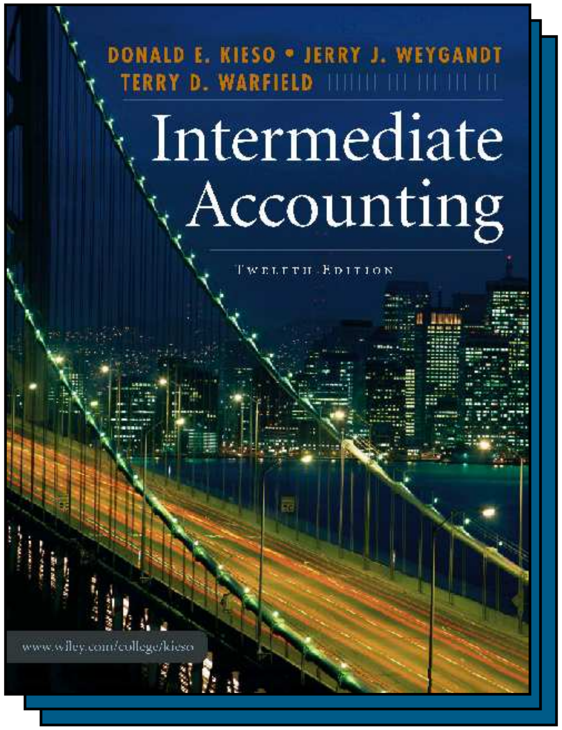
Accounting and Reporting Income Taxes

Chapter 19

Intermediate Accounting
12th Edition
Kieso, Weygandt, and Warfield



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Learning Objectives

1. Identify differences between pretax financial income and taxable income.
2. Describe a temporary difference that results in future taxable amounts.
3. Describe a temporary difference that results in future deductible amounts.
4. Explain the purpose of a deferred tax asset valuation allowance.
5. Describe the presentation of income tax expense in the income statement.
6. Describe various temporary and permanent differences.
7. Explain the effect of various tax rates and tax rate changes on deferred income taxes.
8. Apply accounting procedures for a loss carryback and a loss carryforward.
9. Describe the presentation of deferred income taxes in financial statements.
10. Indicate the basic principles of the asset-liability method.

Accounting for Income Taxes

Fundamentals of Accounting for Income Taxes

- Future taxable amounts and deferred taxes
- Future deductible amounts and deferred taxes
- Income statement presentation
- Specific differences
- Rate considerations

Accounting for Net Operating Losses

- Loss carryback
- Loss carryforward
- Loss carryback example
- Loss carryforward example

Financial Statement Presentation

- Balance sheet
- Income statement

Review of Asset-Liability Method

Fundamentals of Accounting for Income Taxes

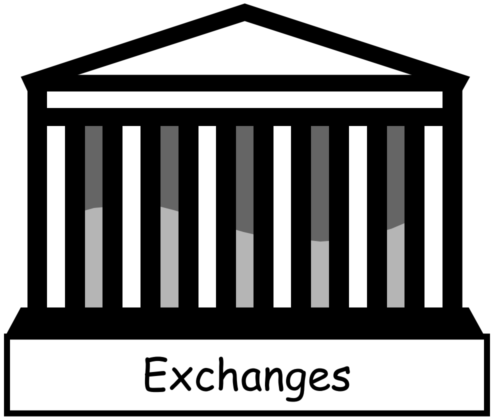
Corporations must file income tax returns following the guidelines developed by the Internal Revenue Service (IRS), thus they:

- calculate taxes payable based upon IRS code,
- calculate income tax expense based upon GAAP.

Amount reported as tax expense will often differ from the amount of taxes payable to the IRS.

LO 1 Identify differences between pretax financial income and taxable income.

Fundamentals of Accounting for Income Taxes

Financial Statements		Tax Return
	vs.	
Investors and Creditors		
Pretax Financial Income	≠	Taxable Income
GAAP		Tax Code
Income Tax Expense	≠	Income Tax Payable

LO 1 Identify differences between pretax financial income and taxable income.

Fundamentals of Accounting for Income Taxes

Illustration Assume the company reports revenue in 2007, 2008, and 2009 of $130,000, respectively. The revenue is reported the same for both GAAP and tax purposes. For simplification, assume the company reports one expense, depreciation, over the three years applying the straight-line method for financial reporting purposes (GAAP) and MACRS (IRS) for the tax return. What is the effect on the accounts of using the two different depreciation methods?

