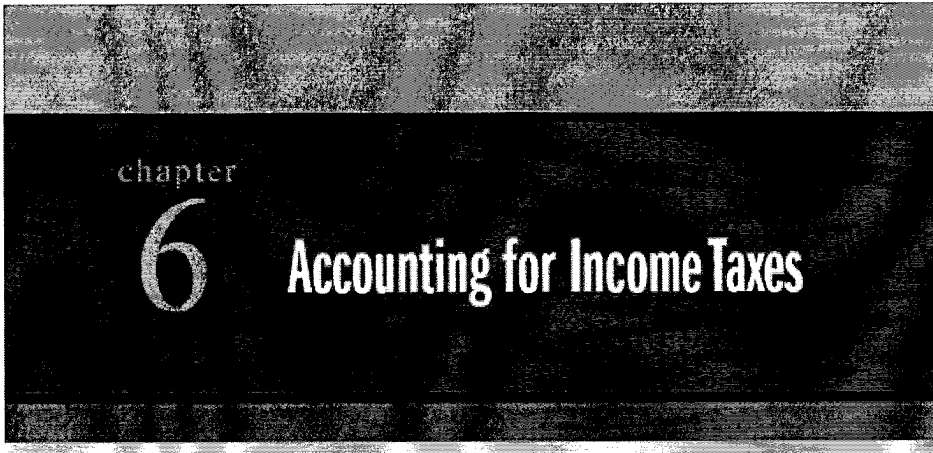


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## Chapter 06 PowerPoint

## Learning Objectives

**Upon completing this chapter, you should be able to:**

1. LO 6-1 Explain the objectives behind FASB ASC Topic 740, *Income Taxes*, and the income tax provision process.
2. LO 6-2 Calculate the current and deferred income tax expense or benefit components of a company's income tax provision.
3. LO 6-3 Recall what a valuation allowance represents and describe the process by which it is determined.
4. LO 6-4 Explain how a company accounts for its uncertain income tax positions under FASB ASC Topic 740.
5. LO 6-5 Recognize the different components of a company's disclosure of its income tax accounts in the financial statements and footnotes and comprehend how a company computes and discloses the components of its "effective tax rate."

Page 6-1

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E

Elise felt a great sense of accomplishment when she completed the federal income tax return for Premiere Computer Corporation (PCC). She was glad the return was filed on time and did not need to be extended. With the tax return filed, Elise was assigned to help the PCC tax department compute the federal income tax provision for the company's soon to be published income statement and to determine the correct amounts in the company's income-tax-related balance sheet accounts. She also was given the responsibility to help prepare the income tax note to the financial statements.<sup>1</sup>

Elise was aware that, as a result of more stringent independence requirements imposed by the Sarbanes-Oxley Act, her colleagues in the tax department were getting a lot of new engagements to help prepare the income tax provision for nonaudit clients. In fact, her firm now considered accounting for income taxes to be a "core competency" for all tax staff. Elise even heard that individuals who understood the nuances of accounting for income taxes were being called the new "rock stars" of accounting.<sup>2</sup> Having recently attended firm training on accounting for income taxes, which was now required of all tax staff, Elise was eager to apply her new knowledge to an actual client situation. She knew that developing her skill set in this complex topic would make her more valuable to her firm and her clients.<sup>3</sup>

Page 6-6

Elise gathered the financial statement and tax return data she needed to get started beginning with the workpaper template she used to compute PCC's taxable income (Exhibit 6-3 reproduces the book-tax reconciliation template from Exhibit 5-7, excluding the book federal income tax expense of \$2,000,000). She identified each of the book-tax adjustments as being either permanent (P) or temporary (T). She was ready to begin the process of computing PCC's federal income tax provision using the six-step process she had learned at firm training.

