NORTHERN ILLINOIS UNIVERSITY

Harmonization of International Income Tax Accounting

In Four Capitalist Countries

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ABSTRACT:

The purpose of this thesis is to explain the need for international accounting standards, the IASC’s role in developing these standards, and a plan to be used by the IASC to harmonize income tax accounting standards in the U.S., the U.K., Germany, and Japan. Most research was taken from secondary sources, with the exception of one speaker from the Financial Accounting Standards Board.

Harmonization of accounting standards is needed to gain easier access into capital markets, and for comparability of financial statements worldwide. The IASC currently issues international accounting standards, however, they are not mandatory, and too broad to be useful. Income tax accounting is a very important and influential part of the financial reporting process in each of these countries, especially in Germany and Japan where much of the current accounting practices are based on tax law. Harmonization of these practices will be, therefore, much more difficult.

To further harmonize accounting standards, it will be necessary for the IASC to gain more authority to enforce their standards, and to narrow the requirements within the standards. Each of the countries must also be willing to concede some of their practices for the greater good.

To harmonize income tax accounting standards in the long run, the U.S., with the issuance of Statement of Financial Accounting Standards No. 109, may be able to take a leadership role. The U.S. has more experience and technical expertise in working with this issue, and may be able to give support to the IASC in developing a useful harmonizing standard.
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Introduction

The purpose of this paper is to explain international accounting standards, the IASC's role in developing these standards, and finally, a plan to be used by the IASC to harmonize income tax accounting standards in the United States, the United Kingdom, Germany, and Japan. While all four of these countries has its own set of accounting standards, each uses very different methods to develop their standards, has different standard setting bodies, and different ways of accounting for income taxes.

Income tax accounting in particular is a very important and influential part of financial reporting and the accounting standard setting process. As will be shown later in the paper, income tax accounting laws dominate the accounting practices in two of the four countries that will be studied. In these countries, to change the way enterprises account for taxes will impact all aspects of their current accounting practices. Therefore, harmonization of this issue will be of great importance to these countries, making the process all the more challenging.

Need for Harmonization of Accounting Standards

When the International Accounting Standards Committee (IASC) was established in 1973, few could imagine the concept of a truly global capital market. Now, in 1992, few obstacles stand in the way. One of these obstacles is the diverse accounting standards that continue to exist among the major and minor countries in the global economy. Why is there a need for compatible accounting standards? To begin, investors and analysts looking to expand into foreign countries must have easier access to foreign capital markets. Firms looking to invest in foreign countries may have to publish their statements using several methods to comply with regulations
in each country, which costs time and money. Additionally, firms looking to invest internationally must have the ability to examine the financial statements of firms in other countries to derive reliable comparisons. Poor decisions may result from drawing conclusions based on incomparable statements. In addition, these multinational firms need to be able to consolidate their foreign accounts (1).

Currently, international accounting standards issued by the IASC do exist, but have serious deficiencies. Currently, when developing standards, the IASC takes the Alternative Harmonization approach, which allows businesses two or more alternative accounting or disclosure practices for an IASC standard (2). The IASC may identify a clear preference for one set of methods, and selection of alternatives are allowed only under narrowly defined criteria, but differences still exist (3). A main goal of harmonization is to reduce the number of acceptable alternatives to relieve the problems already mentioned as international financing increases.

Finally, according to the president of the IASC, international accounting standards can help the theory that has existed primarily in the United States over the last 25 years, that the goal is to beat the system. He hopes that developing standards in a professional and responsible way can defeat that attitude (4).

Background of International Standards

The body that will be focusing on the harmonization of accounting standards is the IASC, a private organization comprised of member bodies from 80 countries with most members being from the business community, and others from stock exchanges and securities regulatory bodies, trade unions, bankers, lawyers, national standard
setting bodies and intergovernmental bodies (5). Currently, the IASC has issued more than 26 statements of international accounting standards. The IASC is the primarily the voice of the private sector, occupying a dominant, but not sole, role in developing international standards. It is currently successful for four main reasons. First, the increasing internationalization of business and finance, second, the flexible nature of its standards, third, its evolutionary strategy, and fourth, absence of a rival organization that has a prolonged interest in the development of global accounting standards (6).