Book vs. Tax Difference

GAAP Reporting	2007	2008	2009	Total
Revenues	$130,000	$130,000	$130,000	$390,000
Expenses (S/L depreciation)	30,000	30,000	30,000	90,000
Pretax financial income	$100,000	$100,000	$100,000	$300,000
Income tax expense (40%)	$40,000	$40,000	$40,000	$120,000

Tax Reporting	2007	2008	2009	Total
Revenues	$130,000	$130,000	$130,000	$390,000
Expenses (MACRS depreciation)	40,000	30,000	20,000	90,000
Pretax financial income	$90,000	$100,000	$110,000	$300,000
Income tax payable (40%)	$36,000	$40,000	$44,000	$120,000

LO 1 Identify differences between pretax financial income and taxable income.

Book vs. Tax Difference

Comparison	2007	2008	2009	Total
Income tax expense (GAAP)	$40,000	$40,000	$40,000	$120,000
Income tax payable (IRS)	36,000	40,000	44,000	120,000
Difference	$4,000	$0	$(4,000)	$0

Are the differences accounted for in the financial statements? **Yes**

Year	Reporting Requirement
2007	**Deferred tax liability account increased to $4,000**
2008	**No change in deferred tax liability account**
2009	**Deferred tax liability account reduced by $4,000**

LO 1 Identify differences between pretax financial income and taxable income.

Financial Reporting for 2007

Balance Sheet	2007
Assets:	
Liabilities:	
Deferred taxes	**4,000**
Income tax payable	**36,000**
Equity:	

Income Statement	2007
Revenues:	
Expenses:	
Income tax expense	**40,000**
Net income (loss)	

Where does the "deferred tax liability" get reported in the financial statements?

LO 1 Identify differences between pretax financial income and taxable income.

Temporary Differences

A **Temporary Difference** is the difference between the tax basis of an asset or liability and its reported (carrying or book) amount in the financial statements that will result in taxable amounts or deductible amounts in future years.

Future Taxable Amounts

Deferred Tax Liability represents the increase in taxes payable in future years as a result of taxable temporary differences existing at the end of the current year.

Future Deductible Amounts

Deferred Tax Asset represents the increase in taxes refundable (or saved) in future years as a result of deductible temporary differences existing at the end of the current year.

Illustration 19-22 Examples of Temporary Differences

LO 2 Describe a temporary difference that results in future taxable amounts.

Future Taxable Amounts and Deferred Taxes

E19-1 South Carolina Corporation has one temporary difference at the end of 2007 that will reverse and cause taxable amounts of $55,000 in 2008, $60,000 in 2009, and $65,000 in 2010. South Carolina's pretax financial income for 2007 is $300,000, and the tax rate is 30% for all years. There are no deferred taxes at the beginning of 2007.

Instructions

a) Compute taxable income and income taxes payable for 2007.

b) Prepare the journal entry to record income tax expense, deferred income taxes, and income taxes payable for 2007.

LO 2 Describe a temporary difference that results in future taxable amounts.

Future Taxable Amounts and Deferred Taxes

Ex. 19-1

INCOME:		Current Yr. 2007	2008	2009	2010
Financial income (GAAP)		300,000			
Temporary Diff.		(180,000)	55,000	60,000	65,000
Taxable income (IRS)	a.	120,000	55,000	60,000	65,000
Tax rate		30%	30%	30%	30%
Income tax	a.	36,000	16,500	18,000	19,500

b. Income tax expense (plug)	90,000	
Income tax payable		36,000
Deferred tax liability		54,000

LO 2 Describe a temporary difference that results in future taxable amounts.

Future Deductible Amounts and Deferred Taxes

Illustration Columbia Corporation has one temporary difference at the end of 2007 that will reverse and cause deductible amounts of $50,000 in 2008, $65,000 in 2009, and $40,000 in 2010. Columbia's pretax financial income for 2007 is $200,000 and the tax rate is 34% for all years. There are no deferred taxes at the beginning of 2007. Columbia expects to be profitable in the future.

Instructions

a) Compute taxable income and income taxes payable for 2007.

b) Prepare the journal entry to record income tax expense, deferred income taxes, and income taxes payable for 2007.

