Valuation of the firm in the presence of temporary book-tax differences: the role of deferred tax assets and liabilities

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This study uses an analytical model to investigate the value of the firm when there are temporary differences between when revenue and expense items are recognized for tax- and financial-reporting purposes. The model shows that deferred tax assets and liabilities transform book values of underlying liabilities and assets into estimates of the after-tax cash flows on which the firm's market value is based. The analysis shows that if tax deductions are taken on a cash basis, and if the underlying assets and liabilities are recorded at the present value of their associated future cash flows, then the value of deferred tax assets and deferred tax liabilities is their recorded amount, regardless of when the asset will be realized or when the liability will reverse. If tax deductions are not taken when the expenditure is made (e.g., depreciation) or if underlying assets and liabilities are recorded at more than the present value of their associated future cash flows (e.g., warranty liabilities), then the market value of deferred tax assets and deferred tax liabilities is less than their recorded values. The value of the deferred tax account is independent of when that account will reverse.

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