Harmonization, as intended by the IASC is a matter of degree, and the standards set by the IASC are not enforceable or intended to supersede local standards. Instead, it expects that the member bodies will use their "best endeavors" to conform to the IASC standards (7).

Current Practices in Developing New Accounting Standards

To achieve harmonization of income tax accounting standards, it is important that the IASC work with the standard setting bodies in each of the four countries to come to an agreement with which everyone can work. The next section will explain how each of these countries develops its standards of accounting.

United States

The responsibility of developing accounting standards in the United States theoretically rests with the power given to Securities and Exchange Commission (SEC) by Congress. However, the SEC has further delegated this power to the Financial Accounting Standards Board (FASB), a private, independent, standard
setting body. However, the government, the SEC, and Congress have at times exercised influence on the standards set by the FASB. Despite government intervention, standard setting in the U.S. has continued to be a completely public process, receiving continual input from the public interest, mainly American business. As a result, standard setting is a combination of a professional (FASB and the business community), and legalistic (SEC, Congress) influences (8).

**United Kingdom**

The body responsible for standard setting in the U.K. is the Accounting Standards Committee (ASC), a private body that is also separated from the government. Topics for new standards may result from a special request from an interested party, from a change in law, or from international development, also resulting in a professional and legalistic approach to developing standards (9). However, their standards tend to be less stringent, and lesser in number than their U.S. counterparts (10). The standard setting process is similar to that in the U.S., being very open to public response by issuing exposure drafts and holding hearings. Again similar to the U.S., the standards set by the ASC are not enforceable by law, although auditors do note lack of compliance with the standards in audit opinions, as does the Stock Exchange. The theory the U.K. uses in its standard setting process is basically very similar to that adopted in the U.S.

**Germany**

In contrast to the approaches used in the U.S. and U.K., the standard setting process in Germany is largely dominated by government influences, as statutory law
governs accounting standards. The tax laws are the main influence on financial reporting, as the practice of accounting exists in a large part to aid tax administration and government. Financial statements are not commonly used to serve the needs of other parties besides tax authorities and creditors (11). Predominantly, figures shown in annual reports are the same as those shown in tax returns. Two private, professional accounting organizations do exist, and they also issue standards, but their standards are not mandatory, and their purpose is more focused on compliance rather than with development of new standards (12).

Japan

Similar to Germany, the standard setting process in Japan is largely a function of government. The Ministry of Finance is the controlling influence over the accounting profession, and delegates the standard setting process to an advisory board called the Business Accounting Deliberation Council. The council consists of 25 appointed members, and its purpose is to prepare standards that are mandatory for publicly traded firms (13). Again similar to Germany, tax laws have a major influence on financial reporting, and the rules are commonly the same for both purposes. Any interest group may bring a proposed accounting change to a forum, but voluntary efforts to improve standards are weak as the profession has little experience and traditionally limited impact on the standard setting process (14). In total, the standard setting process in Japan is time-consuming, slow, and seemingly not of major importance to Japanese business.
When examining the accounting standard setting processes of the four countries, the key issues are whether the standards are mandated by law or not, and whether the process is a function of the government or the profession. There is a major split between the four countries. The processes in the U.S. and U.K. are mainly dominated by the profession, with limited government interference. Their standards are only mandatory for public companies, and are not as largely influenced by tax laws as Germany and Japan. The processes appear to be more developed, and more of an importance to the business community. In contrast to this are the processes adopted by Germany and Japan. The government and tax laws dominate the accounting profession and financial reporting. Their standards are enforced more heavily, and the accounting profession has limited, if any, experience and influence on the accounting standards that are set. The key to harmonization of standards will be to develop a solution that will allow the IASC to work between these two very different approaches to accounting standard setting.

