

Lucent technologies deferred taxation

Technology



Executive Summary This memorandum is intended to communicate the deferred tax issues of Lucent Technologies Inc. on the basis of analysis of the veracity of the situation according to the reporting framework's guidelines to anticipate unfavorable implications that had been resulted due to poor performance of the company over the past years. The Financial Accounting Standards Board (FASB) is the recognized body for making pronouncements as Generally Accepted Accounting Principles (GAAPs) in the United States.

The FASB has promulgated Statement of Financial Accounting Standard # 103 " Accounting for Income Taxes" which specifically prescribes the treatment of income taxes of corporate entities and guidance for how deferred taxes should be recorded either an asset or a liability in the financial statements. It also provides assistance in certain cases requiring a valuation allowance to be used to reduce the carrying value of any deferred tax asset for which it was " more likely than not" that the asset would not be realized.

The main reason behind the issue is the impact of cut-throat competition in the telecom industry and downturn in the economic conditions which had adversely affected the company's overall financial performance as a result deferred taxes amounting to \$ 7. 6 billion as of September 30, 2011 have been recognized against deductible temporary differences, operating losses and tax credit carry forwards. However, under the prevailing circumstances, it is apparent that the company will not be able to generate positive taxable income in the future periods to offset the losses.

Accordingly, as per FAS # 109 the valuation allowance has to be reviewed against potential tax assets and for any items in which it is more probable

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through persuasive and reliable evidence that the asset will not reduce future taxable income Analysis Since after the inception of its operations in November 1995, the quality production and innovation were key business success factors. However, eventually with the passage of time the entry of new firms in the telecom industry such as Alcatel, Ciena, Cisco, Ericsson, and Motorola Inc. , have intensified the level of competition.

As a result of this most industry participant opted to strengthen their relationships with large service providers, as they represented over 70% of global carrier spending. The collapse of competitive local exchange carriers and other competitors of incumbent carriers had resulted in fewer customers. In addition the large service providers, has been consolidating, thus giving the remaining service providers additional buying power. Furthermore, as service providers continued to reduce their capital spending, fewer sales opportunities existed.

Moreover, a number of its existing competitors were very large companies with substantial technical, engineering, and financial resources, brand recognition and established relationships with global service providers. These competitors were able to offer low prices, additional products or services, or other incentives. These potential competitors were also in a stronger position to respond quickly to new or emerging technologies and to undertake more extensive marketing campaigns, adopt more aggressive pricing policies, and make more attractive offers to potential customers, employees, and third-party agents.

During the company's financial year ending September 30, 2001, Lucent had lost \$16 billion placing its retained earnings into a net deficit. Subsequently, <https://assignbuster.com/lucent-technologies-deferred-taxation/>

in the first and second quarters of fiscal 2002, the trend continued with losses of \$423 million and \$495 million respectively. As of September 30, 2001, Lucent had tax credit carry forwards of \$898 and federal, state and local, and non-U. S. net operating loss carry forwards of \$ 1, 640 (tax effected), most of which expire primarily after the year 2019.

As of September 30, 2001, Lucent has recorded valuation allowances totaling \$ 742 against these carry forwards, primarily in certain states and foreign jurisdictions in which Lucent has concluded it is ‘ more likely than not’ that these carry forwards will not be recognized. The components of deferred income tax assets and liabilities are as follows; Year Ended September 30, |

	2001	2000	\$ in ‘ 000’	\$ in ‘ 000’
Deferred Income Tax Assets				
Bad Debt and customer financing reserves	\$ 1, 004	\$ 2		
Inventory reserves	685	314		
Business restructuring reserves	632	-		
Other operating reserves	536	407		
Postretirement and other benefits	2, 386	2, 352		
Net operating loss/ credit carry forwards	2, 538	240		
Other	636	364		
Valuation allowance	(742)	(197)		
Total deferred tax assets	7, 675	3, 562		

Deferred Income Tax liabilities				
Pension	1, 971	2, 480		
Property, plant and equipment	5	417		
Other	521	734		
Total deferred tax liabilities	\$ 2, 497	\$ 3, 631		

Keeping in view the above figures, it turned out that the company’s remaining deferred tax assets amount to \$ 5. 2 billion and since it is a substantial amount the company’s management may however believe that it would be realized based on forecasted taxable income.

