, the captions preceding paragraphs 26 and 28, and footnotes 2 and 3 are deleted.

q. FASB Statement No. 38, *Accounting for Preacquisition Contingencies of Purchased Enterprises.* In the fourth sentence of paragraph 2*, benefits of preacquisition net operating loss carryforwards* is replaced by *effects of (a) temporary differences and carryforwards of the acquired enterprise that exist at the acquisition date and (b) income tax uncertainties related to the acquisition (for example, an uncertainty related to the tax basis of an acquired asset that will ultimately be agreed to by the taxing authority).* The last sentence of paragraph 2 is deleted. In the first sentence of paragraph 5, *tax benefit of a loss carryforward*[2] is replaced by *income tax effects referred to in paragraph 2 of this Statement.*[2]

The first sentence of footnote 2 is replaced by the following:

> Those potential income tax effects shall be accounted for in accordance with the provisions of FASB Statement No. 109, *Accounting for Income Taxes.*

The second and third sentences of footnote 2 are deleted.

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

s. FASB Statement No. 57, *Related Party Disclosures.* The following item is added to the end of paragraph 2:

> (e) The information required by paragraph 49 of FASB Statement No. 109, *Accounting for Income Taxes.*

t. 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. 109, *Accounting for Income Taxes.*

Paragraphs 56-58 and footnote 8 are deleted.

The first and second sentences of paragraph 59 are deleted.

The third sentence of paragraph 59 is replaced by the following:

> As described in Statement 109, a life insurance enterprise should not provide deferred

taxes on taxable temporary differences related to "policyholders' surplus" that arose in fiscal years beginning on or before December 15, 1992.

Paragraph 60(i) is replaced by the following:

Statement 109 specifies the requirements for financial statement disclosures about income taxes.

Paragraph 60 (j) is deleted.

u. 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* is deleted and *tax deductions* is inserted before *tax credits and allowances.* In paragraphs 40 and 41 of Appendix A, *permanent differences* is replaced by *tax deductions.*

v. 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. 109, *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.

w. 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 prices.* are replaced by *Deferred tax assets*[a] and *Deferred tax liabilities*[a]*,* respectively.

x. 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. 109, *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.

y. FASB Interpretation No. 18, *Accounting for Income Taxes in Interim Periods.* The following sentence is inserted after the second sentence in paragraph 8:

It also includes the effect of any valuation allowance expected to be necessary at the end of the year for deferred tax assets related to originating deductible temporary differences and carryforwards during the year.

Paragraph 14 is replaced by the following:

Recognition of the tax benefit of a loss. Paragraph 20 of Opinion 28 (as amended by Statement 109) provides that a tax benefit is recognized for a loss that arises early in a fiscal year if the tax benefits are expected to be (a) realized during the year or (b) recognizable as a deferred tax asset at the end of the year in accordance with the provisions of Statement 109. Paragraph 17(e) of Statement 109 requires that a valuation allowance be recognized if it is more likely than not that the tax benefit of some portion or all of a deferred tax asset will not be realized. 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.

Footnotes 9-11 are deleted.

Paragraph 15 is replaced by the following:

Reversal of taxable temporary differences. A deferred tax liability related to existing taxable temporary differences is a source of evidence for recognition of a tax benefit when (a) an enterprise anticipates an "ordinary" loss for the fiscal year or has a year-to-date "ordinary" loss in excess of the anticipated "ordinary" loss for the fiscal year, (b) the tax benefit of that loss is not expected to be realized during the year, and (c) recognition of a deferred tax asset for that loss at the end of the fiscal year is expected to depend on taxable income from the reversal of existing taxable temporary differences (that is, a higher valuation allowance [paragraph 17(e) of Statement 109] would be necessary absent the existing taxable temporary differences). If the tax benefit relates to an estimated "ordinary" loss for the fiscal year, it shall be considered in determining the estimated annual effective tax rate described in paragraph 8 above. If the tax benefit relates to a year-to-date "ordinary" loss, it shall be considered in computing the maximum tax benefit that shall be recognized for the year-to-date.

