

Reading 30: Income Taxes

Question #1 of 69

Question ID: 434307

Habel Inc. owns equipment with a tax base of \$400,000 and a carrying value of \$600,000. Habel also has a tax loss carryforward of \$200,000 that is expected to be utilized in the foreseeable future. Deferred tax items on the balance sheet are valued based on a tax rate of 30%. If the tax rate increases to 35%, the adjustments to the value of deferred tax items will *most likely* cause Habel's total liabilities-to-equity ratio to:

- ☐ A) remain unchanged.
- ☒ B) increase.
- ☐ C) decrease.

Explanation

The \$200,000 difference between the tax base and the carrying value of the equipment gives rise to a taxable temporary difference that leads to a deferred tax liability of \$60,000 ($\$200,000 \times 30\%$). The tax loss carryforward of \$200,000 leads to a deferred tax asset of \$60,000 ($\$200,000 \times 30\%$).

The increase in the tax rate from 30% to 35% will increase both the DTL and the DTA by \$10,000 ($\$200,000 \times 5\%$). Equity is unchanged. Therefore, the total liabilities-to-equity ratio will increase because of the increase in the deferred tax liability.

References

Question From: Session 8 > Reading 30 > LOS e

Related Material:

- Key Concepts by LOS

Question #2 of 69

Question ID: 414546

Nespa, Inc., has a deferred tax liability on its balance sheet in the amount of \$25 million. A change in tax laws has increased future tax rates for Nespa. The impact of this increase in tax rate will be:

- ☐ A) a decrease in deferred tax liability and a decrease in tax expense.
- ☒ B) an increase in deferred tax liability and an increase in tax expense.
- ☐ C) a decrease in deferred tax liability and an increase in tax expense.

Explanation

An increase in tax rates will increase future deferred tax liability, and the impact of the increase in liability will be reflected in the income statement of the year in which the tax rate change is effected.

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #3 of 69

Question ID: 596409

For analytical purposes, if a deferred tax liability is expected to not be reversed, it should be treated as a(n):

- ☐ A) immaterial amount and ignored.
- ☐ B) liability.
- ☒ C) an addition to equity.

Explanation

If deferred tax liabilities are expected to never reverse, they should be treated as equity for analytical purposes.

References

Question From: Session 8 > Reading 30 > LOS b

Related Material:

- Key Concepts by LOS
-

Question #4 of 69

Question ID: 414559

Graphics, Inc. has a deferred tax asset of \$4,000,000 on its books. As of December 31, it became more likely than not that \$2,000,000 of the asset's value may never be realized because of the uncertainty of future income. Graphics, Inc. should:

- ☐ A) reverse the asset account permanently by \$2,000,000.
- ☒ B) reduce the asset by establishing a valuation allowance of \$2,000,000 against the asset.
- ☐ C) not make any adjustments until it is certain that the tax benefits will not be realized.

Explanation

If it becomes more likely than not that deferred tax assets will not be fully realized, a valuation allowance that reduces the asset and also reduces income from continuing operations should be established.

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #5 of 69

Question ID: 414575

Which of the following situations will *most likely* require a company to record a valuation allowance on its balance sheet?

- ☒ A) A firm is unlikely to have future taxable income that would enable it to take advantage of deferred tax assets.
- ☐ B) A firm has differences between taxable and pretax income that are never expected to reverse.
- ☐ C) To report depreciation, a firm uses the double-declining balance method for tax purposes and the straight-line method for financial reporting purposes.

Explanation

A valuation allowance is a contra account (offset) against deferred tax assets that reflects the likelihood that the deferred tax assets will never be realized. If a firm is unlikely to have future taxable income, it would be unlikely to ever use its deferred tax assets, and therefore must record a valuation allowance.

References

Question From: Session 8 > Reading 30 > LOS g

Related Material:

- Key Concepts by LOS
-

Question #6 of 69

Question ID: 434306

A company purchased a new pizza oven for \$12,676. It will work for 5 years and has no salvage value. The tax rate is 41%, and annual revenues are constant at \$7,192. For financial reporting, the straight-line depreciation method is used, but for tax purposes depreciation is 35% of original cost in years 1 and 2 and the remaining 30% in Year 3. For this question ignore all expenses other than depreciation.

What is the deferred tax liability as of the end of year three?

- X **A)** \$1,029.
- X **B)** \$780.
- ✓ **C)** \$2,079.

Explanation

For tax purposes the machine is 100% depreciated at the end of year three, while for financial reporting it is only 60% depreciated.

The difference in depreciation is $\$12,676 \times (1.00 - 0.60) = \$5,070$.

Deferred tax liability = difference in depreciation \times tax rate = $\$5,070 \times 0.41 = \$2,079$.

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #7 of 69

Question ID: 414547

Corcoran Corp acquired an asset on 1 January 2004, for \$500,000. For financial reporting, Corcoran will depreciate the asset using the straight-line method over a 10-year period with no salvage value. For tax purposes the asset will be depreciated straight line for five years and Corcoran's effective tax rate is 30%. Corcoran's deferred tax liability for 2004 will:

- X **A)** decrease by \$15,000.
- ✓ **B)** increase by \$15,000.
- X **C)** decrease by \$50,000.

Explanation

Straight-line depreciation per financial reports = $500,000 / 10 = \$50,000$

Tax depreciation = $500,000 / 5 = \$100,000$

Temporary difference = $100,000 - 50,000 = \$50,000$

Deferred tax liability will increase by $\$50,000 \times 30\% = \$15,000$

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #8 of 69

Question ID: 414556

<i>Year ending 31 December:</i>	<i>2002</i>	<i>2003</i>	<i>2004</i>
<i>Income Statement:</i>			
Revenues after all expenses other than depreciation	\$200	\$300	\$400
Depreciation expense	<u>50</u>	<u>50</u>	<u>50</u>
Income before income taxes	\$150	\$250	\$350
<i>Tax return:</i>			
Taxable income before depreciation expense	\$200	\$300	\$400
Depreciation expense	<u>75</u>	<u>50</u>	<u>25</u>
Taxable income	\$125	\$250	\$375

Assume an income tax rate of 40% and zero deferred tax liability on 31 December 2001.

The deferred tax liability to be shown in the 31 December 2003, balance sheet and the 31 December 2004 balance sheet, is:

	<u>2003</u>	<u>2004</u>
✓ A) \$10	\$0	
X B) \$25	\$20	
X C) \$0	\$10	

Explanation

First, for 2003, remember that the deferred tax liability (DTL) is cumulative so, it includes the balance from prior years, (assume 2002 in this example since we have no other information).

DTL cumulative = (tax return depreciation - financial statement depreciation) \times tax rate + DTL from previous year

- DTL for 2002: $(75 - 50) \times 0.4 + 0 = 10$
- DTL for 2003: $(50 - 50) \times 0.4 + 10 = 10$
- DTL for 2004: $(25 - 50) \times 0.4 + 10 = 0$

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #9 of 69

Question ID: 485782

A firm has deferred tax assets of \$315,000 and deferred tax liabilities of \$190,000. If the tax rate increases, adjusting the value of the firm's deferred tax items will:

- ☐ A) have no effect on income tax expense.
- ☐ B) increase income tax expense.
- ☒ C) decrease income tax expense.

