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AN EXPLANATION OF FASB #96

by

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Senior Thesis

Presidential Scholars Board

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DEDICATION

First, I dedicate this paper to Professor LaVerne Andreessen whose enthusiasm in the classroom inspired my study of accounting. Second, to Dr. Darrel W. Davis whose inflexible standards of excellence, unending patience and understanding, and above all his friendship, made this possible. Finally, to my parents, who instilled in me the desire to learn, the determination to succeed, and the freedom to try.

Deferred taxes exist because Generally Accepted Accounting Principles (GAAP) and tax laws differ. These differing rules require companies to prepare two sets of financial statements, one for their stockholders and other financial statement users (GAAP) and one for the Internal Revenue Service. The two sets of financial records result in a net income for GAAP purposes which differs from the income on which the tax is computed. Since 1967, the reconciliation of these two sets of books was prescribed by Accounting Principle Board Opinion (APB) #11. The reconciliation is necessary because expenses are usually recognized faster and revenue recognized later under tax law than under GAAP. The amount which reconciles the difference between the reported tax expense and the taxes actually paid to the federal government is called deferred taxes. The taxes are said to be deferred since the events which cause the initial difference in tax and book income should eventually reverse and the taxes will have to be paid. In this way the taxes associated with GAAP income are not eliminated, but are deferred or postponed to later years.

EXAMPLE A:

Entry to Record Taxes in 1986

Tax Expense (Based on GAAP)	200	
Deferred Tax Liability		75
Taxes Payable (Based on IRS Rules)		125

Entry to Record Taxes in 1995

Tax Expense (Based on GAAP)	300	
Deferred Tax Liability	75	
Taxes Payable (Based on IRS Rules)		375

APB #11 required the calculation of deferred taxes by using the deferral method. The deferral method emphasized the matching principle (i.e. revenue recognized when earned and expenses accrued when incurred under GAAP rules.) The focus of APB #11 was on the current year's difference between tax and book income and on events reflected in the current year's income statement. Under the deferred method the deferred tax is recorded at the tax rate in effect the year the difference originates. If the tax rate changed, the increase or decrease in taxes payable was recognized in the year of the reversal (Dickert, 1986, p.8). This meant no adjustment was made to the deferred tax balance whole the year the tax rate changed.

After almost twenty years of computing deferred taxes under APB #11, the Financial Accounting Standards Board (FASB) issued standard #96 in December of 1987. The issuance came after nearly six years of deliberation and numerous drafts. The FASB issued the statement with hopes of correcting the shortcomings of APB #11 which the accounting profession acknowledged (Meonske & Sprohge, 1988, p.16). APB #11 was criticized for its complexity. This complexity led

to little uniformity in the statement's application. It was argued that the cost of complying with APB #11 outweighed the benefits derived (Volken & Rue, 1985, p 32.) The account was also criticized for being meaningless and not meeting the definition of a liability. That definition is "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. (Kieso & Weygandt, 1983)."

Most of the criticism of APB #11 centered around the meaninglessness of the deferred tax account and its failure to meet the theoretical definition of a liability. One reason for the meaninglessness of the account is the fact that it grew at a rate faster then other balance sheet accounts. Since the numbers in the deferred tax account grow out of other events recorded on the balance sheet, the account should grow at the same rate as other balance sheet accounts. However, an Ernst and Whinney study showed that deferred taxes accounted for only 9% of stockholder's equity in 1970, but had risen to 26% by 1979 and has grown even faster with the advent of ACRS and MACRS, accelerated methods of depreciation for tax purposes, in the 1980's (Weiss, 1986, p. 82). This means that deferred taxes have grown 2 1/2 times as fast as stockholders' equity in the same period.

Another study of 1571 companies showed 54% had increasing deferred tax accounts, while only 3% had decreasing deferred tax account balances (Volken & Rue, 1985, p. 35). A study of the top 250 Fortune Firms in 1980 showed deferred tax balances ranging from 20%-39% of stockholder's equity (Beresford, Best & Weber, 1984, p. 73).

