San Fernando Valley State College

ACCOUNTING FOR INVESTMENT TAX CREDIT

A thesis submitted in partial satisfaction of the requirements for the degree of Master of Science in

Business Administration

by

Gary Goodman Stone

June, 1967
The thesis of Gary Goodman Stone is approved:

________________________

________________________
Committee Chairman

San Fernando Valley State College
June, 1967
# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABSTRACT</td>
<td>1</td>
</tr>
<tr>
<td>Chapter</td>
<td></td>
</tr>
<tr>
<td>I. INTRODUCTION</td>
<td>3</td>
</tr>
<tr>
<td>II. LEGISLATIVE HISTORY OF INVESTMENT TAX CREDIT</td>
<td>5</td>
</tr>
<tr>
<td>Need for Tax Incentive</td>
<td>5</td>
</tr>
<tr>
<td>Business World Disagrees</td>
<td>7</td>
</tr>
<tr>
<td>House Ways and Means Committee</td>
<td>8</td>
</tr>
<tr>
<td>Senate Finance Committee</td>
<td>12</td>
</tr>
<tr>
<td>Summary</td>
<td>16</td>
</tr>
<tr>
<td>III. INITIAL ACCOUNTING TREATMENT PROPOSALS</td>
<td>18</td>
</tr>
<tr>
<td>Income Treatment</td>
<td>18</td>
</tr>
<tr>
<td>100 Percent Flow Through</td>
<td>18</td>
</tr>
<tr>
<td>&quot;48-52&quot; Method</td>
<td>19</td>
</tr>
<tr>
<td>Cost reduction</td>
<td>20</td>
</tr>
<tr>
<td>Contribution to capital</td>
<td>21</td>
</tr>
<tr>
<td>Comparative Analysis</td>
<td>21</td>
</tr>
<tr>
<td>Opinion No. 2 of the Accounting Principles Board</td>
<td>22</td>
</tr>
<tr>
<td>Initial Aftermath of Opinion No. 2</td>
<td>24</td>
</tr>
<tr>
<td>Securities and Exchange Commission's Position</td>
<td>26</td>
</tr>
<tr>
<td>Arguments Advanced for the Cost Reduction Method</td>
<td>27</td>
</tr>
<tr>
<td>Arguments Advanced for the 100 Percent Flow Through Method</td>
<td>28</td>
</tr>
<tr>
<td>Arguments advanced for the &quot;48-52&quot; Method</td>
<td>28</td>
</tr>
<tr>
<td>Balance Sheet Treatment</td>
<td>29</td>
</tr>
<tr>
<td>Methods Actually Used in 1962 and 1963</td>
<td>31</td>
</tr>
<tr>
<td>Excerpts from 1962 and 1963 Annual Reports</td>
<td>32</td>
</tr>
<tr>
<td>Chapter</td>
<td>Page</td>
</tr>
<tr>
<td>------------------------------------------------</td>
<td>------</td>
</tr>
<tr>
<td>Cost Reduction Method</td>
<td>33</td>
</tr>
<tr>
<td>&quot;48-52&quot; Method</td>
<td>37</td>
</tr>
<tr>
<td>Other Methods</td>
<td>45</td>
</tr>
<tr>
<td>Reflections on the Cost Reduction and &quot;48-52&quot; Methods Used During 1962 and 1963</td>
<td>49</td>
</tr>
<tr>
<td>Reflections on Other Methods Used During 1962 and 1963</td>
<td>50</td>
</tr>
<tr>
<td>Summary</td>
<td>51</td>
</tr>
<tr>
<td>IV. SIGNIFICANT EVENTS OCCURRING IN 1964</td>
<td>52</td>
</tr>
<tr>
<td>Revenue Act of 1964</td>
<td>52</td>
</tr>
<tr>
<td>The Accounting Principles Board</td>
<td></td>
</tr>
<tr>
<td>Revised Opinion No. 2</td>
<td>54</td>
</tr>
<tr>
<td>Methods Actually Used in 1964</td>
<td>57</td>
</tr>
<tr>
<td>Excerpts from 1964 Annual Reports</td>
<td>58</td>
</tr>
<tr>
<td>Change from cost reduction method</td>
<td>58</td>
</tr>
<tr>
<td>Change from &quot;48-52&quot; method</td>
<td>63</td>
</tr>
<tr>
<td>Change from other methods</td>
<td>67</td>
</tr>
<tr>
<td>Reflections on the methods used in 1964</td>
<td>68</td>
</tr>
<tr>
<td>Summary</td>
<td>69</td>
</tr>
<tr>
<td>V. ANALYSIS AND DETERMINATION OF THE PROPER METHOD OF ACCOUNTING FOR THE INVESTMENT CREDIT</td>
<td>71</td>
</tr>
<tr>
<td>Fixed Assets and Depreciation Accounting</td>
<td>71</td>
</tr>
<tr>
<td>Income Recognition</td>
<td>74</td>
</tr>
<tr>
<td>Federal Income Tax Accounting</td>
<td>77</td>
</tr>
<tr>
<td>Summary</td>
<td>80</td>
</tr>
<tr>
<td>VI. CONCLUSIONS</td>
<td>81</td>
</tr>
<tr>
<td>BIBLIOGRAPHY</td>
<td>84</td>
</tr>
</tbody>
</table>
ABSTRACT

ACCOUNTING FOR INVESTMENT TAX CREDIT

by

Gary Goodman Stone

Master of Science in Business Administration

June, 1967

The investment tax credit introduced by the Revenue Act of 1962 caused a great deal of furor within the accounting profession in that there was not initially, or even today, any general consensus as to its proper accounting treatment. Basically, the investment tax credit provisions allow purchasers of equipment for business use, a direct credit against federal income taxes. The amount of the credit depends primarily on the cost of the equipment and its estimated useful life.

This paper discusses the proper accounting treatment to be rendered the investment tax credit and the controversies which it provoked in the accounting profession. The legislative history of the investment tax credit is reviewed in an attempt to determine the intent of its creator and the Congress which enacted it. The paper then evaluates the various suggested treatments and their effect on income and financial condition. It goes on to investigate methods used in practice and indicates which methods were supported by various informed individuals. Finally, the paper relates the proposed methods to basic accounting theory and concludes that
the "100 percent flow through" method is the treatment which is in accordance with acceptable and sound accounting principles.
CHAPTER I
INTRODUCTION

The Revenue Act of 1962 introduced a new method for stimulating American industry into purchasing additional machinery and equipment by allowing a credit against federal income taxes for investment in certain depreciable personal property. The credit, which reduced the income tax liability, was computed as a percentage of the cost of the property purchased. Accountants, however, could not agree on the financial treatment to be accorded this investment credit. There were several methods proposed, but they varied to such an extent that the resulting net income and balance sheet presentation would be materially different depending on the method utilized. The methods ranged from treating the entire credit as income in the year that the property was purchased, to allocating the credit over the estimated useful life of the property.

With the possible exception of the introduction of the Federal Income Tax Law itself, few tax innovations have had the impact or created the controversy within the accounting profession that resulted from enactment of the investment tax credit. To this date, almost five years after its introduction, the investment credit remains an unsolved issue in terms of the proper accounting treatment which it should receive.

In the succeeding chapters an attempt will be made
to resolve this controversial issue by (1) reviewing the legislative history of the investment credit in terms of the intent of its creator and the Congress which introduced it, in order to determine which method conforms thereto, (2) evaluating the different methods which are presently in use on the basis of the effect on reported income and reported financial position, (3) investigating the methods which were actually used by the business community including the reaction of the independent accountants in rendering their opinions on the financial statements, (4) presenting what members of the accounting profession and business community have said about accounting for the investment credit and analyzing their position and (5) finally, relating the proposed methods to basic accounting theories such as fixed asset and depreciation accounting, income recognition and accounting for income taxes to determine which method is in accordance with acceptable and sound accounting principles.
CHAPTER II

LEGISLATIVE HISTORY OF INVESTMENT TAX CREDIT

During the winter of 1960-61 the United States' economy appeared to be lagging. The Labor Department reported six percent unemployment in January 1961, and indicated that 76 of 150 major labor market areas had substantial labor surpluses. This was not a mere recurring seasonal type problem, but rather the worst labor situation since the recession of 1958. A "shot in the arm" was needed to stimulate industry which, it was reasoned, would induce additional employment and thus help eliminate the labor surplus.

To solve this problem, President Kennedy had established a committee on tax policy which was headed by a Harvard Law professor, Stanley S. Surrey, who later was appointed Assistant Secretary of the Treasury for tax matters. Rep. Wilbur D. Mills (D-Ark.), chairman of the Ways and Means Committee, was also collaborating with Surrey's task force and the Treasury Department. There was general agreement among leaders in government and commerce, except for the AFL-CIO, that the answer was to stimulate capital spending.

Need for Tax Incentive

Initial thinking on the method to be used related to a tax incentive which would benefit those who would invest in new plant and equipment. The first proposal was
to allow a tax credit of anywhere between ten and twenty percent of the excess of capital investment over depreciation during a taxable year.¹

On April 20, 1961, President Kennedy sent to Congress his plans comprised of proposals which would result in an estimated $1.7 billion in tax incentives, but this tax package also included measures which would raise revenues in the same amount, thus keeping the Treasury in balance. The major tax incentive included in these proposals was the brainchild of Stanley Surrey and related to encouraging capital spending. A tax credit, not to exceed thirty percent of the total tax liability, for purchases of new equipment with at least a six year tax life was presented and was computed as follows:

(1) Ten percent of the first $5,000 spent for new plant and equipment, plus

(2) Six percent of the excess of purchases of new plant and equipment over fifty percent of depreciation, not to exceed fifty percent of the depreciation allowance, plus

(3) Fifteen percent of additional investments in new plant and equipment.

Answering his critics (who would have preferred a straight tax cut), the President pointed out that this method forced spending in order to reap benefits from the proposed tax law.² He believed that the proposed credit would have a


double effect: (1) stimulation to the economy and (2) greater competition with foreign products because of modernizing equipment.  

Business World Disagrees

First reactions of the business world indicated that, in general, they did not believe the proper approach was being followed. Some of their criticisms and suggested alternatives included the following:

(1) Not fair to companies which have always maintained their capital spending.

(2) Depreciation, not tax credits, is the answer to the problem.

(3) Companies with low depreciation allowances are favored.

(4) Not helpful to companies whose primary investment is people.

(5) Purchases in one year could be bunched in order to take advantage of the fifteen percent bracket.

(6) Companies with temporary loss years will not be able to use the credits during subsequent profitable years.

