

TS Insights

Financial reporting in an uncertain economy

A closer look at income tax valuation allowances

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Notwithstanding early signs that the global recession may be waning, the uncertain economic future continues to constrict corporate America. As companies continue to incur losses, focus has heightened on income tax valuation allowance assessments by companies and their auditors, as well as the Securities and Exchange Commission staff, through the issuance of comment letters. Specifically, much of this focus is on whether deferred tax assets reflected on corporate balance sheets will ultimately be realized. When a deferred tax asset is not fully realizable, a valuation allowance must be established against the deferred tax asset to reduce it to a net amount that is realizable. The related expense is generally reflected in the income statement as an income tax expense. A clear understanding of the judgmental nature of valuation allowance accounting models is critical in addressing this issue.

The need for judgment

The accounting requirements for deferred tax assets are set out in ASC 740, "Income Taxes," which establishes a "more likely than not" threshold for recognizing deferred tax assets. The interpretation of this criteria has historically been (and continues to be) one of the most judgmental areas of accounting in practice. Performed on a jurisdictional basis, ASC 740 requires the following four sources of taxable income to be considered in assessing the need for a valuation allowance against deferred tax assets:

- Taxable income in prior eligible carryback year(s)
- Future reversals of existing taxable temporary differences (i.e., deferred tax liabilities)
- Future taxable income exclusive of reversing temporary differences and carryforwards
- Tax-planning strategies that would, if necessary, be implemented

The existence of taxable income in carryback years and future reversals of existing taxable temporary differences are generally matters of fact. However, the

evaluation of the other two sources of taxable income — projections of future taxable income and the identification and assessment of available tax planning strategies — requires significant judgment. This paper explores these sources of taxable income, as well as other considerations relevant to valuation allowance assessments in today's turbulent economic environment.

Weighing available evidence

In the valuation allowance world, not all available evidence related to deferred tax asset realizability is created equal. ASC 740 requires the weighing of positive and negative evidence.

For example, consider a company that experiences current operating losses that are attributable to today's economic environment. This presents negative evidence indicating deferred tax assets may not be realized. However, when forecasting its future taxable income, the company projects a return to profitability in 2010 — an indication of positive evidence. In addition, prior to the economic downturn, the company has historically been profitable.

In this case, the operating losses that have most recently occurred would likely carry more weight in the analysis of the need for a valuation allowance than either the historic profitability or the projection of future taxable income. What has recently occurred is generally more verifiable than what may occur in the future, or what has occurred in the more distant past.

Cumulative losses in recent years

In ASC 740, cumulative losses in recent years are cited as an example of significant negative evidence that is difficult to overcome. While not defined by ASC 740, practice has generally been to consider the most recent three years when assessing cumulative losses. Positive evidence of sufficient quantity and quality would be needed to overcome this significant negative evidence and conclude that a valuation allowance is not warranted. As with all elements of available evidence, a cumulative loss is simply one data point — it is not a "bright line" test that is in and of itself determinative of the need for a valuation allowance.

To illustrate, assume that a company is in a three-year cumulative income position of \$10 million, but the results of the past three years have flipped from income to losses (2006: income of \$100 million; 2007: loss of \$30 million; 2008: loss of \$60 million). Does the fact that the company is still in a three-year cumulative income position at the end of 2008 automatically suggest that a valuation allowance is not warranted?

On the other hand, assume a company had previously recorded a full valuation allowance and incurred a loss of \$100 million in 2008, but earned \$30 million in 2009 and \$60 million in 2010. Does the fact that the company is still in a three-year cumulative loss position at the end of 2010 automatically suggest that maintaining the previously recorded valuation allowance is still warranted?

Although in both cases more information is needed, the examples suggest that the three-year cumulative loss is not a "bright line" test. Other factors, such as what caused the losses and when the losses occurred in the three-year period, may affect the relative weight given to that particular piece of evidence and, accordingly, its ultimate assessment and conclusion.

Tax planning strategies

Tax planning strategies may also provide a source of taxable income when deciding whether a valuation allowance is necessary. ASC 740 gives characteristics of tax planning strategies. Specifically, tax planning strategies are:

- Actions that an enterprise ordinarily might not take, but would take to prevent an operating loss or tax credit carryforward from expiring unused
- Actions that would result in realization of deferred tax assets
- Actions considered both "prudent" and "feasible"

To be considered prudent, the strategy would need to be in the best interests of the company. For a strategy to be considered feasible, management must have the ability to carry it out. When considering tax planning strategies, companies should ask the question, "Is the proposed strategy ultimately providing the company a cash tax savings?"