The major reason for the growing deferred tax account is the indefinite postponement of tax payments. Differences which will theoretically reverse, causing tax income to exceed book income, are offset by new and larger tax deferrals. One way this postponement can be accomplished is through the continual expansion or replacement of company assets before the temporary differences reverse (Gleckman, 1988, p. 22). By continually buying new and usually more expensive equipment, a company can take a larger amount of depreciation on the new equipment then the amount reversing on the old equipment.

EXAMPLE B:
A company buys a piece of equipment for $10,000,000 in 1973 and another piece in 1978 for $20,000,000. Both pieces of equipment have useful lives of 10 years with no residual values and are depreciated straight-line for book purposes and double-straight-line rate for tax purposes.

YEAR	Depreciation TAX	BOOK
1973	2,000,000	1,000,000
1974	2,000,000	1,000,000
1975	2,000,000	1,000,000
1976	2,000,000	1,000,000
1977	2,000,000	1,000,000
1978	4,000,000**	3,000,000***
1979	4,000,000	3,000,000

**Entirely from the new equipment; The old equipment is entirley depreciated for tax purposes.

***1 million from old equipment and 2 million from the new equipment.

Assuming a 50% tax rate, the company has a deferred tax liability each year from 1973-77 of $500,000. However, when the company buys the new equipment in 1978 it still defers a tax liability of $500,000 even with the reversal of the $500,000 from the preceding five years.

Entry 1973-1977

Tax Expense (Based on GAAP)	1,500,000	
Deferred Tax Liability		500,000
Taxes Payable (Based on IRS Rules)		1,000,000

Entry 1978

Tax Expense (Based on GAAP)	2,500,000	
Deferred Tax Liability (Reverse Old Equipment	500,000	
Deferred Tax Liability (New Equipment)		1,000,000
Taxes Payable		2,000,000

Thus the deferred tax account grows as reversals are rolled over year after year as companies offset the reversal with new write-offs.

This continual rollover is why theorists and

practitioners do not believe deferred taxes should be recorded as a liability. Since the taxes will probably not be paid, due to the continual generation of new depreciation deductions from asset acquisitions, no sacrifice of future economic benefits or impairment of an asset has occurred and no liability should be accrued (Volken & Rue, 1985, p. 32). The fact that this liability will not result in an outflow of cash is important for people making investment and finance decisions, because the deferred method implies the tax will be paid.

APB #11 was also criticized for being too complex, causing the cost of compliance to outweigh the benefits derived. The complexity of the rule led to inconsistent application, resulting in an even more meaningless account. The rule was also considered inconsistent because of its differing rules for Net Operating Loss (NOL) carryforwards and NOL carrybacks. APB #11 presented a meaningful income statement account, tax expense, in that it represented the amount of taxes that would have been paid had the temporary differences not existed. However, this method did leave a distorted balance sheet account, deferred taxes (Meonske & Sprohge, 1988, p. 42).

"Thirty years of applying the deferral method prescribed by APBO #11 have left many corporation balance sheets with

deferred tax balances that defy meaningful description ("Gearing Up", 1987, p. 9)." It was for this reason that the FASB began looking at deferred taxes in 1982. The main focus of the Board's study was to develop a statement that would provide more relevant, understandable, and internally consistent information (Carpenter & Wilburn, 1988, p. 53). The Board accomplished this by switching from the deferred to the liability method. The liability method switched the emphasis from the income statement to the balance sheet. This emphasis on the balance sheet was consistent with other recent FASB pronouncements. Namely, FASB #91 which deals with nonrefundable fees in lease arrangements and FASB #87, accounting for pensions (Parks, 1988, p. 24). The liability method required under #96 is forward looking in that it recognizes future taxes payable and refundable, at the expected future tax rates, that result from events already recorded in the financial statements (Nurnberg, 1988, p. 34). Thus with the issuance of FASB #96 an entirely new method of accounting for deferred taxes was required, prompting one practitioner to say, ". . . it is probably best to forget everything you know about income tax accounting." (Klinger & Savage, 1988, p. 32).

