



# Financial Reporting Insights

## ACCOUNTING FOR INCOME TAXES - VALUATION ALLOWANCE

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### OVERVIEW

This whitepaper is the fourth in a series of whitepapers to be used a resource in understanding and analyzing the accounting for income taxes under FASB Accounting Standards Codification (ASC) 740, “Income Taxes.” This whitepaper addresses the realizability or recoverability of deferred tax assets. Deferred tax assets may require a valuation allowance to be recorded to reduce the deferred tax asset to the amount that is expected to be realized. The realization of deferred tax assets is evaluated using the more-likely-than-not standard, (i.e. a valuation allowance would be recognized if it is more likely than not that some or all of the deferred tax asset will not be realized). ASC 740 outlines the sources of taxable income and types of evidence to consider when determining whether to record a valuation allowance. A valuation allowance is an estimate that requires careful consideration of all facts and circumstances. This whitepaper does not address every aspect of accounting for income taxes and should therefore be read in conjunction with the FASB Accounting Standards Codification (ASC) 740 “Income Taxes”.

For ease of use, definitions for acronyms are included in [Appendix A](#). In addition, several terms with specific meaning are used throughout this whitepaper. Those terms and the corresponding definitions are provided in [Appendix B](#).

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# 1. Introduction

## 1.1 General

ASC 740 requires a balance sheet approach to account for income taxes. This approach assumes that assets and liabilities on the balance sheet will eventually be recovered and settled, respectively, at their reported amounts. A temporary difference is created when an item has been treated differently for financial statement and tax return purposes in the same period, provided that such difference is expected to reverse in a future period. Taxable temporary differences lead to taxable amounts in the future when the related asset is recovered or the liability is settled. Deductible temporary differences will result in deductible amounts in the future when the related asset is recovered or the liability is settled. A taxable temporary difference will result in a deferred tax liability while a deductible temporary difference will result in a deferred tax asset. Such deferred tax asset or liability is computed by multiplying the temporary differences by the entity's applicable tax rates for the jurisdictions in which it conducts business.

ASC 740-10-55-7 requires entities to assess deferred tax assets (DTAs) for realization and to record a valuation allowance if the DTA is not fully realizable. The objective of the valuation allowance is to reduce the deferred tax asset to the amount that is more likely than not to be realized. It is important to remember that the valuation allowance is assessed on the gross deferred tax asset, not the net deferred tax asset (i.e., the deferred tax asset less the deferred tax liability). There are no valuation allowances on deferred tax liabilities.

ASC 740-10-30-17 requires that all available evidence, both positive and negative, be considered to determine whether, based on the weight of that evidence, a valuation allowance for deferred tax assets is needed.

ASC 740-10-30-18 further states that the realization of tax benefits is dependent on whether there will be sufficient future taxable income of the appropriate character (e.g., ordinary income versus capital gain income) in the period during which the deductible temporary differences reverse or within the carryback and carryforward periods available under the tax law. If, based on available evidence, it is more likely than not that all or a portion of the deferred tax asset will not be realized, the asset must be reduced by a valuation allowance.

## 1.2 More Likely Than Not Threshold

A key concept in determining the need for a valuation allowance is the more likely than not threshold. ASC 740-10-25-6 defines the term "more likely than not" as a likelihood of more than 50%. A valuation allowance is recorded when, based on the weight of the available evidence, it is more likely than not (a likelihood of more than 50%) that a deferred tax asset will not be realized. Thus, in purely mathematical terms, a likelihood of 50.0% would mean that no valuation allowance is needed, but a likelihood of 50.1% would mean a valuation allowance is needed. It will never be possible to determine the likelihood in purely mathematical terms. Therefore, assessing the need for, or the sufficiency of, a valuation allowance will require a significant amount of judgment in evaluating positive and negative evidence. Additionally, it is possible to have evidence that meets the more likely than not threshold supporting the realization of some portion of, but not all, of the entity's deferred tax assets. For example, an entity may require valuation allowances on its state deferred tax assets only, potentially due to changes in its current model and the business being conducted in those states. Alternatively, the entity may be able to support the realization of current deferred tax assets, while not being able to meet the "more likely than not threshold" on certain long-term deferred tax assets. The more likely than not threshold, is lower than other thresholds within U.S. GAAP that are used to measure asset impairments or loss contingencies. For example, when evaluating loss contingencies, an accrual would generally not be recorded unless it is probable that such loss has or will occur, and the amount of the loss can be reasonably estimated. While probable is not defined in the Codification, generally 75% is considered a standard measure for probable. This difference

in the threshold for recording a valuation allowance and other asset impairment or loss contingencies may lead to different results even when considering the same macroeconomic or entity-specific information.

## 2. Sources of taxable income



### ASC 740-10-30-18

Future realization of the tax benefit of an existing deductible temporary difference or carryforward ultimately depends on the existence of sufficient taxable income of the appropriate character (for example, ordinary income or capital gain) within the carryback, carryforward period available under the tax law. The following four possible sources of taxable income may be available under the tax law to realize a tax benefit for deductible temporary differences and carryforwards:

- a. Future reversals of existing taxable temporary differences
- b. Future taxable income exclusive of reversing temporary differences and carryforwards.
- c. Taxable income in prior carryback year(s) if carryback is permitted under the tax law.
- d. Tax-planning strategies (see paragraph 740-10-30-19) that would, if necessary, be implemented to, for example:
  1. Accelerate taxable amounts to utilize expiring carryforwards.
  2. Change the character of taxable or deductible amounts from ordinary income or loss to capital gain or loss.
  3. Switch from tax-exempt to taxable investments

Evidence available about each of those possible sources of taxable income will vary for different tax jurisdictions and, possibly, from year to year. To the extent evidence about one or more sources of taxable income is sufficient to support a conclusion that a valuation allowance is not necessary, other sources need not be considered. Consideration of each source is required, however, to determine the amount of the valuation allowance that is recognized for deferred tax assets.

### 2.1 General

ASC 740-10-30-18 provides four possible sources of taxable income that may be available under the tax law to realize a portion or all of a tax benefit for deductible temporary differences and carryforwards.

Those sources, in descending order of objectivity and verifiability, are as follows:

1. Taxable income in prior carryback years, if carryback is permitted under the tax law
2. Future reversals of existing taxable temporary differences
3. Tax planning strategies
4. Future taxable income exclusive of reversing temporary differences and carryforwards

An entity must evaluate each source of income to determine the amount of the valuation allowance. Other sources of income do not need to be considered if one source of income supports the conclusion that a valuation allowance is not necessary. In general, entities should consider evaluating sources of income while putting more weight on objective and verifiable evidence rather than subjective evidence.

The following sections discuss each source of taxable income in further detail.



## 2.2 Taxable income in prior carryback years

Taxable income in prior carryback years, if carryback is permitted under the tax law, is the most objectively verifiable source of taxable income. Where permitted, current year losses and other tax credits generated in the current year may be carried back to prior years, which then generates refunds of taxes paid in prior years.

U.S. federal income tax law no longer allows entities to carryback net operating losses (NOLs) to offset taxable income in prior years, though this treatment may still be permitted in certain state and foreign jurisdictions.

