FINANCIAL ACCOUNTING STANDARDS BOARD
STATEMENT NO. 109

Accounting for Income Taxes

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Date: 5/23/94
INTRODUCTION

The main objective of this capstone project is to focus on one of the more significant issues contained in Statement of Financial Accounting Standards No. 109, which was effective for fiscal years beginning after December 15, 1992. This focus will center upon the recognition of deferred tax assets and the related valuation allowance. This paper is not meant to be a comprehensive discussion and analysis; but, instead will discuss the selected topic of deferred tax assets and the related valuation allowance and then present both a discussion and a case which will discuss the significant issues and problems that have been associated with the application of the new standard. The case subject will be Square D Company, a large manufacturing company, and the discussion subject will be Ernst & Young, a Big Six public accounting firm.

The new Standard has established financial accounting and reporting for the effects of income taxes resulting from an enterprise's activities for current and preceding years. This new Standard supersedes the American Institute of CPAs Accounting Principles Board Opinion No. 11 and Financial Accounting Standards Board Statement No. 96.
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HISTORICAL DEVELOPMENT

Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes*, is a culmination of several attempts to develop a workable standard. Until the 1980's, there was little change in the GAAP for accounting for income taxes (2). However, recent history shows that this topic has fallen under intense scrutiny.

**Accounting Principles Board Opinion No. 11**

The development of the current standard began with the issuance of the Accounting Principles Board Opinion No. 11, which was issued in 1967. The basic provisions of APB 11 included that income taxes payable would be determined through the application of two computations. The first calculation would exclude any transactions that would cause timing differences. The second calculation would include all such transactions. The difference between the two calculations would be the deferred income tax for the period. This amount would be shown as an addition to or a reduction from the income tax expense amount reported on the income statement and also as an offsetting deferred tax credit or debit on the balance sheet. One aspect that should be noted concerning APB 11 is that the discounting of deferred taxes was not allowed. This Opinion also took an income statement approach by trying to match income tax expense with the related financial accounting income (2, 6).

**Criticisms of APB Opinion 11**

Due to rising criticism of APB Opinion No. 11, in 1982, the Financial Accounting Standards Board began to reexamine the rules on accounting for income taxes. The majority of these criticisms focused on the numerous amendments that had increased the complexity of accounting for income taxes (6). These criticisms claimed that the amendments were not only creating a complex structure, but also that the amendments themselves were conceptually inconsistent (specifically concerning the definition of liability within the conceptual framework).
The direct result of this would be a complex report that lacked meaningfulness (2, 6). One specific factor was that since U.S. corporate tax rates were lowered from 52% to 34%, then-present balance sheets had an accumulation of tax credits that were usually removed at lower rates than they had originally been recorded (2, 6).

Statement of Financial Accounting Standards No. 96

In response to earlier criticisms and in order to correct many of the problems created by APB Opinion 11, in 1987 the Financial Accounting Standards Board issued Statement No. 96. Unlike APB Opinion 11, SFAS No. 96 took a balance sheet approach. Although this Statement had the benefits of making deferred tax balances more meaningful, conceptually sound, and also allowed for the recognition of deferred tax assets along with deferred tax liabilities, it simultaneously created additional problems (2, 6). These problems included an increased complexity, more extensive requirements for both record-keeping and disclosure, and a failure to address the issues of discounting, and the impact of differing tax rates at the time of reversal and original recording. (2, 6)

Criticisms of SFAS No. 96

In March of 1989, the Financial Accounting Standards Board began to consider requests to amend Statement No. 96. Many views considered the detrimental aspects of the Statement to overshadow the beneficial changes (2). These criticisms included technical issues such as the lack of discounting, the complex applications required, and the specific criteria required for recognition of deferred tax assets (2, 6). So, in December of 1991, the FASB issued Statement No. 108, which deferred the effective date of Statement No. 96 to fiscal years beginning after December 15, 1992. Then, after the release of and the discussion of an exposure draft, on December 15, 1992 the FASB issued Statement of Financial Accounting Standards No. 109 which was to be effective for fiscal years beginning after December 15, 1992.
FASB STATEMENT NO. 109 IMPLEMENTATION

Basic Objectives and Principles

SFAS No. 109, Accounting for Income Taxes, establishes standards for the accounting and reporting of both income taxes that are currently payable and for the tax consequences of certain events, regardless of the taxing entity from which they arise (1, 4, 8). One objective of SFAS 109 is to recognize the tax effects of an event in the same period as the underlying event itself (8). A second objective is to recognize deferred taxes for the future tax consequences of any events that have already been recognized in either the financial statements, the entity's tax returns, or events that have resulted because of enacted changes in the tax laws (1, 4, 8).

