

Citigroup, Inc. (C)

The Deferred Tax Asset Issue

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SYM/EXCH	Current	Previous
Rating	Buy	Buy
Target Price	\$6.90	\$6.90
Est. Normalized Earnings	\$0.72	\$0.72

Stock Data (6/10)		
Current Price	\$3.67	
52 Week Low/High	\$3.11	\$5.43
Est. 2010 EPS/PE Multiple	\$0.41	9.0x
Est. Revenue Per Share/P:RPS	\$3.11	1.18x
Book Value/Price:Book	\$5.19	0.71x
Tangible BV/Price:TBV	\$4.08	0.90x
Dividend/Yield	\$0.00	0.0%
Est. Shares Out/Mkt. Cap (mil)	29,753	\$109,194

Income Statement (mil)/ Percent of Revenue (6/10)		
Net Interest Income	\$14,039	63.6%
Commissions and Fees	\$3,229	14.6%
Administrative & Fiduciary Fees	\$910	4.1%
Insurance Premiums	\$636	2.9%
Principal Transactions	\$2,217	10.0%
Sales Gains/Losses	\$69	0.3%
Other Revenues	\$971	4.4%
Operating Revenues	\$22,071	100.0%
Loan Losses & Benefits	\$6,665	30.2%
Personnel Costs	\$5,961	27.0%
All Other Expenses	\$5,905	26.8%
Pretax Income	\$3,540	16.0%

Balance Sheet (mil)/Percent of Assets (6/10)		
Cash	\$185,488	9.6%
Fed Funds & Repos	\$230,784	11.9%
Brokerage Receivables	\$36,872	1.9%
Trading Assets	\$309,412	16.0%
Securities	\$317,066	16.4%
Loans	\$692,166	35.7%
Reserves	(\$46,197)	(2.4%)
Other	\$212,065	10.9%
Assets	\$1,937,656	100.0%
Domestic Deposits	\$301,045	15.5%
Foreign Deposits	\$512,906	26.5%
Fed Funds & Repos	\$196,112	10.1%
Brokerage Payables	\$54,774	2.8%
Trading	\$131,001	6.8%
Borrowings	\$92,752	4.8%
Other Liabilities	\$78,439	4.1%
Long-Term Debt	\$413,297	21.3%
Minority Interest	\$2,524	0.1%
Preferred Stock	\$312	0.0%
Common Equity	\$154,494	8.0%
Tangible Common Equity	\$121,425	6.3%

Key Ratios (6/10)	
Loans to Deposits	85.0%
Tier One Common	9.7%
Return on Equity	6.9%
Return on Assets	0.56%
RPS 3-Year Growth	N.M.
EPS 3-Year Growth	N.M.



Source: Trade Station

Highlights

- Let me indicate at the outset, that I do not believe that Citigroup's books are out of order due to a misstatement of its deferred tax asset (DTA).
- Moreover, it would appear that no one has claimed that they are. An issue has been raised concerning the company's DTA based on a court case that will be explained below. However, since the issue of how the bank accounts for its DTA has been raised, it is necessary to review the concepts involved.
- The specific question is this. Citigroup has a sizable deferred tax asset. At the end of 2009 it was \$52.6 billion (currently \$49.9 billion). The company also had a deferred tax liability (DTL) at the end of 2009 of \$6.5 billion leaving a net tax asset of \$46.1 billion.
- In order to justify maintaining this deferred tax asset at its current level (\$49.9 billion), the bank must be able to demonstrate to the appropriate auditors, regulators, and the IRS that it can earn \$99 billion. Failure to earn this money for any reason would cause a mark down of the deferred tax asset.
- The time frame for earning this money varies. For approximately \$19 billion of the total, the company has 7 to 19 years to earn enough money to use the benefit. For the additional almost \$31 billion there is no specific time frame.
- Those who are questioning the ability of Citigroup to meet these parameters have not raised any specific examples as to why the company will not meet the time schedules.
- Rather, it is simply being implied that the company cannot meet the required goals. Therefore, it is being implicitly suggested (remember no one has advanced any examples or claims) that the company will fail and, therefore, it should have created a valuation allowance (VA) against the deferred tax asset.

Note: The tables in this report have been prepared by Rochdale Securities from sources believed to be accurate. However, accuracy cannot be guaranteed.