## 2.3 Future reversals of existing taxable temporary differences

A future reversal of an existing taxable temporary difference is a source of taxable income that may support the realization of a deferred tax asset. As a reminder, a taxable temporary difference results in a deferred tax liability and indicates amounts waiting to be taxed. The most common deferred tax liability relates to accelerated depreciation. Future reversals of existing taxable temporary differences (i.e., deferred tax liability) may offset future reversals of existing deductible temporary differences (i.e., deferred tax asset), which is why a reversal of a deferred tax liability is a source of taxable income. However not all taxable differences can be offset with deductible differences due to differences in the nature, timing and jurisdiction of the differences. See [Section 2.3.1](#) below for a discussion of indefinite-lived deferred tax liabilities and assets.

To offset a deferred tax liability against a deferred tax asset, the deferred tax liability must be similar in nature to the deferred tax asset in terms of character of income, timing of the reversal and jurisdiction. Character of income relates to the type of income, such as ordinary versus capital. For example, a capital loss may only be deductible against a capital gain. The timing of the reversal is important to ensure that both the deferred tax asset and deferred tax liability are expected to reverse in the same period. ASC 740 does not require formally scheduling out the reversal of existing temporary differences; however, scheduling may be necessary depending on each entity's circumstances and complexity of tax positions. See [Section 2.3.2](#) for further discussion of scheduling. Lastly, the jurisdictions of both the deferred tax liability and deferred tax asset are important because a taxable difference from one jurisdiction may not be offset against a deductible difference from another jurisdiction.

### 2.3.1 Indefinite lived deferred tax assets and liabilities

Certain deferred tax liabilities arise from assets with indefinite useful lives (e.g., goodwill and indefinite-lived intangibles). These assets are considered to have indefinite lives as they are not being amortized for book purposes but may be amortized for tax purposes. The deferred tax liability will therefore not reverse until an indefinite future time, such as when an asset is sold or written down due to impairment. It may not be appropriate to offset a deferred tax asset that reverses at a specific time with an indefinite-lived liability when the reversal of the deferred tax asset does not become an indefinite-lived NOL upon reversal.

Deferred tax assets that reverse in periods where the entity incurs losses may, in the absence of income, become NOL carryforwards in certain jurisdictions. An NOL carryforward that does not expire is a type of deferred tax asset with an indefinite life. For example, under U.S. federal income tax law, NOLs originating after 2017 do not have an expiration date and therefore would generate an indefinite-lived deferred tax asset. An indefinite-lived deferred tax liability may therefore be considered to support the realization of that deferred tax asset. In this case, however, it may not be a dollar-for-dollar source of taxable income because under U.S. federal income tax law, NOLs originating after 2017 are limited to 80% of taxable income in a given year.

Further, indefinite-lived deferred tax liabilities may be able to be converted into reversing deferred tax liabilities if the entity can determine the expected timing of the reversal of the deferred tax liability that was previously indefinite-lived. For example, if an entity would sign an agreement to sell the particular asset

underlying the temporary difference, the reversal date of the deferred tax liability would no longer be indefinite and would be eligible to be considered as a source of future income against reversing deferred tax assets.

The following example illustrates the evaluation of indefinite lived intangible assets and liabilities.



### Example 2-1: Evaluating indefinite lived deferred tax assets and liabilities.

ABC Company is finalizing its financial statements as of December 31, 20X1, and is assessing whether a valuation allowance is required against its existing deferred tax asset. ABC Company had a blended federal and state tax income tax rate of 25%.

Though ABC Company was a consistently profitable entity, due to macroeconomic factors, it generated a net loss of \$16,000,000 in 20X1. ABC Company had the following deferred tax asset and deferred tax liability as of December 31, 20X1:

	Amount
NOL (\$16,000,000 x 25%)	\$4,000,000
Indefinite lived trademark	(4,000,000)
Net deferred tax asset (liability)	\$ -

ABC Company projected pretax income of \$22,000,000 for the upcoming year ending December 31, 20X2. ABC Company's NOL may be carried forward indefinitely under U.S. Federal income tax law (subject to 80% of taxable income in a given year). ABC Company calculates that 80% of 20X2 projected income is \$17,600,000, which exceeds the 20X1 NOL of \$16,000,000. ABC Company would consider the indefinite-lived deferred tax liability as evidence of realizability of the deferred tax asset. ABC Company would carefully consider the reliability and timing of its projected income, as well as all other available evidence, before making a final judgement on the need for a valuation allowance. If ABC Company concludes that the projected income meets the more-likely-than-not criteria, no valuation allowance would be appropriate.

### 2.3.2 Scheduling of the reversals of deferred tax assets and liabilities

ASC 740-10-55-16 to 55-18 do not require an entity to outline a detailed schedule of existing temporary difference reversals; however, scheduling may be necessary to support the realization of deferred tax assets and carryforwards with reversing deferred tax liabilities, specifically when the entity has a large volume of deferred tax assets and liabilities which vary in useful life (i.e., timing of reversal). Alternatively, when the entity has a smaller number of deferred tax assets and liabilities with relatively consistent reversal periods, it may not be necessary to perform a formal scheduling analysis. The nature and extent of the scheduling exercise is a matter of judgment and depends on the facts and circumstances of each situation.

Entities should consider the following (not all-inclusive) items when determining if scheduling is needed:

- Magnitude of the temporary differences
- Pattern and timing of the reversal of existing temporary differences
- Relevant tax law
- Amount and reliability of projected taxable income.

ASC 740-10-55-22 states that entities should pay careful attention when performing a scheduling exercise and ensure that the method is applied consistently to temporary difference categories within a

jurisdiction and from year to year. Entities should also ensure that their method is logical and systematic, and it should avoid complexity where possible. Entities may use different methods for different categories of temporary differences; however, if the same temporary difference exists in two tax jurisdictions, the same method should be used for that temporary difference in both tax jurisdictions. The term “category,” which is used in ASC 740-10-55-22 to describe general rules for scheduling, is not defined in the guidance; however, two specific examples cited are those related to liabilities for deferred compensation and those related to investments indirect financing and sales-type leases.

Entities would generally use one of two methods for scheduling reversing temporary differences. The first method would be used when the entity is unable to forecast future income. This method would therefore include only reversals of temporary differences; carrybacks, if any; and tax strategies, if any, and would not include projections of income or future originating temporary differences. The second method, which would be used when the entity is able to forecast future income, would include everything in the first exercise and add projections of future income and any projections of future originating temporary differences and their reversal periods.

The following example illustrates scheduling temporary differences to determine whether a valuation allowance is required.



### Example 2-2: Scheduling temporary differences

At December 31, 20X1, ABC Company evaluated whether future reversals of existing taxable temporary differences would more likely than not provide sufficient taxable income to support the realization of the deferred tax assets related to its deductible temporary differences.

As of December 31, 20X1, ABC Company's taxable temporary differences included an indefinite-lived trademark of \$8,000,000 and accumulated depreciation of \$9,000,000 that is expected to reverse ratably over the next three years. ABC Company does not plan to dispose of the indefinite-lived trademark in the foreseeable future. ABC Company's 20X1 deductible temporary differences included an allowance for expected credit losses of \$5,000,000 and an NOL carryforward of \$8,000,000 that does not expire but which is limited to 80% of taxable income in any future year. ABC Company did not have (and was not able to forecast) any other sources of taxable income other than its taxable temporary differences. ABC Company expects \$3,000,000 of the allowance for expected credit losses to reverse in 20X3 and the remaining \$2,000,000 in 20X4.

ABC Company performed its scheduling exercise in the table below.

