

Accounting for Income Taxes: A Study of Early vs. Postponed Adoption Decisions for Controversial Accounting Standards

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Abstract

The provisions of the FASB standard on accounting for income taxes, SFAS No. 96, were complex and controversial. Moreover, the FASB provided corporations with considerable flexibility in deciding when to adopt SFAS No. 96. Under these circumstances, managements had an opportunity to time their adoption decisions to best serve the interests of the corporation and stockholders. This study compares the attitudes and perceptions of controllers for corporations that adopted SFAS No. 96 early with controllers of corporations that postponed adoption. While the controllers' opinions on the usefulness of SFAS No. 96 reporting are mixed, the results indicate that the effects on the financial statements and the ease of gathering needed data seem to influence a firm's timing decision when there is a choice between early and delayed adoption of controversial accounting standards.

Introduction

Since 1967 U.S. corporations have accounted for income taxes in accordance with the requirements of Accounting Principles Board Opinion (ABPO) No. 11. This standard established the deferred method to show the timing differences of tax effects on the balance sheet with deferred credits and charges. However, the figures that resulted from applying this method have been greatly misunderstood and criticized as being conceptually flawed. In response to these criticisms, the Financial Accounting Standards Board (FASB) issued a pronouncement requiring the asset-liability method in replacement of the APBO No. 11 deferred method. The new method of accounting for income taxes was specified in Statement of Financial Accounting Standards (SFAS) No. 96.

SFAS No. 96 was issued in 1987 to establish U.S. generally accepted principles of accounting for income taxes. Although the new liability method was originally intended to be simpler than the deferred method, it actually proved to be more complicated [Johnson, 1988]. The complexities of SFAS No. 96 generated consider-

able criticisms from U.S. corporations and their accountants. Consequently, on three occasions the FASB was forced to change the effective date for implementation of the new standard. Corporations were originally required to adopt SFAS No. 96 for fiscal years beginning after December 15, 1988, but earlier adoption was explicitly encouraged. Shortly before the aforementioned effective date, the issuance of SFAS No. 100 changed the effective date of SFAS No. 96 to fiscal years beginning after December 15, 1989. Next, SFAS No. 103 further extended the effective date of SFAS No. 96 to fiscal years beginning after December 15, 1991. Finally, SFAS No. 108 recently extended the effective date to fiscal years beginning after December 15, 1992, but SFAS No. 96 has since been entirely superseded by SFAS No. 109.

The promulgation of three different effective dates together with the FASB's formal recommendation that corporations should adopt SFAS No. 96 before the earliest effective date allowed corporate management considerable flexibility in making an adoption decision.

This flexibility gave management an opportunity to time the adoption decision so as to best serve the corporation and stockholders. The purpose of this study is to compare the attitudes and perceptions of controllers for corporations that adopted SFAS No. 96 early with controllers of corporations that postponed adoption.

Background

The accounting requirements in SFAS No. 96 are numerous and complex. While this paper does not purport to serve as a guide for accounting methodology, several factors need to be mentioned as they bear directly on the study presented herein. Under SFAS No. 96, the deferred amounts are computed using the tax rates that are in effect for the years involved. Thus, records must be kept for each year's originating amounts and reversals of deferred taxes for each tax jurisdiction. The adjustments of balance sheet amounts is accomplished through the increase or decrease of income tax expense on the income statement and net income is affected by the changes in deferred taxes. Corporations maintain off-balance sheet realization of deferred tax assets, but these assets seldom appear on the balance sheet due to the stringent recognition rules in SFAS No. 96. In the initial adoption of SFAS No. 96, a firm may choose to restate prior years or may report the cumulative effect as a change in accounting principle.

Several factors are capable of influencing the decision to adopt a controversial standard, such as SFAS No. 96, early or postpone adoption until the mandatory date. The economic consequences theory of accounting policy decision-making suggests that firms optimize income in relation to their circumstances through an overall income strategy [Zmijewski and Hagerman, 1981]. Thereby, credence is given to the idea that firms will consider the effects on financial statements as justification for decision-making on when and how to adopt new accounting standards. In the case of SFAS No. 96 significant financial statement effects are possible [Johnson, 1989; Nurnberg, 1988 and Valenti, 1988]. In particular, the possibility of an increase in reported earnings for the year of adoption is likely to have a strong bearing on management's adoption decision [Bell and Bible, 1987; and Carpenter and Wilburn, 1988]. For example, one study of the earnings of firms that were among the first to adopt SFAS No. 96 for the 1987 fiscal year found large increases in reported income by all but one of these firms [Seidler, 1988]. On the other hand, the treatment of deferred tax assets under the new standard could have adverse effects on reported income and thus cause management to postpone the date of adoption [Parks, 1988].