LO 3 Describe a temporary difference that results in future deductible amounts.

Future Deductible Amounts and Deferred Taxes

Illustration

INCOME:		Current Yr. 2007	2008	2009	2010
Financial income (GAAP)		200,000			
Temporary Diff.		155,000	(50,000)	(65,000)	(40,000)
Taxable income (IRS)	a.	355,000	(50,000)	(65,000)	(40,000)
Tax rate		34%	34%	34%	34%
Income tax	a.	120,700	(17,000)	(22,100)	(13,600)

b. Income tax expense	68,000	
Income tax payable		120,700
Deferred tax asset	52,700	

LO 3 Describe a temporary difference that results in future deductible amounts.

Future Deductible Amounts and Deferred Taxes

Deferred Tax Asset—Valuation Allowance

A company should reduce a deferred tax asset by a **valuation allowance** if **it is more likely than not** that it will not realize some portion or all of the deferred tax asset.

"More likely than not" means a level of likelihood of at least slightly more than 50 percent.

LO 4 Explain the purpose of a deferred tax asset valuation allowance.

Future Deductible Amounts and Deferred Taxes

E19-14 Jennifer Capriati Corp. has a deferred tax asset balance of $150,000 at the end of 2006 due to a single cumulative temporary difference of $375,000. At the end of 2007 this same temporary difference has increased to a cumulative amount of $450,000. Taxable income for 2007 is $820,000. The tax rate is 40% for all years. No valuation account is in existence at the end of 2006.

Instructions

Assuming that it is more likely than not that $30,000 of the deferred tax asset will not be realized, prepare the journal entries required for 2007.

LO 4 Explain the purpose of a deferred tax asset valuation allowance.

Future Deductible Amounts and Deferred Taxes

E19-14

INCOME:	2006	Current Yr. 2007	2008	
Financial income (GAAP)		745,000		
Temporary difference	375,000	75,000	(450,000)	
Taxable income (IRS)	375,000	820,000	(450,000)	-
Tax rate	40%	40%	40%	40%
Income tax	150,000	328,000	(180,000)	-

Income tax expense	298,000	
Income tax payable		328,000
Deferred tax asset	30,000	
Income tax expense	30,000	
Allowance for deferred tax asset		30,000

LO 4 Explain the purpose of a deferred tax asset valuation allowance.

Future Deductible Amounts and Deferred Taxes

Deferred Tax Asset—Valuation Allowance

E19-14 Balance Sheet Presentation

Assets:	2007
Deferred tax asset	$ 180,000
Allowance for deferred tax	(30,000)
Deferred tax asset, net	150,000

LO 4 Explain the purpose of a deferred tax asset valuation allowance.

Income Statement Presentation

Illustration 19-20

Formula to Compute Income Tax Expense

Income tax payable or refundable	±	Change in deferred income tax	=	**Income tax expense** or **benefit**

In the income statement or in the notes to the financial statements, a company should disclose the significant components of income tax expense (current and deferred).

LO 5 Describe the presentation of income tax expense in the income statement.

Specific Differences

Temporary Differences

- **Taxable temporary differences** - Deferred tax liability
- **Deductible temporary differences** - Deferred tax Asset

Text Illustration 19-22 Examples of Temporary Differences

Specific Differences

Permanent differences are caused by items that (1) enter into pretax financial income but never into taxable income or (2) enter into taxable income but never into pretax financial income.

Permanent differences affect only the period in which they occur, they do not give rise to future taxable or deductible amounts.

There are no deferred tax consequences to be recognized.

Text Illustration 19-24 Examples of Permanent Differences

Specific Differences

Do the following generate:

- Future Deductible Amount = Deferred Tax Asset
- Future Taxable Amount = Deferred Tax Liability
- A Permanent Difference

1. The MACRS depreciation system is used for tax purposes, and the straight-line depreciation method is used for financial reporting purposes.	Future Taxable Amount
2. A landlord collects some rents in advance. Rents received are taxable in the period when they are received.	Future Deductible Amount
3. Expenses are incurred in obtaining tax-exempt income.	Permanent Difference
4. Costs of guarantees and warranties are estimated and accrued for financial reporting purposes.	Future Deductible Amount

LO 6 Describe various temporary and permanent differences.