Footnotes 12-14 are deleted.

In paragraph 16, the following sentence is inserted after the first sentence:

Paragraph 20 of Opinion 28 (as amended) excludes the effects of changes in judgment about beginning-of-year valuation allowances and effects of changes in tax laws or rates from the estimated annual effective tax rate calculation.

The reference to *Paragraph 52 of APB Opinion No. 11*[18] in the third sentence is replaced by *Paragraphs 35-38 of Statement 109.* The fourth sentence and footnote 18 are deleted.

In the first sentence of paragraph 18, *shall not be recognized until it is realized or realization is assured beyond any reasonable doubt* is replaced by *shall be recognized when the tax benefit of the loss is expected to be (a) realized during the year or (b) recognizable as a deferred tax asset at the end of the year in accordance with the provisions of Statement 109.* The second sentence of paragraph 18 is deleted.

The third sentence of paragraph 18 is replaced by the following:

> Realization would appear to be more likely than not if future taxable income from (ordinary) income during the current year is expected based on an established seasonal pattern of loss in early interim periods offset by income in later interim periods.[19]

In footnote 19, *paragraph 47 of APB Opinion No. 11 (see Appendix A, paragraph 31) and* is deleted.

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

> If recognition of a deferred tax asset at the end of the fiscal year for all or a portion of the tax benefit of the loss depends on taxable income from the reversal of existing taxable temporary differences, refer to paragraph 15 above.

In the fifth sentence, *assured beyond any reasonable doubt* is replaced by *more likely than not* in all three places.

Paragraph 20 is replaced by the following:

> Paragraph 37 of Statement 109 requires that the manner of reporting the tax benefit of an operating loss carryforward recognized in a subsequent year generally is determined by the source of the income in that year and not by (a) the source of the operating loss carryforward or (b) the source of expected future income that will result in realization of a deferred tax asset for the operating loss carryforward. The tax benefit is allocated first to reduce tax expense from continuing operations to zero with any excess allocated to the other source(s) of income that provides the means of realization, for example, 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 the tax benefit is expected to be realized as a result of "ordinary" income in the current year. 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 or, in the case of a change in judgment about realizability of the

related deferred tax asset in future years, the effect shall be recognized in the interim period in which the change occurs.

Footnotes 21-23 are deleted.

Paragraph 23 is replaced by the following:

> Paragraph 20 of Opinion 28 (as amended by Statement 109) sets forth the requirements for recognition of the tax effects of a change in tax laws or rates. That paragraph refers to effective dates prescribed in the statutes. Paragraph 24 below describes the determination of when new legislation becomes effective.

Footnote 25 is deleted.

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 second sentence of the last subparagraph of paragraph 43, *assured of future realization beyond any reasonable doubt at year-end* is replaced by *recognizable at the end of the current year in accordance with the provisions of Statement 109.* The third and fourth sentences of that subparagraph are deleted.

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

> Established seasonal patterns provide evidence that realization in the current year of the tax benefit of the year-to-date loss and of anticipated tax credits is more likely than not.

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

> There is no established seasonal pattern and it is more likely than not that the tax benefit of the year-to-date loss and the anticipated tax credits will not be realized in the current or future years.

In footnote *, *realization of* is deleted and *assured beyond any reasonable doubt* is replaced by *expected to be (a) realized during the current year or (b) recognizable as a deferred tax asset at the end of the current year in accordance with the provisions of Statement 109.*

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 109.* In the last sentence of paragraph 49, *assured beyond any reasonable doubt* is replaced by *expected to be (a) realized during the current year or (b) recognizable as a* *deferred tax asset at the end of the current year in accordance with the provisions of Statement 109.*

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 the 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) *nor* is added directly before, and *recognizable pursuant to Statement 109* is added directly after, *anticipated tax credits were.*

In the third sentence of paragraphs 53 and 54, (1) *Realization of* is replaced by *It is more likely than not that,* (2) *is assured beyond any reasonable doubt only to the extent* is replaced by *in excess,* and (3) *will not be realized* is added to the end of each sentence.

