

Learning Module 9: Analysis of Income Taxes

LOS 9a: contrast accounting profit, taxable income, taxes payable, and income tax expense and temporary versus permanent differences between accounting profit and taxable income

Accounting profit, also known as income before taxes, is reported on a company's income statement according to prevailing accounting standards. By definition, accounting profit does not account for income tax expense.

Taxable income is the portion of a company's income subject to income taxes following the jurisdiction's tax laws within which a company operates. Taxable income determines the company's income tax payable (a liability) or recoverable (an asset), which is reflected on the balance sheet. Consequently, the income tax paid during a period is the actual cash amount paid for income taxes, reducing the income tax payable.

The **tax base** of an asset or liability is the amount at which it is valued for tax purposes. In contrast, the **carrying amount** is the amount at which it is valued according to accounting principles. Differences between the tax base and carrying amount result in differences between the accounting profit and taxable income.

The tax base of an asset or liability is the amount assigned to it for tax purposes, while the carrying amount is the value recorded in the financial statements. Differences between the tax bases and carrying amounts can arise due to variations in accounting standards and tax laws.

Common differences include:

- **Timing Differences:** Revenues and expenses may be recognized in one accounting period and in another for tax purposes.
- **Recognition Differences:** Certain revenues and expenses may be recognized for accounting purposes but not for tax purposes, or vice versa.
- **Deductibility Differences:** The deductibility of gains and losses on assets and liabilities may differ for accounting and tax purposes.

- **Tax Loss Carryforwards:** Subject to tax rules, tax losses from prior years might be used to reduce taxable income in future years, leading to differences between accounting income and taxable income.
- **Adjustment Differences:** Adjustments of reported financial data from previous years may not be recognized equally for accounting and tax purposes or may be recognized in different periods.

Differences between the tax base and the carrying amount of liabilities (and, consequently, between taxable income and accounting profit) can be categorized as either temporary or permanent.

Taxable Temporary Differences

Temporary differences are divided into two categories: taxable temporary differences and deductible temporary differences.

Taxable Temporary Differences

Taxable temporary differences occur when the carrying amount of an asset exceeds its tax base, or when the tax base of a liability exceeds its carrying amount. For example, this might happen with accelerated depreciation, where the asset's carrying amount is higher than its tax base at the end of the year. Taxable temporary differences lead to the recognition of **deferred tax liabilities**.

Deductible Temporary Differences

Deductible temporary differences are those that will reduce taxable income in future periods when the related balance sheet item is recovered or settled. These differences create a **deferred tax asset** when the tax base of an asset is higher than its carrying amount or when the carrying amount of liability exceeds its tax base. Recognition of a deferred tax asset is only permitted if it is likely that there will be future profits against which the asset or liability can be settled or

recovered.

To determine if there will be sufficient future profits to utilize the deferred tax asset, the following must be considered:

1. There must be enough taxable temporary differences associated with the same tax authority and taxable entity.
2. The taxable temporary differences should be expected to reverse in the same periods as the deductible temporary differences.

The following table summarizes the differences between the tax bases and carrying amounts of assets and liabilities result in deferred tax assets or deferred tax liabilities:

Balance Sheet Item	Carrying Amount vs. Tax Base	Deferred Tax Asset or Liability
Asset	Carrying amount > tax base	Deferred tax liability
Asset	Carrying amount < tax base	Deferred tax asset
Liability	Carrying amount > tax base	Deferred tax asset
Liability	Carrying amount < tax base	Deferred tax liability

Permanent Differences

Permanent differences are discrepancies between tax laws and accounting standards that will not be reversed in the future. Since these differences do not reverse, they do not lead to deferred tax but rather result in a disparity between the company's effective tax rate and the statutory corporate income tax rate.

Examples of permanent differences include:

- Income or expense items not permitted by tax laws, such as penalties and fines that are recognized as expenses in financial reporting but are not tax-deductible.
- Tax credits for certain expenditures that reduce taxes directly, such as credits for purchasing solar power systems or electric vehicles, are provided by tax authorities to incentivize these purchases.

Example: Demonstrating Taxable Temporary Differences and Permanent Differences

Consider the following assets and liabilities of a company, with their current amounts, tax bases and temporary differences where applicable:

Item	Carrying Amount (euros)	Tax Base (euros)	Temporary Difference (euros)	Will it Result in Deferred Tax Asset or Liability
1. Loan (capital)	600,000	600,000	0	?
2. Interest paid	0	0	0	?
3. Development costs	2,750,000	2,500,000	250,000	?
4. Research costs	0	400,000	(400,000)	?
5. Accounts receivable	1,600,000	1,300,000	300,000	?
6. Donations	0	0	0	?
7. Interest received in advance	350,000	0	(350,000)	?
8. Rent received in advance	11,000,000	0	(11,000,000)	?
9. Dividends receivable	1,200,000	1,200,000	0	?

