Question #1 of 63

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 assets based on the likelihood that those assets will not be realized.

C) against deferred tax liabilities based on the likelihood that those liabilities will be paid.

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.

(Study Session 8, Module 29.1, LOS 29.a)

Question #2 of 63

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

A) To report depreciation, a firm uses the double-declining balance method for tax purposes and the straight-line method for financial reporting purposes.

B) A firm has differences between taxable and pretax income that are never expected to reverse.

C) A firm is unlikely to have future taxable income that would enable it to take advantage of deferred tax assets.

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.

(Study Session 8, Module 29.5, LOS 29.g)

Question #3 of 63

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

A) is the reported net of deferred tax assets and liabilities.

B) includes taxes payable and deferred income tax expense.

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.

(Study Session 8, Module 29.1, LOS 29.a)

Question #4 of 63

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) $2,080.

B) $1,040.

C) $1,570.

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.

(Study Session 8, Module 29.4, LOS 29.d)

Question #5 of 63

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

A) arise primarily due to differences between financial and tax accounting.

B) can relate to either permanent or temporary differences.

C) should be treated as debt when calculating financial statement ratios.

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.

(Study Session 8, Module 29.5, LOS 29.f)

Question #6 of 63

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) 30%.

B) 25%.

C) 5%.

Explanation

Reported effective tax rate = Income tax expense / pretax income

= $3,000 / $10,000

= 30%

(Study Session 8, Module 29.5, LOS 29.i)

Question #7 of 63

Deferred tax items should be measured based on the:

A) firm's effective tax rate at the time when the temporary difference reverses.

B) tax rate that will apply when the temporary difference reverses.

C) statutory tax rate at the time when the temporary difference is recognized.

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.

(Study Session 8, Module 29.5, LOS 29.h)

Question #8 of 63

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?

A) $2,948.

B) $1,039.

C) $3,144.

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.

(Study Session 8, Module 29.4, LOS 29.d)

Question #9 of 63

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) U.S. GAAP, but not IFRS.

B) Neither IFRS nor U.S. GAAP.

C) IFRS, but not U.S. GAAP.

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 reported value of a DTA is reduced if there is a positive probability that the full amount of the DTA will not be realized in the future.

(Study Session 8, Module 29.5, LOS 29.j)

Question #10 of 63

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.

B) Increase income tax expense by $5,000.

C) Decrease 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 × 40%). The tax loss carryforward of $300,000 also leads to a DTA but for $120,000 ($300,000 × 40%).

The decrease in the tax rate from 40% to 35% will reduce the DTA of the equipment by $10,000 ($200,000 × 5%). It will reduce the DTA of the tax loss carryforward by $15,000 ($300,000 × 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.

(Study Session 8, Module 29.4, LOS 29.e)

Question #11 of 63

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*:

	DTA	DTL
A)	$55,500	$6,650
B)	$55,500	$7,030
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.

(Study Session 8, Module 29.4, LOS 29.d)

Question #12 of 63

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) Income tax expense will be greater than taxes payable.

B) A temporary difference will result between tax and financial reporting.

C) A permanent difference will result between tax and financial reporting.

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.

(Study Session 8, Module 29.1, LOS 29.a)

Question #13 of 63

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.

	Year 1	Year 2
A)	$3,900	$3,900
B)	$600	-$200
C)	$3,300	$4,100

Explanation

Using SL:

	Yr. 1	*Yr. 2*
Revenue	15,000	15,000
Dep.	2,000	2,000
Pretax income	13,000	13,000
Tax Expense	3,900	3,900

(Study Session 8, Module 29.3, LOS 29.d)

Question #14 of 63

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 increase in equity.

B) should be considered an asset or liability.

C) must be reduced by a valuation allowance.

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.

(Study Session 8, Module 29.2, LOS 29.b)

Question #15 of 63

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.

	Year 1	Year 2
A)	600	-200
B)	3,300	4,100
C)	3,900	3,900

Explanation

Using DDB:

	Yr. 1	*Yr. 2*
Revenue	15,000	15,000
Depreciation	4,000	1,333
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

(Study Session 8, Module 29.5, LOS 29.i)

Question #16 of 63

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

A) Return on assets (ROA).