The basic premise of FASB #96 is that actual tax rates expected to be in effect when the differences reverse are

used in calculating the deferred tax. This is accomplished by recalculating the deferrals at the rate currently enacted for the year of the reversal assuming no profit or loss for the enterprise. This allows the balance to be adjusted for newly enacted tax rate changes and other events that occurred subsequent to the initial recording of the deferred taxes. The recalculation will require an adjustment to the deferred tax account. The change in the deferred tax account plus the amount of current taxes actually payable equals the amount of tax expense reported on the income statement (Hanouill, Somich & Tosh, 1987, p. 90). Therefore, the reported tax expense is not as meaningful as before, as part of it is attributable to events in prior years (the change in the deferred tax balance). However, the reported deferred tax account reported on the balance sheet is more representative of the actual amount of taxes to be paid or refunded in the future (Knutson, 1988, p. 17).

"Although the fundamental logic is fairly easy to grasp, applying it raises enough complexities to befuddle even the most sophisticated practitioner of GAAP (Parks, 1988, p.24)." Consequently these seemingly simple objectives of FASB #96 are overshadowed by the complexities of its implementation. The implementation process, difficult to begin with, was further complicated by the Tax Reform Act (TRA) of 1986.

This Act eliminated the Investment Tax Credit (ITC), established Alternative Minimum Tax (AMT), provided new rules for inventory capitalization, and changed the way profit is recognized on installment sales (Siegel, Stepp, Roche & Tomlin, 1988, chap. 1, p. 5).

One of the major problems concerning implementation is the identification of tax and book differences. There are two types of differences, permanent and temporary. Permanent differences do not cause much of a problem, but temporary differences do. Permanent differences are events recorded on the books that will never appear of a tax return due to their tax exempt status. Hence these differences will never reverse, so no deferred tax needs to be accrued. The four permanent differences recognized under FASB #96 are as follows:

1. Undistributed earnings of a subsidiary
2. Bad Debt Reserves for Savings and Loans
3. Stock Life Insurance Policy Surplus
4. Steamship Company deposits in reserve funds (Meonske & Sproghe, 1988, p. 45).

These permanent differences were also recognized under APB #11 so no implementation problem exists.

The following is the definition of a temporary difference as set forth in FASB #96. "[The 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 (Dickert et al., 1988, p. 77)." The nine following items cause differences between tax and book income that need to be identified:

1. Revenues/Gains that are taxable after they are recognized in financial income (Profit from installment sales)
2. Expenses/Lossess that are deductible after they are recognized in financial income (Bad Debts)
3. Revenue/Gains that are taxable before recognized in the financial statements (prepaid Income)
4. Expenses/Losses which are deductible before recognized (accelerated depreciation)
5. A reduction in tax basis of a depreciable asset due to a tax credit.
6. Investment Tax Credit accounted for by the deferral method
7. Foreign operations reported in a foreign currency
8. Increase in the tax basis of an asset due to indexing in certain countries because of high inflation
9. Business combinations accounted for by the purchase method (Siegel et al., 1988, pp. 2-3).

These differences must be identified each year. Basically, every transaction that involves any of these nine items must be identified and the deferred tax implications analyzed. This identification process must be done for every taxing jurisdiction in which the enterprise operates ("Gearing Up", 1987, p. 10). Thus a company will have to identify differences in every state and country in which it does business and in which it pays taxes. A company might have to do it for a city in which it operates if the company is

required to file a municipal tax return. Although temporary differences existed under APB #11, FASB #96 eliminated some previously APB #11 exempted transactions. This will require firms to go back over previous years' transactions and identify those which were previously considered permanent differences and recognize the deferred tax implications (Carpenter & Wilburn, 1988, p. 55). This identification process is difficult and costly for a small or medium size company operating in more then one state. The process will be extremely costly and time consuming for the corporate giants which operate in over 100 different foreign countries alone!!! The only way for a company to identify the differences is to start with the latest return for each jurisdiction and work backwards until all existing temporary differences are identified (Nurnberg, 1988, p. 38)