The following example will illustrate a proposed tax planning strategy that does not result in a cash tax savings, and therefore would not be considered in a valuation allowance analysis:

ABC Company has experienced a history of operating losses over the past five years that total \$20 million, and has a gross deferred tax asset of \$8 million (\$20 million x 40% tax rate) recorded for these net operating loss carryforwards. Due to the history of losses, a full valuation allowance of \$8 million has also been recorded historically.

In the current year, ABC Company introduces a new product line. Based on the anticipated success of this product line, ABC Company expects to "turn the corner" and become profitable in three years. Additionally, due to appreciation in the real estate market, ABC Company's investment in a shopping mall property is now valued at approximately \$500,000 more than the carrying amount in its financial statements. As a result, ABC Company is considering whether or not a reversal of \$200,000 of the valuation allowance (\$500,000 x 40%) should be recorded. The shopping mall is not a "core" asset of ABC Company, and ABC management asserts that it would sell the shopping mall property, if

necessary, before it would permit the NOL carryforward to expire unused. Should ABC Company record a \$200,000 reversal of the valuation allowance for this tax planning strategy?

In this case, we believe that a tax planning strategy to sell appreciated assets constitutes a subset of the broader source of future taxable income from operations. Thus, it would not be appropriate to reduce a valuation allowance when it appears that the tax planning strategy will only reduce an expected future loss. In this example, based on (1) ABC Company's history of losses, (2) an unproven new product line, and (3) the fact that the enterprise does not anticipate being profitable for at least three years, little weight can be assigned to the projection of profitability. Since there is no incremental tax benefit (at least for the foreseeable future), the potential gain on the sale of the shopping mall property would only reduce what otherwise would be a larger operating loss.

As the above example illustrates, when considering tax planning strategies as a source of future taxable income, companies should be certain that any proposed strategy ultimately results in realization of the deferred tax asset through a reduction in cash taxes.

Recording of valuation allowance

Recent losses and uncertainty about the future have led several companies to record additional valuation allowances. In many instances, these valuation allowances are recorded in the tax provision from continuing operations. This is the case even if the deferred tax asset when originally established in a prior year was recorded in a financial statement component other than continuing operations such as other comprehensive income (OCI) or discontinued operations. This mismatch between the deferred tax asset and valuation allowance earnings impact is counterintuitive to many practitioners, who would prefer to "backward trace" the valuation allowance charge to the same classification as the originating benefit. To simplify deferred tax accounting, ASC 740 does not permit backward tracing. The following example illustrates this concept:

At the end of 2007, a company recorded a deferred tax asset and OCI benefit of \$400,000 related to its available-for-sale equity securities. During 2008, the

company concluded that a full valuation allowance was warranted. Even though the benefit related to the deferred tax asset of \$400,000 was originally recorded in OCI, the expense to be recorded for the increase in the valuation allowance would be reflected in the continuing operations tax provision.

Disclosures

Valuation allowance assessments and disclosures are frequently subject to "second-guessing" by financial statement users, auditors, and regulators, especially with respect to the timing of recording or releasing a valuation allowance. ASC 275, "Risks and Uncertainties," requires that certain disclosures be made with regard to significant financial statement estimates and their inherent risks and uncertainties. The Securities and Exchange Commission staff in particular will review these and other disclosures to determine whether the risk of an increase in the valuation allowance was disclosed to financial statement users in advance of any such increase.

As companies evaluate the need for a valuation allowance, they should give careful thought to providing ASC 275 "early warning" disclosures. Transparent disclosure of the nature, timing, and other factors underlying the development of a company's allowance estimates, as well as any factors that may cause the estimates to change, may reduce the risk of being second-guessed.

The following excerpt is an example disclosure provided in ASC 275-10-60-8:

The entity has recorded a deferred tax asset of \$4.8 million reflecting the benefit of \$12 million in loss carryforwards, which expire in varying amounts between 19X5 and 19X7. Realization is dependent on generating sufficient taxable income prior to expiration of the loss carryforwards. Although realization is not assured, management believes it is more likely than not that all of the deferred tax asset will be realized. The amount of the deferred tax asset considered realizable, however, could be reduced in the near term if estimates of future taxable income during the carryforward period are reduced.

What this means for your business

As the economy continues to stress the health of businesses, the focus on income tax valuation allowances on assets becomes paramount, and a clear understanding of the valuation allowance accounting model is critical.



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