Explanation

An increase in the tax rate increases the values of both DTAs and DTLs. Because the firm's DTAs are greater than its DTLs, the net effect of adjusting their values for an increase in the tax rate will be to decrease income tax expense.

References

Question From: Session 8 > Reading 30 > LOS e

Related Material:

- Key Concepts by LOS
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Question #10 of 69

Question ID: 598979

Deferred tax items should be measured based on the:

- ☐ A) statutory tax rate at the time when the temporary difference is recognized.
- ☐ B) firm's effective tax rate at the time when the temporary difference reverses.
- ☒ C) tax rate that will apply when the temporary difference reverses.

Explanation

Measurement of deferred tax items is based on the tax rate that will apply when the temporary difference reverses. In some cases this may depend on how a temporary difference is settled, which determines whether a capital gains tax rate or income tax rate will apply.

References

Question From: Session 8 > Reading 30 > LOS h

Related Material:

- Key Concepts by LOS
-

Question #11 of 69

Question ID: 713913

A dance club purchases new sound equipment for \$25,352. It will work for 5 years and has no salvage value. For financial reporting, the straight-line depreciation method is used, but for tax purposes depreciation is 35% of original cost in years 1 and 2 and the remaining 30% in Year 3. Annual revenues are constant at \$14,384 over these five years. If the tax rate for years 4 and 5 changes from 41% to 31%, what is the deferred tax liability as of the end of year 3?

- X A) \$2,948.
- ✓ B) \$3,144.
- X C) \$1,039.

Explanation

Straight-line depreciation = $\$25,352 / 5 = \$5,070$. Income (years 1, 2, and 3) using straight-line depreciation = $\$14,384 - \$5,070 = \$9,314$.

Accelerated depreciation (years 1 and 2) = $0.35(\$25,352) = \$8,873$. Income (years 1 and 2) = $\$14,384 - \$8,873 = \$5,511$.

Accelerated depreciation (year 3) = $0.3(\$25,352) = \$7,606$. Income (year 3) = $\$14,384 - \$7,606 = \$6,778$.

Cumulative difference in income at end of year 3 = $3(\$9,314) - [2(\$5,511) + \$6,778] = \$10,142$.

DTL value at new tax rate = $0.31(\$10,142) = \$3,144$.

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #12 of 69

Question ID: 414584

A firm purchased a piece of equipment for \$6,000 with the following information provided:

- Revenue will be \$15,000 per year.
- The equipment has a 3-year life expectancy and no salvage value.
- The firm's tax rate is 30%.
- Straight-line depreciation is used for financial reporting and double declining is used for tax purposes.

Calculate taxes payable for years 1 and 2.

	<u>Year 1</u>	<u>Year 2</u>
✓ A) 3,300		4,100
X B) 3,900		3,900
X C) 600		-200

Explanation

Using DDB:

	<u>Yr. 1</u>	<u>Yr. 2</u>
Revenue	15,000	15,000
Depreciation	<u>4,000</u>	<u>1,333</u>

Taxable Income 11,000 13,667

Taxes Payable 3,300 4,100

An asset with a 3-year life would have a straight line depreciation rate of 0.3333 per year. Using DDB the depreciation rate is twice this amount or 0.66667. \$2,000 is the amount of depreciation left on the equipment in year 2 (\$6,000 – \$4,000). Therefore, the amount of depreciation in the 2nd year is $(0.66667)(2,000) = \$1,333$

References

Question From: Session 8 > Reading 30 > LOS i

Related Material:

- Key Concepts by LOS
-

Question #13 of 69

Question ID: 414531

Which of the following statements about tax deferrals is NOT correct?

- ✓ **A)** Taxes payable are determined by pretax income and the tax rate.
- X **B)** Income tax paid can include payments or refunds for other years.
- X **C)** A deferred tax liability is expected to result in future cash outflow.

Explanation

Taxes payable are the taxes due to the government and are determined by taxable income and the tax rate. Note that pretax income is income before tax expense and is used for financial reporting. Taxable income is the income based upon IRS rules that determines taxes due and is used for tax reporting.

References

Question From: Session 8 > Reading 30 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #14 of 69

Question ID: 414543

In 20X8, Oliver Ltd. received \$80,000 cash from a customer for goods that it could not deliver until the next year and established a liability for unearned revenue. Oliver reports under U.S. GAAP, faces a 40% tax rate, and is located in a tax jurisdiction where unearned revenue is taxed as received. On their balance sheet for 20X8, what change in deferred tax should Oliver record as a result of this transaction?

- X **A)** A deferred tax liability of \$32,000.
- X **B)** There is no effect on deferred tax items from this transaction.
- ✓ **C)** A deferred tax asset of \$32,000.

Explanation

Oliver has paid tax on the \$80,000 revenue in 20X8, but has not recorded the revenue on it for financial statement purposes. This results in a temporary difference of \$32,000, which is a deferred tax asset. The tax asset will be realized when the company recognizes the revenue on its financial statements in the subsequent period.

References

Question From: Session 8 > Reading 30 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #15 of 69

Question ID: 414574

Deferred tax liabilities may result from:

- ✓ **A)** pretax income greater than taxable income due to temporary differences.
- X **B)** pretax income greater than taxable income due to permanent differences.
- X **C)** pretax income less than taxable income due to temporary differences.

Explanation

Deferred tax liabilities result from temporary differences that cause pretax income and income tax expense (on the income statement) to be greater than taxable income and taxes due (on the firm's tax form). Temporary differences that cause pretax income to be less than taxable income are recognized as deferred tax assets. Permanent differences do not result in deferred tax items; instead they cause the effective tax rate to differ from the statutory tax rate.

References

Question From: Session 8 > Reading 30 > LOS f

Related Material:

- Key Concepts by LOS
-

Question #16 of 69

Question ID: 414585

Under U.S. GAAP, which of the following statements regarding the disclosure of deferred taxes in a company's balance sheet is *most* accurate?

- X **A)** Current deferred tax liability and noncurrent deferred tax asset are netted, resulting in the disclosure of a net noncurrent deferred tax liability or asset.
- X **B)** There should be a combined disclosure of all deferred tax assets and liabilities.
- ✓ **C)** Current deferred tax liability, current deferred tax asset, noncurrent deferred tax liability and noncurrent deferred tax asset are each disclosed separately.

Explanation

Under U.S. GAAP, deferred tax assets and liabilities are classified as current or noncurrent, based on the underlying asset or liability. Under IFRS, deferred tax items are classified as noncurrent.