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## Premiere Computer Corporation

Income Statement for Current Year	Book Income	Book-Tax Adjustments		Taxable Income
		(Dr)	Cr	
Revenue from sales	\$ 60,000,000			\$60,000,000
Cost of goods sold	38,000,000			38,000,000
Gross profit	\$ 22,000,000			\$22,000,000
Other income:				
Dividend income	30,000			30,000
Interest income (P)	120,000	(12,000)		108,000
Capital gains (losses) (T)	(28,000)		28,000	0
Gain on fixed asset dispositions (T)	54,000		16,000	70,000
Gross Income	\$ 22,176,000			\$22,208,000
Expenses:				
Compensation	(9,868,000)			(9,868,000)
Deferred compensation (T)	(300,000)	(150,000)		(450,000)
Stock option compensation (T)	(100,000)		100,000	0
Bad debt expense (T)	(165,000)		70,000	(95,000)
Charitable contributions (T)	(700,000)		73,700	(626,300)
Depreciation (T)	(2,400,000)	(700,000)		(3,100,000)
Advertising	(1,920,000)			(1,920,000)
Warranty expenses (T)	(580,000)		170,000	(410,000)
Meals and entertainment (P)	(28,000)		14,000	(14,000)
Life insurance premiums (P)	(34,000)		34,000	0
Other expenses	(64,000)			(64,000)
Total expenses before NOL, DRD, DPAD	\$ (16,159,000)			\$ (16,547,300)
Income before NOL, DRD, DPAD	\$ 6,017,000			\$ 5,660,700
NOL carryforward from prior year (T)	0	(24,000)		(24,000)
Dividends received deduction (P)	0	(21,000)		(21,000)
Domestic production activities deduction (P)	0	(465,000)	0	(465,000)
Book/Taxable income	\$ 6,017,000	(1,372,000)	505,700	\$ 5,150,700

## EXHIBIT 6-3

## PCC Book-Tax Reconciliation Template

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Having calculated the current portion of PCC's income tax provision, Elise turned her attention to computing the deferred piece of PCC's income tax provision. She knew from training that the technically correct method to compute PCC's deferred tax provision would be to compare the financial accounting basis of each asset and liability with its corresponding tax basis. Elise had the financial accounting basis of each account from the balance sheet but, like most companies, PCC did not keep a formal **tax accounting balance sheet**.<sup>22</sup> She would need to use an alternative method to calculate the change in the cumulative book-tax basis differences for each account she identified as being a temporary difference.

Page 6-23

Elise recalled from her calculation of PCC's taxable income that there had been some discussion about the appropriate tax treatment of certain items on the tax return. In particular, she and PCC's tax director had debated whether certain income qualified for the domestic production activities deduction. In particular, there was some uncertainty as to whether \$1,000,000 of the company's QPAI would be allowed by the IRS on audit. This amount of QPAI provided the company with a domestic production activities deduction of \$90,000 ( $9\% \times \$1,000,000$ ). The tax director felt "comfortable" in taking the tax return position that the income met the definition of qualified production activity income (QPAI). Elise decided she needed to know more about how to deal with accounting for this tax uncertainty.

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## Storyline Summary

## Elise Brandon

Employment status:

Tax associate for a large public accounting firm.

Assigned to prepare the federal income tax provision and income-tax-related balance sheet accounts and footnote disclosures for Premiere Computer Corporation, a nonaudit client.

## Premiere Computer Corporation

Medium-sized publicly traded company.

Manufactures and sells computer-related equipment.

Calendar-year taxpayer.

*Marginal tax rate:* 34 percent, unless otherwise stated.  
Page 6-2

As you learned in computing PCC's taxable income in the previous chapter, many of the items of income (revenue) and deductions (expenses) that are included in a company's taxable income also are included in the company's net income before taxes. Not all of these items are included in the computations in the same accounting period, however, which creates "temporary" differences between taxable income and net income. Other items affect only one of the computations, which creates "permanent" differences between taxable income and net income. A company must take these differences into account in computing its income tax provision on the income statement and its "deferred" income taxes payable (liabilities) or refundable (assets) on the balance sheet.