(7) Growth companies, not sick companies will benefit. 4

In May 1961 the President's propositions were reviewed by the Congressional Joint Economic Committee, and Secretary of the Treasury, Douglas Dillon, presented a


report on the proposed tax changes to the House Ways and Means Committee. Dillon pointed out how some of the objections of the business world could be offset. He indicated that he favored a proposal to allow a five-year carry forward of unused credits, and also proposed a method to prevent bunching of expenditures in an attempt at utilizing the maximum fifteen percent credit.  

**House Ways and Means Committee**

The House Ways and Means Committee in May 1961 started holding hearings which generally indicated that the business world still did not agree with the current investment credit proposal. They felt that there was definitely a better way to accomplish the same purpose. Numerous ideas were presented by various factions. The one idea which, as we will later see received the most attention was suggested by George Terborgh who represented a group which would certainly benefit from the investment credit - the Machinery and Allied Products Institute. Terborgh said that depreciation should not be included in the computation, but rather a flat rate, not less than ten percent, should be applied to the capital spending.  

The American Institute of Certified Public Accountants also was represented during the House Ways and Means

---


Committee hearings, and offered various alternatives to the proposed investment tax credit. They believed that the proposed law was overly complex and suggested that the answer was a more flexible depreciation allowance. They too recommended that if the credit were to be adopted, its computation be based entirely on investment in qualified properties.7

The House Ways and Means Committee held public hearings for twenty-eight days, ranking as one of the most exhaustive hearings held on administrative taxation proposals in modern times. Subsequently, thirty-two meetings were held in executive session to consider and discuss the testimonies heard. In September 1961, when it become apparent that an acceptable bill could not be drafted and presented to the House of Representatives prior to adjournment, a discussion draft was released to the public.8 The Committee Chairman, Wilbur Mills, stated that the proposed legislation would be "the first order of business in the next session of Congress".9

The 87th Congress reconvened for its second session and in early March 1962, the Ways and Means minority members drafted a substitute for the investment tax credit, replacing


it with accelerated depreciation plus an inventory allowance. The latter would be twenty percent of the First $100,000 of inventory plus three percent of inventory over $100,000. The additional depreciation would be graduated up to twenty percent based on the estimated useful life of the property and would be applied to otherwise allowable depreciation. This proposal did not provide for taxpayers having any more depreciation than in the past; it merely accelerated allowable depreciation. This additional depreciation method did not exclude property outside the United States as did the investment tax credit proposal in its form at that stage. (The investment tax credit proposal excluded property outside the United States because, coupled with the foreign tax credit, a double allowance could result.)

The minority members' proposals were not incorporated into the final draft and on March 16, 1962, the Committee on Ways and Means submitted its report (House of Representatives Report No. 1447) to the House. Mr. Mills pointed out that the entire bill, H.R. 10650, represented a major revision and reform of the federal tax system. He stated that the investment credit in the bill "is designed to provide a stimulant to the economic growth of this country". Mills reported that the Committee proposed retroactive to January 1962, a credit against taxes of eight

percent on investment in new tangible personal property, certain depreciable real property and limited amounts of used property. The eight percent investment credit was for property with expected useful life of eight years or more, and was graduated down to one-third of the eight percent for property with estimated useful lives of four years. The credit was to be limited to the amount of the tax and could not exceed $100,000 plus fifty percent of the tax over $100,000. Mr. Mills further reported that "The tax credit increases the profitability of productive investment by reducing the net cost of acquiring new equipment."  

On March 29, 1962, the House of Representatives passed H.R. 10650. The section relating to the investment credit was substantially unchanged except that the credit was reduced from eight percent to seven percent and the $100,000 limit plus fifty percent excess was cut to $25,000 plus twenty-five percent.

The House Ways and Means Committee had spent ten months on the entire bill, and on April 2, 1962 it was referred to the Senate Finance Committee. The chairman of the committee, Senator Harry F. Byrd (D-Va.) indicated that this was indeed a major tax bill, and predicted that the Senate Finance Committee hearings would last more than a month. 


Secretary Dillon was the first witness and again stressed that the investment tax credit was the most important part of the H.R. 10650. He pointed out that in lieu of the seven percent credit, a fourteen percent tax deduction could have been allowed which would have given the same general tax reduction (for companies in the fifty-two percent tax bracket). However, he stated, the advantage of the flat credit was to give all taxpayers the same advantage, regardless of their type of organization or tax bracket. Dillon emphasized the fact that although the investment tax credit had been criticized because it was a subsidy, in fact, the generally requested alternative of accelerated depreciation was also a subsidy. He further stressed the idea that allowing unrealistic depreciation tax deductions tended to distort costs for tax, and in many instances for financial accounting purposes where the tax depreciation was used for financial accounting and reporting. The Secretary stated that this might result in setting higher prices to compensate for higher costs, and thus the investment credit was a preferable method because it would not be reflected as a cost. He also urged that the credit be raised back to the eight percent originally proposed by the House Ways and Means Committee. Secretary Dillon was succeeded by approximately 200 witnesses, and some of their testimonies are recorded.

Ibid., Part 1, pp. 79-87.
in the following paragraphs.

Leslie Mills, a partner in the accounting firm of Price Waterhouse & Co., and the Chairman of the American Institute of Certified Public Accountants Committee on Federal Taxation, stated that "the investment tax credit as set forth in H.R. 10650 is a satisfactory version of an allowance for stimulation of growth in investment and productive plant and equipment". He further remarked that this in no way should be considered as an alternative for further reform in the depreciation policies of the Internal Revenue Code.14

Maurice E. Peloubet, a certified public accountant, representing the National Small Business Association of Washington, D. C. agreed with Mr. Mills as to the need for reform in depreciation laws, and also indicated that the investment tax credit was an excellent tax incentive.15

The first witness to raise the question of accounting treatment for the investment credit was a gentleman who plays a leading role in the remainder of this presentation, Leonard Spacek, managing partner of Arthur Andersen & Co., public accountants. He explained that he was not present to dispute or praise the proposed investment tax credit, but rather to request that its purpose be clearly stated so that the proper accounting method could be decided upon. He

14 Ibid., Part 2, pp. 541-542.
15 Ibid., Part 2, pp. 803-810.
pointed out that there could be only two reasons for allowing the investment credit: "(a) To grant a selective reduction of the fifty-two percent tax rate on corporate income; or (b) to grant a reduction in the cost of the property, the acquisition of which is intended to be stimulated." Mr. Spacek was quite vehement in his apparent distaste for reason "a", in that, he rationalized, it resulted in a different tax rate for practically all U.S. companies and would "distort and overstate" current earnings which would, in turn, affect stock market prices. Spacek further stated that professional speculators would benefit from this to the detriment of the smaller investors. As a proof that the investment credit would materially affect earnings, and thus stock prices, he presented a schedule of companies on the New York Stock Exchange, selected at random, showing results of operations for 1960, adjusted for the proposed investment credit. Mr. Spacek quite definitely preferred reason "b" and felt that this was the intent of both President Kennedy and the Committee on House Ways and Means. He indicated that he had brought the same points to the attention of the Treasury Department and Congressman Mills, but to no avail. He reiterated that a clear-cut statement of the purpose of the investment tax credit would assure proper accounting. 16 (A review of the Committee's recommendations indicated that Mr. Spacek's pleas were ignored.)

16 Ibid., Part 2, pp. 823-827.
Secretary Dillon returned in the closing days of the hearings to propose several changes based on the various testimonies during the hearings. Among others, he suggested that the investment tax credit limitation of twenty-five percent of the federal income tax in any one year be raised to fifty percent. He pointed out that this change would have little, if any, effect on profitable companies, but would be significant to less profitable companies.17

On August 16, 1962, the Senate Finance Committee presented its report (Senate Report No. 1881) to the Senate; the provisions relating to the investment tax credit were substantially the same as those passed by the House of Representatives except that two new "wrinkles" were added - the tax basis of the asset for depreciation purposes was to be reduced by the amount of the investment credit, and the credit was mandatory because basis was reduced whenever the credit was available.18 The Senate approved the bill with only minor changes from that recommended by the Finance Committee, and on October 16, 1962, Public Law 87-834 (H.R. 10650) - The Revenue Act of 1962 was approved by President Kennedy.19

As passed, the investment tax credit was applicable to taxable years ending after 1961, and was seven percent of

---

17 Ibid., Part 10, p. 4375.
19 Ibid., p. 111.
qualified investment in certain depreciable property. The qualified investment was based on cost, and for most industrial companies was as follows: One-third if the estimated useful life was four years or more, but less than six years; two-thirds if six or more, but less than eight years and 100 percent if eight years or more. The reduction of basis and the $25,000 plus twenty-five percent limitation as previously described were included, and a three year carryback and five year carryforward were also made a part of the law.20 The credit was to be reduced and possibly eliminated if the qualified investment was disposed of prematurely. The investment credit was described in various terms including, "a cash rebate because it is a direct reduction of the tax due."21

Summary

The tax bill was signed into law almost 18 months after President Kennedy first introduced it to Congress. It was apparent that there were several purposes envisioned by its creators, including the following:

(1) To stimulate capital spending by giving a tax incentive to those who would invest in plant and equipment.

(2) To modernize equipment by making the United States more competitive in foreign and domestic markets.


(3) To reduce taxes. Although the law was clear, we will learn, in the succeeding chapter, of the controversies that ensued within the accounting profession as a result of the passage of the investment tax credit.
CHAPTER III
INITIAL ACCOUNTING TREATMENT PROPOSALS

The investment tax credit, an integral part of the Revenue Act of 1962, was now an accomplished fact, and few, if any, accountants realized the uproar which was about to begin within their profession. This chapter will be devoted to discussing the initial methods proposed to account for the investment tax credit, the theory behind each method, the American Institute of Certified Public Accountants' recommendations, the accounting profession's reactions and the methods actually followed in practice. In connection with these methods, statistics will be presented to show the trend of treatment afforded the investment credit and financial statements of selected companies will be included to indicate how specific companies handled the investment credit.

Income Treatment

From the point of view of income treatment, there were basically four different accounting methods proposed; these methods are briefly discussed in the following paragraphs.