References

Question From: Session 8 > Reading 30 > LOS i

Related Material:

- Key Concepts by LOS

Question #17 of 69

Question ID: 414583

Year:	2002	2003	2004
<i>Income Statement:</i>			
Revenues after all expenses other than depreciation	\$200	\$300	\$400
Depreciation expense	<u>50</u>	<u>50</u>	<u>50</u>
Income before income taxes	\$150	\$250	\$350
<i>Tax return:</i>			
Taxable income before depreciation expense	\$200	\$300	\$400
Depreciation expense	<u>75</u>	<u>50</u>	<u>25</u>
Taxable income	\$125	\$250	\$375

Assume an income tax rate of 40%.

The company's income tax expense for 2002 is:

- ☐ A) \$50.
- ☒ B) \$60.
- ☐ C) \$0.

Explanation

Effective tax rate = Income tax expense / pretax income

Income tax expense = Effective tax rate × pretax income

= \$150(0.40)

= \$60

References

Question From: Session 8 > Reading 30 > LOS i

Related Material:

- Key Concepts by LOS

Question #18 of 69

Question ID: 460647

A firm needs to adjust its financial statements for a change in the tax rate. Taxable income is \$80,000 and pretax income is \$120,000. The current tax rate is 50%, and the new tax rate is 40%. The effect on taxes payable of adjusting the tax rate is *closest to*:

- ☒ A) \$8,000.
- ☐ B) \$4,000.
- ☐ C) \$16,000.

Explanation

"Pretax income" denotes earnings before taxes for financial reporting. "Taxable income" is earnings before taxes for computing taxes payable, where taxes payable refers to the actual tax liability to the government. Since taxable income is \$80,000, the difference in taxes payable is $(\$80,000)(0.5) - (\$80,000)(0.4) = \$8,000$.

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #19 of 69

Question ID: 414581

While evaluating the financial statements of Omega, Inc., the analyst observes that the effective tax rate is 7% less than the statutory rate. The source of this difference is determined to be a tax holiday on a manufacturing plant located in South Africa. This item is *most* likely to be:

- ✓ **A)** sporadic in nature, and the analyst should try to identify the termination date and determine if taxes will be payable at that time.
- X **B)** continuous in nature, so the termination date is not relevant.
- X **C)** sporadic in nature, but the effect is typically neutralized by higher home country taxes on the repatriated profits.

Explanation

As the name suggests, a tax holiday is usually a temporary exemption from having to pay taxes in some tax jurisdiction. Because of the temporary nature, the key issue for the analyst is to determine when the holiday will terminate, and how the termination will affect taxes payable in the future.

References

Question From: Session 8 > Reading 30 > LOS i

Related Material:

- Key Concepts by LOS
-

Question #20 of 69

Question ID: 414550

Unit Technologies uses accrual basis for financial reporting purposes and cash accounting for tax purposes. So far this year, Unit Technologies has recorded \$195,000 in revenue for financial reporting purposes, but, on a cash basis, revenue was only \$131,000. Assume expenses at 50 percent in both cases (i.e., \$ 97,500 on accrual basis and \$ 65,500 on cash basis), and a tax rate of 34%. What is the deferred tax liability or asset? A deferred tax:

- X **A)** liability of \$16,320.
- X **B)** asset of \$10,880.
- ✓ **C)** liability of \$10,880.

Explanation

Since pretax income (\$97,500) exceeds the taxable income (\$65,500), United Technologies will have a deferred tax liability of \$10,880 = $[(\$97,500 - \$65,500)(0.34)]$

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #21 of 69

Question ID: 414586

A tax rate that has been substantively enacted is used to determine the balance sheet values of deferred tax assets and deferred tax liabilities under:

- ☐ A) U.S. GAAP only.
- ☒ B) IFRS only.
- ☐ C) both IFRS and U.S. GAAP.

Explanation

Under IFRS, a tax rate that has been enacted or substantively enacted is used to measure deferred tax items. Under U.S. GAAP, only a tax rate that has actually been enacted can be used.

References

Question From: Session 8 > Reading 30 > LOS j

Related Material:

- Key Concepts by LOS

Question #22 of 69

Question ID: 414561

For the year ended 31 December 2004, Pick Co's pretax financial statement income was \$400,000 and its taxable income was \$300,000. The difference is due to the following:

Interest on tax-exempt municipal bonds	\$140,000
Premium expense on key person life insurance	\$(40,000)
Total	\$100,000

Pick's statutory income tax rate is 30 percent. In its 2004 income statement, what amount should Pick report as current provision for tax payable?

- ☐ A) \$102,000.
- ☐ B) \$120,000.
- ☒ C) \$90,000.

Explanation

According to SFAS 109, Current provision = statutory rate × taxable income

$30\% = \text{Taxes Payable} / \$300,000$

$= 0.30 \times \$300,000$

$= \$90,000$

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #23 of 69

Question ID: 456301

All-Star Enterprises purchased a machine on January 1. The company uses straight-line depreciation for financial reporting and accelerated depreciation for tax purposes. Depreciation for tax purposes during the year was \$36,000 greater than depreciation for financial reporting. Assuming a 30% tax rate will apply in the future, how much will be recorded as a deferred tax liability during the year?

- X **A)** \$36,000
- X **B)** \$25,200
- ✓ **C)** \$10,800

Explanation

Deferred tax liability = $\$36,000 \times 30\% = \$10,800$.

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #24 of 69

Question ID: 414587

Under IFRS, deferred tax assets and deferred tax liabilities are classified on the balance sheet as:

- X **A)** current items.
- X **B)** either current or noncurrent items.
- ✓ **C)** noncurrent items.

Explanation

Under IFRS, deferred tax assets and liabilities are classified as noncurrent. Under U.S. GAAP, deferred tax items may be current or noncurrent, depending on how the underlying asset or liability is classified.

References

Question From: Session 8 > Reading 30 > LOS j

Related Material:

- Key Concepts by LOS

Question #25 of 69

Question ID: 434304

A company purchased a new pizza oven for \$12,676. It will work for 5 years and has no salvage value. The tax rate is 41%, and annual revenues are constant at \$7,192. For financial reporting, the straight-line depreciation method is used, but for tax purposes depreciation is 35% of original cost in years 1 and 2 and the remaining 30% in Year 3. For this question ignore all expenses other than depreciation.

What is the tax payable for year one?

- X A) \$1,909.
- ✓ B) \$1,130.
- X C) \$779.

Explanation

Tax payable for year 1 is = $[\$7,192 - (\$12,676 \times 0.35)] \times 0.41 = \$1,130$.

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #26 of 69

Question ID: 414554

A firm purchased a piece of equipment for \$6,000 with the following information provided:

- Revenue will increase by \$15,000 per year.
- The equipment has a 3-year life expectancy and no salvage value.
- The firm's tax rate is 30%.
- Straight-line depreciation is used for financial reporting and double declining is used for tax purposes.

What will the firm report for deferred taxes on the balance sheet for years 1 and 2?