**Current Income Tax Accounting Practices**

Each of the four countries discussed has a different way of accounting for income taxes, as well as methods of developing income tax standards. This section will briefly discuss the methods of accounting for income taxes, with an emphasis on deferred tax accounting, in the U.S., U.K., Germany, Japan, as well as the current international standard. SFAS 109, currently used in the United States will be used as a comparison point for explanation. In this discussion, temporary versus timing differences will be referred to. Temporary differences include timing differences in
addition to other temporary differences not necessary identifiable with a particular asset or liability.

United States

Currently, the generally accepted accounting principles for accounting for income taxes are found in SFAS No. 109, Accounting for Income Taxes. This statement is a simplification of SFAS 96, under which most companies found statement preparation more cumbersome than necessary for the benefits accruing to the users of the financial statements. Specifically, SFAS 109 amends SFAS 96 by relaxing requirements on the recognition of deferred tax assets for temporary differences and NOLs, changing the balance sheet classification requirements, and allowing consideration of assumptions about future events (15).

SFAS 109 requires the use of the asset/liability method for recognizing the tax consequences of temporary differences. Deferred tax assets can be recognized for any future deductible amounts or NOL carryforwards, reduced by a valuation allowance, for the amount which is more likely than not to be realized.

Using current or future enacted tax rates is required for the measurement of deferred tax assets and liabilities. The assets and liabilities are classified in the balance sheet with the related assets and liabilities from which the deferred assets and liabilities arise. If there is no related asset or liability, the deferred balance is classified as long or short term depending upon when the difference is expected to reverse. On the income statement, the main focus of disclosure is on the income tax expense related to continuing operations (16).
United Kingdom

The requirements for financial statement accounting for income taxes in the U.K. is found in Statement of Standard Accounting Practice No. 8, The Treatment of Taxation under the Imputation System in the Accounts of Companies", and Statement No. 15, Accounting for Deferred Tax.

Similar to the U.S., the U.K. uses the liability method for recognizing deferred tax assets and liabilities. However, the method is based on the assumption that a company has a basic core of timing differences that continually renew so that the payment of the related tax is permanently renewed.(17) Therefore, assets and liabilities are recognized only to the extent that they will be "recoverable without replacement" by the same differences. The tax consequences of NOLs that are carried forward indefinitely are recognized by reducing existing deferred tax liabilities. Other tax losses may be recognized as deferred tax assets, subject to the same "recoverable without replacement" test for other deferred tax assets. However, the recognition criterion can rarely be met, and in practice assets resulting from NOLs are rarely presented (18).

The measurement of deferred tax assets and liabilities requires using tax rates expected to apply when the timing differences will reverse, not necessarily those enacted as in the U.S.

The classification and presentation requirements are different in the U.K. than under SFAS 109. In the U.S., deferred balances are presented as either long or short term, along with the related assets or liabilities from which the balance arises. Within
the U.K. standards there are no specific presentation requirements, however, company law requires that deferred tax liabilities be included under "Provision for liabilities and charges", subheading "Taxation, including Deferred". Deferred tax liabilities are reduced by deferred tax assets, with the leftover included under "prepayments and accrued income". Income statement disclosure requirements are the same as under SFAS 109.

**Germany**

The standards for accounting for income taxes in Germany are found in Commercial law as well as some standards issued by the German Institute of Certified Public Accountants. Financial statement presentation is generally based upon tax law requirements in order to reduce the differences for comparability purposes. German standards do not address the issue of deferred taxes in depth as they have little experience or expertise accounting for deferred taxes, and many inconsistencies exist in practice (19).

Generally, all timing differences are included in the deferred tax calculation, unless the reversal of the differences is not "foreseeable" at year end. In individual corporate statements, the recognition of deferred tax assets is optional, and the standards do not address the issue of the limitation of recognition. The tax consequences of NOL carryforwards are not recognized as deferred tax assets as in the U.S., but similar to most situations in the U.K., can reduce deferred tax liabilities, which are revalued again as the benefits are utilized (20).
German accounting statements do not address the issue of balance sheet or income statement presentation or disclosure for deferred taxes. However, in practice, income taxes from current taxes, deferred taxes, and other corporate taxes are lumped together into one heading and deferred tax assets and liabilities are presented separately.

