# ACCOUNTING TREATMENT OF INVESTMENT TAX CREDIT ON CORPORATE FINANCIAL STATEMENTS


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The accounting treatment of the investment credit on corporate financial statements has been a subject for discussion among accountants for some time.[1/] It is a subject which has developed sharp differences of opinion in professional accounting, business and government circles.

The discussion first arose in 1961 when the investment credit was proposed as a tax reduction incentive for new property additions, but since the legislation was not passed in that year the problem was not resolved at that time. When the plan was included in the Revenue Act of 1962 which became law on October 16, 1962, and was made applicable to that year, it became apparent that guidance would soon be needed regarding the accounting to be followed.

On November 1, 1962, the Accounting Principles Board of the American Institute of Certified Public Accountants issued for comment an exposure draft of a proposed statement on the subject and in December issued its Opinion No. 2 on <u>Accounting for the "Investment Credit"</u> which in essence stated that the investment credit should be reflected in income over the productive life of the acquired facilities rather than in the year of their acquisition. This opinion had been approved by 14 members of the 20-member board. Five of the six dissenting members believed that the pronouncement should also recognize the propriety of the 48-52% method of accounting for the investment credit, and the sixth member, while preferring the method set forth in the opinion, believed that, with

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adequate disclosure, the 48-52% method should be considered acceptable. A third alternative plan, the 100% flow-through to income, was recognized for use in regulated industries in appropriate circumstances.

In recognition of the substantial diversity of opinion that existed in this matter, the Securities and Exchange Commission issued Accounting Series Release No. 96 on January 10. This release states that the Commission will accept, with certain limitations, the method endorsed by the Accounting Principles Board or the 48-52% method or, in the case of regulated industries, the 100% flow-through method when authorized or required by regulatory authorities. The release also specifies that the balance sheet credit should not be made directly to the asset account, that the current provision for income taxes should not be stated in excess of the amount payable for the year, and includes other comments regarding adequate disclosure, details of certain other accounts, and acceptance of appropriately qualified certificates in cases where an alternative accounting treatment acceptable to the Commission is followed by the registrant.

Much excitement has been created over the differences of opinion on the Accounting Principles Board and between our release and what is often referred to as the first opinion of the Board. But this was in fact the second opinion. The first opinion dealt with "New Depreciation Guidelines and Rules," which did not stir up a ripple of comment despite five assents with qualifications.

So that you would have something specific before you, I suggested that your attention be called to our Accounting Series Releases No. 85

and 86, as well as 96 to which I have referred. Release 85 resulted from a need to state our views on the classification of the balance sheet credit arising when deferred tax accounting is followed. The conclusion was that this item should not be reported in the shareholders' equity section of the balance sheet. Release 86 was published to reassure some registrants that the general discussion of deferred tax accounting in Release 85 was not intended to extend its application beyond that of generally accepted practice.

The existence of these releases may account for the absence of any disturbance when the Accounting Principles Board Opinion No. 1 announced that "where Guideline lives shorter than the lives used for financial accounting purposes are adopted for income-tax purposes, and there is an excess of tax-return depreciation over book depreciation, provision for deferred income taxes should be made with respect to the part of the excess that is attributable to the adoption of Guideline lives, in the same manner as provided by Accounting Research Bulletin No. 44 (Revised), 'Declining-balance Depreciation,' for liberalized depreciation under the Internal Revenue Code of 1954." The opinion should be studied for certain qualifying details.

Except for the Commission's acceptance of the 48-52% method which recognizes that companies subject to a 52% tax rate have a deferred tax problem to recognize because of the reduction of the tax base by the investment credit, the Commission's views and the majority opinion of the Board are reconcilable.

Our release expresses the Commission's opinion that the full cost of the property should be reported and that the credit should not be made directly to the asset account. On this point we have been both commended and condemned for our views. Appropriate reporting may be accomplished by treating the credit as an addition to the reserve for depreciation or amortization of property or to a deferred credit account. The charge for income tax expense in the income statement should not be stated in excess of the amount payable for the year (another expressly-stated opinion of the Commission). The additional debit item in the income statement should be consistent with the balance sheet treatment, i.e., as additional depreciation or as a separate item identified as a charge equivalent to the tax benefit arising from the investment credit. We had to cope with a similar problem on inconsistent accounting with respect to deferred taxes resulting from accelerated depreciation.

When either the full investment credit or the net tax benefit is deferred the 52% element may be treated in the customary deferred tax manner. When deferred tax accounting is followed with respect to other differences between tax returns and the financial statements, the deferred tax items may be reported in one amount with footnote disclosure of the policy being followed. Because of the continuing differences of opinion on this subject we believe that disclosure of the periodic and cumulative amounts of deferred taxes, unless clearly insignificant, should be made in the financial statements or in notes to which reference is made from the statements. On this point see footnote 7 in Accounting Series Release 85.

Our release and the Board opinion are in agreement that 100% flow-through is unacceptable except for regulated businesses.

Before issuing Release 96 the Commission considered a substantial amount of written material in support of the alternative solutions and listened to informal oral arguments on the subject as well as on the question whether the Accounting Principles Board majority opinion should be supported as the only solution or some exception should be permitted. The problem presented here, as it is in so many situations, was to reach agreement on the facts. As the dissents to the Board's opinion indicate, the difference of opinion ranged from a belief that "the pertinent factors preponderantly support the view that the investment credit is in substance a reduction in income taxes" to the belief of the majority of the Board that the weight of pertinent factors supports their conclusion that the credit is a "reduction in or offset against a cost otherwise chargeable in a greater amount to future accounting periods."

The reduction in taxes advocates (the minority of the Board) recognized that when, as here, a reduction in taxes currently deprives future periods of a portion of the relief, deferred tax accounting is required. The Commission recognized the validity of this view and accepted it as one solution to the problem. At the same time the Commission recognized that an accountant who certifies to financial statements reflecting a method of reporting contrary to the majority opinion is assuming the burden of justifying departure from the recommended procedure and must consider whether he must qualify his certificate with respect to the fairness of presentation of the financial statements or to a departure from generally accepted accounting principles and practices. Such an exception is taken when the amount involved is material. Only one certificate qualified on this point has come to my attention.

The variety of accounting methods has been so great that our staff has insisted in all filings where disclosure is lacking that information be furnished to us as to the accounting followed and that full disclosure be made in the manner I have described in the statements and notes in those situations where the amounts are deemed to be material. Some of the early confusion arose from efforts of some registrants and accountants to develop accounting entries to cover every conceivable situation that could arise under the tax laws. These included memorandum entries needed for internal control purposes but not for public reporting. With more experience I hope the variety now seen will be reduced.

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