However, as per FAS # 109, paragraph 17, issued February 1992, whereby it stipulates that a valuation is required when it is ‘ more likely than not’ that

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all or a portion of a deferred tax asset will not be recognized. Therefore, forming a conclusion that a valuation allowance is not needed is difficult when there is negative evidence such as cumulative losses in past recent years as mentioned above. Hence, cumulative losses weigh heavily in the overall assessment.

During the fiscal 2002 third quarter end review, the company should need to consider several significant developments in determining the need for a full valuation allowance including; * The continuity and recently more severe market decline * Uncertainty and lack of visibility in the telecommunication market as a whole * A significant decrease in sequential quarterly revenue levels * A decrease in sequential earnings after several quarters of sequential improvements The necessity for further restructuring and cost reduction actions to attain profitability As a result of this assessment, the company has established a full valuation allowance for its remaining net deferred tax assets as at June 30, 2002. Lucent recorded a non-cash charge of \$ 5. 83 billion, or \$ 1. 70 per share, to provide a full valuation allowance on its remaining deferred tax assets as June 30, 2002. This charge was partially offset by a third quarter income tax benefit of \$282 million on a pro forma basis, and \$ 505 million on as-reported basis.

In order for the company's management to determine whether a valuation allowance is required, managers should consider all available evidence. FAS # 109 divides this evidence into negative (that is, the asset is unlikely to be realized) and positive evidence. Negative evidence includes items such as cumulative losses in recent years; a history of operating loss carries forwards

expiring unused, losses expected in early future years, or assets expected to reverse in a single year in a cyclical business.

The statement declares that forming a conclusion that a valuation allowance is not needed is difficult when there is negative evidence. In contrast, positive includes a strong earnings history (exclusive of any current loss), existing contracts that will produce taxable income in the period of the asset turnaround, or a large excess of appreciated asset value over a tax basis and tax planning strategies.

Accordingly, based on the two types of evidences mentioned above, the views of the SEC staff with respect to valuation allowances on deferred tax assets and the types of questions that they might ask if they reviewed the Lucent's financial reports are as follows; * With respect to valuation allowances the SEC is likely to look at the basics for having or not having a valuation allowance, the timing of recording changes, or consistency with other forward-looking information * Comments relating to the adequacy of disclosures, the actual descriptions of rate reconciliation items, deferred tax assets and liabilities, uncertain tax positions, timing of reversals, or expiration of net operating losses in various jurisdictions. * The SEC may also ask questions relating to contractual obligations * The SEC may also ask for clarification related to management's material estimates and/or judgments. It is important that changes in estimates be well documented. * Disclose the amount of pretax income that the company needs to generate to realize the deferred tax assets. The SEC staff may ask to include an explanation of the anticipated future trends included in the company's projections of future taxable income. Confirmation to them that the anticipated future trends

included in the company's assessment of the realizability of its deferred tax assets are the same anticipated future trends used in estimating the fair value of your reporting units for purposes of testing goodwill for impairment and any other assessment of your tangible and intangible assets for impairment. Disclose that the deferred tax liabilities that the company is relying on in its assessment of the realizability of its deferred tax assets will reverse in the same period and jurisdiction and are of the same character as the temporary differences giving rise to the deferred tax assets. * Indicate the nature of the uncertainty and the nature of each event that could occur in the next twelve months that would cause the change for each significant tax position.

Conclusion It has been evident from the above analysis that Lucent has been facing poor performance and as many of its assets have very long lives but it's still not indicative of future viability of these assets. Until an appropriate level of profitability is reached, Lucent should not expect to recognize any significant tax benefits in future results of its operations.

The company must use judgment in considering the relative impact of negative and positive evidence. The weight given to the potential effect of negative and positive evidence should be commensurate with the extent to which it can be objectively verified. The more negative evidence that exist (a) the more positive evidence is necessary and (b) the more difficult is to support a conclusion that a valuation is not needed for some portion or the entire deferred tax asset.