Japan

The basic requirements for accounting for income taxes in Japan are found in the Japanese Commercial Code, but are also supplemented by Financial Accounting Standards for Business Enterprise and standards issued by the Audit Committee of the Japanese Institute of Certified Public Accountants. Similar to Germany, tax accounting and financial accounting are closely intertwined, as tax returns for Japanese companies are generally based on financial statements used for financial reporting purposes. This is due to regulations that allow some items only to be deductible for tax purposes if they are deducted on the financial statements (21). As will be shown, Japan presents the largest deviation in accounting for deferred income taxes from the United States and the other countries discussed.

Deferred tax assets and liabilities are generally not recognized in the financial statements of individual companies; and are only permitted, not required, to be recognized for consolidated entities. This presents a unique problem as tax returns are only required for individual companies and not consolidated entities. When deferred tax assets and liabilities are recognized in consolidated statements, either the liability or deferred methods may be used.
Since deferred tax effects are not required to be recognized for any financial reporting purpose, the standards and laws do not extensively address the requirements for reporting the effects of timing or temporary differences. There are no specific limitations for recognizing deferred tax assets, and few requirements for reporting the effects of tax loss carryforwards. However, the tax benefits of loss carryforwards can be recognized in consolidated statements as a subtraction from existing deferred tax liabilities to the extent they are expected to be realized in the future (22).

There are several alternatives for required balance sheet disclosures, covering every classification method, and income statement disclosures are not addressed in accounting standards.

International Standard

The current international standard addressing income tax accounting is IAS 12, Accounting for Taxes on Income. This standard was issued in 1979, and provides explanations for many of the aspects of income tax accounting addressed in the standards of the countries previously mentioned. This standard is broad, and allows many alternatives; so much so that it would be almost impossible to violate the standard.

The standard requires that tax expense be determined using either the deferral or liability method applied to timing differences. However, tax expense should not include effects of differences not expected to reverse for a "considerable period". The threshold for recognizing deferred tax assets is "a reasonable expectation of realization" (23).
The recognition of a deferred tax asset for the consequences of tax losses to be carried forward are subject to more stringent requirements. These should only be included in the determination of income if there is assurance beyond a reasonable doubt that future taxable income will be high enough to allow these losses to be realized, with one exception. A tax savings may be recognized up to the amount of net deferred tax credits that will reverse within the period during which the loss can be claimed as a benefit (24).

The only classification requirement on the balance sheet, is that deferred tax balances be presented separately from shareholder's equity. Disclosures required on the income statement include: separate disclosure of tax expense related to ordinary and unusual items, the amount of tax saving regarding tax losses that is recognized, the amount of future tax losses that has not been recognized in deferred tax balances, and an explanation of the relationship between tax expense and accounting income, if not explained by effective tax rates (25).

The current methods for different facets of income tax accounting are summarized in table one. With the exception of some practices in Japan, there are few fundamental, irreconcilable differences in the methods each of the countries use to account for income taxes, and no blatant violation of IAS 12. Therefore, reconciling the differences between the countries seems less of a real technical problem from an accounting standpoint, than of a simple method of motivating the countries to adopt a single way of accounting for taxes. As Germany and Japan rely
so heavily on tax laws for all financial reporting, an attempt to change their tax practices will almost definitely be viewed as threatening, and met with hostility. In the United States in particular, the tax laws and accounting standards are extremely detailed and complicated. Forcing American businesses and tax professionals to learn a new code of laws will also be viewed as time-consuming and cumbersome. So the question is, how will the IASC harmonize these standards while playing to the needs of all four of these countries?

Fundamental Changes Necessary for Harmonization

In order to harmonize income tax accounting standards between these four countries, there must be some fundamental changes made both within the framework of the standard setting bodies in each of the countries, and within the IASC itself. These changes apply to the harmonization of accounting standards as a whole, not restricted to only income tax accounting.