PPP EPS = Tax Adjusted Pretax, Pre-Provision Earnings Per Share

	2009	2010	2011	2012
Mar	(\$0.18)	\$0.15	\$0.10	\$0.14
Jun	\$0.49	\$0.09	\$0.11	\$0.15
Sep	(\$0.27)	\$0.08	\$0.11	\$0.16
Dec	(\$0.33)	\$0.09	\$0.13	\$0.17
Year	(\$0.29)	\$0.41	\$0.45	\$0.62
Previous	(\$0.29)	\$0.41	\$0.45	\$0.62
Consensus	(\$0.29)	\$0.39	\$0.46	\$0.57
PPP EPS	\$3.67	\$1.00	\$1.03	\$1.16
PE Multiple	N.M.	9.0x	8.2x	5.9x
PPP EPS PE	1.0x	3.7x	3.6x	3.2x

Risk

The valuation allowance, in theory, could be any amount from \$1 to the whole \$49.9 billion. If the worst case is assumed, then Citigroup has been overstating its earnings for some time. Moreover, its common equity is \$49.9 billion higher than it should be. In theory it should be 32.5% lower than it is currently. This, of course, is worst case thinking.

What is being suggested is that Citigroup will ultimately be forced to either create this valuation allowance or simply write off a portion of the deferred tax asset. Should this happen, Citigroup's earnings would be meaningfully, negatively impacted and its capital would fall.

Clearly the analyst who raised the issue does not believe that this will happen. In fact, based on his earnings projections for 2010 and 2011 he does not see any write-off at all. Thus, the discussion around this issue is more hypothetical than real world. However, it is worth pursuing.

Deferred Tax Assets and Liabilities

The discussion starts with a simplistic explanation of what a deferred tax asset or liability is. These items are created because generally accepted accounting principles (GAAP) differ from the accounting principles established for the Internal Revenue Service. Thus, every company has two sets of books and these books rarely agree with each other. One major difference shows up in the tax account of each company.

To link the tax account created by GAAP and the one established by the IRS, deferred tax assets and liabilities are created. The bulk of these deferred tax assets and liabilities are due to timing differences and they are temporary in nature. Consequently, over time the difference is eliminated and the deferred tax asset or liability is used up.

However, there are certain instances when the differential is permanent. In those cases, the deferred tax asset or liability will stay on the books forever (this is the case for a portion of the \$31 billion that was indicated as part of the Citigroup deferred tax asset).

A very simple example of how these differences can develop is shown below.

<u>Example</u>	<u>GAAP</u>	<u>IRS 1</u>	<u>IRS 2</u>
Hypothetical Income	\$2,000	\$2,000	\$2,000
Depreciation	\$200	\$250	\$150
Pretax income	\$1,800	\$1,750	\$1,850
Tax (35% Rate)	\$630	\$613	\$648
Net Income	\$1,170	\$1,138	\$1,203
Deferred tax (liability)/asset		(\$18)	\$18

In this example, it can be seen that under GAAP accounting a tax liability of \$630 has been created. In IRS 1 a faster rate of depreciation is used resulting in a tax payment of \$613 and the creation of a deferred tax liability of \$18. In IRS 2 a slower rate of depreciation is used than in GAAP. This results in a higher tax payment of \$648 and the creation of a deferred tax asset of \$18.

Citigroup's Deferred Tax Asset

Of course, in Citigroup's case the deferred tax asset was created as a result of incredibly complicated calculations. For example, the 2009 10k lists the elements of the deferred tax asset as follows:

- Credit loss deduction: \$14,987 million
- Deferred compensation and employee benefits: \$3,626 million
- Restructuring and settlement reserves: \$794 million
- Unremitted foreign earnings: \$7,140 million (very probably a permanent DTA)
- Cash flow hedges: \$1,906 million
- Tax credit and net operating loss carry forwards: \$20,787 million
- Intangibles: \$1,598 million
- Other deferred tax assets: \$1,753 million
- Total at year end 2009: \$52,591 million (today \$49,900 million)

The net tax deferred liabilities are just as obtuse. No outsider can hope to guess at the real value of these concepts. Investors either believe that the insiders who prepare and analyze these numbers are doing it correctly or not.

There are a number of groups who have access to these numbers. They include the company, itself, the company's auditors, the banking regulators, and the IRS. If one assumes that the numbers are manufactured, one must believe that either these observers are incapable of determining the correct information (they have been hoodwinked by the much smarter accountants inside the company) or that they are acting in collusion with each other to defraud the investor.

My assumption is that the outside observers know what they are doing and that they are not in collusion with each other. If this perhaps naïve view is correct then Citigroup's books are valid.

Source of Complaint

The event that has created the controversy over these numbers did not emanate at Citigroup. It is due to a lawsuit in Puerto Rico arguing that that territory's largest bank has incorrectly stated its deferred tax asset. This has not been proven. However, because the judge found enough merit to allow this suit to continue a leap of imagination was then made. It was asserted that all banks have misstated their deferred tax assets and Citigroup is the worst in the industry.

In sum, based on a lawsuit that has not even been tried a hue and cry has been raised that Citigroup is "cooking its books." This may be a little extreme. There is no evidence, no proof, no analysis, just a strong feeling. Maybe this is enough in these times to take down billions of dollars in the value of bank stocks. Who knows?

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-- Richard X. Bove

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HISTORICAL RATINGS

