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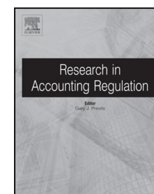

Regular Paper

Balance sheet classification and the valuation of deferred taxes

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ABSTRACT

The Financial Accounting Standards Board recently issued Accounting Standards Update 2015–17, which will require firms to classify all deferred tax assets and liabilities as noncurrent in classified balance sheets instead of separating them into current and noncurrent amounts. This change is designed to simplify the reporting of deferred taxes and align with International Financial Reporting Standards. This study conducts empirical analyses on a broad cross-section of publicly traded U.S. firms in order to examine the stock market's valuation of current and noncurrent deferred tax assets and liabilities. The results suggest that classifying all deferred taxes as noncurrent may adversely affect the usefulness of financial statements for equity investors.

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Introduction

The Financial Accounting Standards Board (FASB) recently issued Accounting Standards Update (ASU) 2015–17, which will require firms to classify all deferred tax assets and liabilities as noncurrent in classified balance sheets instead of separating them into current and noncurrent amounts (FASB, 2015). This update is part of the FASB's Simplification Initiative, which is designed to reduce the cost and complexity of U.S. generally accepted accounting principles (GAAP). In addition, the update will result in convergence with International Financial Reporting Standards (IFRS) on the balance sheet reporting of deferred taxes. The purpose of this study is to provide *ex ante* empirical evidence on the potential consequences of classifying all deferred taxes as noncurrent, in terms of the usefulness of deferred tax amounts to equity investors.

The issue of balance sheet presentation of deferred taxes is important. The FASB has debated the issue since at least Statement of Financial Accounting Standards No. 109 (SFAS 109), where it concluded that classifying all deferred taxes as noncurrent would be "confusing for the users of financial statements" (FASB, 1992, ¶151). In addition, classifying deferred taxes as either current or noncurrent increases the information burden on financial statement preparers and creates divergence between U.S. GAAP and IFRS.[1] Finally, research (e.g., Amir, Kirschenheiter, & Willard, 1997; Laux, 2013) suggests that deferred taxes are relevant for equity prices. Extant research, however, has not empirically examined whether classifying all deferred taxes as noncurrent would impact the usefulness of deferred taxes. This study addresses this issue in light of ASU 2015–17.

In assessing the usefulness of current deferred tax assets and liabilities, this study focuses on two aspects of their valuation. First, whether current deferred tax assets (liabilities) are positively (negatively) related to equity prices is examined. There are reasons to believe that this classification may not be informative for equity valuation. First, it does not always reflect when a temporary difference will reverse. As noted in a comment letter from McGladrey (2015), deferred taxes from net operating loss or tax credit carryforwards are classified based on the expected reversal

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[1] In its comment letter on the proposed ASU, EY (2015) notes that "applying today's [extant GAAP] guidance is challenging."

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date of the temporary differences, while other deferred taxes such as those due to bad debts and fixed assets are classified based on the current or noncurrent classification of the underlying asset or liability. In addition, both McGladrey (2015) and EY (2015) note that pro-rata allocation of valuation allowances between current and noncurrent deferred tax assets is arbitrary and non-intuitive, and thus may not provide meaningful information. Based on these arguments, it is possible that classifying deferred tax amounts into current and noncurrent portions (as in extant GAAP) is not incrementally informative relative to the proposed classification of all deferred taxes as noncurrent.

If current deferred tax assets (liabilities) are valued similarly to noncurrent deferred tax assets (liabilities), separate classification of current deferred tax items is not informative. Accordingly, this study also considers whether current deferred tax items are valued differently from their noncurrent counterparts. Prior research (Dotan, 2003; Guenther & Sansing, 2000, 2004; Laux, 2013) indicates that the valuation of deferred taxes depends on the timing of recognition for financial reporting versus income tax purposes. Deferred taxes arising from temporary differences included in GAAP income prior to taxable income are associated with current stock prices. To the extent that these items tend to be driven by employee benefits and accrued expenses – items that generate deferred tax assets – deferred tax assets are expected to be positively related to equity prices. However, research does not address whether the separation of deferred tax assets into current and noncurrent portions is informative. To the extent that current deferred tax assets are nearer to reversal than are noncurrent deferred tax assets, the former are expected to be more value-relevant.

