

they reflect in their regulatory reports<sup>1</sup> because their loan loss provisions are expensed for reporting purposes but are not deducted for tax purposes until the loans are charged off.

Deferred tax assets arising from an organization's deductible temporary differences may or may not exceed the amount of taxes previously paid that the organization could recover if the temporary differences fully reversed at the report date. Some of these deferred tax assets may theoretically be "carried back" and recovered from taxes previously paid. On the other hand, when deferred tax assets arising from deductible temporary differences exceed such previously paid tax amounts, they will be realized only if there is sufficient future taxable income during the carryforward period. Such deferred tax assets, and deferred tax assets arising from tax carryforwards, are hereafter referred to as "deferred tax assets that are dependent upon future taxable income."

#### FASB 109

In February 1992, the FASB issued Statement No. 109, which superseded Accounting Principles Board Opinion No. 11 (APB 11) and FASB Statement No. 96 (FASB 96), the previous standards governing accounting for income taxes. FASB 109 provides guidance on many aspects of accounting for income taxes, including the accounting for deferred tax assets. FASB 109 generally allows institutions to report certain deferred tax assets on their balance sheets that they could not recognize as assets under previous generally accepted accounting principles (GAAP) and the federal banking agencies' prior reporting policies.<sup>2</sup> Unlike the general practice

under previous standards, FASB 109 permits the reporting of deferred tax assets that are dependent upon future taxable income. However, FASB 109 requires the establishment of a valuation allowance to reduce deferred tax assets to an amount that is more likely than not (*i.e.*, a greater than 50 percent likelihood) to be realized.

FASB 109 became effective for fiscal years beginning on or after December 15, 1992. The adoption of this standard has resulted in the reporting of additional deferred tax assets in Call Reports and TFRs that have directly increased institutions' undivided profits and Tier 1 capital.

#### Concerns Regarding Deferred Tax Assets That Are Dependent Upon Future Taxable Income

The FDIC has certain concerns about including in capital deferred tax assets that are dependent upon future taxable income. Realization of such assets depends on whether a bank has sufficient future taxable income during the carryforward period. Since a bank that is in a net operating loss carryforward position is often experiencing financial difficulties, its prospects for generating sufficient taxable income in the future are uncertain. In addition, the condition of and future prospects for an organization often can and do change very rapidly in the banking environment. This raises concerns about the realizability of deferred tax assets that are dependent upon future taxable income, even when a bank ostensibly appears to be sound and well-managed. Thus, for many banks, such deferred tax assets may not be realized and, for other banks, there is a high degree of subjectivity in determining the realizability of this asset. In this regard, many banks may be able to make reasonable projections of future taxable income for relatively short periods of time and actually realize the projected income, but beyond these short time periods, the reliability of the projections tends to decrease significantly. Furthermore, unlike many other assets, banks generally cannot realize the value of deferred tax assets by selling them.

In addition, as a bank's condition deteriorates, it is less likely that deferred tax assets that are dependent upon future taxable income will be realized. Therefore, the bank is required under FASB 109 to reduce its deferred tax assets through increases to the asset's valuation allowance. Additions to this allowance would reduce the

reporting of deferred tax assets that are dependent upon future taxable income.

bank's regulatory capital at precisely the time it needs capital support the most. Thus, the inclusion in a bank's reported capital of deferred tax assets that are dependent upon future taxable income raises supervisory concerns.

Because of these concerns, the agencies, under the auspices of the Federal Financial Institutions Examination Council (FFIEC), considered how the deferred tax assets of depository institutions should be treated for regulatory reporting and capital purposes. In August 1992, the FFIEC requested public comment on this matter (57 FR 34135, Aug. 3, 1992). After considering the comments received, the FFIEC decided in December 1992, that banks and savings associations should adopt FASB 109 for reporting purposes in Call Reports and Thrift Financial Reports (TFRs) beginning in the first quarter of 1993 (or the beginning of their first fiscal year thereafter, if later). Insured banks were notified by the FFIEC that they should report deferred tax assets in their Call Reports in accordance with FASB 109 in Financial Institutions Letter FIL-97-92 dated December 31, 1992. For insured state nonmember banks, this GAAP reporting standard has superseded the regulatory reporting limitation on deferred tax assets established by the FDIC in Bank Letter BL-36-85 dated October 4, 1985. As a consequence, this 1985 Bank Letter has been withdrawn.

#### II. Proposed Regulatory Capital Treatment of Deferred Tax Assets

The FFIEC, in reaching its decision on regulatory reporting, also recommended that each of the federal banking agencies should amend its regulatory capital standards to limit the amount of deferred tax assets that can be included in regulatory capital. In response to the FFIEC's recommendation, on May 5, 1993, the FDIC issued for public comment a proposal to adopt the recommendation of the FFIEC in full, as summarized below (58 FR 26701). The FFIEC recommended that the agencies limit the amount of deferred tax asset that are dependent upon future taxable income that an institution can include in regulatory capital to the lesser of:

(1) the amount of such deferred tax assets that the institution expects to realize within one year of the quarter-end report date, based on its projection of future taxable income (exclusive of tax carryforwards and reversals of existing temporary differences) for that year, or

(2) ten percent of Tier 1 capital before deducting any disallowed purchased mortgage servicing rights, any disallowed purchased credit card

<sup>1</sup> Insured commercial banks and FDIC-supervised savings banks are required to file quarterly Consolidated Reports of Condition and Income (Call Reports) with their primary federal regulatory agency (the FDIC, the FRB, or the OCC, as appropriate). Insured savings associations file quarterly Thrift Financial Reports (TFRs) with the OTS.

<sup>2</sup> Prior reporting policies of the OCC and FDIC, as set forth in Banking Circular 202 dated July 2, 1985, and Bank Letter BL-36-85 dated October 4, 1985, respectively, limited the reporting of deferred tax assets in the regulatory reports filed by national banks and insured state nonmember banks to the amount of taxes previously paid which are potentially available through carryback of net operating losses. As such, the OCC and FDIC did not permit the reporting of deferred tax assets that are dependent upon future taxable income in the Call Reports filed by national and insured state nonmember banks. The FRB and OTS did not issue policies explicitly addressing the recognition of deferred tax assets. Consequently, state member banks and savings associations were able to report deferred tax assets in accordance with GAAP. Prior to FASB 109, GAAP, as set forth in APB 11 and FASB 96, also for the most part did not permit the