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How a murky balance sheet line signals weak profits ahead

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It’s one of the most murky and least understood parts of a balance sheet. But a line called ”deferred tax assets” – and how it changes quarter to quarter – can provide clues to a company’s future profits.

Or, in the case of 2020, the lack of future profits.

A number of companies have already taken special charges against their tax assets, suggesting that no matter how optimistic management may be about eventually turning the corner of the pandemic, it’s hard to see when, exactly, a fat bottom line will return.

Before we name names, let’s explain the concept. There are many complex ways a company can create a deferred tax asset, but the most easily understood is by losing money. In many jurisdictions (countries, provinces, U.S. states), a net loss can be ”carried forward” and, in a subsequent year, applied against profits to reduce a corporate income tax bill. These accumulated losses are actually assets on the balance sheet until they’re used.

Of course, to use the losses, you have to have profits to apply them against. This is where keeping a close look on the changes comes into play.

Toronto’s Veritas Investment Research recently highlighted the concept in a report called The Accounting Fortune Teller. Veritas says international financial reporting standards, which Canadian public companies use, say future profits must be probable and management must have convincing evidence to support its assumptions.

”In investor terms, that means management must have a high degree of confidence in the business' future profitability and a strong justification for their outlook before they can bring unrecognized tax losses onto the balance sheet,” analyst Dan Fong wrote.

Mr. Fong focused on Air Canada, which in the third quarter of 2017 recognized $806-million of deferred tax assets, nearly doubling its net income. While many investors may have dismissed it as a one-time, non-cash gain, Mr. Fong said, it signalled future profit growth, and in fact between 2017 and 2019, Air Canada’s EBITDA, or earnings before interest, taxes, depreciation and amortization, grew 25 per cent.

Unfortunately, Mr. Fong also noted, Air Canada decided not to recognize potential deferred tax assets in the second quarter of this year, as the pandemic continued to wreak havoc on the

airline industry. In its report to shareholders, it said it kept $278-million in tax assets off its books because it looked at its losses and the "negative evidence" surrounding them and concluded that "uncertainty exists when conditions will improve."

It's not the only one. Imax Corp., one of many movie exhibitors suffering amid the pandemic, said last week it would write down the value of its deferred tax assets by US$23.9-million, to US$17.7-million, citing an inability to estimate future income in certain tax jurisdictions.

Another example is Indigo Books & Music Inc., which decided not to recognize $109.5-million in deferred tax assets in June, when it closed its books on its fiscal year.

The decision, Indigo said, "was influenced by the company's current operating loss, and uncertainty surrounding future profitability as a result of the COVID-19 pandemic, among other factors … uncertainty exists surrounding the probability of sufficient taxable income being available to utilize all deferred tax assets within the time line of management's forecasts."

When questioned, Indigo disagreed with the suggestion that its accounting decision meant it couldn't see a time when it would be profitable again. The company declined to say how far into the future it forecast its profitability when it decided to write down its deferred tax assets, but said, via a spokeswoman, "Any inference to the future profitability of the company could be a misinterpretation of our disclosures … our accounting estimates as at March 28, 2020, are not forward-looking guidance. With a stable balance sheet, confidence in our strategy and a highly engaged customer base, we are energized heading into this upcoming holiday season."

Mr. Fong, who did not examine Imax or Indigo, notes that the deferred tax asset accounting rules set a high bar for companies to clear for the expectation of profits. So writing down or "derecognizing" tax assets does not mean a company will never be profitable again or that profits are unlikely at some point. Indeed, some carryforwards last 10 or 20 years, giving companies plenty of time to use them.

What investors may infer, however, is that a company that's taking deferred tax assets off the balance sheet is in for some rocky times in the near term. You might say that profits are going to be deferred.