Specific Differences

Do the following generate:

- Future Deductible Amount = Deferred Tax Asset
- Future Taxable Amount = Deferred Tax Liability
- A Permanent Difference

5. Sales of investments are accounted for by the accrual method for financial reporting purposes and the installment method for tax purposes.

Future Taxable Amount

6. Proceeds are received from a life insurance company because of the death of a key officer (the company carries a policy on key officers).

A Permanent Difference

7. Estimated losses on pending lawsuits and claims are accrued for books. These losses are tax deductible in the period(s) when the related liabilities are settled..

Future Deductible Amount

Permanent Differences

E19-4 Zurich Company reports pretax financial income of $70,000 for 2007. The following items cause taxable income to be different than pretax financial income. (1) Depreciation on the tax return is greater than depreciation on the income statement by $16,000. (2) Rent collected on the tax return is greater than rent earned on the income statement by $22,000. (3) Fines for pollution appear as an expense of $11,000 on the income statement.

Zurich's tax rate is 30% for all years, and the company expects to report taxable income in all future years. There are no deferred taxes at the beginning of 2007.

Instructions Prepare the journal entry to record income tax expense, deferred income taxes, and income taxes payable for 2007.

LO 6 Describe various temporary and permanent differences.

Permanent Differences

E19-4 INCOME:	Current Yr. 2007	Deferred Asset	Deferred Liability	
Financial income (GAAP)	$ 70,000			
Excess tax depreciation	(16,000)		$ 16,000	
Excess rent collected	22,000	$ (22,000)		
Fines (permanent)	11,000			
Taxable income (IRS)	87,000	(22,000)	16,000	-
Tax rate	30%	30%	30%	
Income tax	$ 26,100	$ (6,600)	$ 4,800	-

Income tax expense	24,300	
Deferred tax asset	6,600	
Deferred tax liability		4,800
Income tax payable		26,100

LO 6 Describe various temporary and permanent differences.

Specific Differences

Tax Rate Considerations

A company must consider presently enacted changes in the tax rate that become effective for a particular future year(s) when determining the tax rate to apply to existing temporary differences.

Revision of Future Tax Rates

When a change in the tax rate is enacted, companies should record its effect on the existing deferred income tax accounts immediately.

LO 7 Explain the effect of various tax rates and tax rate changes on deferred income taxes.

Accounting for Net Operating Losses

Net operating loss (NOL) = tax-deductible expenses exceed taxable revenues.

The federal tax laws permit taxpayers to use the losses of one year to offset the profits of other years (**carryback** and **carryforward**).

LO 8 Apply accounting procedures for a loss carryback and a loss carryforward.

Accounting for Net Operating Losses

Loss Carryback

- Back 2 years and forward 20 years
- Losses must be applied to earliest year first

Loss Carryforward

- May elect to forgo loss carryback and
- Carryforward losses 20 years

LO 8 Apply accounting procedures for a loss carryback and a loss carryforward.

Accounting for Net Operating Losses

BE19-12 (Carryback) Valis Corporation had the following tax information.

Year	Taxable Income	Tax Rate	Taxes Paid
2004	$ 300,000	35%	$ 105,000
2005	325,000	30%	97,500
2006	400,000	30%	120,000

In 2007 Valis suffered a net operating loss of $450,000, which it elected to carry back. The 2007 enacted tax rate is 29%. Prepare Valis's entry to record the effect of the loss carryback.

LO 8 Apply accounting procedures for a loss carryback and a loss carryforward.

Accounting for Net Operating Losses

BE19-12	2004	2005	2006	2007
Financial income	$ 300,000	$ 325,000	$ 400,000	
Difference				
Taxable income (loss)	300,000	325,000	400,000	(450,000)
Rate	35%	30%	30%	29%
Income tax	$ 105,000	$ 97,500	$ 120,000	

NOL Schedule				
Taxable income	$ 300,000	$ 325,000	$ 400,000	(450,000)
Carryback from 2007		(325,000)	(125,000)	450,000
Taxable income	300,000	-	275,000	-
Rate	35%	30%	30%	29%
Income tax (revised)	$ 105,000	$ -	$ 82,500	-
Refund		$ 97,500	$ 37,500	$135,000

LO 8 Apply accounting procedures for a loss carryback and a loss carryforward.