100 percent flow through

Proponents of this method stated that the investment credit was merely a reduction in federal income taxes in the year that the qualified property was purchased. They thus concluded that no special accounting treatment was
necessitated, rather, the provision for taxes should be reduced to reflect the actual tax computed, net of the investment credit. Therefore, this resulted in net earnings being increased to the extent of the entire investment credit. For example (ignoring, for simplicity, the effect of not being allowed to depreciate portions of the qualified investment), assuming earnings before taxes of $100,000, taxes before the computation of the investment credit of $46,500 and an investment credit of $10,000, the reported net earnings in the first year would be $63,500 as follows:

<table>
<thead>
<tr>
<th>Earnings before Federal income taxes</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal income taxes ($46,500 - $10,000)</td>
<td>36,500</td>
</tr>
<tr>
<td>Net earnings</td>
<td>$ 63,500</td>
</tr>
</tbody>
</table>

"48-52" method

Backers of this method were basically in agreement with the 100 percent flow through approach, i.e., that the investment credit was a reduction in taxes, however they went one step further. They pointed out that since the investment credit reduced the depreciable tax basis of the property involved, the investment credit should be taken into current year earnings only to the extent that there was a net tax saving. Assuming a federal income tax rate of fifty-two percent (the then prevailing corporate tax on yearly income in excess of $25,000), the only net tax benefit would be forty-eight percent of the investment credit. This would occur because depreciation expense on the investment credit
which was not allowable would normally have been a deduction over the life of the property with a resulting net tax savings of fifty-two cents on the dollar. Thus, the rationale was that forty-eight percent of the investment credit should be reflected as a decrease in the tax provision and the remaining fifty-two percent be deferred over the estimated useful life of the property offsetting the unallowable depreciation. Using the same example as above, and assuming that all the qualified property had a ten-year life, and including one year amortization of the investment credit, net earnings would be $58,820 reported as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnings before federal income taxes</td>
<td>$100,000</td>
</tr>
<tr>
<td>Federal income taxes ($46,500) - ($10,000</td>
<td></td>
</tr>
<tr>
<td>times forty-eight percent) - ($10,000</td>
<td></td>
</tr>
<tr>
<td>times fifty-two percent, times ten percent)</td>
<td>$41,180</td>
</tr>
<tr>
<td>Net earnings</td>
<td>$58,820</td>
</tr>
</tbody>
</table>

Cost reduction

The cost reduction theorists contended that the investment credit resulted in a reduction in the costs of the qualified property and thus future depreciation costs were reduced. They recommended spreading the investment credit over the life of the property. Using the above example, under the cost reduction concept, the reported net earnings would be $54,500 as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnings before federal income taxes</td>
<td>$100,000</td>
</tr>
<tr>
<td>Federal income taxes ($46,500) - ($10,000 times ten percent)</td>
<td>$45,500</td>
</tr>
<tr>
<td>Net earnings</td>
<td>$54,500</td>
</tr>
</tbody>
</table>


Contribution to capital

A small segment of the profession felt that the investment credit resulted in a subsidy by the Government and thus should be treated as a contribution to capital. This method received relatively little support and was quickly disposed of by the Accounting Principles Board of the American Institute of Certified Public Accountants. They stated that this method was in contradiction to the general conclusion that net income is increased by the investment credit.¹

Comparative analysis

Assuming that there is no change in income, that the tax rate remains the same, that no additional property is purchased and utilizing the previous examples, the table below compares the three methods for a ten-year period.

<table>
<thead>
<tr>
<th></th>
<th>First year</th>
<th>Second through tenth years</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnings before federal income taxes</td>
<td>$100,000</td>
<td>$100,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Federal income tax (net of the investment credit)</td>
<td>$36,500</td>
<td>$46,500</td>
<td>$455,000</td>
</tr>
<tr>
<td>Net earnings</td>
<td>$63,500</td>
<td>$53,500</td>
<td>$545,000</td>
</tr>
</tbody>
</table>

"48-52"

<table>
<thead>
<tr>
<th></th>
<th>First year</th>
<th>Second through tenth years</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnings before federal income taxes</td>
<td>$100,000</td>
<td>$100,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Federal income tax (net of investment credit and amortization)</td>
<td>41,180</td>
<td>45,980</td>
<td>455,000</td>
</tr>
<tr>
<td>Net earnings</td>
<td>$58,820</td>
<td>$54,020</td>
<td>$545,000</td>
</tr>
</tbody>
</table>

Cost reduction

<table>
<thead>
<tr>
<th></th>
<th>First year</th>
<th>Second through tenth years</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnings before federal income taxes</td>
<td>$100,000</td>
<td>$100,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Federal income taxes (net of amortization of the investment credit)</td>
<td>45,500</td>
<td>45,500</td>
<td>455,000</td>
</tr>
<tr>
<td>Net earnings</td>
<td>$54,500</td>
<td>$54,500</td>
<td>$545,000</td>
</tr>
</tbody>
</table>

As can be seen in the above table, in total for the ten-year period there is no difference in net earnings. This example, however, assumes no additional purchases of property which is highly unlikely. Continual acquisition of property would, of course, cause a more or less permanent difference in net earnings, as long as different methods of accounting for the investment credit were in use.

Opinion No. 2 of the Accounting Principles Board

The Accounting Principles Board met in late 1962 to determine the proper method to be used in accounting for the investment credit. The Board stated that:

"There is no significant disagreement with the view that the investment credit is a factor which influences the determination of net income." The basic
accounting issue before us therefore is not whether the investment credit increases net income but, rather, the accounting period(s) during which it should be reflected in the operating statement. Resolution of the accounting issue, in large part, rests upon the accounting principles relative to the realization of income".2

They went on to state that:

"We believe that the interpretation of the investment credit as a reduction in or offset against a cost otherwise chargeable in a greater amount to future accounting periods is supported by the weight of the pertinent factors and is based upon existing accounting principles..."

"In reaching this conclusion we have evaluated the pertinent portions of the legislative history of the investment credit, which we regard as significant but not decisive. [Italics added] We also evaluated the pertinent provisions of the Revenue Act of 1962 which, as earlier stated, require that the investment credit be treated as a reduction in the basis of the property which gives rise to the credit and which contain recapture and other provisions the effect of which is to make realization of the credit dependent to some degree on future events."3

The Board, spearheaded by Leonard Spacek, Arthur Andersen & Co. (from whom we previously heard during the Congressional hearings), thus concluded that the investment credit should be spread over the life of the qualified investment (cost reduction method), except for regulated companies required by public bodies to treat the credit differently for ratemaking purposes. Dissenters to this conclusion felt that the "48-52" method was an equally acceptable method. Messrs. Bevis, Price Waterhouse & Co., Powell, Haskins & Sells, and

2Ibid., p. 5.
3Ibid., p. 6.
Tippit, Ernst & Ernst, indicated that:

"...the pertinent factors preponderantly support the view that the investment credit is in substance a reduction in income taxes. They consider that the generally accepted accounting principles applicable (including the pronouncements of the former Committee on Accounting Procedure, especially those relating to the accounting for income taxes and to the reporting of income, which are still in effect) preponderantly support the treatment of the investment credit as a reduction of the provision for current income taxes in the year in which the credit arises. They believe specifically, that the generation of taxable income for the year in and by itself, rather than the future productive use of the related property, effects the realization of the credit. They point out that opinions received by the Board from practitioners and businessmen make it clear that the "48-52" method discussed in paragraph 7 of the Opinion has at least as wide acceptance among these groups as the method sponsored by the majority of the Board. They believe that, in the circumstances, the "48-52" method must also be considered to have substantial authoritative support and, therefore, to be generally acceptable."4

Initial aftermath of Opinion No. 2

The Board had reached its decision by a vote of fourteen to six. What was particularly significant, however, was that of the eight major certified public accounting firms in the United States, all of which were represented on the Board, four voted with the minority; thus the "big eight" of public accounting had split on the issue. The dissenters indicated that they generally preferred the "48-52" method, and would allow their clients maximum leeway as long as there was full disclosure of the method utilized. (The latters'
clients included over one-half of the companies listed on the New York Stock Exchange.)

The investment tax credit dispute clearly caused a major crisis in the accounting profession. Tempers flared; Thomas G. Higgins, of Arthur Young & Co., was quoted as saying angrily that the minority's position was "prehistoric: This is the first time in my memory that a major firm has thumbed its nose at the recognized authority in the profession." Business Week stated that:

"There's no denying that the gulf that separates the warring factions is a deep one. The men involved all have strong beliefs, and they are not swayed easily. Despite the impasse, though, accounting problems continue to arise - and companies and their accountants are solving them the best way they can."7

The Journal of Accountancy included comments such as "The controversy over the proper accounting treatment of the 7 percent investment credit provided by the Revenue Act of 1962 has focused more journalistic attention on accounting than any single event in years."8 Emphasizing the publicity that the investment credit issue had received, the Journal went on to quote various publications which had reported on the events, including the following:

6 Ibid., p. 55.
7 Ibid., p. 60.
Business Week....."This week, the accounting profession laid down some guidelines on what has been a ticklish, awkward problem for industry: how corporations should treat the new 7 percent investment credit on their books."

The Wall Street Journal....."By barely the required vote, an influential accountants' board passed a disputed "guide rule" on treatment of the new tax credit on equipment purchases in companies' financial reports."

The Chicago Daily News Service....."Big fights are shaping up in the accounting profession". The profession, to a certain extent, seemed to enjoy its newly acquired notoriety, but at the same time realized that a real problem was on the scene.9

Securities and Exchange Commission's position

Adding more "fuel to the fire", the Securities and Exchange Commission appeared to prefer the minority's "48-52" method, but stated that it would also accept the method approved by the Accounting Principles Board. The Commission indicated that although they generally did not accept qualified opinions by independent accountants, they would in instances where the qualification was a result of use of the "48-52" method. The Commission did set up some groundrules. They wanted the property accounts to be stated at cost on the balance sheet (regardless of the fact that the investment

credit reduced the tax basis), and indicated that income tax
should not be stated at more than the actual amount payable. 10

Arguments advanced for
the cost reduction method

The points raised in favor of treating the investment
tax credit as a reduction in cost and spreading the
credit over the life of the asset can be briefly summarized
as follows:

(1) The purpose of the credit was to stimulate acquisi-
tion of machinery and equipment by reducing
the net cost of investing therein, therefore
this reduction should be recognized over the
life of the asset. 11

(2) The credit is earned only if the property is
retained for the required holding period, and
thus the credit should be spread over this
period. 12

(3) Income is not earned merely by the purchase of
equipment but rather from its use; therefore,
the income should be recognized over the life
of the equipment. 13

(4) Spreading the credit equally over the life of
the asset precludes manipulation of earnings
by timing of equipment purchases. 14

10 "Accounting for the 'Investment Credit,'" Accounting
Series Release No. 96, Securities and Exchange Commission,
January 10, 1963.

11 Ronald M. Horwitz, "The Investment Credit, 'Deferred
Income Taxes' and Account Measurement," The Accounting

12 Kenneth B. Berg and Fred J. Mueller, "Accounting for

13 Opinions of the Accounting Principles Board, No. 2,
p. 7.

Arguments advanced for the 100 percent flow through method

Since the 100 percent flow through method was not generally accepted, other than for regulated companies, it will not be examined any further in this chapter.