Given the values of the table, for each asset or liability, determine whether the temporary differences will lead to deferred tax asset or liability.

Solution

Here is the completed table and discussions:

Item	Amount (euros)	Tax Base (euros)	Temporary Difference (euros)	Will it Result in Deferred Tax Asset or Liability
1. Loan (capital)	600,000	600,000	0	N/A
2. Interest paid	0	0	0	N/A
3. Development costs	2,750,000	2,500,000	250,000	DTL
4. Research costs	0	400,000	(400,000)	DTA
5. Accounts receivable	1,600,000	1,300,000	300,000	DTL
6. Donations	0	0	0	N/A
7. Interest received in advance	350,000	0	(350,000)	DTA
8. Rent received in advance	11,000,000	0	(11,000,000)	DTA
9. Dividends receivable	1,200,000	1,200,000	0	N/A

- **Loan:** No temporary differences arise from the loan or interest paid; hence, no deferred tax items are recognized.
- **Interest paid:** No temporary differences result from interest paid, and therefore, no deferred tax asset or liability is recognized.
- **Development costs:** The discrepancy between the carrying amount and tax base represents a temporary difference that will eventually reverse, creating a deferred tax liability for this fiscal period.
- **Research costs:** The variation between the carrying amount and tax base generates a temporary difference, resulting in a deferred tax asset. A deferred tax asset occurs when more taxes are paid upfront than necessary (when taxable income exceeds accounting profit), with the expectation of recovery in future periods. According to accounting standards, the entire amount was deducted, thus lowering the accounting profit, while taxable income remains higher due to reduced expenses.

- **Accounts receivable:** The difference between the asset's carrying amount and tax base is a temporary difference that results in a deferred tax liability.
- **Donations:** It is assumed that tax laws do not permit deductions for donations, leading to no temporary difference. This is considered a permanent difference, and thus, no deferred tax asset or liability is recognized.
- **Interest received in advance:** This situation creates a temporary difference, resulting in a deferred tax asset. Deferred tax asset forms due to excess tax payments (when taxable income is higher than accounting profit) are anticipated to be recuperated in future periods.
- **Rent received in advance:** The difference between the carrying amount and tax base creates a temporary difference, leading to the recognition of a deferred tax asset.
- **Dividends receivable:** Since dividends are non-taxable, their carrying amount is equal to their tax base, which creates a permanent difference. This does not result in the recognition of a deferred tax asset or liability. Permanent differences are not reversed over time and arise from specific tax legislation that excludes certain incomes, like dividends from a subsidiary, from being taxed. Consequently, the dividends received do not affect the taxable income, resulting in a permanent disparity between taxable income and accounting profit.

Tax Expense (Provision for Income Taxes)

A company's tax expense is reported on its income statement and includes both the income tax payable (or recoverable in the case of a tax benefit) and any changes in deferred tax assets and liabilities. This method adheres to the matching principle, ensuring that the tax effects of all current period activities are reported rather than only the income taxes actually paid.

Question

Which of the following statements *accurately* describes an occurrence of a difference between accounting profit and taxable income?

- A. The tax base and carrying amount of assets and liabilities are the same.
- B. The tax losses of previous years cannot be used to reduce the taxable income in later years.
- C. Revenues and expenses may be recognized in one reporting period for accounting purposes and in another period for tax purposes.

Solution

The correct answer is **C**.

The statement, “revenues and expenses may be recognized in one reporting period for accounting purposes and in another for tax purposes,” provides an example of a difference between accounting profit and taxable income.

LOS 9b: explain how deferred tax liabilities and assets are created and the factors that determine how a company's deferred tax liabilities and assets should be treated for the purposes of financial analysis

Recall that deferred tax assets and liabilities originate from temporary differences between financial accounting profit and taxable income. Specifically, deferred tax assets indicate taxes that have already been paid or losses carried forward from prior periods but are not yet reflected on the income statement. On the other hand, deferred tax liabilities arise when the tax expense recorded for financial accounting exceeds the tax expense per tax regulations.