	Temporary Difference December 31, 20X1	Reversing amounts expected in the year ending December 31,				
		20X2	20X3	20X4	Thereafter	Total
Allowance for credit losses	\$5,000,000	(\$3,000,000)	(\$2,000,000)	\$-	\$-	\$-
NOL Carryforward	8,000,000	-	(800,000)	(2,400,000)	(4,800,000)	-
Accumulated depreciation	(9,000,000)	3,000,000	3,000,000	3,000,000	-	-
Indefinite lived trademark	(8,000,000)	-	-	-	8,000,000	-
Total	(\$4,000,000)	\$-	\$ 200,000	\$600,000	\$3,200,000	\$-

ABC Company demonstrated taxable income that is equal to or exceeds the deductible temporary differences expected to reverse in years 20X2-20X4. ABC Company also concluded that since the remaining amount of the NOL carryforward was less than 80% of the indefinite-lived intangible, ABC Company expected sufficient income to be generated from the reversal of such temporary difference, in the period that it occurs, to support future realization of the NOL carryforward.

### 2.3.3 Determining the reversal period

ASC 740-10-55-12 states that the timing of a temporary difference reversal is determined by the recovery of the related asset or settlement of the related liability as well as the relevant tax law that determines whether future reversals of temporary differences will result in taxable and deductible amounts that offset each other in future years. Further, tax law may dictate that the appropriate character be considered when scheduling a reversal. For example, the tax law may provide that capital losses are deductible only to the extent of capital gains. In that case, a tax benefit is not recognized for temporary differences that will result in future deductions in the form of capital losses unless those deductions will offset future capital gains.

ASC 740-10-55-14 further notes that certain temporary differences, such as those related to fixed assets or long-term contracts, may first increase over a period before reversing over an additional period. Entities may sometimes have difficulty predicting the reversal periods of these types of temporary differences without preparing a detailed analysis, known as scheduling. Some temporary difference reversals that relate to long-term contracts or fixed assets, where the financial reporting and tax lives and methods are known, may result in a simpler exercise. In other cases, scheduling the reversal periods may require judgment to estimate when these temporary differences are expected to reverse. In either case, the exercise becomes more complicated as the number of temporary differences increases.

## 2.4 Tax planning strategies



### ASC 740-10-30-19

In some circumstances, there are actions (including elections for tax purposes) that:

- a. Are prudent and feasible.
- b. An entity ordinarily might not take but would take to prevent an operating loss or tax credit carryforward from expiring unused.
- c. Would result in realization of deferred tax assets.

This Subtopic refers to those actions as tax-planning strategies. An entity shall consider tax-planning strategies in determining the amount of valuation allowance required. Significant expenses to implement a tax-planning strategy or any significant losses that would be recognized if that strategy were implemented (net of any recognizable tax benefits associated with those expenses or losses) shall be included in the valuation allowance. See paragraphs 740-10-55-39 through 55-48 for additional guidance. Implementation of the tax-planning strategy shall be primarily within the control of management but need not be within the unilateral control of management.

ASC 740 identifies a tax-planning strategy as a source of taxable income which represents a possible source of positive evidence that could support the realization of a deferred tax asset. A qualified tax-planning strategy can result from the following actions as outlined in ASC 740:

- Accelerate taxable amounts to use expiring carryforwards (i.e., shift estimated future taxable income between future years or shift the estimated pattern and timing of future reversals of temporary differences).



- Change the character of taxable or deductible amounts from ordinary income or loss to capital gain or loss.
- Change the type of income from tax-exempt to taxable income.

Tax-planning strategies may not be used to avoid recognition of deferred tax assets or liabilities. Tax-planning strategies may only be considered after the measurement and recording of deferred tax assets and liabilities when evaluating the need for a valuation allowance for deferred tax assets.

Entities may not choose to consider some tax planning strategies while ignoring other strategies. Rather, entities must consider the effects of all potential tax planning strategies in determining the amount of valuation allowance required for deferred tax assets. Entities may not “cherry pick” which strategies to use and recognize the effect of certain strategies in one year and defer the recognition of other qualifying tax planning strategies until later years.

ASC 740-10-55-41 states that entities must make a reasonable effort to identify all significant qualifying tax-planning strategies in determining the amount of the required valuation allowance unless taxable income from other sources is sufficient to eliminate the need for a valuation allowance.

#### 2.4.1 Characteristics of a qualified tax-planning strategy

The following table explains the characteristics of a qualified tax-planning strategy.

Characteristic of a Qualified Tax-Planning Strategy	Explanation of Characteristic
Is prudent and feasible	<ul style="list-style-type: none"> <li>• Implementation of the strategy must be primarily within the control of management.</li> <li>• Management must have the ability to implement the strategy and expect to do so unless the need is eliminated in future years.</li> <li>• An action is not prudent if management would not normally decide to do it.</li> <li>• An action is not feasible if management is unable to implement it or unable to implement it in a manner that successfully accomplishes its objective.</li> </ul>
An action that the entity ordinarily might not take but would take to prevent an operating loss or tax credit carryforward from expiring unused	An activity that management performs in the normal course of business, other than for utilization of carryforwards that would otherwise expire unused, would usually not qualify as a tax planning strategy under ASC 740.
Would result in the realization of deferred tax assets	Qualifying tax-planning strategies must be considered before a conclusion can be reached about the amount of a valuation allowance.

As noted in ASC 740-10-55-39(b), tax-planning strategies are strategies taken to use operating loss carryforwards that would otherwise expire unused. Thus, an entity with NOLs that do not expire may not consider tax-planning strategies as a possible source of taxable income. Under U.S. federal tax law, NOLs originating after 2017 do not expire, and therefore tax-planning strategies may not be used as a source of taxable income to assess realizability of those NOLs. U.S. federal NOLs originating before 2018 still expire, as do NOLs in certain other state and foreign jurisdictions; tax-planning strategies may continue to be considered related to those NOLs.

### 2.4.2 Recognition of a qualified tax-planning strategy

ASC 740-10-30-20 states that the recognition and measurement principles for tax positions would be applied when assessing the tax-planning strategy, which means that the tax positions within the strategy must meet the more-likely-than-not (MLTN) recognition threshold. This threshold is defined by “an entity shall initially recognize the financial statement effects of a tax position when it is more likely than not [more than 50 percent], based on its technical merits, that the position will be sustained upon examination (ASC 740-10-25-6).” If the MLTN criteria is met for the qualifying tax-planning strategy, the amount of taxable income to be generated from such strategy would be measured as the largest amount of benefit that is MLTN to be realized. Further, ASC 740 permits a tax-planning strategy even though it would involve a significant cost. However, the tax benefit recognized because of a tax-planning strategy must be reduced by any significant expenses or losses that would be incurred to implement the strategy, net of any recognizable tax benefits associated with those expenses or losses. That reduction is included as part of the valuation allowance.



#### **Example 2-3: Tax-Planning Strategy with Significant Implementation Costs (ASC 740-10-55-159 to 55-162)**

This example illustrates the guidance in paragraph 740-10-55-44 for recognition of a deferred tax asset based on the expected effect of a qualifying tax-planning strategy when a significant expense would be incurred to implement the strategy. This Example has the following assumptions:

- a. A \$900 operating loss carryforward expires at the end of next year.
- b. Based on historical results and the weight of other available evidence, the estimated level of taxable income exclusive of the future reversal of existing temporary differences and the operating loss carryforward next year is \$100.
- c. Taxable temporary differences in the amount of \$1,200 ordinarily would result in taxable amounts of approximately \$400 in each of the next 3 years.
- d. There is a qualifying tax-planning strategy to accelerate the future reversal of all \$1,200 of taxable temporary differences to next year.
- e. Estimated legal and other expenses to implement that tax-planning strategy are \$150.
- f. The enacted tax rate is 40 percent for all years.