Once all temporary reversals are identified, the year of their reversal must be scheduled. "The scheduling exercise is tantamount to preparing a separate return for each future year [and jurisdiction] in which temporary differences reverse (Siegel et al., 1988, chap. 3, p.1)." These "mini tax returns" have to be figured not only under regular tax law, but also under the alternative minimum tax rules, thanks to the TRA of '86. In preparing each of these returns the company must use the breakeven assumption. This assumption

does not allow the company to anticipate future earnings or losses. That is, the company's future profits are assumed to be zero for deferred tax computation purposes. How a company accounts for net operating loss carryforwards is affected by this assumption.

Net operating losses are still allowed a three year carryback. That is, the tax entity is allowed to deduct the loss from any profit realized in the prior three years and receive a refund of the amount of taxes paid. However, if the previous three years' earnings are not enough to completely absorb the loss, the amount that can be recognized on the books is severely restricted. Statement #96 does not permit the excess loss to be put on the books to offset future taxes payable, even though the loss can be used for that purpose. This is true even if future earnings are assured beyond a reasonable doubt (Meonske & Sprohge, 1988, p. 26). The asset is disallowed because the breakeven assumption prohibits the anticipation of any future earnings, no matter how assured. Recognition of the loss benefit assumes that the company is going to make a profit in the future. The NOL carryforward can only be used to offset net reversing tax liabilities in the next fifteen years. Any excess loss over this amount may not be booked as a deferred tax asset (Knutson, 1988, p. 17). However, if a company does

realize a profit in the next fifteen years, the unbooked loss can be used to offset the profit. This prevents the company from losing the tax benefit associated with the loss. The tax benefit derived from the NOL carryforward will be classified in the section of the income statement where the benefit was realized (i.e. continuing operations, discontinued operations, extraordinary items). It is not always classified as an extraordinary item as it was under APB #11 (Carpenter & Wilburn, 1988, p. 56). Footnote disclosure is also required in the year of recovery.

A deferred tax asset, taxable income exceeds book income, can come about two different ways. One way is when expenses are recognized on the books before they are deducted on the tax return, like warranty expenses. The other way is when revenue is recognized on the tax return before it is recognized on the books, like prepaid income. Amounts resulting from these two events can only be used to reduce current year's deferred tax liability or to get a refund of prior years taxes (Meonske & Sprohge, 1988, p. 30). Thus a deferred tax asset account can never appear on the balance sheet as a result of these two events.

EXAMPLE C:

COMPANY XYZ

	1986	1987	1988	1989
NET INCOME (LOSS)	$20,000	10,000	20,000	(100,000)

The company can carry the loss back to '86, '87, and '88, leaving $50,000 of the loss to be carried forward. If the company has net reversing deferred tax liabilities of $2,000 every year for the next fifteen year, the deferred tax liability account can be reduced by $30,000 in 1989.

	1990--2005	TOTAL
NET INC.(BREAKEVEN ASS.)	0	0
Reversing Liab. (net)	2,000	30,000
NOL Carry forward	(2,000)	(30,000)

The excess of $20,000 (50,000-30,000) can not be booked as a tax asset in 1989. This $20,000 could be used to offset any income the company had over the next fifteen years.

Tax planning is also affected by FASB #96. Companies will still use tax planning to minimize taxes paid, but FASB #96 now requires companies to plan in order to minimize the amount of deferred taxes reported (Parks, 1988, p. 34). FASB #96 sets forth three criteria for these minimization strategies. First, the strategy must be feasible and the company's management must have the ability to control it. Second, the strategy must not involve significant costs to the company, Third, the strategy cannot disregard basic financial statement assumptions (Dickert et al., 1988, p. 78). By planning, the company will try to have its deferred

tax assets and liabilities reverse in the same year. This way they will offset each year, preventing large fluctuations in the amount of income taxes reported as deferred liabilities.

