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

Free Access

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

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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.

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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