Research further indicates that deferred taxes arising from temporary differences included in taxable income prior to GAAP income are not associated with current stock prices. As these items tend to generate deferred tax liabilities (e.g., depreciation of fixed assets), deferred tax liabilities are expected to be unrelated to equity prices. However, research does not address whether the separation of deferred tax liabilities into current and noncurrent portions is informative. Since depreciation-related deferred tax liabilities relate to a noncurrent asset, they are classified as noncurrent. While one might expect noncurrent deferred tax liabilities not to be value-relevant, current deferred tax liabilities may be. Thus, the valuation of current deferred tax liabilities is an open question addressed in this study.

This study employs a sample that includes a broad cross-section of publicly traded U.S. firms over 1994–2014 to examine whether the separation of deferred taxes into current and noncurrent portions informs equity investors. Using a model controlling for the theoretical determinants of firm value based on Feltham and Ohlson (1995), the results show that the coefficient estimates for both current and noncurrent deferred tax assets are significantly positive. Importantly, the coefficient estimate for current deferred tax assets is significantly greater than that for noncurrent deferred tax assets. This is attributed to investors expecting an earlier time to reversal for current deferred tax assets. Consistent with prior research, noncurrent deferred tax liabilities are not significantly related to stock prices. However, current deferred tax liabilities are significantly associated with stock prices. Overall, the results suggest that the classification of deferred tax items into current and noncurrent amounts provides incremental information that may be lost under the FASB's new rule.

This study provides two primary contributions. First, the results provide empirical support against the reclassification of current deferred taxes as noncurrent. This finding is consistent with Legoria and Sellers (2005), who find that separate recognition of deferred tax assets and liabilities provides incremental useful information in predicting future cash flows. The *ex ante* evidence in this paper adds to prior research that examines the *ex ante* impact of revised postretirement benefits accounting rules (Amir, 1993) and fair value reporting for investment securities (Barth, 1994), and research that examines the prospective effects of fair value accounting for pension plans (Bauman & Shaw, 2016; Heflin, Hann, & Subramanyam, 2007).

Second, this paper adds to research that examines the usefulness of deferred taxes for equity investors (Amir et al., 1997; Laux, 2013). This paper expands this line of research into consideration of classification and balance sheet presentation issues. As both U.S. GAAP and IFRS require classified balance sheets, better understanding of their usefulness is important. While the new rule will better align U.S. GAAP and IFRS, it may adversely impact the usefulness of deferred tax information for equity investors, especially for firms with relatively large amounts of current deferred tax assets or liabilities.

The next section describes the relevant accounting rules for deferred taxes and discusses related research. An overview of research design and inferences follows (details are provided in the Appendix).

Background and related research

Prior U.S. GAAP

Deferred tax assets and liabilities result from timing differences between amounts reported for income tax purposes and those reported for financial reporting purposes. Under prior U.S. GAAP,[2] firms preparing a classified balance sheet present – for each tax jurisdiction within each tax-paying component of the entity – a net *current* deferred tax asset or liability, and a net *noncurrent* deferred tax asset or liability. Deferred tax assets and liabilities that are related to recognized assets or liabilities are classified as current or noncurrent based on the classification of the associated asset or liability. A deferred tax asset or liability is considered to be related to an asset or liability if reduction of the asset or liability causes a reversal of the temporary difference. For example, a deferred tax asset related to the accounting for warranty liabilities will typically be classified as current, while a deferred tax liability related to the accounting for depreciable assets will typically be classified as noncurrent.

[2] U.S. GAAP in place before (after) Accounting Standards Update 2015–17 is labeled “prior” (“new”) GAAP in this paper.

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