FASB Accounting Standards Codification Topic 740, *Income Taxes* (hereafter, ASC 740), governs the computation and disclosure of a company's income tax provision (expense or benefit) and its expected future income tax liabilities or benefits related to "events" that have been recorded on either the financial statement or the tax return. ASC 740 codifies the "majority" of accounting and reporting guidance related to income taxes, primarily FAS 109. Accounting for income taxes guidance related to accounting for investments under the equity method, stock compensation, business combinations, foreign currency translation, and industry subtopics such as real estate, entertainment, and oil and gas is embedded within the ASC topic that deals with that issue. The Emerging Issues Task Force (EITF)<sup>4</sup> and the Securities and Exchange Commission continue to provide guidance on issues related to accounting for income taxes.

A company's failure to accurately compute the income tax provision and related balance sheet accounts can lead to the issuance of a material weakness statement by the auditor and, in some cases, a restatement of the financial statements. Not surprisingly, individuals who understand these complex and sometimes counterintuitive rules are in great demand by public accounting firms and industry.

This chapter discusses the basic rules for how a company computes and discloses its current year income tax provision and its future income taxes payable or refundable using the facts related to Premiere Computer Corporation in the previous chapter. We focus on the portion of the provision that relates to federal income taxes.

<sup>1</sup>Publicly traded companies usually file their financial statements (Form 10-K) with the Securities and Exchange Commission well before they file their income tax returns with the Internal Revenue Service, often by as much as six months. The company must estimate its current year income tax liability when it files its financial statements and then adjust for any "provision to return" differences in the quarter (Form 10-Q) in which the tax return is filed. In today's post-Sarbanes-Oxley environment, staff from public accounting firms that are not a company's auditors often are hired to help prepare the company's income tax provision under ASC 740 because many companies do not have staff with the expertise to make this calculation.

<sup>2</sup>Kris Frieswick, "Too Taxing," *CFO Magazine* (November 1, 2005).


<sup>3</sup> An international tax services partner at a major public accounting firm recently testified before members of Congress that her firm spent more than 7,000 hours auditing a client's accounting for income taxes for its 2011 Form 10-K. See Beth Carr, "Written Testimony for Senate Permanent Subcommittee on Investigations," September 20, 2012, available at <http://www.hsgac.senate.gov/subcommittees/investigations/hearings/offshore-profit-shifting-and-the-us-tax-code>.

<sup>22</sup>Schedule L to Form 1120 requests that the taxpayer report its financial statement balance sheet. An increasing number of corporations are finding that a "best practice" is to maintain a tax basis balance sheet separate from the financial accounting balance sheet.

<sup>4</sup>The Emerging Issues Task Force is a committee of accounting practitioners who assist the FASB in providing timely guidance on emerging issues and the implementation of existing standards.


## OBJECTIVES OF ACCOUNTING FOR INCOME TAXES AND THE INCOME TAX PROVISION PROCESS

### LO 6–1


In addition to filing its federal, state and local, and non-U.S. income tax returns, Premiere Computer Corporation, along with all other U.S. publicly traded corporations and many privately held corporations, must prepare financial statements in accordance with generally accepted accounting principles (GAAP) issued by the FASB. Under GAAP, a company must include as part of its income statement a “provision” for the income tax expense or benefit that is associated with the pretax net income or loss reported on the income statement. The income tax provision includes not only current year taxes payable or refundable, but also any changes to future income taxes payable or refundable that result from differences in the timing of when an item is reported on the tax return compared to the financial statement. The company records these future income taxes payable or refundable on its balance sheet  as the amount the company expects to pay (**deferred tax liability**) or recover (**deferred tax asset**) in a future accounting period.

### Page 6-3

#### Taxes in the Real World *Weatherford International's \$500 Million Material Weakness Related to Accounting for Income Taxes*

On March 1, 2011, Weatherford International informed its shareholders that it would be late in issuing its Form 10-K because of a material weakness in internal control over the company's financial reporting for income taxes. As a result, management  cautioned its investors not to rely on any of its financial statements issued for the years 2007–2010. Management estimated the total financial reporting error to be around \$500 million. At a press conference the next day, the CEO made the following statement:

