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Financial Services

Understanding Valuation Allowance Reversals

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The recent economic downturn has made many banks struggling with high credit loss, real estate impairments, and large net operating losses (NOL) deal with deferred tax asset valuation allowance issues. For some companies, a valuation allowance may have been recorded for the first time in their history, and when this happens management must decide when and how much of the valuation allowance should be reversed.

Analyzing whether a valuation allowance should be reversed requires the same approach as determining whether a valuation allowance is appropriate: You must consider both positive and negative evidence. With that said, deciding to impose or reverse a deferred tax asset valuation allowance is a rather abstract concept, and the asset's value must be evaluated under generally accepted accounting principles in much the same way as any other asset on the balance sheet.

By definition, a deferred tax asset will enable a reduction in future taxes or an increase in future refunds when the temporary difference reverses and taxable income is generated again. In a

company's analysis, evidence must be identified to support the claim that a future tax benefit will more likely than not be realized. The realization of a benefit can't be a hypothetical exercise that goes beyond the implementation of prudent tax-planning strategies. Companies with pretax net losses that have exceeded their pretax earnings during the past three years will see their positive evidence scrutinized more rigorously. This is because projected earnings are usually the only positive evidence available to a company. As a result of the continued uncertainty in the economy, it's a common practice for companies with significant prior-year losses to limit their projected earnings as positive support in their analysis to the succeeding year's projected pretax book net income. This greatly diminishes the likelihood of reversing some or all of the deferred tax asset valuation allowance.

Positive and Negative Evidence

Accounting Standards Codification (ASC) 740-10, Income Taxes (formerly Financial Accounting Standard No. 109, Accounting for Income Taxes) requires a valuation allowance to be applied against deferred tax assets when it's considered more likely than not—a probability of more than 50 percent—that some or all of the gross deferred tax asset will not be realized. The

standard requires that companies consider all available evidence, both positive and negative, to determine if a valuation allowance is necessary. This information should include historical information supplemented by all currently available information about future years and projected income. A significant amount of judgment is required by a company in weighing the positive and negative evidence in order to reach a conclusion to apply or remove a valuation allowance.

Examples of negative evidence include:

- A history of net operating loss carryforwards expiring unused
- A pattern of losses in the most recent prior years
- Losses expected in future years
- Unsettled circumstances that, if unfavorably resolved, would adversely affect future operations and profit levels on a continuing basis
- A carryforward period so brief that it would limit realization of tax benefits if a significant deductible temporary difference is expected to reverse in a single year

When a company concludes it's more likely than not that the deferred tax asset will be fully realized, then a valuation allowance is no longer appropriate.

Companies should consider evidence carefully and weigh its potential effect commensurately with the extent it can be objectively verified. In general, companies should include projected future income in their evaluation if it can be supported at a more-likely-than-not level. When a company determines that positive evidence outweighs negative evidence (for example, a history of accurately projecting income outweighs historic operating losses), projected future taxable income should be included in the evaluation.

For regulatory reporting purposes, the amount of the deferred tax asset to be recognized in the calculation of regulatory capital ratios is generally limited to the amounts of such deferred tax assets that a company expects to realize within one year.

Sources of Taxable Income

ASC 740-10 provides four sources of taxable income or factors that should be considered in the determination of a valuation allowance. If one source of taxable income provides sufficient income, the other sources don't need to be considered. Alternatively, all factors must be considered if a valuation allowance is required. The subjectivity of the four factors varies. A prudent approach is to consider the factors in order of subjectivity, starting with the least:

1. Taxable income in prior carryback years if carryback is permitted under the tax law



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Examples of positive evidence include:

- Existing investment securities, loans, loan commitments, or other earning assets that will produce more than enough taxable income to realize the deferred tax asset based on existing interest rates and interest rate spreads (see below for additional information regarding taxable income)
- An excess of appreciated asset value over the tax basis of the entity's net assets in an amount sufficient to realize the deferred tax asset
- Evidence indicating that a loss is not a continuing condition

2. Future reversals of existing taxable temporary differences
3. Tax-planning strategies
4. Future taxable income exclusive of reversing temporary differences and carryforwards

The analysis typically includes scheduling reversals of temporary differences, evaluating expectations of future profitability, determining refund potential in the event of NOL carrybacks, and evaluating potential tax-planning strategies. Tax-planning strategies should be prudent and feasible. When you assess the need for a valuation allowance, any limitations imposed by Internal Revenue Code Section 382 must be considered.

Projections of future income contain elements of speculation and subjectivity. Qualitative information regarding the company's asset quality, trend analysis, financial ratios, and market environment should be documented in the overall analysis. Projections of future income for valuation allowance purposes will need to remain consistent with other financial statement analysis areas. The consideration of future income will be limited to relatively short periods of time, such as one to three years, in situations where projections are highly uncertain or when prior losses were significant.

Keep Your Audit Team Informed

A company's analysis is highly subjective, and all positive and negative evidence needs to be taken into consideration during each recognition period. As a result, one company's analysis won't be the same as another company's in the same industry or geographic area. A company that believes it has enough positive evidence to support the reversal of its deferred tax asset valuation allowance should be in continuous contact with its audit team to minimize any surprises in the interpretation of the company's analysis. Quite often a partial reversal of the valuation allowance is appropriate until additional positive evidence is exhibited, likely through the generation of positive book earnings. Your accounting provider should be able to answer any questions you might have about your company's analysis or discuss potential tax planning strategies that could be incorporated into your specific analysis.

Amy Jessup has practiced public accounting since 1997 and has a strong technical understanding of C corporation, S corporation, partnership, and individual tax matters.

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