At the end of each reporting period, companies compare the tax bases and carrying amounts of balance sheet items to recalculate deferred tax assets and liabilities. These adjustments are combined with income tax payable to determine the company's income tax expense (or credit) on the income statement.

When statutory tax rates change, the reported value of deferred tax assets and liabilities must be adjusted accordingly. For example, if the corporate tax rate is reduced from 35% to 30%, the value of deferred tax assets decreases because the future tax benefit is reduced. Similarly, the value of deferred tax liabilities decreases as the future tax obligation diminishes.

Treatment of Deferred Tax Liabilities and Assets for the Purposes of Financial Analysis

Assume that a company depreciates its machinery on a straight-line basis at a rate of 8% per year. However, tax authorities allow for a depreciation rate of 12% per year. Consequently, at the end of the fiscal year, this creates a situation where the carrying amount of the machinery for accounting purposes is higher than its tax base, resulting in a temporary difference.

A deferred tax asset can be created if the company expects to realize the economic benefit of this asset in the future. In this scenario, since the machinery is essential to the company's core business and the company is a going concern with stable earnings, it is reasonable to expect future economic benefits from the machinery. Therefore, creating a deferred tax asset would be appropriate.

Conversely, if there were doubts about the realization of future economic benefits from the temporary difference, for example, when the company is liquidated, the temporary difference would not result in the recognition of a deferred tax asset.

It is important to note that if a deferred tax asset had been recognized previously but doubts arose about the realization of economic benefits, then under IFRS, the deferred tax asset would be reversed. However, under US GAAP, a valuation allowance would be set up to reduce the deferred tax asset to the amount that is more likely than not to be realized.

It is crucial to note that management discretion plays a significant role in assessing temporary differences and the likelihood of future economic benefits.

Example: Treatment of Deferred Tax Liabilities and Assets for the Purposes of Financial Analysis

A hypothetical company, Galaxy Manufacturing, reports under IFRS. A snippet of the company's consolidated income statement is given below:

Period Ending 31 December	Year 3	Year 2	Year 1
Revenue	\$50,000	\$40,000	\$30,000
Other net gains	3,000	0	0
Changes in inventories	600	300	400
Raw materials Costs	(6,500)	(5,000)	(9,000)
Depreciation expense	(2,500)	(2,500)	(2,500)
Other expenses	(7,000)	(6,800)	(5,500)
Interest expense	(2,500)	(3,500)	(7,000)
Profit before tax	\$35,100	\$22,500	\$6,400

In the above income statement, assume that all income and expenses on the income statement are treated identically for tax and accounting purposes except for depreciation related to equipment owned by Galaxy Manufacturing. Moreover, assume the equipment was purchased at the beginning of Year 1 for \$25,000. As such, depreciation should thus be calculated and expensed for the full year.

Accounting standards (IFRS in this case) permit equipment to be depreciated on a straight-line basis over a 10-year period, while tax standards specify depreciation over a 7-year period. Assume a salvage value of \$0 at the end of the equipment's useful life. Assume a tax rate of 30%.

From the above information,

1. Calculate the taxable income of the company
2. Calculate the carrying amount and tax base for the equipment
3. Determine whether the difference in the depreciation method in determining accounting profit and taxable income results in deferred tax liability or asset. Also, the value for each year will be determined.
4. Determine income tax expense for each year.

Solution

Taxable income:

The equipment was initially acquired for \$25,000. According to accounting standards, the company will recognize annual depreciation of \$2,500 ($= \frac{\$25,000}{10}$) over the next 10 years, which will be recorded as an expense on the income statement and used to calculate accounting profit (as demonstrated in the data above).

For tax purposes, however, the company will recognize \$3,571 ($\approx \frac{\$25,000}{7}$) in yearly depreciation. Consequently, the depreciation expense will differ each fiscal year for tax and accounting purposes (tax base vs. carrying amount), leading to a difference between accounting profit and taxable income. The taxable income for each fiscal year is outlined below:

Period Ending 31 December	Year 3	Year 2	Year 1
Revenue	\$50,000	\$40,000	\$30,000
Other net gains	3,000	0	0
Changes in inventories	600	300	400
Raw materials Costs	(6,500)	(5,000)	(9,000)
Depreciation expense	(3,571)	(3,571)	(3,571)
Other expenses	(7,000)	(6,800)	(5,500)
Interest expense	(2,500)	(3,500)	(7,000)
Taxable income	\$34,029	\$21,429	\$5,329

Carrying amount and tax base for the equipment:

At the end of each balance sheet date, it is necessary to determine the tax base and carrying amount of all assets and liabilities, as shown below:

Year	Year 3	Year 2	Year 1
Equipment value for accounting purposes (carrying amount) with Dep. of \$2,500 per year	\$17,500	\$20,000	\$22,500
Equipment value for tax purposes (tax base) with Dep. of \$3,571 per year	\$14,286	\$17,857	\$21,429
Difference	\$3,214	\$2,143	\$1,071

Value of Deferred Tax asset or Liability:

Remember that if the tax obligation is calculated based on accounting profits, it will differ due to the differences between the tax base and the carrying amount of the equipment. The table above highlights this difference.