The new standard, like SFAS No. 96 before, is based upon a balance sheet approach. This approach attempts to create deferred tax assets and liabilities that adequately adhere to the definitions of assets and liabilities within the conceptual framework, specifically FASB Concepts Statement No. 6, *Elements of a Financial Statement* (1, 2, 4).

FASB Concepts Statement No. 6 defines an asset as a "probable future economic benefit obtained or controlled by a particular entity as a result of past transactions or events." Liability is defined as "probable future sacrifices of economic benefits obtained or controlled by a particular entity as a result of a past transaction or event." By designing the standards to be conceptually sound, consistency is preserved pertaining to the balance sheet classifications.

The balance sheet approach requires that any future income tax effects due to the difference between the financial statement carrying amount and the tax basis of an asset or liability must be recognized as a deferred tax asset or a deferred tax liability (8). Therefore, all temporary differences require the recording of a deferred tax account.

Additionally, if there is a change in tax rates or other tax law provisions, a deferred tax asset or liability would then be adjusted (in the period of enactment) for the effect of the change (4, 8). The effects of any such change would be charged or credited to income from continuing
operations. This means that if changes in the tax laws occur the future adjustment or recording of these changes will have an income statement impact.

Deferred Tax Liabilities

Under the new standard, deferred tax liabilities shall be recognized for all taxable temporary differences using the enacted marginal tax rate that is expected to be applicable instead of using the tax rate that is applicable during the year of recognition (10).

Deferred Tax Assets

A principal criticism of Statement 96 was that the criteria for recognition of a deferred tax asset were too harsh; therefore, it was difficult for even profitable companies to recognize deferred tax assets for their deductible temporary differences (2, 3, 6). Under APB Opinion 11, because of its "assurance beyond a reasonable doubt" standard, deferred tax assets for operating loss and tax credit carryforwards were almost never recognized; but, the standards for recognition of deferred tax assets arising from normal recurring timing differences were not as stringent (2, 6). Because Statement 96's provisions didn't distinguish between deferred tax assets arising from deductible temporary differences and those arising from loss carryforwards and also made it difficult to recognize deferred tax assets because of its reliance on a mechanical formula approach, many companies that were able to record deferred tax assets under APB Opinion 11 subsequently were not able to record deferred tax assets under Statement 96 (2, 4, 6).

A new development regarding deferred tax assets is that the requirements for recognition of operating loss carryforwards and recurring deductible temporary differences have been eased (2, 4, 6). This was done in response to the earlier criticisms and was corrected by permitting the consideration of future taxable income in assessments relating to the realizability of deferred tax assets (2). The recording of a loss carryforward—and similar deductible temporary differences—result in a deferred tax asset being recorded on the balance sheet and a credit on the income statement for the benefit (8). This occurs because the tax effects represent future tax savings.
Although the criteria for recognition were eased, the FASB reaffirmed its previous conclusion that deductible temporary differences and loss carryforwards are essentially the same and should therefore be accounted for similarly (4, 6).

Although the criteria for the recognition of deferred tax assets have been eased, if it is deemed to be that all or a portion of the recorded deferred tax assets will not be utilized in the future, the applicable balance must be offset by a valuation allowance which is designed to adjust the balance of deferred tax assets to their net realizable value (8). This aspect of a valuation allowance will be discussed in greater detail in a following section.

Financial Statement Disclosure and Presentation

Major disclosures required by the standard include any significant temporary differences, the various components of income tax expense, and a reconciliation of income tax expense (4, 5, 8). These disclosures are the same as those required under the previous standard. Additional disclosures include the total deferred tax assets and liabilities, the total valuation allowance and net change, the amount of carryforwards or carrybacks that result in a deferred tax asset, and any significant matters (4, 5, 8).