B) Leverage ratio.

C) Return on equity (ROE).

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.

(Study Session 8, Module 29.2, LOS 29.b)

Question #17 of 63

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:

	Deferred Taxes	Net Income
A)	Increase	No effect
B)	No effect	Decrease
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.

(Study Session 8, Module 29.4, LOS 29.d)

Question #18 of 63

An analyst has gathered the following tax information:

	Year 1	Year 2
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)?

	Taxes payable	DTL
A)	\$20,000	\$3,000
B)	\$20,000	\$1,500
C)	\$24,000	\$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.

(Study Session 8, Module 29.4, LOS 29.d)

Question #19 of 63

Permanent differences between taxable and pretax income:

A) are not addressed specifically in the financial statements.

B) can be deferred in some cases.

C) are considered as changes in the effective tax rate.

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.

(Study Session 8, Module 29.5, LOS 29.f)

Question #20 of 63

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

A) reduces reported income, reduces assets, and reduces equity.

B) reduces reported income, increases liabilities, and reduces equity.

C) increases 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.

(Study Session 8, Module 29.5, LOS 29.g)

Question #21 of 63

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.

B) sporadic in nature, but the effect is typically neutralized by higher home country taxes on the repatriated profits.

C) continuous in nature, so the termination date is not relevant.

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.

(Study Session 8, Module 29.5, LOS 29.i)

Question #22 of 63

The Puchalski Company reported the following:

	Year 1	*Year 2*	*Year 3*	*Year 4*
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) $80.

B) $40.

C) $120.

Explanation

	Year 1	*Year 2*	*Year 3*	*Year 4*
Income tax expense	$400	$400	$360	$320
Taxes paid	$320	$360	$360	$400
Deferred tax liability	$80	$120	$120	$40

(Study Session 8, Module 29.3, LOS 29.d)

Question #23 of 63

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

A) an addition to equity.

B) liability.

C) immaterial amount and ignored.

Explanation

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

(Study Session 8, Module 29.2, LOS 29.b)

Question #24 of 63

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?

	Net Income	Depreciation Expense
A)	$4,657	$2,748
B)	$2,748	$2,535
C)	$2,535	$3,169

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 years)

(Study Session 8, Module 29.3, LOS 29.d)

Question #25 of 63

An analyst gathered the following information about a company:

- Taxable income = $100,000.
- Pretax income = $120,000.
- Current tax rate = 20%.

Assuming the difference between taxable income and pretax income will reverse in the future, the effect these events on the company's financial statements will be to report income tax expense of:

A) $22,000 with no change in deferred tax items.

B) $24,000 and an addition to deferred tax liabilities of $4,000.

C) $24,000 and a decrease in deferred tax assets of $4,000.

Explanation

Deferred tax liability = (120,000 − 100,000) × 0.2 = 4,000

Tax expense = current tax rate × taxable income + change in deferred tax liability

0.2 × 100,000 + 4,000 = 24,000

(Study Session 8, Module 29.3, LOS 29.d)

Question #26 of 63

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 × 0.40) + ($4,000,000 × 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 × 0.50 × 0.40) + ($4,000,000 × 0.25 × 0.20) =) $600,000 were paid in 2004 and $1,000,000 ($1,600,000 − $600,000) is added to deferred tax liability.

(Study Session 8, Module 29.5, LOS 29.f)

Question #27 of 63

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) $3,500.

C) $35,000.

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.

(Study Session 8, Module 29.2, LOS 29.c)

Question #28 of 63

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

A) either current or noncurrent items.

B) current 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.

(Study Session 8, Module 29.5, LOS 29.j)

Question #29 of 63

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) a decrease in deferred tax liability and an increase in tax expense.

C) an increase 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.

(Study Session 8, Module 29.4, LOS 29.d)

Question #30 of 63

The Puchalski Company reported the following:

	Year 1	*Year 2*	*Year 3*	*Year 4*
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?

A) Asset of $120.

B) Liability of $120.

C) Asset of $80.

Explanation

	Year 1	*Year 2*	*Year 3*
Income tax expense	$400	$400	$360
Taxes paid	$320	$360	$360
Deferred tax liability	$80	$120	$120

(Study Session 8, Module 29.3, LOS 29.d)

Question #31 of 63

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

A) a liability.