	<u>Year 1</u>	<u>Year 2</u>
✓ A)	\$600	\$400
X B)	\$3,900	\$3,900
X C)	\$3,300	\$4,100

Explanation

Using DDB:

	<u>Yr. 1</u>	<u>Yr. 2</u>
Revenue	15,000	15,000

Dep. 4,000 1,333

Taxable Inc 11,000 13,667

Taxes Pay 3,300 4,100

Using SL:

Yr. 1 Yr. 2

Revenue 15,000 15,000

Dep. 2,000 2,000

Pretax Inc 13,000 13,000

Tax Exp 3,900 3,900

Deferred taxes year 1 = $3,900 - 3,300 = 600$

Deferred taxes year 2 = $3,900 - 4,100 + \text{previously deferred taxes} = -200 + 600 = 400$

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #27 of 69

Question ID: 414562

Selected information from Kentucky Corp.'s financial statements for the year ended December 31 was as follows (in \$ millions):

Property, Plant & Equip.	10	Deferred Tax Liability	0.6
Accumulated Depreciation	(4)		

The balances were all associated with a single asset. The asset was permanently impaired and has a present value of future cash flows of \$4 million. After Kentucky writes down the asset, Kentucky's tax accounts will be affected as follows (the tax rate is 40%):

- ✓ **A)** deferred tax liability will be eliminated and deferred tax assets will increase \$200,000.
- ✗ **B)** deferred tax liability will be eliminated and deferred tax assets will increase \$1.4 million.
- ✗ **C)** taxes payable will decrease \$800,000.

Explanation

A permanently impaired asset must be written down to the present value of its future cash flows. The asset's carrying value of (\$10 - \$4 =) \$6 million must be reduced by \$2 million to \$4 million. An impaired value write-down reduces net income for accounting purposes, but not for tax purposes until the asset is sold or disposed of, so taxes payable do not decrease. At a 40% tax rate, the eventual writedown for tax purposes of \$2 million will cause \$800,000 of changes in deferred tax items. The \$600,000 deferred tax liability associated with this asset is eliminated and a deferred tax asset of \$200,000 is established.

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #28 of 69

Question ID: 414582

An analyst gathered the following information about a company:

- Pretax income = \$10,000.
- Taxes payable = \$2,500.
- Deferred taxes = \$500.
- Tax expense = \$3,000.

What is the firm's reported effective tax rate?

- ☐ A) 5%.
- ☐ B) 25%.
- ☒ C) 30%.

Explanation

Reported effective tax rate = Income tax expense / pretax income

= \$3,000 / \$10,000

= 30%

References

Question From: Session 8 > Reading 30 > LOS i

Related Material:

- Key Concepts by LOS
-

Question #29 of 69

Question ID: 414551

This year, Blue Horizon has recorded \$390,000 in revenue for financial reporting purposes, but, on a cash basis, revenue was only \$262,000. Assume expenses at 50% in both cases (i.e., \$195,000 on accrual basis and \$131,000 on cash basis), and a tax rate of 34%. What is the deferred tax liability or asset? A deferred tax:

- ☐ A) liability of \$16,320.
- ☒ B) liability of \$21,760.
- ☐ C) asset of \$21,760.

Explanation

Since pretax income (\$195,000) exceeds the taxable income (\$131,000), Blue Horizon will have a deferred tax liability of \$21,760 $[(\$195,000 - \$131,000)(0.34)]$.

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS
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Question #30 of 69

Question ID: 414535

Which of the following *best* describes valuation allowance? Valuation allowance is a reserve:

- ☐ A) created when deferred tax assets are greater than deferred tax liabilities.
- ☐ B) against deferred tax liabilities based on the likelihood that those liabilities will be paid.
- ☒ C) against deferred tax assets based on the likelihood that those assets will not be realized.

Explanation

Valuation allowance is a reserve against deferred tax assets based on the likelihood that those assets will not be realized. Deferred tax assets reflect the difference in tax expense and taxes payable that are expected to be recovered from future operations.

References

Question From: Session 8 > Reading 30 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #31 of 69

Question ID: 414534

If a firm uses accelerated depreciation for tax purposes and straight-line depreciation for financial reporting, which of the following results is *least likely*?

- ☐ A) A temporary difference will result between tax and financial reporting.
- ☒ B) A permanent difference will result between tax and financial reporting.
- ☐ C) Income tax expense will be greater than taxes payable.

Explanation

A permanent difference between tax and financial reporting is a difference that is expected to not reverse itself. Under normal circumstances, the effects of the different depreciation methods will reverse.

References

Question From: Session 8 > Reading 30 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #32 of 69

Question ID: 414552

Camphor Associates uses accrual basis for financial reporting purposes and cash basis for tax purposes. Cash collections from customers is \$238,000, and accrued revenue is only \$188,000. Assume expenses at 50% in both cases (i.e., \$119,000 on cash basis and \$94,000 on accrual basis), and a tax rate of 34%. What is the deferred tax asset/liability in this case? A deferred tax:

- ☐ A) liability of \$8,500.

- ✓ **B)** asset of \$8,500.
X **C)** asset of \$48,960.

Explanation

Since taxable income (\$119,000) exceeds pretax income (\$94,000), Camphor will have a deferred tax asset of \$8,500 = $[(\$119,000 - \$94,000)(0.34)]$.

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #33 of 69

Question ID: 414565

A company purchases a new pizza oven for \$12,675. It will work for 5 years and have no salvage value. The company will depreciate the oven over 5 years using the straight-line method for financial reporting, and over 3 years for tax reporting. If the tax rate for years 4 and 5 changes from 41% to 31%, the deferred tax liability as of the end of year 3 is *closest to*:

- ✓ **A)** \$1,570
X **B)** \$2,080
X **C)** \$1,040

Explanation

At the end of year 3, the oven has a tax base of zero (it has been fully depreciated for tax reporting) and a carrying value on the balance sheet of $\$12,675 - 3(0.2)(\$12,675) = \$5,070$. The deferred tax liability, valued at the 31% tax rate that will apply when the temporary difference reverses, is $(\$5,070 - \$0)(0.31) = \$1,571.70$.

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #34 of 69

Question ID: 434308

Christophe Inc. is an electronics manufacturing firm. It owns equipment with a tax basis of \$800,000 and a carrying value of \$600,000 as the result an impairment charge. It also has a tax loss carryforward of \$300,000 that is expected to be utilized within the next year or two. The tax rate on these items is 40% but the tax rate will decrease to 35%. Which of the following is *closest to* the effect on the income statement of the change in tax rate?

- ✓ **A)** Increase income tax expense by \$25,000.
X **B)** Decrease income tax expense by \$5,000.
X **C)** Increase income tax expense by \$5,000.

Explanation

The \$200,000 difference between the tax base and the carrying value of the equipment gives rise to a deductible temporary difference that leads to a deferred tax asset (DTA) of \$80,000 ($\$200,000 \times 40\%$). The tax loss carryforward of \$300,000 also leads to a DTA but for \$120,000 ($\$300,000 \times 40\%$).

The decrease in the tax rate from 40% to 35% will reduce the DTA of the equipment by \$10,000 ($\$200,000 \times 5\%$). It will reduce the DTA of the tax loss carryforward by \$15,000 ($\$300,000 \times 5\%$). In total, the DTA will decrease by \$25,000. The decrease in the value of the DTA will increase income tax expense by \$25,000 in the period when the DTA is decreased.