Arguments advanced for the "48-52" method

Because the Accounting Principles Board had recommended the cost reduction method, many of the reasons advanced for the "48-52" method were actually in the form of refuting the cost reduction method suggested by the Accounting Principles Board. The major points raised by the proponents of the "48-52" method are briefly discussed below:

(1) There is substantial authoritative support for the "48-52" method including:15

(a) Numerous responses to the Accounting Principles Board's exposure draft.

(b) The recommendation of the Director of Research of the American Institute of Certified Public Accountants.

(c) Accounting practice of other countries which previously had similar credits.

(d) The opinion of the Securities and Exchange Commission.

(2) Although the intent of the Congress should be considered, it is not the determining factor.16 Furthermore, a careful reading of the Congressional Hearings and selections therefrom of various portions of the records

---


would support almost all of the proposed accounting treatments.17

(3) While the Accounting Principles Board wants to treat the credit effectively as a subsidy, it is not a subsidy, but rather a complicated method of computing taxes, not too unlike the depletion provisions of the tax law where deductions in excess of cost are allowed.18

(4) The credit was not intended as a subsidy since it is only available if a profit is made, and profitable companies are normally not subsidized by the government.

(5) The fact that the credit must be repaid if the property is prematurely disposed of should not be considered an argument against the "48-52" method because equipment is not normally purchased with the idea of disposition prior to full use, and justification based on future assumptions can not be considered valid. Furthermore, the "going concern" concept, i.e., anticipated continuity of existence, followed extensively in accounting literature would also tend to refute considerations of early disposal.

(6) It can be contended that purchases of machinery and equipment do affect income, since a wise choice of equipment can have a material effect on future revenues.19

Balance Sheet Treatment

Although not receiving as much publicity, there apparently existed some question in the minds of the accounting profession as to the proper balance sheet presentation of the investment tax credit. The Revenue Act of 1962 stated that the basis of the qualified asset be reduced by

18 Ibid., p. 559.
19 Ibid., p. 556.
the investment credit.\textsuperscript{20} Literal compliance with this requirement would result, at least initially, assuming a seven percent credit, in showing the assets on the balance sheet at ninety-three percent of cost. This method was not acceptable to the Securities and Exchange Commission\textsuperscript{21} (see page 26). The Accounting Principles Board of the American Institute of Certified Public Accountants indicated that there were two acceptable alternatives,\textsuperscript{22} as follows:

1. Reduction in the property directly, or indirectly by inclusion in a reserve account which was deducted from the property.

2. Treating the investment credit as deferred income to be amortized over the life of the applicable property.

In addition to the above alternatives, there were several other methods offered as "the" solution. These methods included treating the credit as deferred taxes,\textsuperscript{23} as a deferred liability\textsuperscript{24} and even splitting the credit into two parts - fifty-two percent as deferred taxes to be amortized over the life of the asset and forty-eight percent as deferred income to be amortized over the required tax holding period. For example, an asset with a fifteen year life


\textsuperscript{21}Securities and Exchange Commission, January 10, 1963.

\textsuperscript{22}Opinions of the Accounting Principles Board, No. 2, p. 7.


would only have a required tax holding period of eight years to earn the maximum credit.\textsuperscript{25}

Methods Actually Used in 1962 And 1963

The following tables summarize actual methods used in 1962\textsuperscript{26} and 1963\textsuperscript{27} as reported to the American Institute of Certified Public Accountants:

<table>
<thead>
<tr>
<th>Number of companies in survey which disclosed method of reporting investment tax credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income treatment</td>
</tr>
<tr>
<td>Cost reduction method</td>
</tr>
<tr>
<td>&quot;48-52&quot; method</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Balance sheet treatment</td>
</tr>
<tr>
<td>Reserve for deferred taxes (1963 also includes reserve for taxes)</td>
</tr>
<tr>
<td>Reserve for depreciation</td>
</tr>
<tr>
<td>Deferred income</td>
</tr>
<tr>
<td>Other ways</td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>

As can be seen in the above tables, there was a wide diversion of opinion in terms of the methods actually used during 1962 and 1963. It appeared that generally


the companies involved followed the methods which their independent accountants had supported during the discussions of the Accounting Principles Board. It is not surprising that experts in the profession could not reach an agreement on one method. Similar situations in other areas of accounting thinking have existed for years. For example, one company may depreciate property, plant or equipment equally over its life, while another company may choose to accelerate depreciation charges in the earlier years with gradual decreases in later years. Either of these methods is considered to be generally accepted since circumstances from company to company may vary. Today within the accounting profession there is a movement to narrow areas of differences within accounting principles, however, the more astute professional accountants have pointed out the dangers inherent in moving too quickly in this direction. 28

Excerpts from 1962 and 1963 Annual Reports

The following paragraphs illustrate examples of 1962 and 1963 investment credit reporting practices. In those instances where the independent accountants qualified their opinion due to the method of accounting for the investment credit, there is a reference to the opinion. In order to simplify the presentation, the terminology has been standardized.

Cost Reduction Method

National Dairy Products Corporation (Independent accountants - Arthur Andersen & Co.)

Income statement -

- Earnings before income taxes $110,444,358
- Provision for income taxes 54,736,000
- Provision for deferred taxes relating to investment credit (See note) 1,690,000
- 56,426,000
- Net earnings for the year $54,018,358

Balance sheet -

- Deferred income taxes $13,657,804
  (separate caption after long-term debt caption)

Notes to financial statements -

In accordance with the Company's policy of amortizing the investment credit over the useful life of the related property, $185,000 of the credit available for 1963 has been reflected in earnings in 1963 and $1,690,000 has been deferred to future operations.

Discussion -

The $185,000 amortization was apparently included in other income, and the $54,736,000 appears to be the taxes actually payable, net of the investment credit. The portion of the investment credit to be reflected in income of future years was added back to the $54,736,000 to eliminate the

effect of the reduction in taxes due to the investment credit. This is a clear and acceptable manner of reporting the investment credit.

R. J. Reynolds Tobacco Company\textsuperscript{30} (Independent accountants - Ernst & Ernst)

Income statement -

Net earnings for the year \textbf{\$119,803,165}

Notes to financial statements -

The 1962 provision for income taxes is after deducting the investment credit of \$1,121,587, and an equivalent amount has been included as additional depreciation for the year.

Discussion -

Although not indicated, the portion of the investment credit amortized to income was apparently credited to other income as in the previous example, however, instead of a separate line in the tax section, the investment credit was included with depreciation expense. Based on the note, it would appear that the investment credit was included on the balance sheet in the accumulated depreciation account. This is also an acceptable reporting practice.

\textsuperscript{30}Adapted from 1962 Annual Report of R. J. Reynolds Tobacco Company.
Lockheed Aircraft Corporation\textsuperscript{31}  
(Independent accountants - Arthur Young & Company)  

Income statement -  
Net earnings for the year \hfill $37,199,000  

Balance sheet -  
Deferred income (Note 4)  
\hfill $14,406,000  
\textsuperscript{(separate caption after current liabilities caption)}  

Notes to financial statements -  
Deferred income includes a deferred investment credit of $832,000 resulting from the acquisition and lease of equipment. This amount will be amortized over the productive life of the related equipment.  

Discussion -  
The balance sheet treatment is quite clear; however, there is not enough information to identify the investment credit on the income statement. This reporting practice is considered acceptable although it would have been preferable to indicate the income statement treatment accorded the investment credit.  

Peabody Coal Company\textsuperscript{32}  
(Independent accountants - Arthur Andersen & Co.)  

Income statement -  
Net earnings for the year \hfill $17,245,760  

\textsuperscript{31}Adapted from 1962 Annual Report of Lockheed Aircraft Corporation.  
\textsuperscript{32}Adapted from 1963 Annual Report of Peabody Coal Company.
balance of the credit has been included under accumulated depreciation in the accompanying balance sheet.

Discussion -

In the previous cost reduction method examples, there were no references to an "ultimate saving". It is interesting to note mention of the forty-eight percent savings, one of the arguments advanced for the "48-52" method, in a report where the cost reduction method is followed. Again, it is difficult to determine how the investment credit was treated on the income statement, particularly in light of the disclosure of a savings, and the fact that only the "savings" amortization was discussed. Use of the accumulated depreciation account however might imply inclusion with depreciation expense. The treatment is, in any event, acceptable.

"48-52" Method

J. J. Newberry Co. 34 (Independent accountants - Peat, Marwick, Mitchell & Co.)

Opinion of independent accountants -

Qualified due to use of "48-52" method.

Income statement -

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnings before income taxes</td>
<td>$3,639,203</td>
</tr>
<tr>
<td>Provision for income taxes (Note 1)</td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>930,000</td>
</tr>
<tr>
<td>Deferred</td>
<td>725,000</td>
</tr>
<tr>
<td>Net earnings for the year (Note 1)</td>
<td>$1,984,203</td>
</tr>
</tbody>
</table>

Balance sheet -

Deferred income taxes  $ 3,760,000
(Separate caption after current liabilities caption)

Notes to financial statements -

The Company is entitled to claim an investment credit of $390,000 in its 1962 income tax return. Management is of the opinion, however, that the maximum investment credit allowable in reporting current earnings should be based on deferred income taxes payable as well as on income taxes currently payable. Accordingly, $291,000 (forty-six percent of the investment credit of $630,000 computed under this method) was applied as a reduction of income taxes charged to current earnings.

If the investment credit had been based on income taxes currently payable and its absorption in net earnings spread over the useful lives of the related assets (cost reduction method), net earnings would have been reduced by approximately $270,000.

Discussion -

The Company was apparently entitled to an investment credit carry forward and believed that since it charged deferred taxes against current earnings, it would be consistent to compute the investment credit based on the reported total provision for income taxes. The latter procedure along with the use of the "48-52" method caused the independent accountants to render a qualified opinion. The
qualification appears reasonable since the $270,000 was material (approximately fourteen percent) in relation to net earnings.

North American Car Corporation\(^{35}\)
(Independent accountants - Arthur Young & Company)

Opinion of independent accountants -

Qualified due to use of "48-52" method.

Income statement -

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnings before income taxes</td>
<td>$ 7,549,993</td>
</tr>
<tr>
<td>Provision for income taxes (Note 1)</td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>1,821,000</td>
</tr>
<tr>
<td>Deferred</td>
<td>1,608,000</td>
</tr>
<tr>
<td></td>
<td>3,429,000</td>
</tr>
<tr>
<td>Net earnings for the year</td>
<td>$ 4,120,993</td>
</tr>
</tbody>
</table>

Notes to financial statements -

An amount equal to forty-eight percent of the investment credit (after provision for applicable income taxes payable in future years) was reflected in earnings through reduction in the provision for income taxes, thereby increasing reported net earnings by $311,000.