Without the tax-planning strategy, only \$500 of the \$900 operating loss carryforward could be realized next year by offsetting \$100 of taxable income exclusive of reversing temporary differences and \$400 of reversing taxable temporary differences. The other \$400 of operating loss carryforward would expire unused at the end of next year. Therefore, the \$360 deferred tax asset (\$900 at 40 percent) would be offset by a \$160 valuation allowance (\$400 at 40 percent), and a \$200 [*\$500 at 40 percent*] net deferred tax asset would be recognized for the operating loss carryforward.

With the tax-planning strategy, the \$900 operating loss carryforward could be applied against \$1,300 of taxable income next year (\$100 of taxable income exclusive of reversing temporary differences and \$1,200 of reversing taxable temporary differences). The \$360 deferred tax asset is reduced by a \$90 valuation allowance recognized for the net-of-tax expenses necessary to implement the tax-planning strategy. The amount of that valuation allowance is determined as follows.

Legal and other expenses to implement the tax-planning strategy	\$150
Future tax benefit of those legal and other expense (\$150 at 40%)	60
	\$90

In summary, a \$480 deferred tax liability is recognized for the \$1,200 of taxable temporary differences, a \$360 deferred tax asset is recognized for the \$900 operating loss carryforward, and a \$90 valuation allowance is recognized for the net-of-tax expenses of implementing the tax-planning strategy.

As each year passes, facts and circumstances are likely to change. Expected taxable income or losses in future years may change from the amount previously estimated, and the amount and the expected timing of reversing temporary differences may change. Those changes may obviate the need for a tax-planning strategy or may change the amount of a valuation allowance required from that estimated in a prior year. The effects of these subsequent changes adjust (either increase or decrease) a valuation allowance previously recognized in the current period. These changes are generally considered changes in estimates since they are based on new information or changes in facts and circumstances.

Tax-planning strategies that affect the timing of deductions and taxable income must be used consistently for all applicable tax jurisdictions and for all components of a consolidated group. Since any tax-planning strategy must be applied in each tax jurisdiction where it would potentially affect taxable income, it is possible that a strategy which reduces tax in one tax jurisdiction could increase tax in another. The tax strategy must be implemented across all jurisdictions, even if the results in that jurisdiction are not favorable. When different tax elections are allowed in different tax jurisdictions, different elections (e.g., whether to file consolidated or separate tax returns) may be appropriate in different tax jurisdictions to appropriately reflect the strategy.

The following are examples of strategies that may qualify as tax-planning strategies:

- A sale-leaseback of operating assets to accelerate taxable temporary difference reversals to offset an operating loss carryforward that would otherwise expire
- Selling appreciated assets that are not key to future operations to accelerate taxable or deductible temporary difference reversals
- Disposing of excess or obsolete inventory written down to net realizable value for book purposes to accelerate the deduction for the excess of the tax basis over the net realizable value
- Disposing of loans with high allowances for credit losses to accelerate the tax deduction for the excess of the tax basis over the carrying amount of the loan for book purposes
- Delaying certain discretionary expenses (e.g., maintenance, research and development expenses)
- Accelerating the repatriation of foreign earnings for which deferred taxes were previously provided
- Electing to deduct foreign taxes paid or accrued rather than treat them as a credit against a domestic tax liability
- Shifting an investment portfolio from tax-exempt to taxable debt securities (for debt securities carried at amortized cost, this strategy will bring into question the classification of those securities as held-to-maturity since the positive intent and ability to hold them to maturity is absent)

- Changing accounting methods (for tax purposes) such as from the last-in, first out (LIFO) to some other method (e.g., average cost; first-in, first-out) or electing to no longer use the installment sales method
- Merging or liquidating subsidiaries into the parent company in a tax-free transaction

## 2.5 Future taxable income exclusive of reversing temporary differences and carryforwards

The final and most common source of taxable income is future taxable income exclusive of reversing temporary differences and carryforwards. ASC 740-10-55-8 states that if the evidence from other sources of taxable income (i.e., income from carryback periods, tax planning strategies or reversing temporary differences) is sufficient to support realization of the DTA, projections of future taxable income need not be considered. In many cases, sufficient evidence is not available from the other sources and, therefore, many entities rely upon this source of future taxable income. Though this is the most common source of future taxable income, it is also the most subjective source, because projections are highly judgmental. Though ASC 740-10-55-9 does not require the forecast and projections used to determine future taxable income to meet the requirements of prospective information as outlined in AICPA professional standards an entity should ensure that such projections are reasonable, supportable and consistent with other projections used by the entity.

An entity should forecast pretax book income (adjusted for permanent differences) because, over the long-term, future taxable income will equal future pretax book income adjusted for permanent differences. All available and relevant information should be considered, including recent results of operations and internal and external trends, as well as changes in the business and macroeconomic events. Past results would generally be considered indicative of future results, unless there is other reliable evidence indicating it is not. The level of precision and evidence that a forecast or projection provides is dependent on whether there is other significant negative evidence. “The more negative evidence that exists, the more positive evidence [and objectively determined sources of taxable income] is necessary...to support a conclusion that a valuation allowance is not needed for some portion or all of the deferred tax asset” (ASC 740-10-30-23).



### RSM COMMENTARY:

Assessing the need for, or the sufficiency of, a valuation allowance on deferred tax assets is a complex aspect of income tax accounting and will often require the use of significant judgment. No amount of written guidance material can serve as a substitute for judgment; it can only provide the framework in which to apply judgment. Whenever deferred tax assets are material, and especially if those assets are measured on operating loss and tax credit carryforwards, management's skills and professional skepticism need to be carefully applied and appropriately documented.

For example, the staff of the SEC has indicated they will emphasize and apply strictly the provision of ASC 740 that indicates it is difficult to avoid a valuation allowance when there is objective negative evidence, such as cumulative losses in recent years, which is generally defined as cumulative losses over a three-year period. The SEC Staff have also stated that, in situations which they view as egregious, they will not hesitate to refer the registrant and its auditors to the Enforcement Division. Therefore, it is essential that the necessary judgments be carefully made and appropriately documented.

### 3. Nature of evidence

**ASC 740-10-30-23**

An entity shall use judgment in considering the relative impact of negative and positive evidence. The weight given to the potential effect of negative and positive evidence shall be commensurate with the extent to which it can be objectively verified. The more negative evidence that exists, the more positive evidence is necessary and the more difficult it is to support a conclusion that a valuation allowance is not needed for some portion or all of the deferred tax asset. A cumulative loss in recent years is a significant piece of negative evidence that is difficult to overcome.

**ASC 740-10-30-24**

Future realization of a tax benefit sometimes will be expected for a portion but not all of a deferred tax asset, and the dividing line between the two portions may be unclear. In those circumstances, application of judgment based on a careful assessment of all available evidence is required to determine the portion of a deferred tax asset for which it is more likely than not a tax benefit will not be realized.