For presentation within the financial statements, the current or noncurrent classification of the deferred tax accounts within the balance sheet is based on the classification of the specific asset or liability to which the deferred account relates (8, 10). If a deferred tax account does not relate specifically to an asset or a liability, it would be classified according to the expected reversal date of the temporary difference (8, 10). All current deferred tax liabilities and assets are to be offset and presented as net current deferred tax liabilities or assets (10). This same procedure is to be applied to noncurrent deferred tax assets and liabilities (10). However, this netting can only be done for a particular taxpaying component of an enterprise and within a particular tax jurisdiction (4, 10). Offsetting between different tax jurisdictions is prohibited (10). If a complete offsetting were allowed, the presentation of the deferred tax accounts within the financial statements would lose their usefulness and comparability would be reduced.
Presentation within the income statement includes a detailed explanation of income tax expense (8, 10). This explanation includes a reflection of both the current and deferred portion of the income tax expense for the period. This disclosure can be made on the face of the financial statements or within the notes accompanying the financial statements. Details concerning significant items and other disclosures are usually included in the notes to the financial statements (4, 10).

If there is a change in the beginning balance of a valuation allowance because circumstances have arisen that have caused a change in judgment, then the amount of this change is generally included in income from continuing operations for the period and is also considered a discrete event for interim reporting (it therefore requires separate disclosure within the notes to the financial statements) (4, 8).

However, as discussed in paragraph 26, there are certain situations when the effect of a change in the valuation allowance is not reported in income. These include 1) tax benefits initially recognized for deductible temporary differences and carryforwards of a company acquired in a prior purchase business combination—in which case the effects are first reported as a reduction to goodwill or other intangible asset related to the acquisition before any remaining amount is reported as a reduction to income tax expense, and for 2) tax benefits for the following items which are required to be reported directly in stockholder's equity as opposed to a reduction in income tax expense: a) increases or decreases in contributed capital (i.e. stock issue costs), b) expenses for employee stock options recognized differently for financial reporting and tax purposes, c) dividends on unallocated shares of an ESOP that were charged against equity, and finally, d) deductible temporary differences and carryforwards that existed at the date of a quasi reorganization (4, 8, 10).

For interim reporting purposes, the effect of the change in the valuation allowance that is a result from a change in circumstances is included in the annual effective tax rate if the benefit is expected to be realized because of current year ordinary income (8). If the benefit is expected to
be realized in future years instead, then it would be included in the interim period of change as a discrete event (4, 8, 10).

The effect of other changes in the balance of a valuation allowance are allocated among continuing operations and items other than continuing operations based on the intraperiod tax allocation provisions described within the standard (4, 8).

**VALUATION ALLOWANCE**

According to Statement 109, a deferred tax asset is recognized for deductible temporary differences, net operating loss carryforwards, and tax credit carryforwards; however, all deferred tax assets are measured assuming that all existing tax benefits will be realized. However, if based on the weight of all available evidence it is determined that it is "more likely than not" that some or all of the deferred tax asset will not be realized, then a valuation allowance must be established for the asset (the FASB acknowledges that it believes that "more likely than not" means a level of likelihood that is more than 50 percent) (4, 6, 8). This allowance acts as a contra account which offsets each specific deferred tax asset. Although Statement 109 effectively eliminated the strictness of Statement 96 in regard to the recording of deferred tax assets, the replacement consisted of a determination, based heavily on judgmental evidence, that would determine the level of realization with the establishment of a valuation allowance based on several different factors (4, 8, 10). For reporting purposes, a summation of all valuation allowances is shown; however, it should be noted that the evaluation regarding the realizability of deferred tax assets is made on a gross as opposed to a net basis (8, 10). This means that it will affect all companies with significant deductible temporary differences, and not only those companies that may find themselves in a net deferred tax asset position. This evidence, as previously mentioned, requires considerable judgment and is of both a positive and negative nature.
Sources of Taxable Income

The fact that a benefit may be expected for a portion of but not all of a deferred tax asset increases the judgmental complexity required for utilizing and correctly administering a valuation allowance. In order to facilitate the future realization of a deferred tax asset, there must be sufficient taxable income of the appropriate character (ordinary vs. capital gain) in the applicable period -- whether it be a carryback or carryforward period (4, 8). Statement 109 speaks of four sources of taxable income that must be considered when determining whether or not a valuation allowance is needed (8). These four sources are: 1) future reversals of existing taxable temporary differences, 2) taxable income in prior carryback years -- if permitted, 3) tax planning strategies, and 4) future taxable income exclusive of reversing temporary differences and carryforwards (4, 8, 10). As expected, the judgmental complexity arises in determining the fourth source, future taxable income. As noted previously, this is the most significant change from Statement 96. Judgments regarding future taxable income will pose the greatest challenge for management when trying to determine the need for or the level of any valuation allowance. This is because future taxable income inherently requires the use of estimates and judgments about future events that can not be objectively measured although they may be predictable (4). Therefore, in the determination process, future taxable income has by far the lightest weight of any of the four sources of taxable income (4, 6).

