

Accounting for Deferred Tax Assets, 9/29/00

In a **September 2000** report on Concord Camera Corp. (“LENS”), CFRA cited the reversal of the Deferred Tax Asset Valuation Allowance account as a major source of the Company’s increased earnings. Specifically, LENS eliminated its tax valuation allowance account in the June 2000 quarter, adding \$6 million to net income and thereby increasing fiscal 2000 earnings per share by \$0.25 – to \$0.81 from \$0.56. The firm was subsequently cited as the 20th fastest-growing company on Fortune Magazine’s list of “America’s 100 Fastest Growing Companies”. CFRA notes that other firms such as Gen Rad, IOMEGA, Verity, MTI, Great Atlantic and Pacific Tea Co., Laboratory Corp. of America have also reversed all or part of their tax valuation accounts in recent months.

Deferred tax assets present difficult accounting issues.

- What are deferred tax assets?
- How are deferred tax assets valued on the balance sheet?
- How do tax valuation allowance accounts affect the financial statements?
- When should firms establish a tax valuation allowance?
- What happens when a firm decides to reverse its tax valuation allowance account?

What are deferred tax assets?

The Deferred Tax Asset account represents potential future tax benefits from net operating loss carryforwards, unused tax credits, and certain kinds of timing differences between expense and revenue recognition for tax and book purposes. In this report, we will look specifically at deferred tax assets created by the net operating loss (“NOL”) carryforwards that are often accumulated in the early years of a company’s operations. NOL carryforwards are the most important source of deferred tax assets for many new ventures. Even profitable companies like America Online report net operating losses on their tax returns because of the deductions allowed by the tax code for exercise of stock options.

A net operating loss (NOL) occurs when tax-deductible expenses exceed taxable revenues. The firm pays no income taxes in the year the NOL occurs. The company may then use the NOL to obtain a refund of taxes paid in the two most recent prior years (NOL carryback) and/or to offset taxable income and hence taxes to be paid in the next 20 years (NOL carryforward). The Deferred Tax Asset account balance reflects the *potential* tax benefit from future use of NOL carryforwards as well as the other items mentioned above.

The accounting entry to record additions to deferred tax assets *debits* (increases) the Deferred Tax Asset account and *credits* (reduces) Income Tax Expense. The income statement may actually show a “net tax benefit” (negative tax expense) in the year the firm files a tax return with a NOL.

It is important to understand that a firm cannot receive any actual benefit from a NOL carryforward until it reports taxable income on its tax return and uses the carryforward to reduce its tax payments. The potential future benefit from a deferred tax asset therefore depends on generating sufficient future taxable income within the 20-year carryforward period to utilize the NOL carryforward.

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How are deferred tax assets valued on the balance sheet?

Accounting for deferred tax assets is covered by “Statement of Financial Accounting Standards No. 109.” The Statement requires firms to reduce the value of its deferred tax assets by a “valuation allowance” if it is *more likely than not* that some portion/all of the deferred tax asset will not be realized. The balance sheet value of deferred tax assets should measure the expected net realizable value of the firm’s NOL carryforwards and other items that create the deferred tax asset. Management must use all available evidence, both positive and negative, to assess future profitability and determine if a tax valuation allowance is needed.

How does a tax valuation allowance account affect the financial statements?

The entry to establish a tax valuation allowance *debits* Income Tax Expense and *credits* the Deferred Tax Asset Valuation Allowance. The tax valuation allowance is a “contra asset” meaning that its balance is subtracted from the deferred tax asset account to establish the balance sheet value for deferred tax assets. Firms carrying a “full valuation” allowance report no deferred tax assets on their balance sheets.

America Online (“AOL”), for example, had total short and long-term deferred tax assets of \$4,132 million at June 30, 2000, but it maintained a valuation allowance of \$3,752 million. Therefore, AOL reported deferred tax assets of only \$380 million on its balance sheet.

Creation of a “full valuation” allowance for deferred tax assets changes the timing of recognition of the tax benefits from NOL carryforwards on the income statement. The *credit* to income tax expense made when the deferred asset is initially recognized is offset by the *debit* to income tax expense recorded when the valuation allowance is established. Firms electing to create a “full allowance” delay recognition of benefits from NOL carryforwards on their income statement until they are actually used to reduce tax payments – i.e., when the firm has taxable income and owe taxes on that income. Firms not using a tax valuation allowance report tax benefits from NOL carryforwards in the accounting period when the NOL occurs. (See **Example 1** below.)

EXAMPLE 1: Deferred Tax Accounting With and Without a Tax Valuation Allowance

19x1: XYZ Corporation files its 19x1 tax return showing a NOL carryforward with a potential to provide future tax benefits of \$35.

<i>With Full Tax Valuation Allowance</i>			<i>With No Tax Valuation Allowance</i>		
<i>Deferred Tax Asset</i>	\$35		<i>Deferred Tax Asset</i>	\$35	
<i>Income Tax Expense</i>		\$35	<i>Income Tax Expense</i>		\$35
<i>Income Tax Expense</i>	\$35				
<i>Deferred Tax Valuation Allow.</i>		\$35			
<ul style="list-style-type: none"> Income Tax Expense on the income statement is \$0. Deferred Tax Asset value on the balance sheet is \$0. No benefit from the NOL Carryforward is reported on the 19x1 financial statements. 			<ul style="list-style-type: none"> Income Tax (Benefit) on income statement is \$(35). Deferred Tax Asset Value on balance sheet is \$35. Full benefit from NOL Carryforward is reported on the 19x1 financial statements. 		