Statement #96 also affects the way deferred taxes are reported. APBO #11 states that the deferred tax balance shall be segregated between current and noncurrent on the basis of the asset or liability which caused the difference. FASB #96 requires the balance to be segregated according to when differences reverse. In this way the deferred tax balance is allocated between current and noncurrent in the same manner as any other asset or liability. Furthermore, all businesses are now required to reconcile and disclose the difference between book and taxable income (income tax expense and taxes actually paid). Previously, reconciliation was only required in SEC disclosures (Parks, 1988, p. 30). The reconciliation must disclose the nature of items causing the temporary, as well as, the permanent differences. The tax expense or benefit derived from each component of net income should also be disclosed. Unused NOL and tax credit carryforward amounts must be disclosed along with their expiration dates (Siegel et al., 1988, chap. 12, p.1).

The transition from APBO #11 to FASB #96 was supposed to take place for fiscal years starting after December 12, 1988.

However, the implementation date has been pushed back to fiscal years starting after December 15, 1991 (Financial Accounting Standards Board [FASB], 1989, December, p. 2). The reason for the delay is to give financial statement preparers and auditors time to understand and apply the rules of this statement. Many of the implementation rules were complicated by the TRA of '86. The FASB believes that this delay will allow companies to apply FASB #96 more consistently and make the transition to FASB #96 smoothly ("Official Release", 1989, p. 13).

The statement itself puts forth two methods for accounting for the adoption of the liability method. One way is to treat the adoption as a change in accounting principle. This method will result in a one-line-item, cumulative effect of accounting principle change, on the income statement in the year of adoption. The reporting and disclosure requirements of a cumulative effect change will be required in the year of change. Choosing this method will be considerably easier to implement then the alternative method (Carpenter & Wilburn, 1988, p. 58). The alternative method, retroactive application, is encouraged by the FASB, to give investor's more comparable data. Under this method, comparative statements are shown as if FASB #96 had always been used. The transition amount will be treated as a prior

period adjustment for the earliest year presented. Although this method is preferred, it is considerably more complicated due to the fact that some of the information required may no longer be available (Nurnberg, 1988, p. 46).

The effect of FASB #96 on certain financial statements is not small. Though adoption is not required until 1990, some companies chose early adoption which caused drastic changes in their financial statements. Grumman, a diverse manufacturing company, turned a $.20/share loss into a $.94/share gain by adopting FASB #96 in 1987. Pogo, an oil and gas company, did the same, turning a $.42/share loss into a $.49/share gain (Baldo, 1988, p. 16). Other companies that significantly reduced their 1987 deferred tax account are as follows: Exxon---$3 Billion, IBM--$1 Billion, DuPont--$600 million, and Philips Petroleum--$400 million (Weiss, 1986, p. 82). All these companies were able to reduce their liabilities and increase their equity without generating extra cash. They accomplished it simply by switching to FASB #96. However, some companies were not so lucky. CitiCorp had to reduce their retained earnings by $882 million, while American Express had to cut $586 million from its retained earnings (Baldo, 1988, p. 16). These changes not only affect net income, but also all financial ratios involving debt and equity. These drastic effects led a financial analyst to

say,

> So the accountants have managed to exaggerate a company's per/share earnings in both directions. Comparability with past results has been destroyed. And making intelligent earning forecasts has become impossible (Baldo, 1988, p. 17).