Positive and Negative Evidence

A primary indicator of the necessity of a valuation allowance is an entity's reported pretax accounting income for not only the current year but also all preceding years (4, 6). When there is significant negative evidence, positive evidence is required before a conclusion can be reached that a valuation allowance is not needed (4, 8). In general terms, positive evidence refers to the existence of one or more of the four sources of taxable income (4, 8). Additionally, positive evidence also includes any qualitative information about those sources -- especially concerning future taxable income (4). An example of this includes the company's past experiences with
achieving its forecasted results using various elemental projections and methods (4). A firm's management needs to exercise careful judgment in assessing whether the negative evidence is more compelling than the positive evidence (4). Normally, the value of evidence is weighted according to one's ability to verify it objectively; however, the new rules allow for the weighting of intangible evidence because this evidence may be significant (4, 8). The weight given to negative evidence is more easily done because it can normally be objectively verified quite easily; whereas, positive evidence usually is not (4). If a single source of income is sufficient to eliminate the need for an offsetting valuation allowance, then it is not necessary to consider the other sources of income; however, if it is determined that a valuation allowance will be necessary, then it is required that every source of taxable income is considered when determining the level of or the amount of the valuation allowance to be recorded (4, 8, 10).

Examples of negative evidence include cumulative losses, a history of operating loss or tax credit carryforwards expiring unused, expected losses in early future years (in this case, by a currently profitable firm), or contingent liabilities or unsettled circumstances that, if resolved unfavorably, would adversely affect future operations and profit levels (such as a pending patent lawsuit that could strip a company of its main profit contributing products) (4, 8, 10).

Examples of positive evidence, which may also be used to overcome negative evidence, include existing contracts or firm sales backlog that would produce sufficient taxable income at existing prices or profit margin levels (of course, government contracts would carry more significant weight than those pertaining to small affiliates with relatively little income or economic fortitude themselves), an excess of appreciated asset sale value over the tax basis of a company's net assets that would provide an amount sufficient to realize the deferred tax asset (i.e. sale-leaseback), or a strong history of earnings exclusive of the loss that created the future deductible amount supported by evidence that shows that the loss is unusual as opposed to an expected ongoing condition (i.e. extraordinary item or one-time restructuring charge) (4, 8, 10).

Under SFAS 109, companies are required to search out all evidence that is available and consider it (8). Evidence cannot be ignored based on the grounds of conservatism; however, the
standard implies that one can take a position of "no bad news is good news" (2, 4, 6). The meaning of this statement is such that management can assume that the absence of knowledge of evidence to the contrary (negative evidence) implies a condition in which a lack of such evidence will continue (4). In gathering evidence, one should first examine the strongest and more easily obtainable and verifiable evidence in relation to all forms of evidence which may be considered. The weights assigned to the potential effect of positive and negative evidence should be relative to the extent to which the evidence can be objectively verified (4, 8). In fact, as the period of time covered by any projections increases, the ability to objectively verify the evidence proportionately decreases (4).

When considering companies that historically have been profitable and that also, of course, expect to have continued profitability, judgments about the future realization of deferred tax assets should not be difficult (4). However, because of the weight given to negative evidence, the assessments and judgments will be more difficult when dealing with unprofitable companies, marginally profitable companies, or even companies that are experiencing a high degree of volatility of earnings due to either unstable market forces in general or due to an unstable firm environment specific to the firm's industry or field of practice (1, 4).