19x2: XYZ Corporation had taxable income. The taxes owed would have been \$50, but the firm used its entire NOL carryforward to reduce the actual tax payment to \$15.

With Full Tax Valuation Allowance		With No Tax Valuation Allowance	
<i>Income Tax Expense</i>	\$50		
<i>Deferred Tax Asset</i>	\$35		
<i>Taxes Payable or Cash</i>	\$15		
<i>Deferred Tax Valuation Allow.</i>	\$35	<i>Income Tax Expense</i>	\$50
<i>Income Tax Expense</i>	\$35	<i>Deferred Tax Asset</i>	\$35
		<i>Taxes Payable or Cash</i>	\$15
(The allowance is eliminated when the deferred tax asset is removed from the books.)			
<ul style="list-style-type: none"> Income Tax Expense on the income statement is \$15. Benefit from 19x1 NOL Carryforward is reported on the 19x2 financial statements when the NOL carryforward is used to reduce tax payments. 		<ul style="list-style-type: none"> Income Tax Expense on the income statement is \$50. No benefit from the 19x1 NOL Carryforward is reported in 19x2. 	

Total income tax expense for the two-year period (when the firm generated a deferred tax asset and used it up completely) is the same both with and without the tax valuation allowance. The benefit from the NOL carryforward is, however, reported in different periods. (See **Summary**.) Use of a tax valuation allowance postpones recognition of the tax benefit until the year when the carryforward is used to reduce tax payments.

Summary of Tax Expense With and Without a Tax Valuation Allowance

With Full Tax Valuation Allowance		With No Tax Valuation Allowance	
Tax Expense 19x1	\$0	Tax (Benefit) 19x1	\$(35)
Tax Expense 19x2	<u>15</u>	Tax Expense 19x2	<u>50</u>
<i>Total Tax Expense</i>	\$15	<i>Total Tax Expense</i>	\$15

When should a firm establish a tax valuation allowance?

The decision whether to establish a valuation allowance is highly subjective. SFAS No. 109 requires evaluation and adjustment of the tax valuation allowance at the end of each accounting period. Negative evidence of future profitability might include: (a) recent history of net losses; (b) NOL carryforwards expiring unused; (c) losses expected in future years; and (d) only a few years remaining in the carryforward period. Positive evidence could include, among other things: (a) appreciated asset values or (b) a sales backlog or existing contracts that are likely to be profitable. It is very difficult for an outsider to assess whether a change in the tax valuation allowance balance is appropriate or to identify the need for such an account.

What happens when a firm decides to reverse its tax valuation allowance account?

Reversal of the Deferred Tax Asset Valuation Allowance can provide a large one-time increase in reported net income. The entry to reverse an existing tax valuation allowance *debits* the tax valuation allowance and *credits* income tax expense. The credit to income tax expense provides a boost to net income equal to the amount of the reversal. This can make a significant one-time difference in reported profits. (See **Example 2**.)

Example 2: Financial Statement Impact – Elimination of Tax Valuation Allowance

ABC Corporation generated deferred tax assets totaling \$500. The firm had historically carried a full tax valuation allowance so its balance sheet reported no deferred tax assets. In 19x5, ABC's management reassessed the firm's expected future profitability and decided to eliminate the entire tax valuation account.

<i>Entry to eliminate the tax valuation allowance:</i>		
<i>Deferred Tax Asset Valuation Allowance</i>	<i>\$500</i>	
<i>Income Tax Expense</i>		<i>\$500</i>
<ul style="list-style-type: none">• Income Tax Expense on the income statement is reduced by \$500 and net income is increased by \$500.• Deferred Tax Assets reported on the balance sheet increase by \$500 because there is no remaining balance in the contra asset account.		

Looking forward, the decision to eliminate the tax valuation allowance accelerates income statement recognition of tax benefits from future NOL carryforwards. A firm with no tax valuation allowance would report tax benefits (lower tax expense) and higher net income in years when NOL carryforwards are generated and deferred tax assets are growing. Tax expense on the income statement would be higher and net income would be lower in the years when deferred tax assets are used to reduce tax payments.

The Business Press may incorrectly report the effect of reversing the tax valuation allowance.

The business press sometimes understates the impact of reversing the tax valuation allowance. For example, Verity, Inc. eliminated its entire \$18.9 million beginning-of-the-year tax valuation allowance on May 31, 2000, even though the firm generated additional deferred tax assets from NOL carryforwards and unused research and development tax credits. The firm reported the following in the press release announcing its fourth quarter and fiscal year earnings:

“Net income for the quarter was \$14.2 million or \$0.39 per diluted share. The financial results for the fourth fiscal quarter and fiscal year ended May 31, 2000 include an income tax benefit of \$2.6 million as a result of the reversal of the income tax valuation allowance as required by accounting rules. Net income for fiscal 2000 was \$33.0 million or \$0.95 per diluted share. Excluding the income tax benefit, net income for the fiscal year ended May 31, 2000 would have been \$30.4 million, or \$0.87 per diluted share.”

This statement implies that the elimination of the tax valuation asset added only \$2.6 million to its net income. In reality, the elimination of the tax valuation account provided an \$18.9 million “turn-around” in income tax expense and net income for the quarter and the year resulting in a \$2.6 million “Net Tax Benefit” for the fourth quarter and a \$2.2 million “Net Tax Benefit” for the year. Verity would have reported a “Net Tax Expense” of about \$16.7 million if it had continued to provide a full valuation allowance for its beginning-of-the-year deferred tax assets and its fiscal 2000 net income would have been only about \$14.1 million. The Press Release downplayed the importance of the entry and emphasized, instead, the “Net Tax Benefit” figure.