Most of the cited effects of the change can be explained by the corporate tax rate change from 40% to 34%, set forth in the TRA of 1986. Because the deferred method required that the differences be accrued at the rate presently in effect, most of the differences were accrued at the 48%, 46%, or 40%, corporate tax rate. However, the liability approach (FASB #96), requires differences to be accrued at the rate in effect when the differences reverse. Since the differences will reverse at lower rates, the deferred tax liability needs to be reduced, this creates the increases in net income and retained earnings in the firms cited above. However, had a tax rate increase been enacted, net income and retained earnings would have been reduced because more taxes would have had to be accrued.

The fact that a change in the corporate tax rate could produce such a drastic change in a company's net income concerns many investors and financial analysts. Because the liability method is forward looking, each tax rate change will require that the entire balance in the deferred tax account be recalculated. This will be true for any rate

change in any taxing jurisdiction. The restatement of the deferred tax account will require that the schedule of each individual temporary difference be recalculated. The size and direction of the tax rate change, along with the size of the deferred tax balance, will help determine the impact on the current year's financial statements (Knutson, 1988, p. 18). Fortunately, corporate tax rates do not change that often. The tax rates changed in 1965 (48%), 1979 (46%), and 1986 (34%) (Robbins, 1986, p. 37).

Beside the obvious affects on net income, the shifting of liabilities to equity affects a large number of ratios which investors and analysts use (Meonske & Sprohge, 1988, p.17). This sudden shift of millions of dollars from the liability to the equity section could also affect a company's debt covenants and other restrictions. This shift not only affects comparability of current income with previous years' incomes, but also comparability with other current incomes of companies operating in the same industry. Comparability is further diminished by the fact that a firm can adopt FASB #96 for any fiscal year from 1987 through 1991. This multiple year adoption option requires financial statement users to really sort out and analyze a company's reported net income and changes in equity. For instance, General Electric 1987 fourth quarter earnings contained $400 million due to an

accounting change (Gleckman, 1988, p. 22). Likewise, 75% or $900 million of Shell Oil's 1988 first quarter earnings were attributable to the change (Baldo, 1988, p. 16). Instances like this caused one investor to issue the warning, "*Caveat Lector*--Let the Reader Beware (Gleckman, 1988, p. 22)." One critic noted that a provision in #96 requiring the impact from changing tax rates to be spread over several years would greatly enhance the comparability of earnings (Baldo, 1988, p. 16).

One impact of FASB #96 not readily ascertainable from the financial statements is the amount of recordkeeping required. Basically, the statement requires that a schedule for each temporary difference be kept. This schedule will show the year of origination of the defferal, the year(s) and amount of each defferal reversal, and the tax rate(s) at which each reversal will occur. Furthermore, one of these schedules will have to be kept for each taxing jurisdiction which the difference affects. Each year these schedules are combined to arrive at a cumulative amount. A "tax return" is then prepared for each year's cumulative amount. The tax on these separate cumulative amounts are then combined and the total increase or decrease in the deferred tax account will be reported in the current period. The preparation of each year's "tax return" is further complicated by the AMT laws.

This means for each year taxes on the cumulative amounts must be figured for both regular tax laws and AMT laws. Thus, "Statement No. 96 will disappoint practitioners who expected relief from complex and costly recordkeeping procedures (Meonske & Sprohge, 1988, p. 16)."

In summary, there are basically three criticisms of FASB #96. The first criticism is that the recordkeeping requirements are burdensome. The second concern is that the statement makes earnings unpredictable. Third, critics say that parts of FASB # 96 contradict basic accounting theory.

To some extent, the first two criticisms have been addressed. Even with computers, the amount of time and effort required to comply is enormous, and critics claim that the costs of compliance far outweigh the benefits received ("Commentators", 1987, p. 10). The predictability of earnings is not only affected by changes in the tax rate, but by anything that affects when these differences reverse. This means rules affecting the carryback and carryforward of NOL's and unused tax credits will affect the deferred tax calculation. Beside these governmental rulings, management's control over capital investment decisions as well as estimates like depreciation, litigation, and warranties will affect the amount and timing of the reversals. Management decisions and governmental rulings can result in a very

volatile reporting of earnings.