References

Question From: Session 8 > Reading 30 > LOS e

Related Material:

- Key Concepts by LOS
-

Question #35 of 69

Question ID: 598978

Which of the following factors is *least likely* to cause a difference between a firm's effective tax rate and statutory rate?

- ☐ A) Tax credits.
- ☐ B) Non-deductible expenses.
- ☒ C) Deductible expenses.

Explanation

Permanent tax differences such as tax credits, non-deductible expenses, and tax differences between capital gains and operating income give rise to differences in the effective and statutory tax rates.

References

Question From: Session 8 > Reading 30 > LOS f

Related Material:

- Key Concepts by LOS
-

Question #36 of 69

Question ID: 414576

Which of the following statements *best* justifies analyst scrutiny of valuation allowances?

- ☐ A) If differences in taxable and pretax incomes are never expected to reverse, a company's equity may be understated.
- ☒ B) Changes in valuation allowances can be used to manage reported net income.
- ☐ C) Increases in valuation allowances may be a signal that management expects earnings to improve in the future.

Explanation

A valuation allowance is a contra account (offset) against deferred tax assets that reflects the likelihood that the deferred tax assets will never be realized. Changes in the valuation allowance have a direct impact on reported income. Because management has discretion with regard to the amount and timing of a valuation allowance, changes in the valuation allowance give management significant opportunity to manage earnings.

References

Question From: Session 8 > Reading 30 > LOS g

Related Material:

- Key Concepts by LOS
-

Question #37 of 69

Question ID: 434299

A temporary difference between income tax expense and taxes payable result in a(n):

- ☐ **A)** adjustment to the effective tax rate.
- ☐ **B)** gain or loss in comprehensive income.
- ☒ **C)** deferred tax item.

Explanation

Taxes payable is defined as the taxes due to the government as determined by taxable income and the tax rate, while income tax expense is the amount recognized on the income statement. A temporary difference results in a deferred tax liability if income tax expense is greater than taxes payable, or a deferred tax asset if income tax expense is less than taxes payable. A permanent difference results in an adjustment to the firm's effective tax rate. Neither results in a gain or loss.

References

Question From: Session 8 > Reading 30 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #38 of 69

Question ID: 479061

Firm 1 has a deferred tax liability and Firm 2 has a deferred tax asset. If the tax rate decreases, the balance sheet values of these deferred tax items will:

- | <u>Firm 1</u> | <u>Firm 2</u> |
|---|---------------|
| <input checked="" type="checkbox"/> A) decrease. | decrease. |
| <input type="checkbox"/> B) increase. | decrease. |
| <input type="checkbox"/> C) increase. | increase. |

Explanation

A decrease in the future tax rate decreases the balance sheet value of either a deferred tax liability or a deferred tax asset.

References

Question From: Session 8 > Reading 30 > LOS e

Related Material:

- Key Concepts by LOS

Question #39 of 69

Question ID: 414553

A firm purchased a piece of equipment for \$6,000 with the following information provided:

- Revenue will increase by \$15,000 per year.
- The equipment has a 3-year life expectancy and no salvage value.
- The firm's tax rate is 30%.
- Straight-line depreciation is used for financial reporting and double declining balance is used for tax purposes.

Calculate the incremental income tax expense for financial reporting for years 1 and 2.

	<u>Year 1</u>	<u>Year 2</u>
X A) \$3,300		\$4,100
✓ B) \$3,900		\$3,900
X C) \$600		-\$200

Explanation

Using SL:

	<u>Yr. 1</u>	<u>Yr. 2</u>
Revenue	15,000	15,000
<u>Dep.</u>	<u>2,000</u>	<u>2,000</u>
Pretax income	13,000	13,000
Tax Expense	3,900	3,900

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #40 of 69

Question ID: 702537

Which of the following financial ratios is *least likely* to be affected by classification of deferred taxes as a liability or equity?

- X A) Leverage ratio.
- X B) Return on equity (ROE).
- ✓ C) Return on assets (ROA).

Explanation

The ROA will not be affected by the classification of the deferred taxes. The total assets will remain the same regardless of whether the deferred taxes are classified as a liability or equity. Return on equity and the leverage ratio (assets/equity) would both be affected.

References

Question From: Session 8 > Reading 30 > LOS b

Related Material:

- Key Concepts by LOS
-

Question #41 of 69

Question ID: 434303

An analyst gathers the following data for Alice Company:

- Alice Company reported a pretax income of \$400,000 in its income statement for the period ended December 31, 20X2.
- Included in its pretax income are: (1) interest received on tax-free municipal bonds \$50,000 and (2) rent expense of \$20,000. Only \$10,000 was paid in cash for rent during 20X2.
- Alice follows cash basis for tax reporting.
- Alice's tax rate is 40%.

Based on the information provided, which of the following is *most* accurate with respect to deferred tax during 20X2? Alice's deferred tax:

- ☒ **A)** asset will increase by \$4,000.
- ☐ **B)** will remain unchanged.
- ☐ **C)** liability will increase by \$4,000.

Explanation

Because only \$10,000 of the rent expense will be allowed for Alice's tax reporting, a deferred tax asset of $\$10,000 \times 40\% = \$4,000$ will result.

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #42 of 69

Question ID: 414564

If a firm overestimates its warranty expenses, which of the following results is *least likely*?

- ☐ **A)** A timing difference will result between tax and financial reporting.
- ☒ **B)** Income tax expense will be greater than taxes payable.
- ☐ **C)** A deferred tax asset will result.

Explanation

Income tax expense will be less than taxes payable because the firm can only recognize warranty expense as they occur. Thus, if the warranty expenses are overestimated on the financial statements income tax expense will be less than taxes payable.

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #43 of 69

Question ID: 498761

For a company which owns a majority of the equity of a subsidiary, whether to create a deferred tax liability for undistributed profits from the subsidiary depends on an "indefinite reversal criterion" under:

- ☐ A) both IFRS and U.S. GAAP.
- ☐ B) IFRS, but not U.S. GAAP.
- ☒ C) U.S. GAAP, but not IFRS.

Explanation

Undistributed profits from a subsidiary do not require the creation of a deferred tax liability under U.S. GAAP if the subsidiary meets the indefinite reversal criterion. For IFRS, there are circumstances where a DTL is not created but the test for this treatment is not called or equivalent to the indefinite reversal criterion detailed in U.S. GAAP.

References

Question From: Session 8 > Reading 30 > LOS j

Related Material:

- Key Concepts by LOS

Question #44 of 69

Question ID: 654848

The Puchalski Company reported the following:

	<i>Year 1</i>	<i>Year 2</i>	<i>Year 3</i>	<i>Year 4</i>
Income before taxes	\$1,000	\$1,000	\$900	\$800
Taxable income	\$800	\$900	\$900	\$1,000

The differences between income before taxes and taxable income are the result of using accelerated depreciation for tax purposes on an asset purchased in Year 1. Puchalski had no deferred tax liability prior to Year 1. If the tax rate is 40%, what is the amount of the deferred tax liability reported at the end of Year 4?

