

Reading 37**ANALYSIS OF INCOME TAXES**

1. (C) Taxes payable are determined by pretax income and the tax rate.

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.

(Module 37.1, LOS 37.a)

2. (A) 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.

(Module 37.1, LOS 37.a)

3. (A) net taxable loss that can be used to reduce taxable income in the future.

Explanation

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

(Module 37.1, LOS 37.a)

4. (B) income tax expense from the income statement.

Explanation

Effective tax rate = income tax expense / pretax income.

(Module 37.3, LOS 37.c)

5. (A) deferred tax asset.

Explanation

A tax loss carry forward can offset future taxable income, thereby reducing taxes payable. This will be recorded as a deferred tax asset to the extent that the firm expects this to reverse in the future.

(Module 37.1, LOS 37.a)

6. (A) cash tax rate.

Explanation

Cash tax rate = cash taxes paid / pretax income.

(Module 37.3, LOS 37.c)

7. (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.

(Module 37.2, LOS 37.b)

8. (A) Effective tax rate.**Explanation**

Statutory tax rate = enacted rate of 30%. Effective tax rate = income tax expense / pretax income = \$47,000 / \$150,000 = 31.3%. Cash tax rate = tax paid (cash) / pretax income = \$44,000 / \$150,000 = 29.3%. In this case, the highest rate was the effective tax rate.

(Module 37.3, LOS 37.c)

9. (B) €1,400.**Explanation**

DTL = (carrying value – tax base) × statutory rate

Year 2 DTL = (€7,000 – €2,333) × 0.3 = €1,400.

(Module 37.2, LOS 37.b)

10. (C) Unearned revenue.**Explanation**

Unearned revenue is usually taxable at the point of sale, even if not recognized in the income statement until a later period—resulting in higher current taxes payable, and a deferred tax asset being created. Depreciation commonly results in a deferred tax liability (e.g., when the tax return uses accelerated depreciation, while the income statement uses straight-line depreciation), although it could result in either a DTA or a DTL, depending on the method used. A decrease in the enacted tax rate will only decrease any existing deferred tax asset or liability.

(Module 37.1, LOS 37.a)

11. (A) Decrease in net income by \$37,500.**Explanation**

Deferred taxes are recognized at the enacted tax rate (25%). This will give a deferred tax liability of \$562,500 ($\$450,000 / 0.2 \times 0.25$) and a deferred tax asset of \$375,000 ($\$300,000 / 0.2 \times 0.25$). So, the tax expense = tax payable + Δ DTL – Δ DTA, the increase in the DTL will increase the tax expense on the income statement by \$112,500, and the increase in the DTA will decrease the tax expense by \$75,000. Overall, the tax expense will increase, and the net income will decrease by \$37,500.

(Module 37.1, LOS 37.a)

12. (B) 30%.

Explanation

Reported effective tax rate = Income tax expense / pretax income
= \$3,000 / \$10,000
= 30%

(Module 37.3, LOS 37.d)

13. (B) 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.

(Module 37.2, LOS 37.b)

14. (C) An increase in the tax-exempt income earned during the period.

Explanation

An increase in the actual cash paid will change the cash tax rate, but it will not cause the statutory and effective tax rates to differ. Any changes in deferred tax assets and liabilities are because of temporary timing differences, which typically do not cause the statutory and effective tax rates to differ. Permanent differences, such as tax-exempt income, do cause these rates to differ.

(Module 37.3, LOS 37.c)

15. (B) 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.

(Module 37.2, LOS 37.b)

16. (A) an addition to equity.

Explanation

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

(Module 37.2, LOS 37.b)

17. (A) $\Delta DTL = \text{tax expense} - \text{tax payable} + \Delta DTA$.

Explanation

Tax expense = tax payable + ΔDTL - ΔDTA . Once rearranged, the correct answer is $\Delta DTL = \text{tax expense} - \text{tax payable} + \Delta DTA$.

(Module 37.1, LOS 37.a)

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18. (B) **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.

(Module 37.1, LOS 37.a)

19. (A) **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.

(Module 37.2, LOS 37.b)

20. (C) **Tax holiday savings.**

Explanation

When analyzing trends in tax rates, an analyst should only include reconciliation items that are continuous in nature rather than sporadic. Tax-exempt income and differing tax rates in different countries tend to be continuous, whereas tax holiday savings tend to be sporadic.

(Module 37.3, LOS 37.c)

21. (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.

(Module 37.2, LOS 37.b)

22. (A) **23.9%.**

Explanation

Effective tax rate = income tax expense / pretax income = €47,000 / (€150,000 + €47,000) = 23.9%. Note that you are given the net income, so add the tax expense back to find pretax income.

(Module 37.3, LOS 37.c)

23. (B) **sporadic in nature, and the analyst should try to identify the termination date and determine if taxes will be payable at that time.**

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.

(Module 37.3, LOS 37.d)

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24. (B) decrease a deferred tax liability.

Explanation

A decrease in the tax rate will decrease any DTAs and DTLs. This does not affect the current period's taxable income, but it decreases income tax expense in the income statement.

(Module 37.1, LOS 37.a)

25. (A) includes taxes payable and deferred income tax expense.

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.

(Module 37.1, LOS 37.a)

26. (A) Deferred tax assets and liabilities are classified as noncurrent.

Explanation

Deferred tax items are classified as noncurrent.

Module 37.3, LOS 37.d)

27. (C) a deferred tax item.

Explanation

A temporary difference between pretax income for financial reporting and taxable income for tax reporting results in a deferred tax liability if income tax expense (financial reporting) is greater than taxes payable (tax reporting), or a deferred tax asset if income tax expense is less than taxes payable. A permanent difference results in the firm having an effective tax rate that differs from the statutory tax rate. Neither results in a gain or loss.

(Module 37.1, LOS 37.a)

28. (A) no deferred tax items being created.

Explanation

This is an example of a permanent timing difference, as the expense passes through the income statement but is not deducted for tax purposes. Permanent differences do not result in DTAs or DTLs.

(Module 37.1, LOS 37.a)

29. (C) \$60.

Explanation

Effective tax rate = Income tax expense / pretax income
Income tax expense = Effective tax rate × pretax income
= \$150(0.40)
= \$60

(Module 37.3, LOS 37.d)

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30. (B) 3,300 4,100

Explanation

	Yr. 1	Yr. 2
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 $(0.66667)(2,000) = \$1,333$

(Module 37.3, LOS 37.d)

31. (A) \$ 0.

Explanation

On the balance sheet, a warranty liability of \$8,480 ($530 \times 0.2 \times \80) will be recorded. The tax base is equal to the carrying value (\$8,480) minus the amount deductible in the future. The tax base is 0 ($\$8,480 - \$8,480$), and a deferred tax asset of \$8,480 will be recognized.

(Module 37.1, LOS 37.a)

32. (B) the creation of a deferred tax asset.

Explanation

Expensing R&D results in a balance sheet carrying value of zero. The tax base of the asset will be the amortization passing through the tax return in future periods. Carrying value less than the tax base results in a DTA.

(Module 37.1, LOS 37.a)

