RESCINDED

EC - 250

EXAMINING ISSUANCE

Any attachments to this document are rescinded only as they relate to national banks and federal savings associations.

Type: Examining Circular

Subject: Deferred Income Tax Reporting and Review Procedures

TO: Deputy Comptrollers, District Administrators, Department and Division Heads and All Examining Personnel

PURPOSE

This Examining Circular provides suggested procedures for reviewing a bank's reported deferred income taxes. They supplement those outlined in section 220, Other Assets and Other Liabilities, of the Comptroller's Handbook for National Bank Examiners. Examiners should note that these procedures are not required nor always necessary for all banks.

BACKGROUND

Recently, each District was asked to comment on suggested examination procedures for deferred taxes. All indicated that some form of guidance in this area is needed. Some pointed out that the accounting rules for deferred taxes are in the process of changing. In view of this, some suggested that an insert to the Handbook would be premature at this time.

As a result of this input, this examining circular was deemed the most appropriate form of guidance at this time. Once FASB 96 is adopted, we will consider adding a section on deferred taxes to the Handbook.

Many banks continue to have difficulty accounting for deferred income taxes. Errors in reporting deferred taxes can cause a bank to misstate its earnings, capital, and related financial ratios.

When a bank records an income or expense item in one period for financial reporting purposes, but in another period for tax purposes, a "timing difference" occurs. As a result, book income tax expense differs from the income tax liability reported on the tax return (actual tax due).

If a bank's book tax expense is more than the actual tax due, the difference is a deferred tax liability. Conversely, if book tax expense is less than the actual tax due, the difference may be a deferred tax asset. The cumulative tax effect of all timing differences is reported as either a net deferred tax asset or liability on the balance sheet.

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REVIEW GUIDELINES

When a bank's deferred tax accounts are reviewed as part of an on-site examination or an off-site analysis, the following procedures should be considered.

Reconcilement of Deferred Income Tax Accounts

An appropriate first step is to determine whether the deferred tax accounts reconcile for the current period. The attached schedules illustrate this process.

1. Obtain the bank's prior year-end deferred tax liability (asset) account balance from call report Schedule RC-G (RC-F).

2. Add the deferred tax expense (or benefit) for the current year as reported on Schedule RI-C to the prior year-end deferred tax liability (or asset) account balance.

3. The resulting balance should agree with the bank's deferred tax liability (or asset) balance as reported at the current year end.

Balances for the various deferred tax accounts are now available through NBSVDS under the following references:

Call Report Short Name	Reference	Description
DEFTX	RI-C, 4 or 5	Deferred portion of current income taxes
DDTXDR	RC-F, 2	Net deferred income taxes, asset
DDTXCR	RC-G, 2	Net deferred income taxes, liability

Resolution of Potential Reporting Errors

The derived amount (from step 3 above) may differ from the bank's reported deferred tax liability (or asset). This does not necessarily mean the bank has made an error in reporting its deferred taxes. There may be a valid reason for this difference. For example, the bank may have

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reclassified a portion of its <u>current</u> tax liability to deferred, or vice versa. In addition, the bank may have merged with another bank during the year resulting in an increase (decrease) in reported deferred taxes.

In any event, the examiner should ask the bank to provide an explanation for any material difference. If the review is part of an off-site analysis, the attached sample letter may be used to request this explanation.

Examiners should remember that it is the bank's responsibility to properly account for and report its deferred taxes. This includes maintaining sufficient, straightforward documentation to support the recorded deferred tax liability (or asset) balance. In some cases, examiners may require assistance in reviewing this documentation or in addressing specific tax issues. If so, they may contact the appropriate District accounting resource person(s) or call the Bank Accounting Division in Washington, D.C. at (202) 874-5180.

<u>Deferred Tax Assets - Banking Circular 202</u>

Banks reporting deferred tax assets should follow Banking Circular 202, Accounting for Net Deferred Tax Charges. It generally limits the amount of the asset to the taxes previously paid by the bank that are available through carryback of net operating losses (NOLs). This limitation can be checked as follows:

1. Determine the total amount of taxes the bank has paid over its applicable tax loss carryback period (i.e., the bank's NOL carryback potential).

2. Compare the bank's NOL carryback potential to its reported deferred tax asset on call report Schedule RC-F. If the deferred tax asset exceeds the NOL carryback potential, the excess portion is not a bankable asset and should be charged off.

If the bank is a member of a consolidated group, two additional steps should be performed:

3. Determine the NOL carryback potential of the consolidated group.

4. If the group's NOL carryback (#3 above) is less than the bank's NOL carryback potential (#1 above), the bank's deferred tax asset should be limited to the group's NOL carryback. However, this limitation does not apply when the parent is "financially capable" of refunding the tax benefits due to the bank, as the underlying timing differences reverse (i.e., as the tax deductible amounts would be used).

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Determining the parent's financial capability is a matter of judgment. However, in the case of a one-bank holding company this judgment is less difficult. There the parent is probably not financially capable for this purpose, if its sole or primary source of income is its subsidiary bank.

FAS 96, ACCOUNTING FOR INCOME TAXES

Finally, examiners should be aware that the Financial Accounting Standards Board (FASB) has adopted FASB 96. This significantly changes the current method of accounting for deferred taxes. Originally FASB 96 was to become effective in 1989. However, it is now delayed to fiscal years beginning after December 15, 1991 (i.e., for calendar year 1992). By that time the FASB hopes to have resolved the implementation issues surrounding FASB 96.