Currently, as mentioned previously, the majority of the members of the IASC are from professional accounting bodies. However, these bodies are not the institutions that are responsible for the accounting standard setting process. Only four countries on the board of the IASC have this responsibility (26). If the bodies within the IASC are to be truly committed to developing standards that they will see fit to use in their countries, it only makes sense that those responsible for making the standards are those that should be the nations' delegates to the IASC. The professional bodies cannot control the IASC, as it will defeat its mission. In addition, the IASC is currently funded 90% by its board members, and 10% by the
International Federation of Accountants (27). Consequently, the possibility exists for a lack of independent, unbiased process promulgated by those bodies that fund the IASC, instead of the standard setting bodies and users of financial reports. The IASC should in theory be a completely independent body that gives all interested parties an active role, without conforming to the wishes of one dominant party. Its funding, therefore, needs to be independent of those who wish to dominate the standard setting process.

Secondly, in order for true international harmonization to take place, the IASC should have some authority to enforce their standards. This is a more difficult problem. The countries are not readily willing to give up their control over the standards that are used in their countries. Germany and Japan in particular, have been reluctant to endorse the efforts of the IASC, as they believe that the capital markets themselves will require capital to be moved globally, regardless of diverse accounting requirements.(28) However, it is necessary for these countries to realize that while capital markets will continue to exist and grow in the presence of diverse and extensive accounting requirements, they will not be as efficient as possible in the long run. If each of these four countries is committed to a free and efficient global market, and will truly examine the benefits of harmonizing standards, then they need to at least agree to conform to the standards set. The countries will necessarily need to be willing to concede some of their practices, and not try to continually persuade the other countries to their way of thinking. This will necessitate a fundamental change in the way standard setting bodies view international standards.
This leads to the next change, that within the accounting standards themselves. When the IASC works to develop standards that will be acceptable by these four countries, the best approach is probably intermediate harmonization. Intermediate harmonization would allow the IASC to develop a minimum set of general standards that can be agreed upon by each of the countries (29). While the individual standard setting bodies may develop more detailed standards for the businesses located in their own territories, these should be the minimum standards required for entry into the foreign markets. Foreign companies would then be required only to reconcile their financial statements to one set of international regulations. One difficulty with this approach would develop when domestic standards are more complex and restrictive than international standards, giving domestic investors an unfair burden when competing with international investors moving into their market (30). To combat this, all businesses should reconcile their statements to IASC standards to enable all users to compete on a level field.

Finally, as previously mentioned, the international standards need to allow few, if any, alternatives to the practices agreed upon by the IASC. Developing a universal set of standards agreed upon by these four countries, and requiring businesses to only reconcile their statements once to these standards, will reduce the amount of incomparability and complexity required when these countries wish to engage in foreign markets.
Short Term Solutions for Harmonization

While many changes need to be made to achieve harmonization in the long run, there are options that available to harmonize income tax accounting in the short run.

The current international standard, IAS 12, as discussed is a broad, flexible standard that allows many alternatives, and little room for violation. In the long run, this statement needs to be amended to provide more detailed guidance on disclosures in the financial statements. The U.S. can provide guidance for the reformation of this statement, as will be outlined later.

However in the short run, there are ways to provide more harmonization of income tax reporting on the financial statements. Each of the four countries, with the partial exception of Japan, accounts for income taxes on the accrual basis. The accrual accounting numbers should be at least disclosed to provide comparability with the other three countries. In addition, as each country accounts for their deferred taxes in a slightly different way, it might be beneficial to leave the deferred tax numbers off the face of the financial statements temporarily, at least until a more comprehensive statement can be issued by the IASC in this area. Temporary differences should be disclosed, however, in the notes of the statements as they are useful to analysts.