B) a liability or equity, depending on the company's particular situation.

C) neither as a liability, nor as equity.

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.

(Study Session 8, Module 29.2, LOS 29.b)

Question #32 of 63

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

A) deferred tax item.

B) gain or loss in comprehensive income.

C) adjustment to the effective tax rate.

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.

(Study Session 8, Module 29.1, LOS 29.a)

Question #33 of 63

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) both IFRS and U.S. GAAP.

C) IFRS only.

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.

(Study Session 8, Module 29.5, LOS 29.j)

Question #34 of 63

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) asset of $48,960.

B) liability of $8,500.

C) asset of $8,500.

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)].

(Study Session 8, Module 29.3, LOS 29.d)

Question #35 of 63

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?

A) $780.

B) $1,129.

C) $1,909.

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 × (0.35 − 0.20) = $1,901

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

(Study Session 8, Module 29.3, LOS 29.d)

Question #36 of 63

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?

	Year 1	Year 2
A)	$600	$400
B)	$3,300	$4,100
C)	$3,900	$3,900

Explanation

Using DDB:

	Yr. 1	*Yr. 2*
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 + previously deferred taxes = -200 + 600 = 400

(Study Session 8, Module 29.3, LOS 29.d)

Question #37 of 63

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

A) A deferred tax liability is expected to result in future cash outflow.

B) Taxes payable are determined by pretax income and the tax rate.

C) Income tax paid can include payments or refunds for other years.

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.

(Study Session 8, Module 29.1, LOS 29.a)

Question #38 of 63

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

Assume an income tax rate of 40%.

The company's income tax expense for 2002 is:

A) \$50.

B) \$0.

C) \$60.

Explanation

Effective tax rate = Income tax expense / pretax income

Income tax expense = Effective tax rate × pretax income

= $150(0.40)

= $60

(Study Session 8, Module 29.5, LOS 29.i)

Question #39 of 63

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

A) increase or decrease the effective tax rate are called temporary differences.

B) result in deferred tax assets or liabilities are called temporary differences.

C) are not reversed for five or more years are called permanent 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.

(Study Session 8, Module 29.5, LOS 29.f)

Question #40 of 63

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?

A) A deferred tax asset of $32,000.

B) A deferred tax liability of $32,000.

C) There is no effect on deferred tax items from this transaction.

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.

(Study Session 8, Module 29.2, LOS 29.c)

Question #41 of 63

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) $16,000.

B) $8,000.

C) $4,000.

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.

(Study Session 8, Module 29.4, LOS 29.d)

Question #42 of 63

For purposes of financial analysis, an analyst should:

A) always consider deferred tax liabilities as stockholder's equity.

B) determine the treatment of deferred tax liabilities on a case-by-case basis.

C) always consider deferred tax liabilities as a liability.

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.

(Study Session 8, Module 29.2, LOS 29.b)

Question #43 of 63

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?

A) $1,909.

B) $1,130.

C) $779.

Explanation

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

(Study Session 8, Module 29.3, LOS 29.d)

Question #44 of 63

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) decrease income tax expense.

C) increase 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.

(Study Session 8, Module 29.4, LOS 29.e)

Question #45 of 63

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) asset of $21,760.

C) liability 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)].

(Study Session 8, Module 29.3, LOS 29.d)

Question #46 of 63

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?

A) $2,079.

B) $1,029.

C) $780.

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 × (1.00 − 0.60) = $5,070.

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

(Study Session 8, Module 29.3, LOS 29.d)

Question #47 of 63

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.

(Study Session 8, Module 29.5, LOS 29.j)

Question #48 of 63

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

A) Only those components of deferred tax liabilities that are likely to reverse should be considered a liability.

B) If deferred tax liabilities are not included in equity, debt-to-equity ratio will be reduced.

C) If deferred taxes are not expected to reverse in the future then they should be classified as equity.

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.

(Study Session 8, Module 29.2, LOS 29.b)

Question #49 of 63

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?

A) $36,000

B) $25,200

C) $10,800

Explanation

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

(Study Session 8, Module 29.3, LOS 29.d)

Question #50 of 63

Deferred tax liabilities may result from:

A) pretax income less than taxable income due to temporary differences.