In each fiscal year, the carrying amount of the equipment exceeds its tax base. Consequently, the asset's tax base is lower than its carrying value according to financial accounting principles for tax purposes. This difference results in a deferred tax liability, as shown in the following table:

Year	Year 3	Year 2	Year 1
Deferred tax liability	\$964	\$643	\$321

Note that the above values are calculated as:

$$\text{Deferred tax liability} = (\text{Tax base} - \text{Carrying amount}) \times \text{tax rate}$$

So that,

$$\text{Year 1: } (\$22,500 - \$21,429) \times 30\% = \$321$$

$$\text{Year 2: } (\$20,000 - \$17,857) \times 30\% = \$643$$

$$\text{Year 3: } (\$17,500 - \$14,286) \times 30\% = \$964$$

Income tax expense for each year:

Intuitively, the different treatment of depreciation creates a temporary difference, leading to the income tax on the income statement being 30 percent of the accounting profit. However, only a portion of this is income tax payable, with the remainder being a deferred tax liability. Therefore, on the income statement, the company's income tax expense will be the sum of the change in the

deferred tax liability and the income tax payable, as shown below:

Year	Year 3	Year 2	Year 1
Income tax payable (based on tax accounting)	\$10,209	\$6,429	\$1,599
Change in deferred tax liability	\$321	\$322	\$321
Income tax expense (based on financial accounting)	\$10,530	\$6,751	\$1,920

Note that if there was a presence of both deferred tax liabilities and assets, income tax expense would be calculated as:

$$\begin{aligned} \text{Income tax expense} = & \text{Taxes payable plus} \\ & \text{net increase in deferred tax liabilities} \\ & \text{less} \\ & \text{net increase in deferred tax assets} \end{aligned}$$

Given all the information above, we can now present the consolidated income statement of Galaxy Manufacturing, reflecting the income tax as shown below:

Period Ending 31 December	Year 3	Year 2	Year 1
Revenue	\$50,000	\$40,000	\$30,000
Other net gains	3,000	0	0
Changes in inventories of finished goods and work in progress	600	300	400
Raw materials and consumables used	(6,500)	(5,000)	(9,000)
Depreciation expense	(2,500)	(2,500)	(2,500)
Other expenses	(7,000)	(6,800)	(5,500)
Interest expense	(2,500)	(3,500)	(7,000)
Profit before tax	\$35,100	\$22,500	\$6,400
Income tax	(10,530)	(6,751)	(1,920)
Profit after tax	\$24,570	\$15,749	\$4,480

Question

Which of the following statements is the *least accurate*?

- A. Deferred tax assets and liabilities are recalculated at the end of each financial year.
- B. Deferred tax assets and liabilities are based on permanent differences, which result in a company paying an excess or deficit amount for taxes.
- C. A deferred tax asset or liability will not be created if there is no guarantee that future economic benefits will be derived from a temporary difference.

Solution

The correct answer is **B**.

Deferred tax assets and liabilities are based on temporary, not permanent, differences that result in a company paying an excess or deficit amount for taxes.

Options A and C are correct statements.

LOS 9c: calculate, interpret, and contrast an issuer's effective tax rate, statutory tax rate, and cash tax rate

Income taxes payable are mainly influenced by the geographic distribution of taxable income of the company and the corresponding tax rates in each location, but the nature of the business can also have an impact. For instance, some companies receive favorable tax treatment, such as R&D tax credits or accelerated depreciation for fixed assets.

Types of Tax Rates

Variations in tax rates can significantly influence a company's value. Generally, three types of tax rates are essential for analysts:

1. **Statutory Tax Rate:** The corporate income tax rate in the country where the company is based.
2. **Effective Tax Rate:** It is calculated by dividing the reported income tax expense on the income statement by the pre-tax income.
3. **Cash Tax Rate:** The tax paid in cash during the period, divided by pre-tax income.

