Disclosing the Deferred Tax Effects of the New Tax Law [2]: Certified Public Accountant
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ACCOUNTING

Disclosing the Deferred Tax Effects of the New Tax Law

Introduction

While the economic consequences of the new tax law are clearly a concern to most tax-paying organizations, an additional issue arises in connection with its financial-reporting implications. For years, corporations have been building tremendous tax "liabilities" on the balance sheet under the heading "deferred taxes." The effect of permitting different accounting methods for financial reporting and tax purposes has generally been to accelerate expense or postpone revenue recognition on the tax return. As a result, corporations have accrued deferred tax credits for the annual difference between the tax computed on the income statement and the amount actually paid at the tax rate in effect. But now, with the change in the tax rates, the existing timing differences will reverse at rates lower than those in effect when the differences originated. Consequently, given the general perception that the deferred tax credit on the balance sheet is a liability, it will now, in many cases, be materially overstated, causing shareholders' equity to be correspondingly understated. Our purpose in this article is to examine alternative methods of disclosing such overstatements in 1986 financials, now that the FASB's work on accounting for income tax is nearing completion.[1]

Existing Rules

The predominant focus of APB No. 11 is the income statement. It emphasizes the matching principle by requiring comprehensive interperiod tax allocation (recognition of deferred taxes) for all differences in timing between book and taxable income. APB No. 11 permits three alternative methods of measuring deferred taxes:

- specific identification,
- gross change method,
- net change method.

In view of the reduced tax rates under the new tax law, although the specific identification and gross change methods will write off the rate differentials, it is accomplished over considerable lengths of time. The net change method however will *never* eliminate the difference. In short, current GAAP makes no provision for immediate adjustments of deferred taxes when rates change.

Proposed Rules

The perspective on accounting for deferred taxes is moving from the income statement to the balance sheet. The Exposure Draft (ED), *Accounting for Income Taxes*, proposes that deferred taxes on existing timing differences be recomputed each year according to the rules and rates then in effect. Any changes in the balance sheet deferred tax accounts are to be reported as a separate component of the current period income tax expense.

Given the nature of the deferred tax position of most corporations (i.e., a deferred liability), the proposed accounting will have a positive impact on financial position. Discussions in the financial press suggest that many corporations will enjoy a significant boost in net income in the year when the exposure draft is effective. However, it appears unlikely that the FASB proposal will affect 1986 reporting. Moreover, FASB Technical Bulletin No. 86–1 specifically prohibits recognition of adjustments for lower tax rates until the ED becomes a statement. For many firms, this combination of factors produces a reporting dilemma as of the end of 1986.

Problem of Reporting

The obvious problem is that although firms may desire to report the higher net income in 1986 when the tax rates were actually changed, GAAP is not in place to permit such recognition. The question becomes "What do firms do as of December 31, 1986, under these circumstances?" To wait until 1987 for final promulgation of the ED is to forego a considerable positive bottom line effect in 1986. Recognizing the change in 1986 would violate current GAAP and invite difficulties with the audit opinion.

Possible Solutions

Corporations caught in this dilemma face four possibilities:

- Do nothing.
- Hope that the FASB moves quickly and releases the final statement before the corporation issues its annual report.
- Prepare the 1986 statements in accordance with current GAAP but provide supplementary disclosure of what

[1] By release date of this article it may be already complete.

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would have been the effects of pulling the change into income in the current period.

- Report the change in the current period despite the nonconformity with GAAP and accept either a qualified or even an adverse audit opinion.

The first alternative is unacceptable for two reasons. First, since the tax rate changes became known in 1986, the amount by which the deferred tax liability is overstated is determinable. Failure to disclose the nature and amount of the overstatement is inconsistent with the financial reporting objective of providing relevant and reliable information to users. Second, in light of the new principles proposed in the ED, to do nothing would ignore what appears to be a shift in theoretical orientation on the deferred tax issue.

Under the second alternative, the release of a final statement by the FASB before the corporation issues its annual report would be analogous to a post-balance sheet event. Under current GAAP, an event which has its origins in the current period but which does not become known until after the close of the fiscal year (but before the issuance of the annual report) must, if significant, be reflected in the current-period financial statements. The tax act was definitely a 1986 event, with 1986 consequences, and could, therefore, be legitimately included in the current year if the ED were finalized quickly. Moreover, since FASB pronouncements often encourage firms to adopt new principles earlier than is required by the statement, the timely promulgation of the new rules could result in justifiable retroactive application to 1986 on either these grounds or those cited above.

The third alternative, supplemental disclosure either in the footnotes or in management's discussion and analysis (MD&A), would be a conservative compromise that permits presenting the desired information as a gain contingency in the current period without violating current GAAP. But readers of the financial statements either may not see the disclosures or may not understand their impact. Supplemental disclosure, therefore, while complete and descriptive, may not achieve the desired level of effectiveness.

The fourth alternative is perhaps the most attractive, from a reporting entity's point of view, but may be the least desirable: namely, to adopt the ED in the current period before it has been formally accepted, violate current GAAP and invite modification of the standard "clean opinion." Were a company to report the deferred tax reduction in 1986 income that action would neither be in conformity with GAAP nor would the accounting be consistent with that of the previous year. The question becomes, then, "to what degree will an audit exception be taken?"

If the auditor does not consider the departure from GAAP to be pervasive, he would insert a middle paragraph in his report describing the non-compliance, and its effect on the financial statements, and issue a qualified "except for" opinion. If, however, the effects are considered pervasive, he would have to issue an adverse opinion, stating that the financial statements are not fairly presented.

Conclusion

Each alternative has certain advantages and disadvantages. We believe that it is important for users of an entity's financial statements to be alerted, in a timely manner, to the tax law change and its accompanying impact on those statements. Because of this and because certain of the disadvantages cited above are unacceptable reporting outcomes, we encourage the use of supplemental disclosure. Indeed the SEC has already voted to issue guidelines requiring similar disclosures for 1986 financial statements covering entities under its jurisdiction.

In all fairness, however, we feel that it would be inappropriate to disclose the positive effects of reductions in the deferred tax account(s) without considering the potential effects, favorable or unfavorable, of other elements of the ED. We suggest, therefore, that if supplementary disclosure is used, it should give full recognition to all the accounting changes proposed in the ED, realizing that the final statement could differ from the ED.

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Accounting for Non-Pension, Post-Employment Benefits

Introduction

Over the past decade, there has been an increase in the nonpension types of post-employment benefits offered to employees. Historically, medical, dental and life insurance benefits were only provided for active employees. Gradually over time, these types of benefits were extended to retiring employees and their dependents. Initially, the cost of these benefits were not material to a company. However, as the retiree population grew and medical inflation soared, the associated costs increased dramatically.

In many companies, management failed to focus on the ultimate cost of its non-pension, post-employment obligations. The full cost impact often was hidden, since virtually all companies recognized them on a cash basis. Unlike GAAP, that years ago required companies to accrue pension costs, the accrual approach was ignored for matching non-pension, post-employment benefit expense with current revenue.

Shortcomings of Current Practice

Accounting for non-pension, post-employment benefits on a pay-as-you-go basis, using historical industry practice, leaves management and share-