SFAS 109 and the U.S. Role in Harmonization

To achieve the long-term goal of providing a more comprehensive and definitive statement on accounting for income taxes, the IASC might want to look to
the U.S. for guidance. The U.S. has a long track record of issuing pronouncements to satisfactorily solve the issue of accounting for income taxes. This is by no means a debate whose roots have not been heavily debated, from the issuance of APB 11 through SFAS 96, and finally, to what seems to be a viable solution, SFAS 109. Prior to the issuance of SFAS 109, Accounting for Income Taxes, many countries believed that the U.S. standard, SFAS 96, was too complicated to be of any benefit in their countries. SFAS 109, as discussed previously, represents a simplification of SFAS 96, and in some cases has even less stringent requirements than those statements issued in other countries, such as the criteria for recognition of net operating losses. Other countries may be more willing in the future to re-evaluate their standards, and adopt some of the principles found in SFAS 109 for their international statements. Japan and Germany in particular rely on tax law to determine financial reporting requirements. As a result, neither country has a foundation of experience in accounting for income taxes for financial reporting purposes. SFAS 109, its formation based on the successes and failures of past attempts to regulate accounting for income taxes, provides at least a basis from which these countries can establish their own standards. Japan and Germany can, therefore, learn from the track record of the U.S. and prevent some of the mistakes made in the past.

The FASB is choosing a moderate role in this harmonization process. They are in continual support of the IASC, but while providing any technical assistance requested by the IASC in their efforts, they do not wish to become the sole leaders in
this process. They believe that by perhaps appearing as unwelcome dominators of standard setting in the world, they will only be causing negative goodwill towards the harmonization process as a whole (31). However, the issuance of SFAS 109, a comprehensive, but simplified and less stringent version of other standards found in the four countries, may provide a stepping stone for the IASC and other countries to use in their research while working towards harmonization.

Conclusion

In order for the IASC to achieve its goal of harmonization of income tax accounting in these four countries, it should progress slowly and with caution. Unlike many up-and-coming issues in accounting that require standards to be developed quickly, income tax accounting methods are entrenched within these four countries, have been in existence a long time, and are even the basis of financial reporting in two of the four countries examined. If the IASC moved quickly and determinately, hostility could prevent any progress from being made at all.

Harmonization of these standards are necessary to create equality in foreign markets. Although the markets will still function without them, harmonization can only be more useful to those who use financial statements as a basis for their decision making. Harmonization of income tax accounting standards will be a long and time-consuming task. However, if the IASC can develop into a more powerful influence worldwide and convince the countries that this is a worthwhile task, everyone, including investors, businesses, governments, and all users of financial statements, will benefit.
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Table 1
Income Tax Accounting - Taken From "Survey of International Accounting Practices" with modification of SFAS 109

<table>
<thead>
<tr>
<th>INTERNATIONAL</th>
<th>UNITED STATES</th>
<th>U.K.</th>
<th>GERMANY</th>
<th>JAPAN</th>
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<td>Not applicable</td>
<td>Federal and state corporate income tax</td>
<td>Federal corporation tax</td>
<td>Federal corporation tax and local trade tax</td>
<td>Federal corporation income tax, local business tax, and local inhabitant tax</td>
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<td>Accrual Basis</td>
<td>Accrual Basis</td>
<td>Accrual Basis</td>
<td>Accrual Basis</td>
<td>Generally accrual basis, cash basis permitted for business tax</td>
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<td></td>
<td></td>
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<tr>
<td>Deferred taxes recognized on timing differences.</td>
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<td>Deferred taxes recognized on timing differences</td>
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<td></td>
<td></td>
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<tr>
<td>Deferred method or liability method acceptable</td>
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<td>Liability method</td>
<td>Liability method</td>
<td>Deferred method or liability method in consolidated financial statements</td>
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<td>International</td>
<td>U.K.</td>
<td>Germany</td>
<td>Japan</td>
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<tr>
<td><strong>Measurement of Deferred Income Taxes</strong></td>
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<td>Tax rates enacted for future years</td>
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<td>Deferred method - current tax rates for originating timing differences and tax rates originally applied for reversing timing differences</td>
<td>Deferred method - current tax rates for originating timing differences and tax rates originally applied for reversing timing differences</td>
<td>Deferred method - current tax rates for originating timing differences and tax rates originally applied for reversing timing differences</td>
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<td><strong>Criteria for Recognition of Deferred Tax Assets on Timing or Temporary Differences</strong></td>
<td>Reduced by valuation allowance if more likely than not all or a portion of the asset will not be realized</td>
<td>Reduced by valuation allowance if more likely than not all or a portion of the asset will not be realized</td>
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