**Cumulative Losses**

Statement 109 explicitly states that in order to reach a conclusion that a valuation allowance is not required when there is substantial negative evidence such as cumulative losses in recent years, the "more likely than not" criterion would require positive evidence of sufficient quality and quantity whereas the amount of negative evidence present would be counteracted by the combined weight of all available positive evidence (4, 8, 10). Although there are many such examples of negative evidence, cumulative losses is by far the most difficult to counteract with positive evidence (4, 10). One rare example would be such that the losses incurred in the past were the result of changes in accounting principles or extraordinary items that alone caused the company's losses (4).
The FASB considered increasing the measurement standard for the recognition of deferred tax assets to a higher level such as "probable" or "beyond a reasonable doubt" for cases dealing with cumulative pretax losses in recent years; however, it was concluded that the standard of "more likely than not" provided that the cumulative losses would carry such negative weight as evidence that it would be extremely difficult to overcome even if using all available sources of positive evidence (2, 4, 6).
DISCUSSION: ERNST & YOUNG

Sources of Taxable Income

Ernst & Young, a "Big Six" public accounting firm, in concurrence with SFAS 109, also believes that a company should consider the four sources of taxable income in the order of the least subjective to the most subjective. Therefore, the followed order is 1) carrybacks, 2) reversals of existing temporary differences, 3) tax planning strategies, and 4) future taxable income exclusive of reversals of existing temporary differences (4, 8). Hence, subjective and judgmental information concerning future taxable income will be necessary only if the more objectively measurable sources of taxable income are insufficient in determining that the need for a valuation allowance is not required (4). Because of the inherent difficulty in objectively verifying any forward looking data, projections of future income generally are limited to relatively short periods of time -- two to three years (4, 8). Of the four sources of taxable income, taxable income in carryback years and income from reversals of existing taxable temporary differences are stronger forms of evidential matter because they are more readily subject to objective audit verification (4). Additionally, it is important to remember that the sources will vary for different tax jurisdictions.

In situations in which expectations regarding future taxable income are required in order to eliminate the need for a valuation allowance and in relation the weight given to the required information is also increasing, then it is required, for audit evidence purposes, that the detail and formal preparation of the data also increase proportionately (4, 5, 8).

Cumulative Losses

One important area of concern relates to companies that have experienced cumulative losses in recent years. Since Statement 109 does not specifically define "cumulative losses in recent years," but instead leaves that determination up to the judgment of management, Ernst & Young has interpreted cumulative losses to be a position for financial reporting purposes when a company has had a cumulative loss for the latest three years (4, 8). According to a discussion
with Leon Monachos of Ernst & Young, the reasons for this position is based primarily on the fact that for income tax purposes, the Internal Revenue Service only allows a three year carryback period (11). This means that a company with a loss in the current year in excess of income realized in its previous two years as well as a company that has realized losses within each of the last three years would fall into the category of "cumulative losses" (4). In measuring losses for this purpose, it is required per SFAS 109 that the company should include pretax results from all sources except for the effects of cumulative changes in accounting principles (4, 8). This protects some companies, such as Sears, Roebuck, Inc. in 1992, from being detrimentally affected by the computation due to losses produced solely from the adoption of new accounting methods—in the case of Sears it was FASB Statement 106, *Employer's Accounting for Postretirement Benefits Other Than Pensions*. So, pretax results from continuing operations, discontinued operations, and even extraordinary items should all be included in determining whether a company is in a cumulative loss position (4, 8). Therefore, as a direct result, it would be extremely difficult to conclude that a valuation allowance was not necessary for companies in this position. In fact, expectations regarding future taxable income would rarely be sufficient to overcome the negative evidence of recent cumulative losses, even if supported by detailed forecasts and projections (4). However, in the rare and unusual case where a conclusion can be reached that a valuation allowance should not be recorded because of the existence of positive evidence, a company should nonetheless disclose in its financial statements the basis for not recording a valuation allowance, especially if there is a significant deferred tax asset balance, i.e. the balance is material in its amount (4, 8).

**Tax Planning Strategies**

Tax planning strategies are an area of concern because various actions, elections, and strategies are implicit in estimates of expected future taxable income (4). Thus, not all tax planning efforts are considered tax planning strategies under Statement 109. In fact, as defined within the standard a qualified tax planning strategy is an action that is 1) prudent and feasible—this means that the strategy's implementation must be primarily within the control of management...
and they must also expect to do so unless the need is eliminated in future years, or 2) an action that a company ordinarily might not take except for the fact that it would be implemented in order to keep an operation loss or tax credit carryforward from expiring unused—therefore, actions that management engages in during the normal course of business are not tax planning strategies, even if they have a beneficial tax-saving effect, or 3) any actions that would result in the realization of deferred tax assets (4, 8, 10). Examples of strategies include actions that could change the nature of income—from tax-exempt to taxable—or could change the character of taxable or deductible amounts—from ordinary income or loss to capital gain or loss (4). Importantly, it must be noted though that the anticipation of a change from taxable C corporation status to nontaxable S corporation status is not a qualifying tax planning strategy, even though the current U.S. federal tax law provides that the approval of such a change is automatic providing that the statutory criteria are met (4). In fact, changes in tax status are discrete events that are recognized at the date that the change is approved by any necessary authorities and not on the date of management's decision to make such a change (4, 5, 8).