Discussion -

It appears that the Company followed the same procedure as in the previous example, although the independent accountants apparently restricted their qualification to use of the "48-52" method and ignored (or accepted) the concept

\(^{35}\)Adapted from 1962 Annual Report of North American Car Corporation.
of reporting the credit based on current and deferred income taxes. The effect on net earnings was eight percent which is material enough to result in a qualified opinion.

Granite City Steel Company36
(Independent accountants - Price Waterhouse & Co.)

Income statement -

Earnings before income taxes $14,630,419

Provision for income taxes
  Current year 5,742,000
  Income tax deferment resulting from
  accelerated method of depreciation and investment credit (Note 2) 2,450,000
  Income taxes deferred in prior years, currently payable (992,000)

Net earnings for the year $7,430,419

Balance sheet -

Deferred income taxes (Note 2) $22,475,000
  (Separate caption after long-term debt caption)

Notes to financial statements -

The Company is entitled to an investment credit of approximately $470,000 which is a reduction of the current provision for income taxes. An amount of $244,000 has been provided for income taxes which will be payable in future years because the law requires application of the investment credit against the tax basis of the property.

36Adapted from 1962 Annual Report of Granite City Steel Company.
The balance of $226,000, representing the permanent tax savings, is included in net earnings for the year.

Discussion -

The $244,000 is included in the $2,450,000 and the $470,000 is eliminated from the current year income tax provision, therefore, the $226,000, net savings, automatically flows into net earnings. This is certainly a simple, yet clear and acceptable manner of reporting the investment credit.

Westinghouse Electric Corporation
(Independent accountants - Main and Company)

Income statement -

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnings before income taxes</td>
<td>$ 98,661,815</td>
</tr>
<tr>
<td>Provision for income taxes (Note 3)</td>
<td>$ 41,600,000</td>
</tr>
<tr>
<td>Net earnings for the year</td>
<td>$ 57,061,815</td>
</tr>
</tbody>
</table>

Balance sheet -

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred income taxes - investment credit</td>
<td>$ 980,636</td>
</tr>
</tbody>
</table>

Notes to financial statements -

The permanent tax saving (48% of the investment credit, equal to $1,007,582) reduced income tax expense in the year 1962. The balance of the investment credit was deferred to the subsequent accounting periods during which depreciation allowances for tax purposes will be reduced.

Discussion -

This treatment results in the same net effect as that in the previous example.

General Cable Corporation\(^{38}\) (Independent accountants - Peat, Marwick, Mitchell & Co.)

Income statement -

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net earnings before income taxes</td>
<td>$21,692,170</td>
</tr>
<tr>
<td>Provision for income taxes (Note 2)</td>
<td>10,550,000</td>
</tr>
<tr>
<td>Net earnings for the year</td>
<td>$11,142,170</td>
</tr>
</tbody>
</table>

Notes to financial statements -

The portion of the investment credit equal to the tax that may be payable in the future because of reduction in future depreciation has been credited to accumulated depreciation and the remainder of $67,000 has been applied in the reduction of the provision for income tax.

Discussion -

Similar to the two previous examples, the provision for income taxes was reduced by the permanent tax savings, however, the balance sheet treatment is different in that accumulated depreciation not deferred income taxes is credited by the portion of the investment credit which is not a tax savings. This is an equally acceptable reporting practice.

\(^{38}\)Adapted from 1963 Annual Report of General Cable Corporation.
S. S. Kresge Company

(Independent accountants - Price Waterhouse & Co.)

Income statement -

Earnings before income taxes $18,117,163
Provision for income taxes including deferred income taxes, less 48% of investment credit 9,103,000
Net earnings for the year $9,014,163

Balance sheet -

Deferred income taxes $11,940,396
(Separate caption after long-term debt caption)

Notes to financial statements -

The investment credit will reduce federal income tax payments by approximately $495,800 of which 48% has been reflected in income and 52% deferred to future years.

Discussion -

This treatment is virtually identical to that used by Granite City Steel Company.

Koppers Company, Inc.

(Independent accountants - Arthur Young & Company)

Income statement -

Earnings before provision for income taxes $13,823,040
Provision for income taxes (Note 6) 5,997,614
Net earnings for the year $7,825,426

40 Adapted from 1962 Annual Report of Koppers Company, Inc.
Notes to financial statements -

The Company's investment credit amounted to $514,000. Of the credit, 48%, which was immaterial in relation to net income, was reflected in income as a reduction of federal income tax expense and the balance was credited to deferred income taxes.

Discussion -

This is essentially the same treatment as used by Westinghouse Electric Corporation.

Anchor Hocking Glass Corporation

(Independent accountants - Price Waterhouse & Co.)

Income statement -

Net earnings for the year (Note 2) $6,633,104

Balance sheet -

Deferred income taxes (Note 2) $564,501

(Separate caption after current liabilities caption)

Notes to financial statements -

The investment credit reduces income taxes currently payable by $372,000. Net earnings include $178,000, or 48% of the investment credit, and the remaining 52% has been provided as deferred income taxes payable over the estimated service lives of the equipment additions.

Discussion -

41Adapted from 1962 Annual Report of Anchor Hocking Glass Corporation.
This treatment is quite similar to the Granite City Steel Company report.

Other Methods

Tennessee Gas Transmission Company

(Independent accountants - Arthur Andersen & Co.)

Income statement -

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnings before income deductions</td>
<td>$116,755,400</td>
</tr>
<tr>
<td>Income deductions</td>
<td></td>
</tr>
<tr>
<td>Charge equivalent to investment credit income tax deduction (Note 7)</td>
<td>$4,985,000</td>
</tr>
<tr>
<td>Interest and other income deductions</td>
<td>45,945,372</td>
</tr>
<tr>
<td></td>
<td>50,930,372</td>
</tr>
<tr>
<td>Net earnings for the year</td>
<td>$65,825,028</td>
</tr>
</tbody>
</table>

Notes to financial statements -

The investment credit generally has been recorded pursuant to an order of the Federal Power Commission prescribing interim accounting which provides for a charge to "Income Deductions" equivalent to the reduction in current federal income taxes and a corresponding credit to "Deferred Credits" pending a final determination of the proper accounting treatment by the Commission. At December 31, 1963, the companies' unused investment credit aggregated approximately $3,800,000.

42Adapted from 1963 Annual Report of Tennessee Gas Transmission Company.
Discussion -

This treatment results in the entire investment credit being deferred to future periods, with no part being recorded as income in the current year.

General Telephone Company of California (Independent accountants - Arthur Andersen & Co.)

Income statement -

\[
\begin{align*}
\text{Provision for income taxes (Note 4)} & \quad \$ 22,390,000 \\
\text{Net earnings for the year} & \quad \$ 24,486,255
\end{align*}
\]

Notes to financial statements -

The investment tax credit applicable to eligible property additions amounted to $1,728,000 in 1963 and $1,070,000 in 1962. In accordance with the requirements of the uniform system of accounts prescribed by the California Public Utilities Commission, these amounts have been deducted from the provisions for income taxes, thereby increasing reported net earnings by the same amount. For income tax purposes, depreciable property is being reduced by the investment credit resulting in lower depreciation allowances and higher income taxes in future years. These higher taxes will be charged to expense as they arise.

Discussion -

As can be seen from the note, the entire investment credit was recorded as income (100 percent flow through method).

Adapted from 1963 Annual Report of General Telephone Company of California.
Income statement -

Net earnings for the year $105,086,000

Notes to financial statements -

The estimated amount of the investment credits as recorded in the accounts of consolidated subsidiaries, totaling $6,222,000 in 1963 and $4,065,000 in 1962, has been reflected in the consolidated financial statements as follows:

Manufacturing Companies - The investment credits of $833,000 in 1963 and $581,000 in 1962 have been applied as reductions in the net cost of the applicable property additions and are being amortized over the estimated service life of the property through reduced depreciation expense. The amount of such amortization was $154,000 in 1963 and $45,000 in 1962.

Telephone Operating Companies - The investment credits applicable to regulated telephone operating companies amounted to $5,389,000 in 1963 and $3,484,000 in 1962.

At December 31, 1962, the Federal Communications Commission and most other regulatory agencies had not yet determined the permanent accounting treatment which subject companies would be required to follow. For this reason, the total amount of the investment credits applicable to all

Adapted from 1963 Annual Report of General Telephone & Electronics Corporation.
regulated telephone companies was deferred in the consolidated financial statements, including $1,216,000 applicable to companies operating in two states which had accounted for the investment credit as a reduction in the provision for income taxes in accordance with orders or notices received from regulatory commissions. The accounts of all companies were adjusted to interim procedures authorized by the Federal Communications Commission.

In the 1963 consolidated financial statements, the investment credits for all telephone operating companies have been accounted for in substantially the same manner as recorded by the individual companies (including those amounts applicable to 1962 which had been adjusted). The investment credits for companies which are subject to the Federal Communications Commission or which have not received permanent accounting orders from other regulatory agencies having jurisdiction have been deferred in the same manner as in 1962. The investment credits for companies which have received permanent accounting orders from regulatory agencies having primary jurisdiction have been reflected in the consolidated financial statements in accordance with such orders.

Pursuant to this accounting treatment, investment credits of telephone operating companies totaling $3,317,000, of which $1,216,000 applies to 1962, are included in net earnings for 1963.
As of December 31, 1963, investment credits of $5,556,000 are included in reserves and deferred credits.

Discussion -

It would appear that at least three different methods were in use, including the cost reduction method, 100 percent deferral and the 100 percent flow through method. This is indeed an interesting but somewhat confusing presentation.

Reflections on the Cost Reduction and "48-52" Methods Used During 1962 and 1963

As has been previously stated, it would appear that generally the various companies reported the investment credit on the basis supported by their independent accountants. In the preceding examples, both Arthur Young & Company and Peat, Marwick, Mitchell & Co. rendered qualified opinions; they also gave opinions without qualification on companies which had in one instance followed the cost reduction method and in another the "48-52" method. The Peat, Marwick, Mitchell & Co. qualification appears inconsistent with their previously stated position of allowing their clients maximum leeway. Arthur Young & Company, however, had been rather outspoken in its support of the cost reduction method, but as indicated in the note to the Koppers Company's financial statements, the effect on income was immaterial. (Based on the amounts given, it would appear that the variation from the Arthur Young & Company stated position had an approximate three
percent effect on net income - accountants traditionally use a five to ten percent rule of thumb for materiality in relation to net income.) Although not included in any of the preceding examples, no doubt other certified public accountants found themselves in positions similar to Arthur Young & Company.

Reflections on Other Methods Used During 1962 and 1963

It is interesting to note that the three examples of other methods (all regulated companies) produced three completely opposing accounting treatments. These methods included 100 percent deferral of the investment credit in the first instance (Tennessee Gas Transmission Company), 100 percent flow through to income in the second instance (General Telephone Company of California) and, in the third instance (General Telephone & Electronics Corporation), a combination of several different methods used by the parent's various subsidiaries.