B) pretax income greater than taxable income due to permanent differences.

C) pretax income greater 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.

(Study Session 8, Module 29.5, LOS 29.f)

Question #51 of 63

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) liability of $17,000.

C) asset 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)].

(Study Session 8, Module 29.3, LOS 29.d)

Question #52 of 63

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

A) Current deferred tax liability, current deferred tax asset, noncurrent deferred tax liability and noncurrent deferred tax asset are each disclosed separately.

B) There should be a combined disclosure of all deferred tax assets and liablities.

C) Current deferred tax liability and noncurrent deferred tax asset are netted, resulting in the disclosure of a net noncurrent deferred tax liability or asset.

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.

(Study Session 8, Module 29.5, LOS 29.i)

Question #53 of 63

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) Increases in valuation allowances may be a signal that management expects earnings to improve in the future.

C) Changes in valuation allowances can be used to manage reported net income.

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.

(Study Session 8, Module 29.5, LOS 29.g)

Question #54 of 63

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

A) difference of deferred tax liabilities and deferred tax assets.

B) net taxable loss that can be used to reduce taxable income in the future.

C) net taxable loss that can be used to refund paid taxes from the previous year.

Explanation

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

(Study Session 8, Module 29.1, LOS 29.a)

Question #55 of 63

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
A)	$20,000 Asset	$6,000 Liability
B)	$20,000 Liability	$4,000 Asset
C)	$30,000 Asset	$6,000 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

(Study Session 8, Module 29.3, LOS 29.d)

Question #56 of 63

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:

A) increase by $15,000.

B) decrease by $50,000.

C) decrease by $15,000.

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 × 30% = $15,000

(Study Session 8, Module 29.3, LOS 29.d)

Question #57 of 63

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.

(Study Session 8, Module 29.2, LOS 29.c)

Question #58 of 63

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 based on a tax rate of 30%. Based only on this information, an increase in future tax rates to 35% will cause Habel's total liabilities-to-equity ratio to:

A) increase.

B) remain unchanged.

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 $200,000 × 30% = $60,000. The tax loss carryforward of $200,000 leads to a deferred tax asset of $200,000 × 30% = $60,000.

Because these amounts are equal, the increase in the tax rate will increase the associated DTA and DTL by the same amounts, leaving equity unchanged. Therefore, the total liabilities-to-equity ratio will increase because of the increase in the deferred tax liability.

(Study Session 8, Module 29.4, LOS 29.e)

Question #59 of 63

Year ending 31 December:	*2002*	*2003*	*2004*
Income Statement:			
Revenues after all expenses other than depreciation	$200	$300	$400
Depreciation expense	50	50	50
Income before income taxes	$150	$250	$350
Tax return:			
Taxable income before depreciation expense	$200	$300	$400
Depreciation expense	75	50	25
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:

	2003	2004
A)	$10	$0

B)	$0	$10	✗
C)	$25	$20	✗

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) × tax rate + DTL from previous year

- DTL for 2002: (75 – 50) × 0.4 + 0 = 10
- DTL for 2003: (50 – 50) × 0.4 + 10 = 10
- DTL for 2004: (25 – 50) × 0.4 + 10 = 0

(Study Session 8, Module 29.3, LOS 29.d)

Question #60 of 63

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:

A) liability of $10,880. ✓

B) asset of $10,880. ✗

C) liability of $16,320. ✗

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)]

(Study Session 8, Module 29.3, LOS 29.d)

Question #61 of 63

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 base for this asset at the end of the first year is *closest* to:

A) $60,000. ✓

B) $80,000. ✗

C) $40,000. ✗

Explanation

The asset's tax base is reduced by the DDB depreciation (2/5 × 100,000 = 40,000) from $100,000 to $60,000.

(Study Session 8, Module 29.2, LOS 29.c)

Question #62 of 63

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:

	Firm 1	Firm 2
A)	increase.	decrease.
B)	increase.	increase.
C)	decrease.	decrease.

Explanation

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

(Study Session 8, Module 29.4, LOS 29.e)

Question #63 of 63

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

A) Non-deductible expenses.

B) Tax credits.

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.

(Study Session 8, Module 29.5, LOS 29.f)