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Earnings Management Using the Valuation Allowance for Deferred Tax Assets under SFAS No. 109*

Catherine M. Schrand, M. H. Franco Wong

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Abstract

Statement of Financial Accounting Standards No. 109 (SFAS No. 109) allows firms to use their discretion to set arbitrarily high valuation allowances against deferred tax assets. Firms can then later use these "hidden reserves" to manage earnings. Our evidence indicates that most banks do not record a valuation allowance to manage earnings, but rather to follow the guidelines of SFAS No. 109. However, if the bank is sufficiently well capitalized to absorb the current-period impact on capital, then the amount of the valuation allowance increases with a bank's capital. In later years, bank managers adjust the valuation allowance to smooth earnings. The magnitude of the discretionary adjustment increases with the deviation of unadjusted earnings from the forecast or historical earnings.

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