All of the latter three companies' financial statements were reported on by Arthur Andersen & Co. and in each instance an unqualified opinion was given. In the first two instances, the investment credit was over seven percent of net income, and thus, assuming the ten percent materiality concept, the independent accountant apparently felt that no qualification as to use of "generally accepted accounting principles" was necessary. In any event, there
was adequate disclosure of the methods used. It would appear that the materiality concept was the reason for the "clean" opinions since the firm involved was managed by Leonard Spacek, probably the accounting profession's leading advocate of the cost reduction method, even in instances where regulated companies were involved.45

Summary

Although the Accounting Principles Board of the American Institute of Certified Public Accountants had officially gone on record as recommending the cost reduction method of accounting for the investment credit, it is apparent that competent certified public accountants and leading executives of the business community did not agree that this was the only and/or best method of accounting therefor. As a result of this disagreement, we will discover in the next chapter that the Accounting Principles Board dramatically reconsidered and altered its original stated position. We will also see how the provisions of the Revenue Act of 1962 related to the investment credit were amended.

CHAPTER IV
SIGNIFICANT EVENTS OCCURRING IN 1964

The previous chapter described events occurring during 1962, 1963 and early 1964. In this chapter, consideration will be given to 1964 amendments to the original provisions of the investment tax credit. We will also see that in 1964, as a result of the accounting practices discussed in Chapter III, the American Institute of Certified Public Accountants in spite of numerous criticisms, modified its initial stand on accounting for the investment credit. The remainder of this chapter will deal with the effect of this change in terms of the methods used to report the investment credit during 1964.

Revenue Act of 1964

Since the introduction of the investment tax credit, the business community and accounting profession had been highly critical of Section 48(g) of the Internal Revenue Code. This section required that the depreciable tax basis of the qualified investment be reduced by the investment credit taken thereon.¹ The requirement resulted in a great deal of clerical work and, of course, reduced the actual tax benefits to approximately one-half of what they would have otherwise been. The Congress accepted the latter complaints

as being factual and introduced the Revenue Act of 1964 which included an amendment to the Internal Revenue Code repealing Section 48(g).\(^2\) The Revenue Act of 1964 was enacted into law as Public Law 88-272 on February 26, 1964.\(^3\) The requirement to reduce the basis was eliminated, basically, as to property placed in service after December 31, 1963.\(^4\)

As soon as the Revenue Act of 1964 was announced, supporters of both the cost reduction and "48-52" method claimed victory. Each side stated that elimination of the basis reduction proved that its method had been right from the start. Proponents of the 100 percent flow through and "48-52" method argued that now quite clearly the Internal Revenue Code supported the contention that the investment credit was, and always had been, a selective reduction in taxes. Those who preferred the cost reduction method disputed this and indicated that the change was to further reduce the net cost of depreciable property by effectively allowing a larger tax reduction.

As a result of the change, the "48-52" method became the same as the 100 percent flow through method since the only difference between the two methods was the deferral of the lost depreciation benefits which no longer existed.

\(^2\)Ibid.
\(^3\)Ibid., p. ii.
\(^4\)Ibid., p. 3920.
The Accounting Principles Board
Revises Opinion No. 2

In early 1964, in an unprecedented action, the Accounting Principles Board of the American Institute of Certified Public Accountants met to again discuss the accounting treatment of the investment credit and in March 1964 released Opinion No. 4. The new Opinion pointed out that despite the previously recorded preference for the cost reduction method, a significant number of companies had chosen to use the 100 percent flow through ("48-52") method. The Opinion also acknowledged that the Revenue Act of 1964 eliminated the basis reduction, but stated that this in no way changed the nature of the investment credit and was not the reason for revising Opinion No. 2. Apparently, the reasoning was that regardless of the requirement for reduction in basis, the basic accounting question related to the period of income realization which was not affected by the change in basis. The Accounting Principles Board indicated that the main reason for the amendment was due to the fact that subsequent experience showed that Opinion No. 2 had not received general acceptability.5

Opinion No. 4 which passed by a vote of fifteen to five reiterated that the cost reduction method was still preferable, but concluded that "the alternative method of treating the credit as a reduction of Federal income taxes

---

of the year in which the credit arises is also acceptable."⁶

Typical of all the previous furor over the investment credit, there were eight assents with qualification, and these assents along with the five dissents were approximately twice as long as the Opinion itself. Much of the assenting with qualification and dissenting related to fears that the current emphasis within the accounting profession on narrowing the area of accounting principles was undermined by authorizing acceptance of two different accounting principles for the investment credit. Five of the assenters felt that the order of preference should be reversed. Leonard Spacek in a very lengthy dissent stated, among other issues, that "Alternative procedures under this opinion can increase by up to 25 per cent the earnings otherwise reported...this Opinion approves accounting of the type that precipitated the 1929 financial crisis, and that history is being repeated by actions of the very authorities created to prevent such catastrophes."⁷ It would appear that Mr. Spacek's main concern was not so much his disagreement with the alternative method, but rather that the amended opinion, instead of narrowing the area of accounting differences actually accomplished the opposite effect by "authorizing" two different methods. He apparently believed that the 1929

---

⁶Ibid.

⁷Ibid., pp. 22-25.
crisis was partially caused by a lack of uniformity in accounting principles.

The Accounting Principles Board's acceptance of the alternative method raised the question as to how the independent accountant should report upon companies which changed their methods of accounting for investment credit. It appeared that since the Revenue Act of 1964 essentially made the "48-52" and 100 percent flow through methods identical, changing from the former to the latter method was due to changed conditions and, therefore, no mention need be made in the accountant's report (opinion); however, if a material effect resulted, footnote disclosure would be required. A change from the cost reduction to the 100 percent flow through method, however, was a change in accounting principles, much the same as a change from straight line to accelerated depreciation would be, and should be covered in the report if it materially affected the financial statements.

As a result of the Accounting Principles Board's new stand on the accounting treatment of the investment credit, three federal regulatory agencies, the Federal Power Commission, the Federal Communications Commission and

---

the Civil Aeronautics Board authorized the use of either of the acceptable methods recognized by Opinion No. 4.\textsuperscript{10}

**Methods Actually Used in 1964**

The following tables summarize actual methods used in 1964 as reported to the American Institute of Certified Public Accountants.\textsuperscript{11}

<table>
<thead>
<tr>
<th>Income treatment</th>
<th>Number of companies in survey which disclosed method of reporting investment tax credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>100 percent flow through method</td>
<td>302</td>
</tr>
<tr>
<td>Cost reduction method</td>
<td>68</td>
</tr>
<tr>
<td>Other ways</td>
<td>7</td>
</tr>
<tr>
<td></td>
<td>377</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Balance sheet treatment</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred investment credit</td>
<td>40</td>
</tr>
<tr>
<td>Reserve for depreciation</td>
<td>17</td>
</tr>
<tr>
<td>Deferred income taxes</td>
<td>12</td>
</tr>
<tr>
<td>Other ways</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>72</td>
</tr>
</tbody>
</table>

As can be seen from the above tables, there was a decided switch from the cost reduction method as compared to 1962 and 1963 (see page 31). Very few balance sheet treatments are indicated because of the 302 companies which recorded the investment credit as income.


Excerpts from 1964 Annual Reports

The following paragraphs illustrate examples of some of the 1964 disclosures of changes to the 100 percent flow through method of accounting for the investment credit. Excerpts from the independent accountant's opinion are shown only where there was a qualification relative to the investment credit. As in the previous chapter, the accounting terminology has been standardized.

Change from Cost Reduction Method

Southern California Edison Company\textsuperscript{12}
(Independent accountants - Arthur Andersen & Co.)

Income statement -

Net earnings for the year \$77,053,122

Notes to financial statements -

Inasmuch as the Company's rates were reduced in 1964, on the basis of the investment tax credit "flowing through" for the benefit of customers, the Company, commencing in 1964, discontinued further provisions to normalize the effect of the investment tax credit. The amount of the investment tax credit is estimated to be \$3,564,000 for 1964. Other income includes a credit of \$4,495,000 as of December 31, 1964, for the deferred amount of the investment tax credit which was charged to miscellan-

\textsuperscript{12}Adapted from 1964 Annual Report of Southern California Edison Company.
eous deductions ($1,228,000 in 1962 and $3,267,000 in 1963) according to regulatory requirements.

Discussion -

The disclosure of the change in accounting for the investment credit appears adequate, but it is not clear why the independent accountants' opinion is not qualified. Since net earnings for the year appears to be increased by approximately ten percent (approximately $8,000,000 out of $77,000,000) as a result of the change, an opinion qualified as to consistency would appear appropriate.

Kennecott Copper Corporation13 (Independent accountants - Lybrand, Ross Bros. & Montgomery)

Income statement -

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net earnings before provision for income taxes</td>
<td>$140,498,279</td>
</tr>
<tr>
<td>Provision for income taxes (Note 8)</td>
<td>74,400,000</td>
</tr>
<tr>
<td>Net earnings for the year</td>
<td>$66,098,279</td>
</tr>
</tbody>
</table>

Notes to financial statements -

Prior to 1964, the Company reflected the investment credit in earnings over the productive lives of the related properties. Beginning in 1964, the investment credit is being accounted for as a reduction of income taxes in the year in which the credit arises. As a result of this change, net earnings for the year have been increased by approximately

13 Adapted from 1964 Annual Report of Kennecott Copper Corporation.
$900,000. The investment credit provided in prior years ($2,100,000) was transferred to taxes accrued to provide for possible prior years' assessments.

Discussion -

The disclosure of the accounting change appears adequate, and since the investment credit is not material in relation to net earnings, no consistency qualification is necessary. It is interesting to note that the deferred portion of the investment credit (from prior years) was transferred to the tax liability account, thus bypassing the income statement.

Draper Corporation\(^{14}\)

*Independent accountants - Price Waterhouse & Co.*

Opinion of independent accountants -

Qualified as to consistency relative to the change, approved by the independent accountants, in accounting for the investment credit.

Income statement -

Net earnings for the year $6,046,127

(Depreciation and provision for income taxes were each referenced to Note 3)

Balance sheet -

Deferred credits - Note 3 $-0-

(Separate caption after current liabilities caption)

\(^{14}\)Adapted from 1964 Annual Report of Draper Corporation.
Notes to financial statements -

In prior years the Company followed the practice of taking the investment tax credit into earnings over the estimated useful lives of the related assets. In 1964 they changed to the 100 percent flow through method, whereby investment tax credits are taken into earnings in the year in which the related assets are acquired. This change in accounting method had the effect of increasing 1964 net earnings by about $450,000, which amount includes $280,000 applicable to prior years.