- ☒ A) \$40.
- ☐ B) \$80.
- ☐ C) \$120.

Explanation

	<i>Year 1</i>	<i>Year 2</i>	<i>Year 3</i>	<i>Year 4</i>
Income tax expense	\$400	\$400	\$360	\$320
Taxes paid	\$320	\$360	\$360	\$400
Deferred tax liability	\$80	\$120	\$120	\$40

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #45 of 69

Question ID: 414570

Enduring Corp. operates in a country where net income from sales of goods are taxed at 40%, net gains from sales of investments are taxed at 20%, and net gains from sales of used equipment are exempt from tax. Installment sale revenues are taxed upon receipt.

For the year ended December 31, 2004, Enduring recorded the following before taxes were considered:

- Net income from the sale of goods was \$2,000,000, half was received in 2004 and half will be received in 2005.
- Net gains from the sale of investments were \$4,000,000, of which 25% was received in 2004 and the balance will be received in the 3 following years.
- Net gains from the sale of equipment were \$1,000,000, of which 50% was received in 2004 and 50% in 2005.

On its financial statements for the year ended December 31, 2004, Enduring should apply an effective tax rate of:

- ☐ A) 26.67% and increase its deferred tax liability by \$1,000,000.
- ☐ B) 22.86% and increase its deferred tax asset by \$1,000,000.
- ☒ C) 22.86% and increase its deferred tax liability by \$1,000,000.

Explanation

Total taxes eventually due on 2004 activities were $((\$2,000,000 \times 0.40) + (\$4,000,000 \times 0.20) =) \$1,600,000$. Permanent differences are adjusted in the effective tax rate, which is $(\$1,600,000 / \$7,000,000 =) 22.86\%$. Of the \$1,600,000 taxes due, $((\$2,000,000 \times 0.50 \times 0.40) + (\$4,000,000 \times 0.25 \times 0.20) =) \$600,000$ were paid in 2004 and \$1,000,000 $(\$1,600,000 - \$600,000)$ is added to deferred tax liability.

References

Question From: Session 8 > Reading 30 > LOS f

Related Material:

- Key Concepts by LOS
-

Question #46 of 69

Question ID: 652916

Permanent differences between taxable and pretax income:

- ☒ A) are considered as changes in the effective tax rate.
- ☐ B) are not addressed specifically in the financial statements.
- ☐ C) can be deferred in some cases.

Explanation

The permanent differences are never deferred but are considered increases or decreases in the effective tax rate. The financial statements include an effective tax rate reconciliation that addresses permanent differences between pretax and taxable income. If the only difference between the taxable and pretax incomes were a permanent difference, then tax expense would simply be taxes payable.

References

Question From: Session 8 > Reading 30 > LOS f

Related Material:

- Key Concepts by LOS

Question #47 of 69

Question ID: 414558

The Puchalski Company reported the following:

	<i>Year 1</i>	<i>Year 2</i>	<i>Year 3</i>	<i>Year 4</i>
Income before taxes	\$1,000	\$1,000	\$900	\$800
Taxable income	\$800	\$900	\$900	\$1,000

Puchalski has no deferred tax asset or liability prior to Year 1. If the tax rate is 40%, what is the amount of the deferred tax asset or liability reported at the end of Year 3?

- X **A)** Asset of \$120.
- ✓ **B)** Liability of \$120.
- X **C)** Asset of \$80.

Explanation

	<i>Year 1</i>	<i>Year 2</i>	<i>Year 3</i>
Income tax expense	\$400	\$400	\$360
Taxes paid	\$320	\$360	\$360
Deferred tax liability	\$80	\$120	\$120

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #48 of 69

Question ID: 414541

For purposes of financial analysis, an analyst should:

- X **A)** always consider deferred tax liabilities as stockholder's equity.
- X **B)** always consider deferred tax liabilities as a liability.

- ✓ **C)** determine the treatment of deferred tax liabilities on a case-by-case basis.

Explanation

For financial analysis, an analyst must decide on the appropriate treatment of deferred taxes on a case-by-case basis. These can be classified as liabilities or stockholder's equity, depending on various factors. Sometimes, deferred taxes are just ignored altogether.

References

Question From: Session 8 > Reading 30 > LOS b

Related Material:

- Key Concepts by LOS

Question #49 of 69

Question ID: 485781

A health care company purchased a new MRI machine on 1/1/X3. At year-end the company recorded straight-line depreciation expense of \$75,000 for book purposes and accelerated depreciation expense of \$94,000 for tax purposes. Management estimates warranty expense related to corrective eye surgeries performed in 20X3 to be \$250,000. Actual warranty expenses of \$100,000 were incurred in 20X3 related to surgeries performed in 20X2. The company's tax rate for the current year was 35%, but a tax rate of 37% has been enacted into law and will apply in future periods. Assuming these are the only relevant entries for deferred taxes, the company's recorded changes in deferred tax assets and liabilities on 12/31/X3 are *closest to*:

	<u>DTA</u>	<u>DTL</u>
✓ A)	\$55,500	\$7,030
X B)	\$55,500	\$6,650
X C)	\$52,500	\$6,650

Explanation

DTL = (tax depreciation - financial statement depreciation) × future tax rate
= (\$94,000 - \$75,000) × 37% = \$7,030.

DTA = (estimated warranty expense - actual warranty expense) × future tax rate
= (\$250,000 - \$100,000) × 37% = \$55,500.

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #50 of 69

Question ID: 414530

Which of the following statements is CORRECT? Income tax expense:

- X **A)** is the reported net of deferred tax assets and liabilities.
- ✓ **B)** includes taxes payable and deferred income tax expense.
- X **C)** is the amount of taxes due to the government.

Explanation

Income tax expense is defined as expense resulting from current period pretax income. It includes taxes payable and deferred income tax expense. *Taxes payable* are the amount of taxes due the government.

References

Question From: Session 8 > Reading 30 > LOS a

Related Material:

- Key Concepts by LOS

Question #51 of 69

Question ID: 434300

An analyst has gathered the following tax information:

	<i>Year 1</i>	<i>Year 2</i>
Pretax Income	\$60,000	\$60,000
Taxable Income	\$50,000	\$65,000

The current tax rate is 40%. Assume the tax rate is reduced to 30% and the change is enacted at the beginning of Year 2.

In year 1, what are the taxes payable and what is the deferred tax liability (DTL)?

	<u>Taxes payable</u>	<u>DTL</u>
X A) \$24,000		\$1,500
✓ B) \$20,000		\$3,000
X C) \$20,000		\$1,500

Explanation

Taxes payable = taxable income × current tax rate = \$50,000 × 40% = \$20,000.

Taxes payable will be based on the current tax rate of 40%.

DTL = (pretax income – taxable income) × 30%

= (\$60,000 – 50,000) × 30% = \$3,000.

Deferred tax assets and liabilities must reflect the impact of a change in tax rates or tax laws.