In the second sentence of paragraph 55, *are not assured beyond any reasonable doubt* is replaced by *exclusive of reversing temporary differences are unlikely.* In the third and fourth sentences of paragraph 55, (1) *credits* is replaced by *liabilities* and (2) *timing differences* is replaced by *existing net taxable temporary differences.* In the fifth sentence of paragraph 55, *(refer to paragraph 15 of this Interpretation)* is added after *to be used.* In the computation at the end of paragraph 55, (1) *credits* is replaced by *liabilities* and (2) *amortized* is replaced by *settled.*

The third sentence of paragraph 58 is replaced by the following:

> The loss cannot be carried back, and available evidence indicates that a valuation allowance is needed for all of the deferred tax asset.

In the fourth sentence of paragraph 58, (1) *realization of* is deleted and (2) *not assured beyond any reasonable doubt except* is replaced by *recognized only.* Paragraphs 59-61 and the heading *Using a Prior Year Operating Loss Carryforward* are deleted.

In the fifth sentence of paragraph 66, (1) *Realization of* is replaced by *It is expected that* and (2) *is not assured beyond any reasonable doubt* is replaced by *will not be recognizable as a deferred tax asset at the end of the current year pursuant to Statement 109.*

Paragraph 70 and all references thereto are deleted.

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

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

bb. 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 47 of FASB Statement No. 109, Accounting for Income Taxes.*

cc. 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 47 of FASB Statement No. 109, *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 income 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 109.

dd. FASB Technical Bulletin No. 87-2, *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. In Appendix B, in the second sentence of paragraph 36, the reference to *Opinion 11* should remain. In paragraph 40, the fifth, sixth, and seventh sentences should be deleted.

Appendix E: GLOSSARY

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

Carrybacks

Deductions or credits that cannot be utilized on the tax return during a year that may be carried back to reduce taxable income or taxes payable in a prior year. An operating loss carryback is an excess of tax deductions over gross income in a year; a tax credit carryback is the amount by which tax credits available for utilization exceed statutory limitations. Different tax jurisdictions have different rules about whether excess deductions or credits may be carried back and the length of the carryback period.

Carryforwards

Deductions or credits that cannot be utilized on the tax return during a year that may be carried forward to reduce taxable income or taxes payable in a future year. An operating loss carryforward is an excess of tax deductions over gross income in a year; a tax credit carryforward is the amount by which tax credits available for utilization exceed statutory limitations. Different tax jurisdictions have different rules about whether excess deductions or credits may be carried forward and the length of the carryforward period. The terms *carryforward, operating loss carryforward,* and *tax credit carryforward* refer to the amounts of those items, if any, reported in the tax return for the current year.

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 enacted tax law to the taxable income or excess of deductions over revenues for that year.

Deductible temporary difference

Temporary differences that result in deductible amounts in future years when the related asset or liability is recovered or settled, respectively. Also refer to **Temporary difference.**

Deferred tax asset

The deferred tax consequences attributable to deductible temporary differences and carryforwards. A deferred tax asset is measured using the applicable enacted tax rate and provisions of the enacted tax law. A deferred tax asset is reduced by a valuation allowance if, based on the weight of evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized.

Deferred tax consequences

The future effects on income taxes as measured by the applicable enacted tax rate and provisions of the enacted tax law resulting from temporary differences and carryforwards at the end of the current year.

Deferred tax expense or benefit

The change during the year in an enterprise's deferred tax liabilities and assets. For deferred tax liabilities and assets acquired in a purchase business combination during the year, it is the change since the combination date. Income tax expense or benefit for the year is allocated among continuing operations, discontinued operations, extraordinary items, and items charged or credited directly to shareholders' equity.

Deferred tax liability

The deferred tax consequences attributable to taxable temporary differences. A deferred tax liability is measured using the applicable enacted tax rate and provisions of the enacted tax law.