Discussion -

Both the disclosure and the qualified opinion relative to the change in accounting for the investment credit appear proper.

Polaroid Corporation 15

(Independent accountants - Leonard Levine & Co.)

Opinion of independent accountants -

Consistency qualification due to change, concurred in by the independent accountants, in accounting for the investment credit.

Income statement -

Net earnings for the year (Note G) $18,323,096

Notes to financial statements -

In prior years the Company elected to amortize investment credit over the life of property to which it

15 Adapted from 1964 Annual Report of Polaroid Corporation.
applied. With a change in the Internal Revenue Code for 1964, a decision has been made to reflect the full credit in the period in which the equipment to which it pertains is put into use. The provision for 1964 income taxes is after deduction of $1,189,000. Of this, $281,512 represents credit for capital additions in 1964. The remainder, $907,488, is an adjustment of prior years' unamortized balances, resulting in non-recurring earnings from this source of 5.8¢ per share.

Discussion -

The reporting method appears adequate, but it may be more informative to disclose within the income statement, rather than by footnote only, that there is an extraordinary income item included in the accounts.

Goodman Manufacturing Company\[16\]
(Independent accountants - Price Waterhouse & Co.)

Opinion of independent accountants -

Qualification as to change, approved by the independent accountants, in accounting for the investment credit.

Income statement -

Net earnings for the year \( $368,454 \)
(Provision for income taxes was referenced to Note 2)

\[16\] Adapted from 1964 Annual Report of Goodman Manufacturing Company.
Notes to financial statements -

Since the Revenue Act of 1964 provides that the investment tax credit no longer reduces the depreciable base of the related assets, the Company has adopted the accounting method which reflects such credit in earnings in the year in which it arises. Accordingly, the 1964 provision for income taxes has been reduced approximately $42,500 for the investment credit arising from qualified property additions during the years 1962, 1963 and 1964.

Discussion -

An acceptable reporting method, and although relatively more of a material change, it is identical to the practice followed by the Draper Corporation in a previous example.

Change from "48-52" Method

Jones & Laughlin Steel Corporation\(^\text{17}\)

(Independent accountants - Price Waterhouse & Co.)

Income statement -

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net earnings for the year</td>
<td>$ 60,078,000</td>
</tr>
</tbody>
</table>

(Last caption under costs and expenses was - Provision for income taxes, less investment tax credit of $7,235,000 in 1964 and $1,537,000 in 1963 (Note F))

Notes to financial statements -

\(^{17}\) Adapted from 1964 Annual Report of Jones & Laughlin Steel Corporation.
The Revenue Act of 1964 eliminated, retroactively, the provision of the tax law requiring a reduction in the depreciable basis of properties which qualified for the investment tax credit. The remaining balance of amounts deferred (52 percent) in 1962 and 1963, $2,454,000, was transferred to current liabilities to provide for additional taxes that may arise relating to prior years. The entire investment tax credit of $7,235,000 applicable to properties placed in service during 1964 is included in net earnings as a reduction of the provision for income taxes.

Discussion -

An acceptable reporting practice, and similar to Kennecott Copper Corporation, in a prior example, the previously deferred portion of the investment credit was transferred to the tax liability account to provide for possible prior years' assessments.

Genesco Inc.18 (Independent accountants - Peat, Marwick, Mitchell & Co.)

Income statement -

Net earnings for the year $13,221,918
(Provision for income taxes was referenced to Note 2)

Balance sheet -

Deferred income taxes (Note 2) $4,283,000
(Separate caption after current liabilities caption)

18 Adapted from 1964 Annual Report of Genesco, Inc.
Notes to financial statements -

The provision for income taxes is after deducting the investment credit for the current year of $402,193 and $198,046 deferred in prior years.

Discussion -

The method of reporting is acceptable.

The General Tire & Rubber Company\(^{19}\)

*(Independent accountants - Price Waterhouse & Co.)*

Income statement -

- Net earnings before provision for income taxes: $65,133,465
- Provision for income taxes (Note H): 28,210,000
- Net earnings for the year: $36,923,465

Notes to financial statements -

Due to revisions in 1964 of the Internal Revenue Code, the entire investment tax credit for 1964 of $1,940,000 and the deferred portion of the investment tax credit provided in 1962 and 1963 of $1,497,000 are included in the net earnings for 1964 as a reduction of the provision for income taxes and a reduction of the depreciation expense, respectively.

Discussion -

Acceptable reporting practice is followed, however, this is the first cited example where the investment credits

\(^{19}\)Adapted from 1964 Annual Report of The General Tire & Rubber Company.
of prior years are taken into earnings by reducing depreciation expense.

The Budd Company20 (Independent accountants - Peat, Marwick, Mitchell & Co.)

Income statement -

Net earnings before extraordinary items $ 2,527,991
Extraordinary items:
  Gain (loss) on sales of certain properties and investments, less tax effect 372,298
  Prior year's income tax adjustments 808,783

Net earnings for the year $ 3,709,072

Notes to financial statements -

As the Revenue Act of 1964 now permits the full recovery of the investment credit, the unamortized investment credit of $458,783 representing the 52 percent that was deferred at the beginning of the year was taken into earnings and is included under "Extraordinary items" in the income statement. Since the Company has no federal income tax liability for 1964, an investment credit of approximately $850,000 relating to current year's capital additions is available to reduce future tax provisions.

Discussion -

The method of reporting is acceptable, and somewhat similar to that followed by Polaroid Corporation in a previous example except that The Budd Company clearly identified the extraordinary item in the income statement rather than by a footnote.

20Adapted from 1964 Annual Report of The Budd Company.
Change from Other Methods

Tennessee Gas Transmission Company (Independent accountants - Arthur Andersen & Co.)

Opinion of independent accountants -

Qualified as to consistency relative to the change in accounting for the investment credit. It was noted that the new method was an acceptable method.

Income statement -

Net earnings before provision for income taxes $91,319,277

Provision for income taxes (Note 7):
  Current 9,220,300
  Deferred 4,319,600
  13,539,900

Net earnings for the year $77,779,377

Notes to financial statements -

Prior to 1964 the investment tax credit was recorded as a deferred credit pursuant to an interim order of the Federal Power Commission. In 1964 the Commission issued a final order with respect to the accounting for such credit and as permitted in such order the flow through method of accounting was adopted whereby the benefit of the investment tax credit is reflected in the income statement in the period in which the credit is utilized. The investment tax credit so utilized in 1964 amounted to $4,020,600. For the year 1963 such credit amounted to $4,665,800

and the financial statements for 1963 have been restated accordingly for such amount. At December 31, 1964 the companies' unused investment tax credit aggregated approximately $5,400,000.

Discussion -

The method of reporting is acceptable and is the first cited example where rather than inclusion in the 1964 income statement, the prior years' deferred portion of the investment credit was retroactively recorded in the 1963 income statement.

Reflections on the Methods Used in 1964

As was previously discussed, there was no need for the independent accountant to qualify the consistency portion of his opinion where companies had changed from the "48-52" method to the 100 percent flow through method, and no such qualifications were noted in the preceding examples. Where the investment credit was material and there was a change from other than the "48-52" method to the 100 percent flow through method, a qualified opinion would be expected. In the preceding examples, as noted, the only changes of the latter type where the opinions of the independent accountants were not qualified were Southern California Edison Company and Kennecott Copper Corporation. The Kennecott change was pointed out to be not material, therefore, no qualification appeared necessary. However, as previously
mentioned, Southern California Edison's 1964 income statement reflected net earnings of $77 million, approximately $8 million of which was a result of the change in accounting for the investment credit. It is not known why a qualified opinion was not rendered in the latter instance.

It is interesting to note that in all the preceding examples where opinions were qualified, each independent accountant except Arthur Andersen & Co. expressed his approval of the change to the 100 percent flow through method. In Arthur Andersen & Co.'s qualified opinion of the financial statements of Tennessee Gas Transmission Company it was indicated that the 100 percent flow through method was an acceptable method, but not that the independent accountant approved thereof. This is undoubtedly in keeping with Leonard Spacek's position taken in connection with Opinion No. 4 of the Accounting Principles Board.

Another point of interest was that in spite of the fact that Opinion No. 4 indicated that the change in the Revenue Act of 1964 was not the reason for revising Opinion No. 2, two (Polaroid and Goodman) of the five cited companies changing from the cost reduction method made references to the new Revenue Act.

Summary

As can be seen, 1964 saw a series of events which began to support the position previously taken by the
minority with a definite movement away from the cost reduction method of accounting for the investment tax credit. This, of course, is not proof in itself of which method is best, and in the next chapter considerable analysis will be undertaken to determine which method stands up when it is critically evaluated and related to basic accounting theories.
CHAPTER V

ANALYSIS AND DETERMINATION OF THE PROPER METHOD OF ACCOUNTING FOR THE INVESTMENT CREDIT

This chapter will be devoted to determining which of the proposed methods of accounting for the investment credit is in accordance with acceptable and sound accounting principles. This will be accomplished by relating the various alternative methods to basic accounting theory. Since the previously discussed change in the Revenue Act of 1964 made the "48-52" method identical with the 100 percent flow through method, this chapter will limit the evaluation as between the latter and the cost reduction method.

Only the cost reduction method will require discussion as to proper balance sheet treatment since the 100 percent flow through method results in no income deferral to future periods.

Fixed Asset and Depreciation Accounting

Accounting for fixed assets and depreciation has long been a problem to accountants; however, historical cost is the prevailing basis for financial statement presentation of fixed assets.\(^1\) Some of the advantages of historical cost are its objectivity, availability, analytical use and fact

---

that it is not overly subject to manipulation. Depreciation has traditionally been based on cost and is viewed as a process of allocating the cost to the product or period that utilized the services of the fixed asset.

Cost is generally measured by a current expenditure of cash or when there is a delay in the cash payment, cost should be considered as that amount of cash which would be required to effect final settlement. It is generally conceded that purchase discounts should be treated as a reduction in cost rather than as income. The latter concept is probably one of the main reasons that various organizations, including the American Institute of Certified Public Accountants, have considered the investment credit as a reduction in cost under the cost reduction method. This is a highly questionable position because although proponents of the cost reduction method would argue that there is some similarity in the fact that there is a reduction in the net

---


outlay of cash for the assets in question, the purchase discount results in a reduced periodic charge on the income statement while the investment credit results in a one-time tax reduction in the year of purchase. Furthermore, any similarity which might have existed between the investment credit and the purchase discount was eliminated when the Revenue Act of 1964 dropped the requirement that the asset basis be reduced by the amount of the investment credit.