Forecasting Tax Expenses and Rates

Recall that differences between cash taxes and reported taxes usually arise from discrepancies between financial accounting standards and tax laws, as well as from changes in deferred tax assets or liabilities.

When predicting tax expenses and cash taxes, the effective tax rate and cash tax rate are crucial. Moreover, understanding the operational factors and financial structure of a company is beneficial for forecasting these tax rates.

Differences between the statutory tax rate and the effective tax rate can occur for various reasons, such as tax credits, withholding tax on dividends, adjustments to prior years, and non-deductible expenses. Effective tax rates may also vary when companies operate internationally, as the effective tax rate becomes an average of the tax rates of the countries where the company operates, weighted by the profit (before tax) generated in each country.

Consequently, if a company earns higher profits in countries with higher tax rates and lower profits in countries with lower tax rates, the effective tax rate will be a weighted average, typically higher than the simple average of the tax rates.

Additionally, consistently lower effective tax rates compared to statutory rates or the rates reported by competitors is not necessarily unusual but may require further analysis when forecasting future tax expenses. Financial statement notes should provide a reconciliation between the statutory tax rate and the effective rate, highlighting items that cause significant variations in the effective tax rate.

The cash tax rate is useful for forecasting cash flows, while the effective tax rate is relevant for projecting earnings on the income statement.

When developing an estimated tax rate for forecasts, analysts should adjust for one-time events. For instance, if income from equity-method investees constitutes a large and volatile part of pre-tax income, excluding this amount from the effective tax rate calculation may provide a better estimate of future tax costs.

A good starting point for estimating future tax expense is a tax rate based on normalized operating income. Normalized operating income implies excluding results from associates and special items to provide a reliable indication of future tax expense, adjusted for special items, in an analyst's earnings model.

Creating a model allows the calculation of the effective tax amount in profit and loss projections and the cash tax amount in the cash flow statement or as supplemental information. Note that the difference between the profit and loss tax amount and the cash flow tax figures should correspond to changes in deferred tax assets or liabilities.

Example: Analyzing Effective Tax Rates

Dolie, a confectionery manufacturer, operates in countries C and E. Table 1 contains information on both countries' tax rates. In year one, both countries' earnings before tax (EBT) are the same.

Table1: Tax rates in different jurisdictions.

	Country C	Country E	Total
EBT	250	250	500
Effective tax rate	15%	35%	25%
Tax	37.5	87.5	125
Net profit	212.5	162.5	375

If earnings before tax for country C increase by 10 percent per year while earnings before tax for country E remain the same for the next three years, what will happen to the effective tax rate?

Solution

Consider the following table:

Table 2: Tax Estimate Problem

Year	0	1	2	3
EBT, Country C	250	275	302.5	332.75
Growth rate		10%	10%	10%
EBT, Country E	250	250	250	250
Growth rate		0%	0%	0%
Total EBT	500	525	552.5	585.75
Effective tax rate, Country C	15%	15%	15%	15%
Effective tax rate, Country E	35%	35%	35%	35%
Total tax	125	128.75	132.88	137.41
Total effective tax rate	25%	24.5%	24%	24.5%

The effective tax rate will gradually decline since a higher proportion of EBT is generated in the country with the lower tax rate.

Note that the total effective rate is the average of the effective tax rates of the countries where the company operates, weighted by the profit (before tax) generated in each country.

For instance, the total effective tax for year 0 is calculated as:

$$\begin{aligned}\text{Effective tax rate} &= \frac{250}{500} \times 15\% + \frac{250}{500} \times 35\% \\ &= 25\%\end{aligned}$$

Question 1

AlphaTech, a hypothetical company based in Canada, also has significant operations in Germany. The statutory tax rate in Canada is 26%, while the statutory tax rate in Germany is 15%. Assume AlphaTech earns CAD 2,000 in profit before taxes in each country during year 20X1.

On January 1 of the following year, 20X2, AlphaTech acquires Beta Corp, which is domiciled in Japan. The statutory tax rate in Japan is 23%. Beta Corp earns CAD 1,000 in profits in 20X2. Assuming that Canadian and German operations each increase pre-tax profits by 20%, the effective tax rate in 20X2 for the consolidated entity is *closest to*:

1. 18.4%
2. 19.8%
3. 20.9%

The correct answer is C.