#### 3.1 General

In assessing the need for a valuation allowance, ASC 740-10-30-17 requires that an entity consider all available evidence, both positive and negative. As usual, information or evidence available or knowable at the financial statement reporting date would be considered in the assessment. Information that becomes available after the financial statement reporting date but before the financial statements are released may provide supplemental evidence about the likelihood of the realization of existing deferred tax assets. Examples of these type of subsequent events would be collections of overdue receivables or litigation settlements. Other subsequent events, such as business combinations, or losses due to accidents or fires would not provide evidence about the realizability of deferred tax assets as of the prior year end.

The weight given to the potential effect of negative and positive evidence should be commensurate with the extent to which it can be objectively verified. Some evidence (e.g., pretax income or loss for recent periods) is objective and verifiable whereas other information (e.g., earnings projections into the distant future) is less objective and verifiable, or subjective. Objective verifiable evidence generally carries more weight than subjective estimates. Historical losses and expected reversals of existing temporary differences are usually considered objective evidence, while tax-planning strategies and future taxable income exclusive of reversing temporary differences are usually more subjective.

Determining if positive evidence exceeds negative evidence is a significant area of judgement. When negative evidence exists, more positive evidence will be necessary, and a conclusion that a valuation allowance is not needed for some, or all the deferred tax asset recognized will be more difficult to support.



### 3.2 Negative evidence



#### ASC 740-10-30-21

Forming a conclusion that a valuation allowance is not needed is difficult when there is negative evidence such as cumulative losses in recent years. Other examples of negative evidence include, but are not limited to, the following:

- a. A history of operating loss or tax credit carryforwards expiring unused
- b. Losses expected in early future years (by a presently profitable entity)
- c. Unsettled circumstances that, if unfavorably resolved, would adversely affect future operations and profit levels on a continuing basis in future years.
- d. A carryback, carryforward period that is so brief it would limit realization of tax benefits if a significant deductible temporary difference is expected to reverse in a single year or the entity operates in a traditionally cyclical business.

The following are examples of negative evidence.

Negative Evidence	Examples of Negative Evidence
Cumulative losses in recent years	<ul style="list-style-type: none"> <li>• An entity has incurred operating losses for financial reporting and tax purposes during the current and preceding two years, and those losses exceed income generated on a cumulative basis for the last five years.</li> <li>• A profitable entity has a majority ownership interest in a recently-formed subsidiary that has incurred losses since its inception and, although consolidated financial statements are issued, the tax jurisdiction in which the subsidiary operates prohibits the filing of a consolidated tax return. The negative evidence would relate only to the deferred tax assets related to the losses incurred by such subsidiary.</li> </ul>
History of operating loss or tax credit carryforwards expiring unused	<ul style="list-style-type: none"> <li>• An entity has generated tax credit carryforwards during the current year. During the last several years, tax credits which originated in prior years expired unused.</li> </ul>
Losses expected in early future years by a presently profitable company	<ul style="list-style-type: none"> <li>• An entity has a significant investment in manufacturing facilities that produce the entity's only product which is currently profitable. A competitor has introduced a new product which will make the entity's product obsolete. Thus, the entity expects to incur significant losses during the next two to four years, during which time the entity expects to invest in facilities that will manufacture a new but, not yet, unidentified product.</li> <li>• An entity operates in an industry that is cyclical. Following industry cycles, the entity has historically generated income during favorable periods that more than offsets losses incurred during unfavorable periods. However, during the last favorable period, the entity has experienced a decline in its market share and a downturn in the industry is predicted during the next four years.</li> </ul>

Negative Evidence	Examples of Negative Evidence
Unsettled circumstances that, if unfavorably resolved, would adversely affect future profit levels on a continuing basis in future years	<ul style="list-style-type: none"> <li>• An entity manufactures and sells devices with a five-year warranty. Through its own testing, management has determined that the devices may fail and cause severe injuries under certain conditions. Although no failures have been reported, if they do occur, the entity could face legal liability claims significantly greater than its insurance coverage.</li> <li>• An entity has contracted with a third party for the disposal of hazardous material. That third party is now out of business and the entity has learned that the hazardous material was not disposed of in accordance with environmental regulations. A governmental agency may propose that the entity pay for the costs of environmental clean-up.</li> <li>• An entity, as defendant, may lose patent infringement litigation, and the patent is key to the manufacture of the entity's only product.</li> </ul>
A carryback or carryforward period that is so brief that it would limit realization of tax benefits if a significant deductible temporary difference is expected to reverse in a single year or the entity operates in a traditionally cyclical business	<ul style="list-style-type: none"> <li>• An entity records a significant liability during the current year for a restructuring charge, and it is expected the restructuring costs will be incurred, and thus be deductible for tax purposes, next year. The tax jurisdiction allows no carryback and permits only a three-year carryforward period. The costs exceed the taxable income expected to be generated during the next four years.</li> <li>• An entity incurs a capital loss during the current year which must be carried forward to offset future capital gain income. The carryforward period is five years, and management does not believe sufficient capital gain income will be generated during the carryforward period to realize the full tax benefit of the capital loss.</li> </ul>

### 3.2.1 Cumulative losses and going concern

ASC 740-30-23 states that a cumulative loss in recent years is a significant piece of negative evidence that is difficult to overcome. However, ASC 740 does not define the components of cumulative loss, nor does it define the time period contemplated by "recent years". Although not codified, however, the term "cumulative losses in recent years" was described in the basis for conclusions to FASB Statement No. 109, Accounting for Income Taxes (a FASB superseded standard and nonauthoritative literature), as the "current and two preceding years." We believe that cumulative loss in recent years should be calculated as pretax book income or loss from all sources (i.e., including discontinued operations and other comprehensive income or loss) for the current year plus the previous two years, adjusted for permanent differences. Entities may also exclude the cumulative effect of a change in accounting principle from the calculation of the cumulative loss. Entities should not consider the existence of three-years of cumulative losses as absolute evidence that a valuation allowance must be recorded. Rather, the existence of such cumulative losses is evidence that is difficult to overcome.

Entities must consider the objectivity of positive and negative evidence. Objectively verifiable evidence is generally more reliable than subjective evidence. Projections of future taxable income are not objectively

verifiable, and thus are not likely to overcome the negative evidence of the cumulative loss in recent years. Taxable income from future reversals of existing taxable temporary differences is objective, and thus may, in certain cases, be sufficient to overcome the negative evidence of cumulative losses in recent years. Entities may also consider other factors including an entity's specific earning cycle, specific non-recurring events that may have caused the losses and when the losses occurred in the preceding three-year period. Positive objective evidence from the factors identified above may be sufficient, in specific circumstances, to overcome the negative evidence of cumulative losses. In all cases, entities should consider the specific facts and circumstances and all available positive and negative evidence when evaluating the need for a valuation allowance.

When an entity concludes that there is substantial doubt about its ability to continue as a going concern, this represents significant negative evidence supporting a valuation allowance against the realizability of its deferred tax assets. Projections of uncertain events such as future taxable income are generally not sufficient to outweigh the negative evidence related to an entity's ability to continue to exist.



### Example 3-1: Cumulative losses

Big City Hotel has the following information related to the year ended December 31, 20X0, and is evaluating whether a valuation allowance is necessary against its deferred tax asset balance. The hotel has experienced a significant loss in 20X0 due to a global pandemic and economic downturn. While the business began to recover in 20X1, projected income is still breakeven, and it is not clear when, or if, the tourism industry in Big City and prior profitability will return to levels prior to the global pandemic.