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #52 of 69

Question ID: 414555

Laser Tech has net temporary differences between tax and book income resulting in a deferred tax liability of \$30.6 million. According to U.S. GAAP, an increase in the tax rate would have what impact on deferred taxes and net income, respectively:

	<u>Deferred Taxes</u>	<u>Net Income</u>
--	-----------------------	-------------------

- | | |
|--|-----------|
| <input type="radio"/> A) No effect | Decrease |
| <input type="radio"/> B) Increase | No effect |
| <input checked="" type="radio"/> C) Increase | Decrease |

Explanation

If tax rates rise then deferred tax liabilities will also rise. The increase in deferred tax liabilities will increase the current tax expense, and if expenses are increasing the net income will decrease.

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS

Question #53 of 69

Question ID: 414560

An analyst gathered the following information about a company:

- Taxable income = \$100,000.
- Pretax income = \$120,000.
- Current tax rate = 20%.
- Tax rate when the reversal occurs will be 10%.

What is the company's tax expense?

- ☐ A) \$24,000.
- ☐ B) \$10,000.
- ☒ C) \$22,000.

Explanation

Deferred tax liability = $(120,000 - 100,000) \times 0.1 = 2,000$

Tax expense = current tax rate \times taxable income + deferred tax liability

$0.2 \times 100,000 + 2,000 = 22,000$

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #54 of 69

Question ID: 414542

At the end of 20X8, Martin Inc. estimates that \$26,000 of warranty repairs will be required in the future on goods already sold. For tax purposes, warranty expense is not deductible until the work is actually performed. The firm believes that the warranty work will be required over the next two years. The tax base of the warranty liability at the end of 20X8 is:

- ☐ A) \$13,000.
- ☐ B) \$26,000.
- ☒ C) zero.

Explanation

The carrying value of the warranty liability is \$26,000 (the same amount is recorded as a liability on the balance sheet and as an expense on the income statement). The tax base is equal to the carrying value less any amounts deductible in the future. Therefore, the tax base is \$0 (\$26,000 – \$26,000) since the warranty expense will be deductible when the work is performed next year.

References

Question From: Session 8 > Reading 30 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #55 of 69

Question ID: 414536

If timing differences that give rise to a deferred tax liability are not expected to reverse then the deferred tax:

- ☐ A) should be considered an asset or liability.
- ☐ B) must be reduced by a valuation allowance.
- ☒ C) should be considered an increase in equity.

Explanation

If deferred tax liabilities are expected to reverse in the future, then they should be classified as liabilities. If, however, they are not expected to reverse in the future, then they should be classified as equity.

References

Question From: Session 8 > Reading 30 > LOS b

Related Material:

- Key Concepts by LOS
-

Question #56 of 69

Question ID: 414577

Which of the following statements *best* describes the impact of a valuation allowance on the financial statements? A valuation allowance:

- ☐ A) reduces reported income, increases liabilities, and reduces equity.

- ☐ **B)** increases reported income, reduces assets, and reduces equity.
- ☒ **C)** reduces reported income, reduces assets, and reduces equity.

Explanation

A valuation allowance is a contra account (offset) against deferred tax assets that reflects the likelihood that the deferred tax assets will never be realized. The establishment of a valuation allowance reduces reported income, offsets (reduces) assets, and reduces equity.

References

Question From: Session 8 > Reading 30 > LOS g

Related Material:

- Key Concepts by LOS
-

Question #57 of 69

Question ID: 498762

Under which financial reporting standards is the full amount of a deferred tax asset shown on the balance sheet, regardless of its probability of being realized fully?

- ☐ **A)** Neither IFRS nor U.S. GAAP.
- ☐ **B)** IFRS, but not U.S. GAAP.
- ☒ **C)** U.S. GAAP, but not IFRS.

Explanation

Under U.S. GAAP, the full amount of a DTA is shown on the balance sheet, with a contra account (valuation allowance) if it is likely that the full amount of the DTA will not be realized in the future. Under IFRS, the carrying value of a DTA is reduced to its expected recoverable amount if it is likely that the full amount of the DTA will not be realized in the future.

References

Question From: Session 8 > Reading 30 > LOS j

Related Material:

- Key Concepts by LOS
-

Question #58 of 69

Question ID: 596408

When analyzing a company's financial leverage, deferred tax liabilities are *best* classified as:

- ☐ **A)** a liability.
- ☐ **B)** neither as a liability, nor as equity.
- ☒ **C)** a liability or equity, depending on the company's particular situation.

Explanation

The recommended analyst treatment of deferred tax liabilities is to treat them as liabilities if they are expected to reverse or as equity if they are not expected to reverse.

References

Question From: Session 8 > Reading 30 > LOS b

Related Material:

- Key Concepts by LOS
-

Question #59 of 69

Question ID: 414544

Alter Inc. determines that it has \$35,000 of accounts receivable outstanding at the end of 20X8. Based on past experience, it recognizes an allowance for bad debt equal to 10% of its credit sales. The tax base of Alter's accounts receivable at the end of 20X8 is *closest* to:

- ☐ A) \$31,500.
- ☒ B) \$35,000.
- ☐ C) \$3,500.

Explanation

For tax purposes, bad debt expense cannot be deducted until the receivables are deemed worthless. Therefore, the tax base is \$35,000 since no bad debt expense has been deducted on the tax return. Note that the carrying value would be \$31,500 since bad debt expense is reflected on the income statement.

References

Question From: Session 8 > Reading 30 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #60 of 69

Question ID: 722200

An analyst gathers the following data for Alice Company:

- Alice Company reported a pretax income of \$400,000 in its income statement for the period ended December 31, 20X2.
- Included in its pretax income are: (1) interest received on tax-free municipal bonds \$50,000 and (2) rent expense of \$20,000. Only \$10,000 was paid in cash for rent during 20X2.
- Alice follows cash basis for tax reporting.
- Alice's tax rate is 40%.

What is the income tax expense that Alice should report on its income statement for the year ended December 31, 20X2?

- ☒ A) \$140,000.
- ☐ B) \$132,000.
- ☐ C) \$160,000.

Explanation

The municipal bond income is not subject to tax and represents a permanent difference between pretax income for financial reporting and taxable income for tax reporting (that is, it will not result in a deferred tax item). For financial statement reporting,

the company should subtract this non-taxable income before applying the 40% tax rate:

$\$400,000 - 50,000 = \$350,000$. Income tax expense = $\$350,000 \times 40\% = \$140,000$.

The non-taxable income thus reduces the company's effective tax rate to $140,000/400,000 = 35\%$.

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #61 of 69

Question ID: 414548

A company purchased a new pizza oven directly from Italy for \$12,676. It will work for 5 years and has no salvage value. The tax rate is 41%, and annual revenues are constant at \$7,192. For financial reporting, the straight-line depreciation method is used, but for tax purposes depreciation is accelerated to 35% in years 1 and 2, and 30% in year 3. For purposes of this exercise ignore all expenses other than depreciation.

What is the net income and depreciation expense for year one for financial reporting purposes?