Other factors that are likely to influence adoption decisions are related to implementation issues. For example, the complexities of the new standard and the

time needed to understand its various requirements could cause managements to postpone adoption [Chaney and Jeter, 1989; Leibtag, 1987; Stewart and Ripepi, 1988; Walk, Martin and Nichols, 1988]. More directly related to the question of when a firm will choose to adopt the standard is the time needed to gather the required data. The ability to assemble all the necessary information and the availability of time are relevant considerations in deciding when to adopt SFAS No. 96 [Nurnberg, 1988; Valenti, 1988].

Description of Study

Using the Compact Disclosure data base, 122 firms were identified as early-adopters of SFAS No. 96. Questionnaires and cover letters were sent to the controllers of each of these firms. The questionnaire consisted of six items related to the following: 1) the controllers' evaluations of the usefulness of the information provided by the new standard; 2) the need to gather additional data to comply with SFAS No. 96 reporting requirements; 3) the degree of change necessary in their accounting systems in order to adopt SFAS No. 96; 4) the reasons their firm chose to adopt the standard early; 5) whether the firm lost recognition of significant amounts of deferred tax assets in so doing; and 6) the cost of adopting SFAS No. 96.

The firms that responded to the survey were matched by industry (using SIC codes) and by 1988 sales with companies that at the time, had not yet adopted SFAS No. 96. Comparisons were made between the sales and profits of the early-adopting firms and the adoption-postponing firms. Also, a questionnaire was sent to the controllers of each of the postponing firms. This questionnaire was similar to the one sent to early-adopters except that the line item reasons for not adopting replaced the reasons for adopting.

Results

Response Rates

Of the 122 questionnaires mailed to early-adopting firms, 75, or 61% were completed and returned. Regarding the 62 questionnaires sent to firms that did not adopt early, 33 or 53%, of these provided usable responses. Comparisons were made between the average sales during 1987 and 1988 for respondents, but no significant differences were noted. Also, the difference in percentages change in profits between these two years was not significant. Thus, the respondents were considered to be representative of the total firms sampled.

Perceived Usefulness for Early-Adopters

The first item in the questionnaire asked controllers

of early-adopting companies whether they perceive the usefulness of the information provided on the financial statements in accordance with SFAS No. 96 to be greater than the information provided in accordance with APB No. 11. The responses were almost evenly divided. Forty-nine percent of the respondents stated that the information was more useful; and 51% stated that it was not more useful. Several respondents commented that SFAS No. 96 makes balance sheets more useful, but does not make income statements more useful. This is not surprising since the new standard is a balance sheet approach to accounting for deferred income taxes. One respondent commented that the information was more useful, but that it did not justify the effort involved. In addition, two respondents asserted that conceptually SFAS No. 96 is preferable, but it is not practical.

Information Needs of Early-Adopters

The second and third items on the questionnaire asked controllers to indicate whether their firm needed to gather additional data to implement the new standard and whether changes needed in the firm's accounting system were major or minor. Although a significant percentage, 89%, of the early-adopting firms had to gather additional data, only 37% had to make major changes to their accounting systems. These results are consistent with the literature on SFAS No. 96 that notes the availability of data and the time needed to gather and compile it might influence a decision to adopt the accounting standards early.

Stated Reasons for Early Adoption

Controllers felt that the impact on the financial statements was an important factor in the decision for early adoption of the new standard. According to Exhibit 1, 65% of the respondents indicated that a beneficial effect on the financial statements was a reason

for the early adoption of SFAS No. 96. In comparison, only 16% stated that early adoption of SFAS No. 96 had no material effect upon the financial statements. Similarly, 13% of the early adopters indicated that the presence of offsetting effects, such as net operating loss carrybacks, on the other results obtained for the financial statements was a significant decision factor. These findings are consistent with the previously discussed literature concerning SFAS No. 96.

