Contemporary Accounting Research / Volume 20, Issue 3 / pp. 579-611

Free Access

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

Catherine M. Schrand, M. H. Franco Wong

First published: 15 January 2010

https://doi.org/10.1506/480D-098U-607R-5D9W

* Accepted by Gord Richardson. We thank participants at the UCLA accounting workshop and the 1999 Summer Symposium on Accounting Research at HKUST for their comments and suggestions. We especially thank Gord Richardson, the editor, and two anonymous referees, David Aboody, Gary Biddle, Kevin Chen, Peter Chen, Carla Hayn, Patricia Hughes, Greg Miller, Chul Park, and T. J. Wong. We also thank Steve Pilloff of the Federal Reserve Board for providing regulatory data and Lukas Nebehay for research assistance. We gratefully acknowledge the contribution of I/B/E/S International Inc. for providing earnings per share forecast data, available through the International Brokers Estimate System.

PDF

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.

References

Google Scholar

American Banker. 1993. FDIC proposes to let banks count tax loss carryforwards as capital. April 21.

Google Scholar

American Banker. 1994. Reserves rule to remain in force; Use of deferred-tax assets limited. November 22.

Google Scholar

Bartov, E. 1993. The timing of asset sales and earnings manipulation. *Accounting Review* **68** (4): 840–55.

Web of Science® | Google Scholar

Bartov, E., D. Givoly, and C. Hayn. 2002. The rewards to meeting or beating earnings expectations. *Journal of Accounting and Economics* **33** (2): 173–204.

Web of Science® | Google Scholar

Beatty, A., S. L. Chamberlain, and J. Magliolo. 1995. Managing financial reports of commercial banks: The influence of taxes, regulatory capital, and earnings. *Journal of Accounting Research* **33** (2): 231–61.

Web of Science® | Google Scholar

Beaver, W. H., P. Kettler, and M. Scholes. 1970. The association between market determined and accounting determined risk measures. *Accounting Review* **45** (4): 654–82.

Web of Science® | Google Scholar

Behn, B. K., T. V. Eaton, and J. R. Williams. 1998. The determinants of the deferred tax allowance account under SFAS 109. *Accounting Horizons* **12** (1): 63–78.

Google Scholar

Cocco, A. F., D. M. Ivancevich, G. A. Vent, and J. C. Zimmerman. 1994. FASB 106's deferred tax implications. *Journal of Accountancy* **178** (4): 89–91.

Google Scholar

Collins, D. W., M. S. Rozeff, and D. S. Dhaliwal. 1981. The economic determinants of the market reaction to proposed mandatory accounting changes in the oil and gas industry. *Journal of Accounting and Economics* **3** (1): 37–71.

Google Scholar

Collins, J. H., D. A. Shackelford, and J. M. Wahlen. 1995. Bank differences in the coordination of regulatory capital, earnings and taxes. *Journal of Accounting Research* **33** (2): 263–91.

Web of Science® | Google Scholar

Davis, A. 1999. SEC case claims profit "management" by Grace. *Wall Street Journal*, April 7, C1.

Google Scholar

Dhaliwal, D., C. A. Gleason, and L. F. Mills. 2002. Last chance earnings management: Using tax expense to achieve earnings targets. Working paper, University of Arizona.

Google Scholar

Degeorge, F., J. Patel, and R. Zeckhauser. 1999. Earnings management to exceed thresholds. *Journal of Business* **72** (1): 1–33.

Web of Science® | Google Scholar

Docking, D., M. Hirschey, and E. Jones. 1997. Information and contagion effects of bank loan-loss reserve announcements. *Journal of Financial Economics* **43** (2): 219–39.

Web of Science® | Google Scholar

Google Scholar

Financial Accounting Standards Board (FASB). 1987. *Statement of Financial Accounting Standards No. 96: Accounting for income taxes*. Stamford, CT: FASB.

Google Scholar

Financial Accounting Standards Board (FASB). 1992. *Statement of Financial Accounting Standards No. 109: Accounting for income taxes*. Stamford, CT: FASB.

Google Scholar

Imhoff, E. A., and J. K. Thomas. 1988. Economic consequences of accounting standards: The lease disclosure rule change. *Journal of Accounting and Economics* **10** (4): 277–310.

Web of Science® | Google Scholar

Kasznik, R., and M. F. McNichols. 2002. Does meeting expectations matter? Evidence from analyst forecast revisions and share prices. *Journal of Accounting Research* **40** (3): 727–59.

Web of Science® | Google Scholar

Khalaf, R. 1993. Read those footnotes! Forbes, February 15, 154.

Google Scholar

Lys, Thomas. 1984. Mandated accounting changes and debt covenants: The case of oil and gas accounting. *Journal of Accounting and Economics* **6** (1): 39–65.

Web of Science® | Google Scholar

Maddala, G. S. 1983. *Limited-dependent and qualitative variables in econometrics*. New York: Cambridge University Press.

Google Scholar

Web of Science® Google Scholar

Minton, B. A., and C. Schrand. 1999. The impact of cash flow volatility on discretionary investment and the costs of debt and equity financing. *Journal of Financial Economics* **54** (3): 423–60.

Web of Science® Google Scholar

Moehrle, S. R. 2002. Do firms use restructuring charge reversals to meet earnings targets *Accounting Review* **77** (2): 397–413.

Web of Science® Google Scholar

Moyer, S. E. 1990. Capital adequacy ratio regulations and accounting choices in commercial banks. *Journal of Accounting and Economics* **13** (2): 123–54.

Web of Science® Google Scholar

Petree, T. R., G. J. Gregory, and R. J. Vitray. 1995. Evaluating deferred tax assets. *Journal of Accountancy* **179** (3): 71–7.

Google Scholar

Read, W. J. and R. A. J. Bartsch. 1992. Accounting for deferred taxes under FASB 109. *Journal of Accountancy* **174** (6): 36–41.

Google Scholar

Robb, S. W. G. 1998. The effect of analysts' forecasts on earnings management in financial institutions. *Journal of Financial Research* **21** (3): 315–31.

Google Scholar

Rose, P. 1996. *Commercial bank management*. New York: Irwin.

White, G. I., A. C. Sondhi, and D. Fried. 1998. *The analysis and use of financial statements*. 2nd ed. New York: John Wiley & Sons, Inc..

Google Scholar

Citing Literature