The third criticism is that the statement ignores basic accounting theory. As earlier stated, some critics view the entire concept of deferred taxes as invalid. They claim that the taxes will probably never be paid, and, therefore, the reporting of them as a liability creates an inaccuarate picture. The critics claim that the continual purchase of new property, plant, and equipment, creates new deductions. These deductions offset reversing amounts so the deferred taxes are never paid (Andresky, 1984, p. 206). Thus even under FASB #96 these critics do not believe deferred taxes meet the definition of a liability and so should not be accrued.

Critics also claim that by limiting the recognition of deferred tax assets, FASB #96 violates the going concern assumption. Remember, the board prohibits a company from accruing an asset in excess of reversing liabilities, i.e. future earnings can not be anticipated. Critics' say this not only overstates the liability, but does not meet the matching principle by failure to recognize the tax benefit in the same period as the contingent liability ("Commentators", 1987, p. 10).

FASB #96's failure to require discounting is another area where critic's claim basic accounting theory is

violated. They claim that real estate depreciation may be reversing for thirty or forty years and failure to discount these amounts for the time-value of cash flows overstates the liability. Critics feel deferred taxes should be reported in the same manner as any other long-term liability, at their present value (Stern, 1988, p. 16). While proponents of the statement agree that reporting them at their discounted rate would be more accurate, no one has yet been able to determine an appropriate rate of discount.

Proponents of FASB #96 claim the liability method is theoretically superior to the deferred method (Meonske & Sprohge, 1988, p. 16). One of the main reasons for this claim is the ability to immediately recognize newly enacted tax rate changes. This prevents taxes accrued at a higher rate from being lodged in the account until the reversal of the differences. Although it is hard to imagine that corporate proponents would be willing to embrace the statement had it occurred at the time of a tax rate increase, theorists would still probably find it superior. Beside recognizing enacted tax rate changes, the scheduling of reversals should provide a more realistic picture of taxes to be actually paid or refunded in the future. By scheduling reversals, taxes on offsetting reversals will not be accrued, only an amount for the excess will be accrued. This should

prevent the deferred tax account from growing continually, a major criticism of the deferred method (Moch, 1986, p.22).

Another major criticism of the deferred method is its complexity. Although few would argue that FASB #96 is easier, most proponents attribute its complexity to the TRA of 1986, and not to the statement itself. "When a tangled tax law is passed, such as the TRA, recordkeeping requirements are bound to increase at an exponential rate (Parks, 1988, p. 32)." This act brought about the AMT computations and the elimination of the investment tax credit. These two provisions alone created extra bookkeeping requirements.

The restrictions placed on deferred tax assets, while not consistent with the going concern principle, is consistent with the conservatism principle. These restrictions prevent a company from understating their tax liability by assuming some sort of net income figure. Even though the unused amounts are not entered in the books, they are disclosed in the footnotes to the financial statements. Also, while management does have control over estimates and other policies, continual manipulation is not only prohibited by the tax planning rules in #96, but would also affect more than their deferred tax liability account.

Although FASB #96 is difficult to understand and

implement, there are benefits. The statement does provide a balance sheet account which reflects economic conditions (Carpenter & Wilburn, 1988, p. 54). It does so at the expense of the income statement, but the related disclosure requirements should allow investors to sort out and analyze actual profits. The scheduling of differences prevents offsetting differences from being accrued in the liability account. This makes more sense then simply accruing the difference between book and tax income. The fact that FASB #96 makes an account meaningful which for years has been meaningless and unexplainable should be benefit enough. Yes, the initial scheduling will be tedious; however, once a scheduling system is in place, future additions and deletions should not prove to be an arduous task. FASB #96, while not perfect, is better then the present system and should be welcomed by analysts and investor alike. No longer will the deferred tax account be the "black hole" of the balance sheet. The account is now explainable and can be used when evaluating a firm's financial position, because the theory behind the account's existence is sound.

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