Accounting for Net Operating Losses

E19-12 Journal Entry for 2007

Income tax refund receivable	135,000	
Benefit due to loss carryback		135,000

LO 8 Apply accounting procedures for a loss carryback and a loss carryforward.

Accounting for Net Operating Losses

BE19-13 (Carryback and Carryforward) Zoop Inc. incurred a net operating loss of $500,000 in 2007. Combined income for 2005 and 2006 was $400,000. The tax rate for all years is 40%. Zoop elects the carryback option. Prepare the journal entries to record the benefits of the loss carryback and the loss carryforward.

LO 8 Apply accounting procedures for a loss carryback and a loss carryforward.

Accounting for Net Operating Losses

BE19-13	2005	2006	2007	2008
Financial income	$ 200,000	$ 200,000		
Difference				
Taxable income (loss)	200,000	200,000	(500,000)	
Rate	40%	40%	40%	
Income tax	$ 80,000	$ 80,000		

NOL Schedule				
Taxable income	$ 200,000	$ 200,000	(500,000)	
Carryback from 2007	(200,000)	(200,000)	400,000	
Taxable income	-	-	(100,000)	
Rate	40%	40%	40%	
Income tax (revised)	$ -	$ -	(40,000)	
Refund	$ 80,000	$ 80,000		

$\underbrace{\$80{,}000 + \$80{,}000}_{\$160{,}000}$

$160,000

Deferred Tax Asset

LO 8 Apply accounting procedures for a loss carryback and a loss carryforward.

Accounting for Net Operating Losses

E19-13 Journal Entries for 2007

Income tax refund receivable	160,000	
Benefit due to loss carryback		160,000
Deferred tax asset	40,000	
Benefit due to loss carryforward		40,000

LO 8 Apply accounting procedures for a loss carryback and a loss carryforward.

Accounting for Net Operating Losses

BE19-14 (Carryback and Carryforward with Valuation Allowance) Use the information for Zoop Inc. given in BE19-13. Assume that it is more likely than not that the entire net operating loss carryforward will not be realized in future years. Prepare all the journal entries necessary at the end of 2007.

LO 8 Apply accounting procedures for a loss carryback and a loss carryforward.

Accounting for Net Operating Losses

E19-14 Journal Entries for 2007

Income tax refund receivable	160,000	
Benefit due to loss carryback		160,000
Deferred tax asset	40,000	
Benefit due to loss carryforward		40,000
Benefit due to loss carryforward	40,000	
Allowance for deferred tax asset		40,000

LO 8 Apply accounting procedures for a loss carryback and a loss carryforward.

Valuation Allowance Revisited

Whether the company will realize a deferred tax asset depends on whether sufficient taxable income exists or will exist within the carryforward period.

Text Illustration 19-37 Possible Sources of Taxable Income

If any one of these sources is sufficient to support a conclusion that a valuation allowance is unnecessary, a company need not consider other sources.

Text Illustration 19-38 Evidence to Consider in Evaluating the need for a Valuation Account

LO 8 Apply accounting procedures for a loss carryback and a loss carryforward.

Financial Statement Presentation

Balance Sheet Presentation

An individual deferred tax liability or asset is classified as current or noncurrent based on the classification of the related asset or liability for financial reporting purposes.

Companies should classify deferred tax accounts on the balance sheet in two categories:

- one for the **net current amount**, and
- one for the **net noncurrent amount**.

LO 9 Describe the presentation of deferred income taxes in financial statements.

Financial Statement Presentation

Income Statement Presentation

Companies should allocate income tax expense (or benefit) to continuing operations, discontinued operations, extraordinary items, and prior period adjustments.

Companies should disclose the significant components of income tax expense attributable to continuing operations (current tax expense, deferred tax expense, etc.).

LO 9 Describe the presentation of deferred income taxes in financial statements.

Review of the Asset-Liability Method

Companies apply the following basic principles:

(1) Recognize a current tax liability or asset for the estimated taxes payable or refundable.

(2) Recognize a deferred tax liability or asset for the estimated future tax effects attributable to temporary differences and carryforwards using enacted tax rate.

(3) Base the measurement of current and deferred taxes on provisions of the enacted tax law.

(4) Reduce the measurement of deferred tax assets, if necessary, by the amount of any tax benefits that, companies do not expect to realize.

LO 10 Indicate the basic principles of the asset-liability method.

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