To a degree, the discipline of tax within our Company is a two-headed animal—one, planning, and two, process. Both pieces must work well in order for us to be able to maximize the value of our multinational status. This mistake, the embarrassment of which is difficult, if not impossible to quantify, highlights that we have work to do on strengthening the process piece. We will work hard to make sure this happens with all appropriate speed and effectiveness.<sup>a</sup>

As of August 2012, the company had not remediated the deficiencies in its internal controls and had not filed its Form 10-K for 2010 and 2011. In addition, the company spent considerable resources engaging third-party tax advisers and consultants to assist with enhancing internal controls over financial reporting for income taxes and developing and implementing a remediation plan, revising the process for the quarterly and annual tax provisions, recruiting positions within the tax and financial reporting departments, and providing income tax accounting training  to tax and financial personnel. Because of the significance of the deficiency, the company informed investors that it would not be able to conclude that the material weakness had been eliminated until, at the earliest, the completion of the 2012 year-end income tax provision (February 2013)!

<sup>a</sup>Final transcript of “Weatherford International to Adjust 2007–2010 Results Due to ‘Material Weakness’ in Its Income Tax Reporting—Conference Call,” available at <http://sec.gov>.

### Why Is Accounting for Income Taxes So Complex?

ASC 740 provides the general rules that apply to the computation of a company's income tax provision. The basic principles that underlie these rules are fairly straightforward, but the application of the rules themselves can be very complex. Much of the complexity is due to the fact that the U.S. tax laws are complex and often ambiguous. In addition, companies frequently prepare their financial statements (Form 10-K) much earlier than when they file their corresponding tax returns. For example, a calendar-year corporation generally files its Form 10-K with the SEC in February or early March, but the company might not file its federal income tax return (Form 1120) with the Internal Revenue Service (IRS) until August or September.<sup>5</sup> As a result, a company often must exercise a high degree of judgment in estimating its income tax return positions currently and in future years when a tax return position might be challenged by the tax authorities. After the tax return is filed, it may take five years or more before the tax return is audited by the IRS and the final tax liability is determined.<sup>6</sup> For example, General Electric (GE) mentions in its Form 10-K for 2011 that the IRS currently was auditing its U.S. income tax returns for 2008–2009. GE also notes that it files more than 6,500 income tax returns in over 250 global taxing jurisdictions!

### Objectives of ASC 740

ASC 740 applies only to *income* taxes levied by the U.S. federal government, U.S. state and local governments, and non-U.S. (“foreign”) governments. The FASB defines an *income tax* as a tax *based on income*. This definition excludes property taxes, excise taxes, sales taxes, and value-added taxes. Companies report nonincome taxes as expenses in the computation of their net income before taxes.

### Page 6-4

ASC 740 has two primary objectives. One objective is to “recognize the amount of taxes payable or refundable in the current year” (referred to as the **current tax liability or asset**).<sup>7</sup> A second objective is to “recognize deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity's financial statements or tax returns.”<sup>8</sup> Both objectives relate to reporting a company's income tax amounts on the balance sheet, not the *income statement*. The FASB refers to this method as the “asset and liability approach” to accounting for income taxes.<sup>9</sup> The FASB chose this approach because it felt it is most consistent with the definitions in FASB Concepts Statement No. 6, *Elements of Financial Statements*, and produces the most useful and understandable information.<sup>10</sup>

To compute the deferred tax liability or asset, a company must calculate the future tax effects attributable to temporary differences and **tax carryforwards**.<sup>11</sup> As you learned in the previous chapter, temporary differences generally can be thought of as revenue (income) or expenses (deductions) that will appear on both the income statement and the tax return but in different accounting periods. Temporary differences that are cumulatively favorable create deferred tax liabilities, while temporary differences that are cumulatively unfavorable create deferred tax assets.

### Example 6-1

Before she began the income tax provision process, Elise knew she needed to get the ending balances in PCC's deferred tax accounts from the prior year. Accordingly, she retrieved PCC's prior year balance sheet (Exhibit 6-1) and the deferred tax component of the company's income tax note (Exhibit 6-2).

Looking at Exhibit 6-1, what income tax accounts appear on PCC's balance sheet from the prior year?