	Amount
Pretax income 20X7	\$1,500,000
Pretax income 20X8	2,150,000
Pretax income 20X9	2,850,000
Pretax loss 20X0	(7,500,000)

Big City Hotel has a cumulative pretax loss (for the past three years, including the current year) as of December 31, 20X0, of (\$2,500,000), which is objective evidence supporting the need for a valuation allowance that is difficult to overcome.

### 3.3 Positive evidence

Following are certain examples, which are not all-inclusive, of positive evidence that may support a conclusion that a valuation allowance is not necessary even when negative evidence exists.

Positive Evidence (from ASC 740-10-30-22)	Examples of Positive Evidence
Existing contracts or firm sales backlog that will produce more than enough taxable income to realize the deferred tax asset based on existing sales prices and cost structure.	<ul style="list-style-type: none"> <li>• An entity enters into a long-term contract that will generate sufficient future taxable income to enable it to utilize all existing operating loss carryforwards.</li> <li>• During the year, an entity acquires another company in a tax-free merger that operates in a different industry that has a history of stable profit margins. The acquired company's existing long-term sales contracts will produce sufficient taxable income to enable utilization of the acquiring entity's loss carryforwards.</li> </ul>
An excess of appreciated asset value over the tax basis of an entity's net assets in an amount sufficient to realize the deferred tax asset	<ul style="list-style-type: none"> <li>• An entity has excess land with a tax and financial reporting basis less than its fair value. If the land were sold at its fair value, the sale would generate sufficient taxable income to utilize all tax loss carryforwards.</li> </ul>
A strong earnings history exclusive of the loss that created the future deductible amount (tax loss carryforward or deductible temporary difference) coupled with evidence indicating that the loss is an aberration (i.e., unusual or infrequent) rather than a continuing condition	<ul style="list-style-type: none"> <li>• During the current year, an entity generates a loss carryforward for tax purposes due to the disposal of an unprofitable subsidiary. After the elimination of the unprofitable operations of the subsidiary, the entity's earnings have been, and continue to be, strong enough that those earnings will produce sufficient taxable income to utilize the loss carryforward resulting from the disposal during the carryforward period.</li> </ul>

An entity must be able to demonstrate positive evidence supporting taxable income of sufficient amounts and character within the carryback and carryforward periods available under the tax law, to overcome existing negative evidence.

### 3.4 Other considerations

Along with the above negative and positive evidence examples, entities should also consider other factors that may impact the realizability of deferred tax assets. There are economic conditions and industry changes that could factor into the entity's ability to generate taxable income. Examples of negative economic conditions include:

- Market or industry changes that are inconsistent with management's forecasted taxable income
- Changes in tax law that impact an entity's assumption in their expect future taxable income or tax-planning strategy

Careful considerations and evaluation should be performed because it may cause historical data to be irrelevant.

## 4. Assessing the evidence

As noted in [Section 3.1](#) above, an entity must consider all available evidence, both positive and negative, in assessing the need for a valuation allowance. The assessment is to be based on the weight of evidence available at the balance sheet date. The weight given to evidence should be commensurate with its ability to be objectively verified. Objective negative evidence (e.g., cumulative losses from operations) is difficult to overcome. The realization of a deferred tax asset is dependent on whether there will be sufficient future taxable income of the appropriate character in the period during which deductible temporary differences reverse or within the carryforward period established under the tax law. If, based on available evidence, it is more likely than not that a portion of the deferred tax asset will not be realized, the asset must be reduced by a valuation allowance.

The scenarios that follow illustrate the types of judgments that would be used in assessing all available negative and positive evidence in concluding whether, or in what amount, a valuation allowance may be needed. These scenarios are not designed to address every situation and may not include all information that an entity would need to consider in making its conclusions on whether valuation allowance is required.

### 4.1 Deferred tax asset on deductible temporary differences, with deferred tax liability on taxable temporary differences

The deferred tax liability exceeds the deferred tax asset. Based on a general understanding of the reversal patterns of the temporary differences, the deductible differences will reverse over a shorter period than the taxable differences. The entity has been profitable over the past several years and there is no known negative evidence. In this case, the entity would evaluate the evidence supporting the reversal patterns of the temporary differences. If the entity believes that the estimated reversal patterns are reasonable, the entity would conclude that no valuation allowance is needed on the deferred tax asset.

### 4.2 Deferred tax asset on deductible temporary difference, with no deferred tax liability

A deferred tax asset has been measured on an estimated warranty claim liability and the allowance for expected credit losses. Both temporary differences are expected to reverse during the next year. Although the entity was profitable in the past, a small loss is expected for the next year because significant maintenance expenses are scheduled to be incurred on the entity's heavy equipment. The entity expects to return to profitability in the following year. If the entity is a U.S. entity, which only allows a carryforward of losses, the entity would assess whether it expects sufficient future taxable income during the carryforward period to realize the deferred tax assets from the carryforward of the loss and from the reversal of the temporary differences. Such conclusion is based on judgement and facts and circumstances.

Alternatively, if the entity operates in a tax jurisdiction that permits carryback of losses to previous years with taxable income, the entity would assess whether the entity had sufficient taxable income within the carryback period to realize the deferred tax assets from the NOL and from the reversal of the temporary differences.

### 4.3 Deferred tax asset on investment tax credit (ITC) carryforward, with no deferred tax liability

The deferred tax asset consists solely of an ITC carryforward that originated ten years prior to the reporting date from the acquisition of equipment. When the ITC was originated, it was carried back to recover previously paid income taxes to the extent permitted under the tax laws of the jurisdiction, and the balance was carried forward. As of the balance sheet date, the ITC carryforward has a remaining



carryforward period of four years, and to the extent it is not utilized, it will expire. A full valuation allowance was recorded against this deferred tax asset as of the prior year end.

The entity has a tax-planning strategy available that, if adopted, would accelerate taxable income into the third or fourth year following the reporting date and would produce additional taxable income sufficient to use approximately 30% of the remaining ITC carryforward. The entity's forecast of future earnings during the remaining four-year carryforward period indicates that an additional 10% of the ITC will be used to reduce income taxes payable. In this case, the entity would consider the negative evidence that it has been unable to use the ITC in the intervening years between the origination date and the reporting date, together with the positive evidence of the tax-planning strategy and the forecast. With respect to the forecast, the entity would evaluate the supportability of the forecast considering, in part, whether the assumptions used in the forecast are consistent with the company's actual operating experience during the past three years. The entity would also consider whether the tax planning strategy was both prudent and feasible and the level of objectivity and verifiability of such evidence.

#### **4.4 Deferred tax asset on deductible temporary differences and on operating loss carryforward with a deferred tax liability**

The deferred tax asset consists of a deductible temporary difference for the transition obligation recorded for postretirement benefits other than pensions. Management believes the transition obligation will reverse over the next 40-50 years. The remainder of the deferred tax asset consists of an operating loss carryforward incurred three years prior to the reporting date. The loss originated largely due to the settlement of a personal injury lawsuit. When the loss was incurred for tax purposes, it was carried back to recover previously paid income taxes to the extent permitted by the applicable tax law of the jurisdiction. Under the tax law, the loss carryforward will expire in 11 years if not used.

