37 ANALYSIS OF INCOME TAXES

1. 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) Income tax paid can include payments or refunds for other years.
   (C) Taxes payable are determined by pretax income and the tax rate.

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

3. A tax loss carry forward is best described as the:
   (A) net taxable loss that can be used to reduce taxable income in the future.
   (B) net taxable loss that can be used to recover taxes paid previously.
   (C) difference between deferred tax liabilities and deferred tax assets.

4. A company's effective tax rate is determined using its:
   (A) taxable income as shown on its tax filing.
   (B) income tax expense from the income statement.
   (C) taxes paid to the government during the period.

5. A current or past loss in a tax return most likely will result in a:
   (A) deferred tax asset.
   (B) deferred tax liability.
   (C) neither a deferred tax asset nor a deferred tax liability.

6. The ratio of taxes paid to pretax income is a company's:
   (A) cash tax rate.
   (B) effective tax rate.
   (C) statutory tax rate.

7. 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 equity (ROE).
   (B) Leverage ratio.
   (C) Return on assets (ROA).

8. A firm operates in a country with a 30% enacted tax rate. The firm had pretax income of $150,000, income tax expense of $ 47,000, and paid $44,000 in income tax. Which of the following tax rates was most likely the highest?
   (A) Effective tax rate.
   (B) Statutory tax rate.
   (C) Cash tax rate.

9. Gator Sarl (Gator) purchased some PP&E at the start of the period costing €21,000 with a three-year useful economic life and no residual value. Gator uses straight-line depreciation in its accounts, but the tax authorities use double declining balance. The following balances are given for carrying value and the value of the tax base over the asset's life:

	Year 1 €	Year 2 €	Year 3 €
Carrying value	14,000	7,000	0
Tax base	7,000	2,333	0

   Assuming a statutory tax rate of 30%, which of the following is closest to the DTL reported in Gator's balance sheet at the end of Year 2?
   (A) € 700.
   (B) € 1,400.
   (C) € 2,100.

10. Which of the following is most likely to result in a deferred tax asset being created?
   (A) Depreciation.
   (B) A decrease in the enacted tax rate.
   (C) Unearned revenue.

11. Harding Industrials, Inc., has a deferred tax asset of $300,000 and a deferred tax liability of $450,000 at the end of the reporting period, based on a tax rate of 20%. If the tax rate increases to 25%, what will be the most likely impact on the income statement?
   (A) Decrease in net income by $37,500.
   (B) Increase in net income by $7,500.
   (C) Increase in tax expense by $237,500.

12. 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) 30%.

(C) 25%.

13. For purposes of financial analysis, an analyst should:

(A) always consider deferred tax liabilities as a liability.

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

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

14. Which of the following is most likely to cause a difference between a firm's statutory and effective tax rates?

(A) An increase in the deferred tax asset from the prior period, and no change in the deferred tax liability.

(B) An increase in the actual cash paid to the tax authorities.

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

15. 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.

16. 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) immaterial amount and ignored.

(C) liability.

17. Which of the following most accurately depicts the relationship between income tax expense and deferred taxes?

(A) Δ DTL = tax expense – tax payable + ΔDTA.

(B) Tax payable = tax expense + ΔDTL – ΔDTA.

(C) Δ DTA = tax payable – tax expense – ΔDTL.

18. 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.

19. When analyzing a company's financial leverage, deferred tax liabilities are best classified as:
    (A) a liability or equity, depending on the company's particular situation.
    (B) a liability.
    (C) neither as a liability, nor as equity.

20. Which of the following is an analyst least likely to include when analyzing trends in tax rates, given a reconciliation of statutory to effective tax rates?
    (A) Differing tax rates in different countries.
    (B) Tax-exempt income.
    (C) Tax holiday savings.

21. If timing differences that give rise to a deferred tax liability are not expected to reverse then the deferred tax:
    (A) must be reduced by a valuation allowance.
    (B) should be considered an asset or liability.
    (C) should be considered an increase in equity.

22. Last year, Schoenberg AG earned net income of €150,000, an income tax expense of € 47,000, and paid tax of €51,000. What was the effective tax rate?
    (A) 23.9%.
    (B) 25.9%.
    (C) 31.3%.

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

24. Under the liability method of accounting for deferred taxes, a decrease in the tax rate at the beginning of the accounting period will:
    (A) increase taxable income in the current period.
    (B) decrease a deferred tax liability.
    (C) increase a deferred tax asset.

25. Which of the following statements is CORRECT? Income tax expense:
    (A) includes taxes payable and deferred income tax expense.
    (B) is the amount of taxes due to the government.
    (C) is the reported net of deferred tax assets and liabilities.

26. Which of the following statements regarding the disclosure of deferred taxes in a company's balance sheet is most accurate?
    (A) Deferred tax assets and liabilities are classified as noncurrent.
    (B) There should be a combined disclosure of all deferred tax assets and liabilities that are likely to reverse in the current period.
    (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.

27. A temporary difference between pretax income reported in a firm's financial statements and taxable income the firm reports to the tax authorities results in:
    (A) an adjustment to the firm's effective tax rate.
    (B) a gain or loss in comprehensive income.
    (C) a deferred tax item.

28. Compass Company made a donation to a charity and expensed it in the period in which it was made. The country's tax authorities do not allow charitable donations to be deducted for tax purposes. The difference between the treatment of the expense in the accounts and the tax returns will result in:
    (A) no deferred tax items being created.
    (B) the creation of a deferred tax asset.
    (C) the creation of a deferred tax liability.

29.

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) $ 0.

(B) $ 50.

(C) $ 60.

30. 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)	3,900	3,900
(B)	3,300	4,100
(C)	600	-200

31. A firm sold 530 units during the year with a one-year warranty. The firm estimates that 20% of these units will have claims made on them during the next year, costing the firm $80 per unit. In the country where the firm operates, a warranty expense is not tax deductible until the warranty work is performed. What is the tax base of the warranty liability?

(A) $ 0.

(B) $ 8,480.

(C) $ 42,400.

32. Grace Ltd. develops flying discs for use in sport. Grace currently expenses all R&D when incurred. The tax authorities require R&D expenditures to be capitalized and amortized. The differing accounting and tax treatment of R&D will result in:

(A) no deferred tax items being created.

(B) the creation of a deferred tax asset.

(C) the creation of a deferred tax liability.