Recall that the effective tax rate is calculated by dividing the reported income tax expense on the income statement by the pre-tax income. As such, the effective tax rate in 20X2 for the consolidated Alphatec is calculated in the table below:

Country	Taxable Income	Statutory Rate	Taxes
Canada	CAD 2,400	26%	CAD 624.00
Germany	CAD 2,400	15%	CAD 360.00
Japan	CAD 1,000	23%	CAD 230.00
Total	CAD 5,800		CAD 1,214.00

Therefore, the effective tax rate is:

$$\text{Effective tax rate} = \frac{1,214}{5,800} = 20.9\%$$

Question 2

When might an effective tax rate consistently lower than statutory or competitors' rates warrant additional analyst attention?

- A. When forecasting future tax expenses.
- B. When it is reported in the financial statements.
- C. When it is consistently lower than statutory rates.

Solution

The correct answer is A.

An effective tax rate consistently lower than statutory or competitors' rates might warrant additional attention when forecasting future tax expenses.

LOS 9d: analyze disclosures relating to deferred tax items and the effective tax rate reconciliation and explain how information included in these disclosures affects a company's financial statements and financial ratios

Income tax disclosures included in the notes to financial statements can provide analysts with very useful information. Therefore, including income tax disclosures in the notes to financial statements can have a material impact on financial statement analysis, including the derivation of financial ratios.

Disclosures relating to deferred tax items and effective tax rate reconciliation are important because:

- Income tax disclosures can be used to reconcile how a company's income tax provision was determined, beginning with its reported income before taxes.
- Disclosures can highlight the current income tax provision and indicate if the net income tax provision results from offsetting by deferred tax benefits.
- Whether in percentage terms or absolute dollar amounts, disclosures may also display the reconciliation of how income tax provisions are derived from the US federal statutory rate.
- Disclosures can provide detailed information on the derivation of deferred tax assets and liabilities.
- Disclosures can indicate if any valuation allowance was applied against net deferred tax assets. An explanation may also be found for why the valuation allowance has changed.
- Disclosures also help to determine if there is any operating loss carryforwards or unused tax credits.

Impact of Disclosures on Financial Statements and Ratios

Other considerations relating to the usefulness of disclosures include the following:

- A change in the federal statutory tax rate could make net deferred assets less valuable.
- As reported on the income statement, a reduction in the valuation allowance could lead to a reduction in the income tax provision. Similarly, it can occasion a decline in reported income taxes in future periods.
- A company acquiring another company may use the target company's tax loss carry-forwards to offset its tax liabilities. The value to the acquiring company would be the present value of the carry-forwards, based on the acquiring company's tax rate and expected realization time. The higher the profitability and tax rate of an acquiring company, the sooner it will be able to benefit.
- A deferred tax liability should be classified as debt if it's expected to reverse with subsequent tax payment(s). If the liability is not expected to reverse, it should be treated as equity. Additionally, a deferred tax liability should be excluded from debt and equity in case of uncertainty on the amounts and timing of tax payments arising from the reversal of temporary differences. These classifications (debt or equity) will affect the computation of financial ratios involving debt or equity, such as profitability ratios.

Question 1

GammaCorp's tax provision resulted in effective tax rates attributable to earnings from ongoing operations, excluding the cumulative effect of changes in accounting principles, which differed from the statutory corporate income tax rate of 30%, as detailed below:

Year Ended 31 December	Year 3	Year 2	Year 1
Expected corporate income tax expense (benefit)	(\$ 120,000)	\$780,000	\$690,000
Change in Valuation allowance for deferred tax asset	(160,000)	(770,000)	(760,000)
Income tax expense	230,000	60,000	85,000

Over the three years shown, adjustments to the valuation allowance for deferred tax assets most likely indicate:

- A. increased likelihood of future profitability.
- B. a decreased likelihood of future profitability.
- C. assets being carried at a value lower than their tax base.

The correct answer is A.

Throughout the three-year period, adjustments to the valuation allowance reduced cumulative income taxes by USD 1,830,000 (= USD 160,000 + USD 770,000 + USD 760,000). The reductions in the valuation allowance indicate that the company is "more likely than not" to generate enough taxable income to utilize the deferred tax assets.

Question 2

Which of the following statements is the *least* accurate?

- A. An acquiring company may not use a target company's tax loss carry-forwards to offset own tax liabilities.
- B. A deferred tax liability should be classified as debt if expected to reverse with a subsequent tax payment.
- C. Note disclosures can indicate the reconciliation of how income tax provisions are derived from the US federal statutory rate.

Solution

The correct answer is **A**.

An acquiring company may use a target company's tax loss carry forward to offset its tax liabilities.

Options B and C are correct statements.