Exhibit 1 also shows that 20% of the respondents adopted the standard early because the cost of implementation was not material to their firm. A somewhat related finding reveals that only 13% of the respondents indicated that the ready availability of data was a factor in the decision to adopt SFAS No. 96 prior to the mandatory date. Five respondents expressed less positive reasons for early adoption. Of these, three firms stated that they adopted early in order to satisfy an accounting obligation. For example, the philosophy of one respondent regarding early adoption was that "it had to be done some time;" another responded that the firm wanted "to adopt it and move on;" and a third stated their desire "to get it over with." Two firms felt obligated to follow through with adoption after having publicly announced an intention to do so prior to the FASB's first postponement of the mandatory effective date. Other reasons given relate to the usefulness or comparability of the information provided by SFAS No. 96. One respondent emphasized the relationship of SFAS No. 96 information to records required for Chapter 11 bankruptcy filings. Another respondent mentioned that SFAS No. 96 avoids confusion by providing comparability, and yet another wrote of the increased clarity of the tax expense as it was based on effective rates under SFAS No. 96. The desire to provide the users with the best information on which to make decisions on debt and equity purchases was also expressed as a motive for early adoption. Additionally, eleven respondents indicated a variety of other reasons

Exhibit 1
Stated Reasons For Early Adoption

Reason	Frequency	Percent*
Beneficial Financial Statement Effects	49	65
Cost to Implement Not Material	15	20
Financial Statement Effects Not Material	12	16
Data Readily Available	10	13
Offsetting Financial Statement Effects	10	13
Discharge Accounting Obligation	5	7
Provides Useful Information	4	5
Other	11	15

* Total does not add to 100% because some respondents indicated that more than one answer was applicable.

for early adoption of SFAS No. 96. The most common of these other reasons was the increased ease of handling the reporting of a purchase acquisition in the year of the adoption of SFAS No. 96. According to Bell and Bible [1987] there are complications in the transition to SFAS No. 96 created by business combinations completed prior to the adoption year. Therefore, these firms adopted early in order to avoid these complications.

Implementation Effects for Early-Adopters

The stated incremental costs incurred through the adoption of SFAS No. 96 range from zero to \$2.8 million with a mean of \$102,000 and a median of \$30,000. When these incremental costs were considered as a percentage of total accounting expenses, they ranged from zero to 16% with a mean of 2.6% and a median of 1.3%. However, these dollar amounts and the percentages may be misleading. First, dollar amounts were not examined in relationship to the size of the responding company. More importantly, comments made by several respondents indicated that at least some of the controllers did not fully understand the concepts of incremental costs or opportunity costs. For example, several respondents stated that there were little or no costs for implementation because the work was performed by salaried employees. These respondents failed to consider the opportunity cost of extra hours spent to implement SFAS No. 96 -- hours which could have been spent on other, more productive activities. Some respondents referred to an increase in audit fees while others made no mention of this. It is difficult to know what factors were considered by those respondents who provided dollar amounts but did not furnish any information regarding how the costs of implementation were estimated.

SFAS No. 96's required treatment for deferred tax assets and the adverse effect that the loss of significant amounts of these assets could have on the financial statements led to a prediction that early-adopters would probably include those companies that were not likely to lose large deferred tax assets. The questionnaire results proved this to be true as 92% of the respondents stated that they had not lost significant deferred tax assets.

Comparisons of Early-Adopters and Postponed-Adopters

Investigations were made to determine differences between the early-adopting firms and the postponing firms. The firms that adopted early were compared to the matched non-adopting firms in terms of certain aspects of positive economic consequences theory. Also, other differences between the two groups were compared on the basis of their responses to the questionnaire.

Differences in Financial Data

Early-adopters showed an average increase in sales of \$105 million, or 8.4%, between 1987 and 1988. Adoption-postponing firms had a larger average increase in sales of \$176 million or 13.7%. However, early-adopters showed a \$13 million average decrease in net income, or 27.5%, for those years while postponing firms had an average increase in net income of \$5 million, or 6.2%. While the difference in the direction of the change in profits is notable, there was such a large variation in profits for both groups that the difference in net income is only significant at the 0.06 alpha level. Therefore it is questionable whether all the early-adopters were able to significantly improve their financial statements under the new standard. Conclusions cannot be drawn without being able to compare differences in the early-adopters' financial statements under adoption of FASB 96 and non-adoption of the new standard. These differences could not be determined because the dollar amounts of offsetting items are not segregated on the financial statements. However, in view of the fact that 65% of early-adopters stated that a beneficial effect on their financial statements was a reason for early adoption, it appears that the differences in profits between the two groups would have been larger, and more significant, if the adopters had postponed adoption until the required date.