Answer: There are three deferred tax accounts on PCC's prior year balance sheet: current deferred tax assets of \$271,660, noncurrent deferred tax assets of \$408,000, and noncurrent deferred tax liabilities of \$3,400,000.

Looking at Exhibit 6-2, is PCC in a net deferred tax asset or net deferred tax liability position at the end of the prior year (gross deferred tax assets less gross deferred tax liabilities)?

Answer: PCC ended the prior year with a net deferred tax liability of \$2,720,340.

Since its inception, has PCC had net favorable or unfavorable temporary differences (i.e., has PCC's cumulative pretax net income been greater or less than its taxable income)?

Answer: PCC's net deferred tax liability indicates that the company has had net cumulative favorable temporary differences, which indicates its cumulative pretax net income has exceeded its cumulative taxable income.

**Assets****Current Assets**

Cash	\$10,722,380
Municipal bonds	300,000
Accounts receivable	17,250,000
Less: Allowance for bad debts	(345,000)
Accounts receivable (net)	16,905,000
Inventory	4,312,500
Deferred tax assets	271,660
<b>Total Current Assets</b>	<b>\$32,511,540</b>

**Noncurrent Assets**

Fixed assets	\$60,000,000
Less: Accumulated depreciation	(12,000,000)
Fixed assets (net)	48,000,000
Life insurance (cash surrender value)	1,100,000
Investments	497,960
Goodwill	180,000
Deferred tax assets	408,000
<b>Total Noncurrent Assets</b>	<b>50,185,960</b>

**Total Assets****\$82,697,500****Liabilities and Shareholders' Equity****Current Liabilities**

Accounts payable	\$20,013,000
Reserve for warranties	430,000
Deferred tax liabilities	—
<b>Total Current Liabilities</b>	<b>\$20,443,000</b>

**Noncurrent Liabilities**

Long-term debt	\$40,000,000
Deferred compensation	1,200,000
Deferred tax liabilities	3,400,000
<b>Total Noncurrent Liabilities</b>	<b>\$44,600,000</b>

**Total Liabilities****\$65,043,000****Shareholders' Equity**

Common stock (par value = \$1)	\$ 500,000
Additional paid-in-capital	5,000,000
Retained earnings	12,154,500
<b>Total Shareholders' Equity</b>	<b>\$17,654,500</b>

**Total Liabilities and Shareholders' Equity****\$82,697,500****EXHIBIT 6-1**

PCC Balance Sheet at 12/31/2012

<b>Deferred Tax Assets</b>	
Allowance for bad debts	\$ 117,300
Reserve for warranties	146,200
Net operating loss carryforward	8,160
	<u>          </u>
<b>Current deferred tax assets</b>	\$ 271,660
Deferred compensation	408,000
Capital loss carryforward	—
Contribution carryforward	—
	<u>          </u>
<b>Noncurrent deferred tax assets</b>	\$ 408,000
	<u>          </u>
<b>Total deferred tax assets</b>	\$ 679,660
Valuation allowance for deferred tax assets	—
	<u>          </u>
<b>Deferred tax assets, net of valuation allowance</b>	\$ 679,660
<b>Deferred tax liabilities</b>	
Depreciation	(3,400,000)
	<u>          </u>
<b>Total deferred tax liabilities</b>	(\$3,400,000)
	<u>          </u>
<b>Net deferred tax liabilities</b>	<u>(\$2,720,340)</u>

## EXHIBIT 6-2

## PCC Deferred Tax Accounts at 12/31/2012

## The Income Tax Provision Process

A company computes the two components of its income tax provision (current and deferred) separately (independently) for each category of income tax (U.S. federal, U.S. state and local, and international<sup>5</sup>) and then combines the components to produce the total income tax provision. The “formula” to compute a company's total income tax provision can be summarized as:

$$\text{Total income tax provision} = \text{Current income tax expense (benefit)} + \text{Deferred income tax expense (benefit)}$$

There are six steps in the computation of a company's federal income tax provision. These steps are:

1. Adjust pretax net income for all permanent differences.
2. Identify all temporary differences and tax carryforward amounts.
3. Calculate the current income tax expense or benefit (refund).
4. Determine the ending balances in the balance sheet<sup>6</sup> deferred tax asset and liability accounts.
5. Evaluate the need for a valuation allowance for gross deferred tax assets.
6. Calculate the deferred income tax expense or benefit.