Event

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

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

Under present practice, gains and losses included in comprehensive income but excluded from net income include 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.

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.

Taxable income

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

Taxable temporary difference

Temporary differences that result in taxable amounts in future years when the related asset or liability is recovered or settled, respectively. Also refer to **Temporary difference.**

Tax consequences

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

Tax-planning strategy

An action (including elections for tax purposes) that meets certain criteria (paragraph 22) and that would be implemented to realize a tax benefit for an operating loss or tax credit carryforward before it expires. Tax-planning strategies are considered when assessing the need for and amount of a valuation allowance for deferred tax assets.

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 11 cites 8 examples of temporary differences. Some temporary differences cannot be identified with a particular asset or liability for financial reporting (paragraph 15), 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 years based on provisions of 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.

Valuation allowance

The portion of a deferred tax asset for which it is more likely than not that a tax benefit will not be realized.

Footnotes

FAS109, Footnote 1--Words that appear in the glossary are set in **boldface type** the first time they appear.

FAS109, Footnote 2--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 the activities of a not-for-profit organization that are subject to income taxes.

FAS109, Footnote 3--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.

FAS109, Footnote 4--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.

FAS109, Footnote 5--The Tax Equity and Fiscal Responsibility Act of 1982 provided 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.

FAS109, Footnote 6--Refer to paragraph 9. A deferred tax liability shall be recognized for the temporary differences addressed by Opinion 23 in accordance with the requirements of this Statement (paragraphs 31-34) and that Opinion, as amended.

FAS109, Footnote 7--Paragraph 230 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.

FAS109, Footnote 8--Acquired Opinion 23 differences are accounted for in accordance with the requirements of Opinion 23, as amended by this Statement.

FAS109, Footnote 9--A last-in, first-out (LIFO) pattern determines whether reversals pertain to differences that arose in fiscal years beginning on or before December 15, 1992.

FAS109, Footnote 10--In that situation, the sum of the amounts allocated to individual members of the group may not equal the consolidated amount. That may also be the result when there are intercompany transactions between members of the group. The criteria are satisfied, nevertheless, after giving effect to the type of adjustments (including eliminations) normally present in preparing consolidated financial statements.

FAS109, Appendix A, Footnote 11--Refer to paragraph 9.

FAS109, Appendix A, Footnote 12--Under Statement 52, another foreign currency could be the functional currency when the local currency is not the functional currency for a foreign entity. The requirements of this Statement and the basis for the Board's conclusions are the same for those situations as for when the U.S. dollar is the functional currency for a foreign entity.

FAS109, Appendix A, Footnote 13--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.

FAS109, Appendix B, Footnote 14--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 about 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 deferred tax liabilities and assets.

FAS109, Appendix B, Footnote 15--Refer to paragraph 9.

FAS109, Appendix B, Footnote 16--The terms *forecast* and *projection* refer to any process by which available evidence is accumulated and evaluated for purposes of estimating whether future taxable income will be sufficient to realize a deferred tax asset. Judgment is necessary to determine how detailed or formalized that evaluation process should be. Furthermore, information about expected future taxable income is necessary only to the extent positive evidence available from other sources (refer to paragraph 21) is not sufficient to support a conclusion that a valuation allowance is not needed. This Statement does not require either a *financial forecast* or a *financial projection* within the meaning of those terms in the Statements on Standards for Accountants' Services on Prospective Financial Information issued by the Auditing Standards Board of the American Institute of Certified Public Accountants.

FAS109, Appendix B, Footnote 17--This requirement pertains to all ITC carryforwards regardless of whether the flow-through or deferral method is used to account for ITC.

FAS109, Appendix B, Footnote 18--In this example, if AFUDC had consisted entirely of a net-of-tax debt component in the amount of $26,000, the related accounts and their balances at the end of year 1 would be construction in progress in the amount of $439,394 and a deferred tax liability in the amount of $13,394.

FAS109, Appendix D, Footnote 19--Except as in paragraph 288(dd).