Positive and Negative Evidential Matter

According to Ernst & Young audit guidance, in the event that there is a substantial existence of negative evidence, especially cumulative losses, and an absence of carryback potential, reversals of existing taxable temporary differences, or qualifying tax planning strategies, it is emphasized that expectations of future income would rarely justify the position that a valuation allowance is not required for a portion of, if not all of, the deferred tax assets (4, 5, 8). For determination of the need for a valuation account, other conditions and events are also evaluated, and subsequently considered negative evidence, that are listed under SAS 59, The Auditor's Consideration of a Company's Ability to Continue as a Going Concern. These conditions include 1) negative trends such as recurring operating losses, working capital deficiencies, negative cash flows from operating activities, and adverse key financial ratios, and 2) other indications of possible financial difficulties such as arrearages in dividends, the needs to seek new sources of financing, and default on loans or similar agreements; and 3) internal matters such
as work stoppages and substantial reliance upon the success of a particular project; and finally 4) external matters that have occurred such as legal proceedings, legislation, or the loss of a principal customer or supplier that can adversely effect the company's operations (4).

Auditing a Client's Determination of Valuation Allowances

If negative evidence does not exist, then the audit procedures designed to support the client's representations related to the expected realization of deferred tax assets may not need to be extensive; however, some procedures will be designed toward affirming that no negative evidence actually exists (4, 5). As the amount of negative evidence either discovered or affiliated increases, then the need for positive objective evidence; hence, would increase in greater proportion. Subsequently, the amount of evidential matter necessary and the extent of testing necessary will also increase (4, 5). Of course, the judgments made concerning the type of evidence, the extent of testing and the determined need for a valuation allowance will depend upon the specific client related facts and circumstances (4). The most heavily scrutinized area relates to management's estimated made in conjunction with the determination of the need for a valuation allowance (4). The extent of the audit procedures relating to the estimates will vary based on the significance of the estimates, the extent to which the estimates are subject to error, and the nature of the evidence available to support the estimates (4, 5). Additionally, the approach used by the client in determining whether a valuation allowance is required is also a consideration in determining the nature and extent of the auditing procedures to be performed (4, 5).

Disclosure

Although Statement 109 does not require that a company disclose its basis for not recording a valuation allowance, it is generally acknowledged that such disclosures would enhance a reader's understanding of the risk pertaining to realization (4, 5). Therefore, disclosure is encouraged.

One special instance occurs if consideration is being given to a report modification because of an uncertainty about the realization of deferred tax assets (4). This requires special
consideration because for Securities and Exchange Commission clients, the SEC will not accept an independent auditors' report that is modified for an uncertainty regarding the realization of assets unless the modification directly relates to a going concern problem (4, 5).

Current Perceptions

The current opinion among professionals can be generalized as to being positive regarding the effectiveness of the new standard. According the Leon Monachos of Ernst & Young, he feels that, "[FASB] Statement 109 improvement over previous standards is that its net effect on the financial statements better reflects the true operations and position of the company. [Additionally], this benefits the individuals who are supposed to benefit from the presentment of financial information--third party users of the financial data" (11).
CASE ANALYSIS: SQUARE D COMPANY

This case analysis will discuss how Square D Company, Corporate Headquarters, Palatine, Illinois office, has conformed to the requirements of the new standard and the problems and observations associated with the process. In compliance with confidentiality constraints, I will refrain from disclosing any data regarding actual account balances. The majority of the information contained hereafter has been compiled from conversations with Kevin Powers, Director of Technical Accounting, and John Gorman, a staff tax accountant, who have dealt with many of the issues relating to compliance with SFAS No. 109.

Square D Company is currently a wholly-owned subsidiary of the Paris based company Groupe Schneider; however, they are allowed to operate independently. So, the scope of this discussion will only include Square D Company and its subsidiaries (also known as Schneider North America).

