FIN 620: DISCUSSION BOARD UNIT 4

Student's Name

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Valuation allowance refers to an accounting item in the statement of financial position that is used by the management to offset all or part of the company's deferred tax assets. The deferred tax asset refers to the tax advantage that a company may benefit from in future while the deferred tax liability refers to the tax penalties that a firm may receive in future. At times, valuation of the company's current assets and liabilities alongside with future cash flow may indicate that the company may not be able to realize the benefits of the deferred tax assets. It happens, especially where the profitability of the company over a given time in future commensurate to the deferred tax assets rates is expected to fall below the full value making it impossible for the company to take advantage of its tax benefits. The provision for valuation allowance requires the management to make assumptions on the future profitability of the company based on the depth of available evidence and where a valuation allowance change is realized, it is recording as earning in the financial reports. This paper will address some of the positive and negative evidences used in the establishment of the need for valuation allowance as well as the effect of valuation allowance on the free cash flow forecast in a company (Nightingale, 2002).

The valuation allowance must be based on the weight of available evidence, be it positive or negative. Further, the more-likely-than-not standard of more than fifty per cent must be achieved, as provided for by the Financial Accounting Standards Board's section on accounting for income taxes. Negative evidence for valuation allowance refers to the history of operating loss, cumulative operating losses in the recent financial years, and operating financial losses expected in the near future of the company. The losses may emanate from situations that would unfavorably affect future of the company's operations on a continuing basis, thereby limiting realization of tax benefits. On the other hand, positive evidence includes any future transactions and circumstances that may lead to increased future earnings. The circumstances include existing contracts and sales expectations that are capable of producing additional taxable income that leads to the realization of deferred tax assets based on the prevailing sales prices and product cost structures. The increased earnings could also result from the increase in value of assets after revaluation in amounts large enough to realize tax benefits as well as losses that create future deferred tax assets couple with the suitable evidence that the loss is an unusual and unexpected event and not a continuing condition (Nightingale, 2002).

The valuation allowances impact directly on the future cash flows of the company. The impact takes place in four main avenues including the reversal of current taxable temporary differences, acceleration of the taxable income by use of the expiring deferred tax assets, and the change over to the taxable investments from tax-exempt. The valuation allowance allows for the change of character of deductible amounts or taxable income from ordinary income or ordinary loss into capital gains or capital losses on the revaluation of assets and shares. Just as it is difficult to precisely value the amounts of deferred tax assets, the valuation allowances require significant judgment in the evaluation of positive evidence and negative evidence and as such there must be objective and verifiable data and information to determine whether or not valuation allowance is required and in equal measure, the impact of the allowance on the cash flows of the company (Nightingale, 2002).

In conclusion, valuation allowance gets provided for in a company’s financial statements when the company positively predicts that it may not be able to enjoy tax benefits where there are deferred tax assets. The Financial Accounting Standards Board requires the fulfillment of the more-likely-than-not standard for the provision for the valuation allowance. Once accomplished, the valuation allowance directly affects the cash flow of the organization with the reversal of the current taxable differences being one major avenue.

References

Nightingale, K. (2002). *Taxation: Theory and Practice*. NJ: Prentice hall.