Aside from that loss, the company had always been profitable, some years more so than others due largely to cyclical fluctuations in the industry. Management believes that the industry has now fully recovered from the downturn in the industry. Management's belief is supported by forecasts from two industry trade associations. Based on this information, management has prepared a forecast of earnings for the next four years and projected earnings based on a stable industry (with price increases sufficient to recover cost increases) for the next six years. The entity also considered tax-planning strategies. A strategy is available whereby an entity could sell a building that it has abandoned and has a zero carrying value, in which a tax gain of approximately 60% of the operating loss carryforward would result. The deferred tax liability relates to temporary taxable differences on property and equipment. The taxable differences are estimated to reverse over the next 12 years. This is a very complex scenario, and a scheduling exercise would likely be performed to conclude on whether a valuation allowance is required. Some considerations may include:

- If the entity would be able to conclude that the tax strategy is both prudent and feasible, the entity would assume that the gain from the sale of the building would reduce the amount of any valuation allowance required.
- The entity would consider the reliability of their projections, and whether such income projections would be able to be extended for some or all of the remaining reversal periods of the entity's deferred tax assets and liabilities.

These judgements are specific to the facts and circumstances. Based on the results of that exercise, the entity would conclude whether it requires a full, partial or no valuation allowance.

#### **4.5 Deferred tax asset on operating loss carryforwards, with no deferred tax liability**

The deferred tax asset on operating loss carryforwards results from losses incurred during the past three years, resulting in a cumulative loss (from the past three years) as of the reporting date. The existence of negative evidence of this nature is objective and verifiable and is difficult to overcome. The entity

attributes the losses to declining customer demand for the company's products because of cheaper prices for products of a comparable nature and function imported by a competitor. The entity has therefore streamlined its production process to enable its products to be manufactured at a lower cost. The entity has invested in an advertising campaign to be rolled out in the middle of the next year. The only sources of positive income are from a tax-planning strategy and future taxable income.

The tax-planning strategy is the sale-leaseback of its manufacturing facility, which is substantially depreciated for both book and tax purposes. If implemented, the strategy would produce taxable income sufficient to use approximately 30% of the loss carryforward. In these circumstances, the tax-planning strategy is determined to be prudent and feasible as well as reasonably objective and verifiable.

The entity has prepared projections for the next ten years which assume no annual growth in sales, reduced production costs due to the streamlined production process, gain on the sale-leaseback and rent resulting from the anticipated sale-leaseback strategy. These projections indicate that approximately 40% of the loss carryforward will be used.

In this scenario, the entity is faced with objective negative evidence that is difficult to overcome. However, the entity has determined the tax strategy is prudent and feasible as well as objective and verifiable. Therefore, it would likely conclude that the gain on the sale-leaseback would reduce the valuation allowance. The entity would then consider whether their projections are verifiable and determine whether there is sufficient positive evidence to further reduce the valuation allowance. This scenario illustrates the judgement involved when assessing the negative and positive evidence and concluding whether the evidence from the tax planning strategies and the forecast outweighs the objective evidence of the historical losses, (i.e., whether there is appropriate evidence supporting the more-likely-than-not assessment).

#### **4.6 Deferred tax asset on operating loss carryforward (development stage enterprise), with no deferred tax liability**

Similar to the preceding scenario, the entity has a cumulative loss over a period of three years. This entity, however, is a development stage entity and has not yet generated income since it is still developing its product. Development stage enterprises will rarely have significant (if any) sources of future income other than future projected taxable income from operations.

In this case, the entity would likely conclude that a full valuation allowance is required due to the objective evidence of three years of cumulative losses that is hard to overcome. Therefore, a valuation allowance equal to the deferred tax asset is recorded to reduce the deferred tax asset to an amount that is more likely than not to be realized, which is zero.

#### **4.7 Cumulative losses in discontinued business together with history of income and projected future profitability of core business**

Similar to the preceding scenario, the entity has a cumulative loss over a period of three years. This entity, however, is a commercial bank with cumulative losses solely from a commercial real estate loan portfolio that is not part of its core business. The entity stopped originating commercial real estate loans as of its most recent year end, and no new commercial real estate loans were originated since that date. Future losses on outstanding commercial real estate loans have been fully provided for within the bank's allowance for expected credit losses as of its most recent year end, and the entity does not expect any future costs related to this business. The entity's core business, consisting primarily of residential mortgages and small business loans, was profitable in each of the prior three years. Management of the entity predicts that the entity, which consists solely of its core business, will generate pretax income over the next three years.

As discussed in [Section 3.2.1](#), a three-year cumulative loss is not considered a bright line and may be overcome with sufficient objective and verifiable positive evidence. In this case, the entity would consider:

- The three-year cumulative losses were concentrated in its discontinued commercial real estate business (objective and verifiable).
- Any potential remaining losses related to the outstanding loans have already been reflected in the year-end results (objective and verifiable).
- The entity's core business has historically been profitable (objective and verifiable).
- The entity is projecting income in its core business for the next three years (subjective).

The above evidence includes many objective and verifiable data points. The entity, therefore, may be able to conclude that a valuation allowance is no longer required. However, such decision would be made considering the above evidence and other relevant facts and circumstances that are not part of this example. It is also possible that other facts and circumstances may cause the entity to conclude that a full or partial valuation allowance remains necessary.

## 5. Changes in valuation allowance

### 5.1 General

An entity would continue to assess whether there are facts and circumstances that were not known or knowable as of end of the prior reporting period that would indicate an adjustment to the beginning-of-year valuation allowance is needed. Information that was known or reasonably knowable at the end of the prior reporting period may indicate an error and such evaluation, if necessary, is outside the scope of this publication.

New evidence may be an assumption or fact pattern that is applicable in one period and no longer applicable in another, which may result in a partial or full reduction of the valuation allowance. For example, an entity may have had a history of cumulative losses as of the end of one reporting period, but the entity generates a significant amount of income in the next reporting period which may be sufficient to eliminate the negative evidence that existed previously.

ASC 740-10-45-20 states that the effect of a change in the beginning-of-year valuation allowance would generally be reported as a component of income tax expense from continuing operations, even if the deferred tax asset was set up with an offset against a different financial statement line item (e.g., equity or comprehensive income) in an earlier year. Exceptions to this general rule are discussed in [Section 5.2](#) and [Section 5.3](#).

### 5.2 Equity contributions and quasi-reorganizations

ASC 740-20-45-11(c) and (f) provide for two exceptions to the presentation of changes in the beginning-of-year valuation allowance within income from continuing operations. The first exception relates to equity contributions or distributions while the second exception relates to deductible temporary differences and carryforwards that existed at the date of a quasi-reorganization. These items would be reflected within shareholders' equity or other comprehensive income rather than in income from continuing operations.

### 5.3 Changes in valuation allowance recorded as part of a business combination.

A valuation allowance recorded in acquisition accounting for a business combination may change subsequent to the acquisition date based on new information. The classification of the change in the valuation allowance is dependent on the timing of the new information and if it existed as of the acquisition or not. The change in the valuation allowance would be adjusted to goodwill (or a reduction to the amount of bargain purchase recognized under ASC 805) if management identified new facts and

circumstances that existed as of the acquisition date and within the measurement period. ASC 805-10-25-15 defines the measurement period as "...the period after the acquisition date during which the acquirer may adjust the provisional amounts recognized for a business combination." The measurement period adjustment is reflected in the reporting period in which the adjustment is determined. On the other hand, new facts and circumstances that exist after the acquisition date and may be identified after the measurement period would be recorded as part of income or loss from continuing operations.