Accounting System

The current accounting system is designed to accommodate a large number of tax related accounts. These include summary accounts for state and federal taxes due, and subsidiary accounts that detail which entity was responsible for the taxes prior to consolidation (9). There are also approximately two hundred accounts for the recording of current deferred tax balances. Approximately one-half of these are attributable to federal temporary differences and one-half to state temporary differences (9). These accounts are currently being utilized at about 50% of capacity (9). There are also over 6,000 accounts available for use to record deferred tax assets and liabilities (9). These accounts are only filled at less than 10%.

Due to the nature of their business, a majority of the noncurrent deferred tax accounts on the books are related to depreciation differences, tax credit carryforwards, and tax provision reserves. Generally, these are the most commonly recognized temporary differences (9, 13). There are also several deferred tax accounts relating to warranty reserves because of the large number of manufacturing products that Square D produces (9, 13).
Opinions Regarding SFAS No. 109

Management believes that the new standard is definitely an improvement over earlier pronouncements and regulations (13). The new standard does require large amounts of time in order to correctly record and report (13). The costs associated with the time needed to record and report is mainly due to the size of the company; however, there has not been much difficulty in adhering to the changes required (13). The original obstacle was the difficulty in understanding the new standard and its effect on Square D Company's operations and accounting requirements (13). This problem explains why management feels that one of the problems associated with the new standard is its complexity (13). But, since this is a problem that is inherent in any complex technical calculation, there isn't much that can be changed while still preserving the usefulness of the information that is generated.

Although the technical accounting staff now understands the information that is produced, there are feelings that interested third party users, who do not possess the same level of understanding might become confused and either ignore the presentations or misinterpret them (13). In regards to the accounting profession, the benefits of producing useful information for third party users far exceeds the costs of producing such information (11, 13). This cost-benefit theory applies mainly to the calculation and recognition of a valuation allowance for deferred tax assets (13). Management also feels that third parties will focus less on the specific balances of deferred taxes this year than perhaps in the future because of the simultaneous adoption of SFAS No. 106, Employer's Accounting for Post-Retirement Benefits Other than Pensions (13). In fact, it was recommended within the profession to simultaneously conform to both of these standards this year because a large number of companies will have windfall credits hitting their income statements (13). This windfall is due to the fact that all deferred tax liabilities and assets must be recorded at the expected rate at which they will be reversed (8, 13). Since there were many deferred taxes recorded the 1970's (when a rate of 46% existed), the subsequent adjustment to the current marginal rate of 34% will cause the difference to run through the income statement (13).
This case applies to Square D Company in a limited magnitude, but for some companies it will have an extraordinary effect (13).

Effects

The actual value of the net deferred taxes is very material to Square D Company (9, 13). Because of the fact that this balance is material to Square D Company and because income could be manipulated or mistakenly misstated if changes in the tax laws occur or if any temporary differences are overlooked, this area will have heavy audit exposure due to the possibilities of income being manipulated (13). However, the significance of the deferred tax balance is not due to the required changes but instead due to the size of the consolidated entity (9, 13). In fact, Square D will probably have less of an effect due to changes in the recorded value than many companies (13). This is because Square D Company utilizes a purchase accounting method, which already incorporates the net tax effect to any values recorded (13). For them, there will simply be a large number of reclassifications within the balance sheet (13).

Valuation Allowance

Square D Company's management believes that the concept of a valuation allowance will greatly benefit the profession (13). However, they feel that the heavy reliance upon judgment is both a pro and a con (13). The positive side is that the heavy use of judgment allows management to view all relevant facts, including those that cannot be objectively verified (13). The negative side, or con, is that the heavy use of judgment hurts comparability because judgments and the circumstances and facts that they are based upon can fluctuate each year (13).

When determining whether a valuation account is not necessary, current company practice relies approximately 50% on objectively verifiable historical evidence and the other 50% on management's assessment of additional facts and circumstances (13). Although the use of management's judgment is heavily relied upon, as long as the process is a well-informed and group decision-making process, few difficulties should arise (13).

One specific circumstance where the use of a valuation account is under intense scrutiny is relating to the net operating loss recognition in foreign countries where it is not foreseeable that
they will become profitable (9, 13). Since future projections of income are difficult, it is extremely likely that a valuation allowance account will be used for several of their foreign subsidiaries (9, 13). The amount of negative evidence available is of such magnitude and is so heavily weighted that it will be virtually impossible to accumulate enough positive evidence to warrant not recognizing a valuation allowance for the net operating loss carryforwards currently on the books.
REFERENCE LIST