Another fallacy is that utilizing this method could result in the identical piece of equipment, sold at the same price to various companies, or the same company at various points in time, being initially recorded at different amounts. This could happen because a company must have taxable income before it can take the investment credit and also, once the investment credit exceeds $25,000 it is limited to 25 percent of the tax liability over that amount. Of course, assuming adequate prior and/or current year taxable income, the entire credit would eventually be earned through the use of carrybacks and carryforwards.

The fact that an asset has been defined as representing economic resources devoted to specific business purposes and should be recorded at the required cash outlay or fair market value if cash is not involved⁷, would also tend to discredit any attempt at recording like assets at

different values. Proponents of the cost reduction method, in effect, believe that the investment credit is a subsidy by the Government to reduce the cost of equipment. This is a difficult position to sustain since the investment credit is only available to profitable companies, and the latter type of concerns are not normally subject to Government subsidies unless they are operating in a field which benefits the national interest or are performing other services for the Government.

Inclusion of the investment credit in the accumulated depreciation account or any other account which was deducted from the asset balance would be equally objectionable since the net effect would be the same as reducing the asset cost. As can be seen from the statistics on page 57, in 1964 only seventeen of the companies utilizing the cost reduction method treated the unearned portion of the credit as an asset offset. This would appear to be tacit acceptance of the idea that the credit was an abatement of taxes rather than a reduction in asset cost.

**Income Recognition**

A review of current accounting literature indicates that almost all discussions of income recognition (or realization) center around the sale or transfer of goods or services. One concept of realization, however, appears to be broad enough that it might be applied to the invest-
ment credit. This concept is promulgated by the American Accounting Association and is as follows:

"The essential meaning of realization is that a change in an asset or liability has become sufficiently definite and objective to warrant recognition in the accounts. This recognition may rest on an exchange transaction between independent parties, or on established trade practices, or on the terms of a contract performance of which is considered to be virtually certain. It may depend on the stability of a banking system, the enforceability of commercial agreements, or the ability of a highly organized market to facilitate the conversion of an asset into another form."  

The above definition when coupled with the "going concern" approach used within the framework of accounting concepts would tend to confirm the 100 percent flow through method as being the proper approach since the purchase of equipment which generates (assuming adequate taxable income) the investment credit is a completed transaction. Proponents of the cost reduction method take issue with the completed transaction viewpoint by, (1) stating that income is not realized by the purchase of equipment, but rather by its use, and (2) maintaining that the investment credit is only earned if the equipment is retained for the required holding period. They, therefore, support allocation of the income (tax reduction) over the life of the equipment. While it is generally true that the purchase of equipment does not generate income, it is somewhat out of context to relate this statement to a transaction involving the purchase of equipment which qualifies for the investment

8Ibid., p. 3.
credit. The investment credit is allowed in the year of purchase of the equipment under the assumption that the equipment will be held for the required period. (If the taxing authorities had only allowed the credit to be taken proportionately (annually) over the required holding period then the 100 percent flow through method would be more difficult to support, but this is not the case.) The credit is subject to full or partial recapture only if the equipment is held for less than the required period. The fact that the investment credit is allowed in its entirety in the year of purchase, and is subject to recapture under certain circumstances (to prevent manipulation), refutes several of the above contentions in support of the cost reduction method and further supports the 100 percent flow through method and is consistent with the "going concern" concept since it is normally anticipated that equipment will be utilized during its useful life. It also appears that the 100 percent flow through method more closely accomplishes the basic purpose of the income statement which is to show income actually earned for a given period and the amount available for distribution.

Assuming that the cost reduction method were the better method, and since there appears to be general acceptance that the investment credit increases net income by reducing federal income taxes, it would appear that the unearned portion of the credit should be classified as a deferred credit to income and be amortized over the period
necessary to earn the entire credit taken for tax purposes.

**Federal Income Tax Accounting**

Accountants, for years, have accepted the concept that where federal income tax procedures materially conflict with generally accepted accounting principles, the latter must prevail for financial statement presentation. When these differences do exist, the resulting tax liability might bear no normal relationship to earnings reported on the income statement. As a result, many accountants support a method of allocating taxes based on reported earnings with a resultant prepayment or accrual being shown on the balance sheet. There is not general acceptance, however, as to this type of inter-period income tax allocation. While there is some disagreement as to whether or not federal income taxes are a cost of doing business or a distribution of profits, most accountants accept the cost theory. In support of the cost theory, Herman Bevis states:

"Because profit is the measure of the tax, some have held that the tax is not a corporation cost

---


but a distribution of corporate profits, i.e., in the same general category as dividends to stockholders. This is a highly questionable position. It suggests that the financially significant index of corporate results is the profit before income taxes, and that how this amount is distributed among government, stockholders, and reinvestment is a separable matter. Actually, the stockholder, as a supplier of capital, must look for his return after the levy by the government has been paid. If the corporation is to attract new capital, its pricing structure and revenues must be sufficient, after deducting costs including income taxes, to provide the earnings and dividend rates required in the market place."

The American Institute of Certified Public Accountants supports the theory that income taxes should be treated as any other expense and that it should be allocated to the current year reported earnings as necessary. The American Accounting Association takes the opposite approach, however, and concludes that income taxes do not have the normal characteristics of assets or liabilities, and due to uncertainties and complications should be disclosed in notes rather than by actual entries in the accounts.

It would appear that the main reason for the introduction of the inter-period income tax allocation is the accounting profession's desire to eliminate any

---


13 Accounting Research and Terminology Bulletins, p. 88.

14 Accounting and Reporting Standards for Corporate Financial Statements, pp. 6-7.
distortion of net earnings.\textsuperscript{15} The American Institute of Certified Public Accountants does not feel that income tax allocation is necessary where differences between taxable income and reported earnings are expected to occur regularly over a long period of time.\textsuperscript{16} An example of the latter situation would probably be a company with assets subject to depletion. (The current tax law allows deductions for depletion in excess of asset cost.)

Although investment credit transactions do not fit directly into the theory of income tax allocation, the broad concept appears applicable. In fact, the net effect of the aforementioned depletion provisions of the tax law are not a great deal unlike the investment credit section of the law. Granted, one is a deduction and the other a credit; however, they both accomplish the same end result, i.e., income tax benefits in excess of the cost of the applicable asset, and few, if any, accountants would suggest reducing the cost of a depletable asset by excess tax benefits.

The similarity of the investment credit and depletion deduction, along with the aforementioned position of the American Institute of Certified Public Accountants in regard to considering income taxes as an expense and not using inter-period income tax allocation for regularly


\textsuperscript{16}Accounting Research and Terminology Bulletins, p. 87.
recurring differences between taxable income and reported earnings, would tend to strengthen the fact that the 100 percent flow through method is the theoretically proper way of accounting for the investment credit.

Regardless of which method is used, it does not appear desirable to record a receivable for any investment credit eligible for carryforward to future years. This would be consistent with the accounting principle that carryforward federal income tax operating losses should only be recorded in the year to which such losses are carried. In both instances, adequate footnote disclosure would be appropriate.

Summary

Basic accounting theory appears to support the 100 percent flow through treatment as the proper method to account for the investment credit. In the next (final) chapter, some concluding thoughts will be offered.

17 Ibid., p. 91.
CHAPTER VI
CONCLUSIONS

As was discussed in the preceding chapter, it would appear that the 100 percent flow through method of accounting for the investment credit more properly reflects basic accounting theory than the cost reduction method for the following reasons:

(1) Fixed assets should be stated at cost without regard to the investment credit.

(2) Although proponents of the cost reduction method treat the investment credit as if it were a purchase discount, the change introduced by the Revenue Act of 1964, whereby the asset basis was no longer required to be reduced, clearly eliminated any similarity between the credit and a purchase discount.

(3) The investment credit is not a subsidy since it is only available to profitable companies which are not normally subsidized.

(4) The investment credit results in a current year income benefit (reduced federal income taxes).

(5) The "going concern" concept refutes the suggestion that the credit should be recorded during the required holding period simply because the ultimate realization of the credit is contingent upon future earnings and the validity of the original estimate of useful life.

(6) The basic purpose of the income statement is accomplished by use of the 100 percent flow through method.

(7) Generally accepted accounting principles as they relate to federal income tax accounting, including depletion accounting, consideration of federal income taxes as expenses and inter-period income tax allocation support recording the credit in the year that the credit is allowed.
In reality, proponents of the 100 percent flow through method have maintained that the investment credit was merely a complex method of reducing federal income taxes within the framework of an already complicated system. The fact that in order to obtain this income tax reduction, certain properties had to be acquired, in no way should be related to the cost of those properties.

It remains to be seen how the accounting profession will react in the future to these two methods. Accounting history has traditionally shown that general acceptance is needed by the profession in order to firmly establish any accounting principle. The results of 1964 did not indicate an overwhelming trend towards one method, and as long as the American Institute of Certified Public Accountants recognizes two methods, it is possible that the future will see one method with more dominant authoritative support to the eventual extinction of the other. The other possibility is that the diversity which has existed voluntarily within the profession for many years will continue to be supported and both methods will become generally accepted.

In line with the turmoil created by the investment credit, as the accounting profession continues to attempt to

---


2 Inventory of Generally Accepted Accounting Principles for Business Enterprises, pp. 32-33.
improve financial accounting and reporting, we will perhaps see a struggle between those who wish to allow the profession to voluntarily steer its own course and those who would prefer enforcement of accounting practices through formation of a regulatory body. Only time will tell.

\[\text{3 Corporate Financial Reporting in a Competitive Economy, p. 198.}\]
BIBLIOGRAPHY

Public Documents


Books


Internal Revenue Code, Section 48(g)(1), (Chicago: Commerce Clearing House, Inc., 1962).


**Articles and Periodicals**


Annual Reports

American Cyanamid Company - 1962

Anchor Hocking Glass Corporation - 1962
The Budd Company - 1964
Draper Corporation - 1964
General Cable Corporation - 1963
General Telephone Company of California - 1963
General Telephone & Electronics Corporation - 1963
The General Tire & Rubber Company - 1964
Genesco, Inc. - 1964
Goodman Manufacturing Company - 1964
Granite City Steel Company - 1962
Jones & Laughlin Steel Corporation - 1964
Kennecott Copper Corporation - 1964
Koppers Company, Inc. - 1962
S.S. Kresge Company - 1962
Lockheed Aircraft Corporation - 1962
National Dairy Products Corporation - 1962
J. J. Newberry Co. - 1962
North American Car Corporation - 1962
Peabody Coal Company - 1963
Polaroid Corporation - 1964
R. J. Reynolds Tobacco Company - 1962
Southern California Edison Company - 1964
Tennessee Gas Transmission Company - 1963
Tennessee Gas Transmission Company - 1964
Westinghouse Electric Corporation - 1962

Other

Spacek, Leonard, "Accounting Treatment of Investment Credit," Speech presented before the Great Lakes Conference of