	<u>Net Income</u>	<u>Depreciation Expense</u>
X A)	\$2,535	\$3,169
X B)	\$4,657	\$2,748
✓ C)	\$2,748	\$2,535

Explanation

Net income in year 1 for financial reporting purposes will be $\$2,748 = [(\$7,192 - \$2,535)(1 - 0.41)]$

The annual depreciation expense on financial statements will be $\$2,535 = (\$12,676 / 5 \text{ years})$

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #62 of 69

Question ID: 414545

A firm buys an asset with an estimated useful life of five years for \$100,000 at the beginning of the year. The firm will depreciate the asset on a straight-line basis with no salvage value on its financial statements and will use double declining balance depreciation for tax. The tax basis for this asset at the end of the first year is *closest* to:

- X A) \$40,000.
- X B) \$80,000.

✓ **C)** \$60,000.

Explanation

For tax, the asset's basis is reduced by the DDB depreciation ($2/5 \times 100,000 = 40,000$) from \$100,000 to \$60,000.

References

Question From: Session 8 > Reading 30 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #63 of 69

Question ID: 414549

Kruger Associates uses an accrual basis for financial reporting purposes and cash basis for tax purposes. Cash collections from customers are \$476,000, and accrued revenue is only \$376,000. Assume expenses at 50% in both cases (i.e., \$238,000 on cash basis and \$188,000 on accrual basis), and a tax rate of 34%. What is the deferred tax asset or liability? A deferred tax:

- ☐ **A)** asset of \$48,960.
- ✓ ☒ **B)** asset of \$17,000.
- ☐ **C)** liability of \$17,000.

Explanation

Since taxable income (\$238,000) exceeds pretax income (\$188,000), Kruger will have a deferred tax asset of \$17,000 $[(\$238,000 - \$188,000)(0.34)]$.

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #64 of 69

Question ID: 722201

Which of the following statements regarding differences between taxable and pretax income is *most* accurate? Differences between taxable and pretax income that:

- ✓ ☒ **A)** result in deferred tax assets or liabilities are called temporary differences.
- ☐ **B)** are not reversed for five or more years are called permanent differences.
- ☐ **C)** increase or decrease the effective tax rate are called temporary differences.

Explanation

Temporary differences between taxable income (for tax reporting) and pretax income (for financial statement reporting) result in deferred tax assets or liabilities. Permanent differences result in a company's effective tax rate being different from the statutory tax rate. There is no time limit on temporary differences to reverse.

References

Question From: Session 8 > Reading 30 > LOS f

Related Material:

- Key Concepts by LOS
-

Question #65 of 69

Question ID: 434305

A company purchased a new pizza oven for \$12,676. It will work for 5 years and has no salvage value. The tax rate is 41%, and annual revenues are constant at \$7,192. For financial reporting, the straight-line depreciation method is used, but for tax purposes depreciation is 35% of original cost in years 1 and 2 and the remaining 30% in Year 3. For this question ignore all expenses other than depreciation.

What is the deferred tax liability as of the end of year one?

- X **A)** \$1,909.
- ✓ **B)** \$780.
- X **C)** \$1,129.

Explanation

Pretax Income = \$7,192 – \$2,535 = \$4,657

Taxable Income = \$7,192 – \$4,437 = \$2,755

Deferred Tax liability = (\$4,657 – \$2,755)(0.41) = \$780.

Alternative solution:

Difference in depreciation at the end of year one is $\$12,676 \times (0.35 - 0.20) = \$1,901$

Deferred tax liability = difference in depreciation \times tax rate = $\$1,901 \times 0.41 = \780 .

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #66 of 69

Question ID: 414537

Which of the following statements regarding deferred taxes is NOT correct?

- X **A)** Only those components of deferred tax liabilities that are likely to reverse should be considered a liability.
- X **B)** If deferred taxes are not expected to reverse in the future then they should be classified as equity.
- ✓ **C)** If deferred tax liabilities are not included in equity, debt-to-equity ratio will be reduced.

Explanation

When deferred tax liabilities are included in equity, it will reduce the debt-to-equity ratio (by increasing the denominator), in some cases considerably.

References

Question From: Session 8 > Reading 30 > LOS b

Related Material:

- Key Concepts by LOS

Question #67 of 69

Question ID: 414566

Given the following data regarding two firms under different scenarios, determine the amount of any deferred tax liability or asset.

Firm 1:

Tax Reporting		Financial Reporting	
Revenue	\$500,000	Revenue	\$500,000
Depreciation	\$100,000	Depreciation	\$50,000
Taxable income	\$400,000	Pretax income	\$450,000
Taxes payable	\$160,000	Tax expense	\$180,000
Net income	\$240,000	Net income	\$270,000

Firm 2:

Tax Reporting		Financial Reporting	
Revenue	\$500,000	Revenue	\$500,000
Warranty expense	\$0	Warranty expense	\$10,000
Taxable income	\$500,000	Pretax income	\$490,000
Taxes payable	\$200,000	Tax expense	\$196,000
Net income	\$300,000	Net income	\$294,000

Firm 1 Deferred Tax:

Firm 2 Deferred Tax:

- | | |
|-------------------------|-------------------|
| X A) \$30,000 Asset | \$6,000 Asset |
| X B) \$20,000 Asset | \$6,000 Liability |
| ✓ C) \$20,000 Liability | \$4,000 Asset |

Explanation

A deferred tax liability and asset is created when an income or expense item is treated differently on financial statements than it is on the company's tax returns.

A deferred tax liability is when that difference results in greater tax expense on the financial statements than taxes payable on the tax return.

The deferred tax liability for firm 1 = \$180,000 tax expense - \$160,000 taxes payable = \$20,000

A deferred tax asset is when that difference results in lower taxes payable on the financial statements than on the tax return.

The deferred tax asset for firm 2 = \$200,000 taxes payable - \$196,000 tax expense = \$4,000

References

Question From: Session 8 > Reading 30 > LOS d

Related Material:

- Key Concepts by LOS
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Question #68 of 69

Question ID: 414533

A tax loss carryforward is *best* described as the:

- ✓ **A)** net taxable loss that can be used to reduce taxable income in the future.
- X **B)** net taxable loss that can be used to refund paid taxes from the previous year.
- X **C)** difference of deferred tax liabilities and deferred tax assets.

Explanation

A tax loss carryforward is the net taxable loss that can be used to reduce taxable income in the future.

References

Question From: Session 8 > Reading 30 > LOS a

Related Material:

- Key Concepts by LOS
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Question #69 of 69

Question ID: 596410

Which of the following statements about deferred taxes is *most* accurate? Deferred tax liabilities:

- X **A)** should be treated as debt when calculating financial statement ratios.
- ✓ **B)** arise primarily due to differences between financial and tax accounting.
- X **C)** can relate to either permanent or temporary differences.

Explanation

Deferred tax liabilities result from temporary differences between financial accounting and tax accounting that cause income tax expense for a period to be larger than taxes due. Permanent differences do not result in deferred tax items. Whether to treat deferred tax liabilities as debt or equity depends on whether they are expected to reverse in the foreseeable future.

References

Question From: Session 8 > Reading 30 > LOS f

Related Material:

- Key Concepts by LOS