<sup>5</sup>The due date for a federal income tax return<sup>6</sup> filed by a calendar-year corporation is March 15, but corporations can request a six-month extension to September 15 by filing Form 7004 and paying any remaining tax liability.

<sup>6</sup>Although the statute of limitations for a filed income tax return<sup>6</sup> is three years, large corporations often agree to extend the statute for a longer period of time to allow the IRS to audit the return. As a result, a corporation's tax return may not be audited for five or more years from the date it is filed.

<sup>7</sup>ASC 740-10-10-1(a).

<sup>8</sup>ASC 740-10-10-1(b).

<sup>9</sup>FAS 109, ¶63. (This paragraph was not codified in ASC 740.)

<sup>10</sup>FAS 109, ¶63.

<sup>11</sup>ASC 740-10-25-2(b).

## CALCULATING THE CURRENT AND DEFERRED INCOME TAX EXPENSE OR BENEFIT COMPONENTS OF A COMPANY'S INCOME TAX PROVISION

### LO 6-2

#### Step 1: Adjust Pretax Net Income for All Permanent Differences

As you learned in the previous chapter, not all book-tax differences meet the definition of a temporary difference. Some differences will appear only on the income statement or the tax return, but not on both. Examples of the former include tax-exempt interest income and nondeductible fines. Examples of the latter include the dividends received deduction and the domestic production activities deduction. Although not defined as such in ASC 740, most accounting professionals refer to these types of book-tax differences as **permanent differences**.

A company does not take permanent differences into account in computing its balance sheet deferred tax assets and liabilities (and consequently, the deferred component of its income tax provision). Permanent differences enter into the company's computation of taxable income, and thus affect the current tax expense or benefit, either increasing or decreasing it. As a result, permanent differences usually affect a company's **effective tax rate** (income tax provision/pretax net income) and appear as part of the company's reconciliation of its effective tax rate with its statutory U.S. tax rate (34 percent in PCC's case).<sup>12</sup> We discuss ASC 740 disclosure requirements in a subsequent section of this chapter.

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Exhibit 6-4 provides a list of common permanent differences you will encounter in practice.

Life insurance proceeds	Disallowed meals and entertainment expenses
Tax-exempt interest income	Disallowed premiums on officers' life insurance
Nondeductible tax penalties and fines	Dividends received deduction
Tax credits	Domestic production activities deduction
Political contributions	

#### EXHIBIT 6-4

##### Common Permanent Differences

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##### Example 6-2

Elise went back to the template she used to compute PCC's taxable income and identified the book-tax adjustments that were considered permanent in nature. What are PCC's permanent differences and are they favorable or unfavorable?

Answer: A net favorable permanent difference of \$450,000, computed as follows:

Permanent Differences	Favorable (Unfavorable)
Tax-exempt interest income	\$ 12,000
Meals and entertainment	(14,000)
<u>Life insurance</u> premiums	(34,000)
Dividends received deduction	21,000
Domestic production activities deduction	465,000

Net favorable permanent difference \$450,000

### Example 6-3

Elise used the net favorable permanent difference of \$450,000 to adjust PCC's pretax net income. What is PCC's pretax net income adjusted for permanent differences?

Answer: \$5,567,000, computed as follows:

PCC pretax net income	\$6,017,000
Net favorable permanent difference	(450,000)
PCC pretax net income adjusted for permanent differences	\$5,567,000

Elise remembered that her instructor at ASC 740 training referred to this intermediate computation as a company's **book equivalent of taxable income**. That is, this amount represents the book income that will ultimately be taxable, either currently or in the future.

### Step 2: Identify All Temporary Differences and Tax Carryforward Amounts

ASC 740 formally defines a *temporary difference* as

A difference between the tax basis of an asset or liability... and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively.<sup>13</sup>

As you learned in Chapter 5, temporary differences commonly arise in four instances.