Responses to Questionnaire

Of the matched firms, 54% of the early-adopters found that the financial statements using SFAS No. 96 were more useful, whereas only 15% of the non-adopting matched firms thought the results under SFAS No. 96 would be more useful. This contrast is consistent with the two groups' adoption decisions, i.e., adopt early versus postpone adoption. Similarly, only 30% of those firms that adopted early considered the necessary changes to their accounting systems to be major, while 54% of the postponing firms expected major changes would be needed. Despite these differences, a substantial majority of both early-adopters (91%) and postponing firms (91%) thought that a large amount of extra data was needed to implement SFAS No. 96.

Exhibit 2 presents the reasons given by the controllers of postponing-companies for not adopting SFAS No. 96 early. A comparison of these reasons with the reasons given for early adoption in Exhibit 1 serves to highlight some important differences between the two groups. First, 65% of the early-adopters cited beneficial effects on the financial statements as a reason for early adoption, whereas 36% of the adoption-postponing firms mentioned detrimental effects as the reason for not adopting early. Among the early adopters, 16% indicated that immaterial effects on the financial statements was a factor in deciding to adopt SFAS No. 96 early,

whereas 9% of the adoption-postponing firms stated that a material effect on the financial statements was a reason for not adopting early.

tion, whereas the non-adopting firms believed they would need to make major changes in their accounting systems.

Exhibit 2 State Reasons For Not Adopting Early

Reason	Frequency	Percent
Data Not Readily Available	20	61
Uncertainty Over the Final Form and/or Effective date	13	39
Detrimental Financial Statement Effects	12	36
Material Implementation Cost	8	24
Material Financial Statement Effects	3	9
Other	8	24

Concerning the reasons given other than the effects on the financial statements, only 13% of the early-adopters stated that readily available data was a reason for deciding to adopt early. On the other hand, of the firms that had not yet adopted, 61% stated that the lack of available data was a reason not to adopt early. Of the early-adopters, 20% indicated that immaterial implementation costs were a reason to adopt early, whereas 24% of the postponing firms stated that material implementation costs were a reason for delaying adoption. Finally, 39% of the postponing firms mentioned uncertainty over the final form of the official pronouncement and/or its effective date as a reason for deciding not to adopt SFAS No. 96 early.

Implications and Concluding Comments

In this study early-adopters of SFAS No. 96 were compared with firms that postponed adoption. The comparisons included an examination of the economic consequences considered by the firms and other factors that influenced their adoption decisions. The findings revealed mixed opinions among early-adopters regarding the information usefulness of the new accounting standards. However, the early-adopters were consistent in their observations that beneficial effects on the financial statements had favorably influenced their decision to adopt early. On the other hand, the adoption-postponing firms perceived much less information usefulness in SFAS No. 96, and the lack of readily available data for implementation influenced their adoption postponement decisions more than the potential effects on financial statements. Similarly, questions concerning SFAS No. 96's deferred effective date and uncertainties over its final form seemed to be of primary importance in the non-adopters' decision process. Finally, the firms that adopted the standard early did not, for the most part, have to make significant changes to their accounting systems in order to make the transi-

Based on the results of this study the primary factors that have influenced management's decisions regarding when to adopt a controversial accounting standard, such as SFAS No. 96, have been the effects on corporate financial statements and the ease of compiling the necessary data for the change. These findings suggest that accounting standard setters must make a concerted effort to recognize the economic consequences of their proposals during the course of their deliberations to develop future accounting requirements. Otherwise, further progress in the application of generally accepted accounting principles will be impaired by persistent implementation problems.

Suggestions for Future Research

In response to the harsh criticisms of its accounting rules for income taxes, the FASB recently replaced SFAS No. 96 with SFAS No. 109. The new standard continues the requirement that corporations use the asset and liability approach in accounting and reporting for income taxes. However, the new standard is intended to be less controversial in terms of its measurement rules for determining amounts for interperiod tax allocations. SFAS No. 109 is effective for fiscal years beginning after December 15, 1992, but earlier adoption is encouraged. Given the FASB's intent to issue a less controversial pronouncement, suggested future research should replicate the study reported in this paper using the same corporations for the purpose of comparing the patterns of early vs. delayed adoption for SFAS No. 109 to the adoption patterns for SFAS No. 96. Based on the comparative results, the actual extent, if any, to which the FASB has succeeded in developing a less controversial standard would be indicated by finding that a greater number of the corporations had early-adopted SFAS No. 109 compared to the number that had early-adopted SFAS No. 96.

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