#### Example 5-1: Change in a deferred tax asset valuation allowance recognized in the accounting for the business combination

Buyer recognized deferred tax assets totaling \$1.8 million in its accounting for the business combination. Assume that Buyer also recognized a valuation allowance of \$1 million on those deferred tax assets in the accounting for the business combination. Subsequent to the acquisition-date, Buyer determines that the amount of the valuation allowance should be reduced by \$300,000 to \$700,000. The amount of goodwill that Buyer recognized for book purposes for this business combination was in excess of \$500,000 and Buyer has not elected the private-company goodwill alternative (which means goodwill is not amortized). Consider the following two scenarios:

1. Buyer determined during the measurement period that a reduction in the valuation allowance of \$300,000 was necessary based on new information it obtained concerning the facts and circumstances in existence as of the acquisition date (i.e., the reduction is a measurement period adjustment).
2. Buyer determined after the measurement period that a reduction in the valuation allowance of \$300,000 was necessary based on new information it obtained concerning the facts and circumstances in existence after the acquisition date (i.e., the reduction is not a measurement period adjustment).

The journal entry that Buyer records in each of these scenarios is as follows:

	Scenario 1 Debit (Credit)	Scenario 2 Debit (Credit)
Deferred tax asset - Valuation allowance	\$300,000	\$300,000
Goodwill	(\$300,000)	-
Income tax expense		(300,000)

As these journal entries illustrate, subsequently adjusting a valuation allowance recorded as part of the business combination may or may not affect net income in the period in which the adjustment is made. This determination is based on both the nature of and the timing of the information.

## Appendix A: Acronyms

Acronym	Definition
ASC	Accounting Standards Codification
DTA	Deferred Tax Asset
FASB	Financial Accounting Standards Board
ITC	Investment Tax Credit
MLTN	More Likely Than Not
NOL	Net Operating Loss

## Appendix B: Definitions

Several terms with specific meaning are used throughout this whitepaper. Those terms and the corresponding definitions based on the FASB's Master Glossary of the Codification are provided in the table that follows.

Term	Definition
Carrybacks	Deductions or credits that cannot be utilized on the tax return during a year that may be carried back to reduce taxable income or taxes payable in a prior year. An operating loss carryback is an excess of tax deductions over gross income in a year; a tax credit carryback is the amount by which tax credits available for utilization exceed statutory limitations. Different tax jurisdictions have different rules about whether excess deductions or credits may be carried back and the length of the carryback period.
Carryforwards	Deductions or credits that cannot be utilized on the tax return during a year that may be carried forward to reduce taxable income or taxes payable in a future year. An operating loss carryforward is an excess of tax deductions over gross income in a year; a tax credit carryforward is the amount by which tax credits available for utilization exceed statutory limitations. Different tax jurisdictions have different rules about whether excess deductions or credits may be carried forward and the length of the carryforward period. The terms carryforward, operating loss carryforward, and tax credit carryforward refer to the amounts of those items, if any, reported in the tax return for the current year.
Current Tax Expense (or Benefit)	The amount of income taxes paid or payable (or refundable) for a year as determined by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues for that year.
Deductible Temporary Difference	Temporary differences that result in deductible amounts in future years when the related asset or liability is recovered or settled, respectively. See Temporary Difference.
Deferred Tax Asset	The deferred tax consequences attributable to deductible temporary differences and carryforwards. A deferred tax asset is measured using the applicable enacted tax rate and provisions of the enacted tax law. A deferred tax asset is reduced by a valuation allowance if, based on the weight of evidence available,



Term	Definition
	it is more likely than not that some portion or all of a deferred tax asset will not be realized.
Deferred Tax Consequences	The future effects on income taxes as measured by the applicable enacted tax rate and provisions of the enacted tax law resulting from temporary differences and carryforwards at the end of the current year.
Deferred Tax Expense (or Benefit)	The change during the year in an entity's deferred tax liabilities and assets. For deferred tax liabilities and assets acquired in a purchase business combination during the year, it is the change since the combination date. Income tax expense (or benefit) for the year is allocated among continuing operations, discontinued operations, and items charged or credited directly to shareholders' equity.
Deferred Tax Liability	The deferred tax consequences attributable to taxable temporary differences. A deferred tax liability is measured using the applicable enacted tax rate and provisions of the enacted tax law.
Event	A happening of consequence to an entity. The term encompasses both transactions and other events affecting an entity.
Deferred Tax Liability	The deferred tax consequences attributable to taxable temporary differences. A deferred tax liability is measured using the applicable enacted tax rate and provisions of the enacted tax law.
Income Tax Expense (or Benefit)	The sum of current tax expense (or benefit) and deferred tax expense (or benefit).
Income Taxes	Domestic and foreign federal (national), state, and local (including franchise) taxes based on income.
Income Taxes Currently Payable (Refundable)	See Current Tax Expense (or Benefit).
Tax Consequences	The effects on income taxes—current or deferred—of an event.
Tax Position	<p>A position in a previously filed tax return or a position expected to be taken in a future tax return that is reflected in measuring current or deferred income tax assets and liabilities for interim or annual periods. A tax position can result in a permanent reduction of income taxes payable, a deferral of income taxes otherwise currently payable to future years, or a change in the expected realizability of deferred tax assets. The term tax position also encompasses, but is not limited to:</p> <ol style="list-style-type: none"> <li>A decision not to file a tax return</li> <li>An allocation or a shift of income between jurisdictions</li> <li>The characterization of income or a decision to exclude reporting taxable income in a tax return</li> <li>A decision to classify a transaction, entity, or other position in a tax return as tax exempt</li> <li>An entity's status, including its status as a pass-through entity or a tax-exempt not-for-profit entity.</li> </ol>

Term	Definition
Tax-Planning Strategy	An action (including elections for tax purposes) that meets certain criteria (see paragraph 740-10-30-19) and that would be implemented to realize a tax benefit for an operating loss or tax credit carryforward before it expires. Tax-planning strategies are considered when assessing the need for and amount of a valuation allowance for deferred tax assets.
Taxable Income	The excess of taxable revenues over tax deductible expenses and exemptions for the year as defined by the governmental taxing authority.
Taxable Temporary Difference	Temporary differences that result in taxable amounts in future years when the related asset is recovered or the related liability is settled. See Temporary Difference.
Temporary Difference	<p>A difference between the tax basis of an asset or liability computed pursuant to the requirements in Subtopic 740-10 for tax positions, and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively. Paragraph 740-10-25-20 cites examples of temporary differences. Some temporary differences cannot be identified with a particular asset or liability for financial reporting (see paragraphs 740-10-05-10 and 740-10-25-24 through 740-10-25-25), but those temporary differences do meet both of the following conditions:</p> <ol style="list-style-type: none"> <li>a. Result from events that have been recognized in the financial statements.</li> <li>b. Will result in taxable or deductible amounts in future years based on provisions of the tax law.</li> </ol> <p>Some events recognized in financial statements do not have tax consequences. Certain revenues are exempt from taxation and certain expenses are not deductible. Events that do not have tax consequences do not give rise to temporary differences.</p>
Valuation Allowance	The portion of a deferred tax asset for which it is more likely than not that a tax benefit will not be realized.

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