Regardless of the method a bank uses to account for its deferred taxes, the procedures outlined in this Examining Circular are applicable. Of course, once the FASB finalizes the implementation of FASB 96, further guidance will be issued.

Questions regarding this issuance, or deferred taxes, may be directed to the Chief National Bank Examiner's Office, Bank Accounting Division, or to those in your district with expertise in this area.

ORIGINATING OFFICE

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Related Links

- Sample Letter
- Deferred Tax Account Reconcilement Worksheet

ATTACHMENT 1

The following letter may be used to request an explanation for any material difference noted in reconciling the deferred tax accounts from the prior year to the current year end:

Mr. John Doe, President
XYZ Bank
123 Main Street, USA 11111

Dear Mr. Doe:

An off-site analysis of your bank revealed an apparent unreconciled amount in the accounting for deferred taxes as reported in the call report. It was noted that the difference between the bank's 19X1 year-end deferred tax liability (asset) balance of $000,000 is not totally explained by the reported deferred tax expense (benefit) of $000,000.

In many cases, the deferred tax provision is the only item recorded in the deferred tax liability (asset) account. However, we recognize that other entries, not captured in retrievable form on the call report, are sometimes made to this account.

Accordingly, please send us a reconciliation of the 19X1 deferred tax liability (asset) balance to the 19X2 balance, including all pertinent supporting documentation. If you have questions regarding this request, please call me at (XXX) XXX-XXXX.

Sincerely,

Jane Doe
National Bank Examiner

ATTACHMENT 2

DEFERRED TAX ACCOUNT RECONCILEMENT

1) TAKE THE BANKS PRIOR YEAR-END DEFERRED TAX BALANCE FROM CALL REPORT SCHEDULE RC-F OR RC-G.

Schedule RC-F - Other Assets

Dollar Amounts in Thousands			C130		
			Mil	Thou	
1. Income earned, not collected on loans		RCON XXXX		335	1.
2. Net deferred income taxes (if debit balance)		RCON XXXX			2.
3. Other (Itemize amounts greater than $25,000 that exceed 25% of item 4 of this schedule)		RCON XXXX		85	3.
4. Total (sum of items 1 through 3) (must equal Schedule RC, item 11)		RCON XXXX		420	4.

Schedule RC-G - Other Liabilities

Dollar Amounts in Thousands			C136		
			Mil	Thou	
1. Income earned, not collected on loans		RCON XXXX		195	1.
2. Net deferred income taxes (if debit balance)		RCON XXXX		140	2.
3. Minority interest in consolidated subsidiaries		RCON XXXX			3.
4. Other (Itemize amounts greater than $25,000 that exceed 25% of item 5 of this schedule)		RCON XXXX			4.
5. Total (sum of items 1 through 4) (must equal Schedule RC, item 20)		RCON XXXX		335	5.

DEFERRED TAX ACCOUNT RECONCILEMENT

2) ADD OR SUBTRACT, THE DEFERRED TAX EXPENSE OR BENEFIT FOR THE CURRENT YEAR FROM RI-C. (BENEFITS ARE REFLECTED IN PARENTHESES).

Schedule RI-C - Applicable Income Taxes by Taxing Authority

Schedule RI-C is to be reported only with the December Report of Income.

					1189		
Dollar Amounts in Thousands					Mil	Thou	
1. Federal				RCON XXXX		105	1.
2. State and local				RCON XXXX		45	2.
3. Total (sum of items 1 and 2) (must equal sum of Schedule RI, items 9 and 11.b)				RCON XXXX		150	3.
4. Deferred portion of item 3	RCON XXXX		40				4.

DEFERRED TAX ACCOUNT RECONCILEMENT

3) THE NUMBER YOU ARRIVE AT SHOULD RECONCILE TO THE BANK'S DEFERRED TAX BALANCE REPORTED AT YEAR-END

Schedule RC-F - Other Assets

Dollar Amounts in Thousands				C130 Mil	C130 Thou	
1. Income earned, not collected on loans			RCON XXXX		410	1.
2. Net deferred income taxes (if debit balance)			RCON XXXX			2.
3. Other (Itemize amounts greater than $25,000 that exceed 25% of item 4 of this schedule)			RCON XXXX		95	3.
4. Total (sum of items 1 through 3) (must equal Schedule RC, item 11)			RCON XXXX		505	4.

Schedule RC-G - Other Liabilities

Dollar Amounts in Thousands				C136 Mil	C136 Thou	
1. Expenses accrued and unpaid (Included accrued interest payable and income taxes payable)			RCON XXXX		200	1.
2. Net deferred income taxes (if credit balance)			RCON XXXX		180	2.
3. Minority interest in consolidated subsidiaries			RCON XXXX			3.
4. Other (Itemize amounts greater than $25,000 that exceed 25% of item 5 of this schedule)			RCON XXXX			4.
5. Total (sum of items 1 through 4) (must equal Schedule RC, item 20)			RCON XXXX		380	5.

DEFERRED TAX
ACCOUNT RECONCILEMENT

PRIOR YEAR-END BALANCE	$ 140
ADD: DEFERRED TAX EXPENSE - CURRENT YEAR	40
CURRENT YEAR-END BALANCE	$ 180