**Revenues or Gains That Are Taxable after They Are Recognized in Financial Income** An example of such a “favorable” book-tax adjustment is gain from an installment sale that is recognized for financial accounting purposes in the year of sale but is recognized over the collection period for tax purposes.<sup>14</sup>

**Expenses or Losses That Are Deductible after They Are Recognized in Financial Income** Examples of such “unfavorable” book-tax adjustments include bad debt expenses, warranty expenses, and accrued compensation and vacation pay that are recorded using the reserve method for financial accounting purposes but can only be deducted when paid on the tax return.<sup>15</sup> Capitalized inventory costs under §263A also fall into this category, as do nonqualified stock option compensation expenses that are recorded at the grant date for financial reporting purposes under ASC 718 but do not become tax deductible until the exercise date.

### Page 6-9

**Revenues or Gains That Are Taxable before They Are Recognized in Financial Income** An example of such an “unfavorable” book-tax adjustment is a prepayment that is recognized in the year received for tax purposes but is not recognized for financial accounting purposes until the revenue is earned.

**Expenses or Losses That Are Deductible before They Are Recognized in Financial Income** A common example of such a “favorable” book-tax adjustment is the excess of tax depreciation over financial reporting depreciation.

Temporary differences also can arise from items that cannot be associated with a particular asset or liability for financial accounting purposes but produce revenue (income) or expense (deduction) that has been recognized in the financial statement and will result in taxable or deductible amounts in future years. For example, a net operating loss carryover and a net capital loss carryover create unfavorable temporary differences without being associated with a specific asset or liability.

Exhibit 6-5 lists common temporary differences.

Depreciation	Reserves for bad debts (uncollectible accounts)
Accrued vacation pay	Inventory costs capitalized under §263A
Prepayments of income	Warranty reserves
Installment sale income	Stock option expense under ASC 718
Pension plan deductions	Accrued bonuses and other compensation
Accrued contingency losses	Net operating loss and net capital loss carryovers

## EXHIBIT 6-5

### Common Temporary Differences

#### Identifying Taxable and Deductible Temporary Differences

#### THE KEY FACTS

#### Identifying Taxable and Deductible Temporary Differences

- **ASC 740 defines a temporary difference as a difference between the financial reporting and tax basis of an asset or liability that will create a future tax liability or benefit when the difference reverses.**
- **A temporary difference that cumulatively is *favorable* gives rise to a taxable temporary difference.**
- **The future tax cost associated with a taxable temporary difference is recorded on the balance sheet as a deferred tax liability.**
- **A temporary difference that cumulatively is *unfavorable* gives rise to a deductible temporary difference.**
- **The future tax benefit associated with a deductible temporary difference is recorded on the balance sheet as a deferred tax asset.**

**Taxable Temporary Difference** A temporary difference that is cumulatively *favorable* (i.e., an item that has cumulatively decreased taxable income relative to book income) gives rise to what ASC 740 refers to as a **taxable temporary difference**.<sup>16</sup> This category of temporary difference gets its name from the fact that when the difference reverses in a future period it will *increase taxable income* relative to book income.

Taxable temporary differences generally arise when (1) revenues or gains are taxable *after* they are recognized in net income (e.g., gross profit from an installment sale) and (2) expenses or losses are deductible on the tax return *before* they reduce net income (e.g., excess tax depreciation over financial accounting depreciation). From a balance sheet perspective, a taxable temporary difference generally causes the financial reporting basis of an asset to exceed its corresponding tax basis or the financial reporting basis of a liability to be less than its corresponding tax basis. The future tax cost associated with a taxable temporary difference is recorded on the

balance sheet as a deferred tax liability.

**Deductible Temporary Difference** A temporary difference that is cumulatively *unfavorable* (i.e., an item that has cumulatively increased taxable income relative to book income) gives rise to what ASC 740 refers to as a **deductible temporary difference**.<sup>17</sup> This category of temporary difference gets its name from the fact that when the difference reverses in a future period it will *decrease taxable income* relative to book income.

Page 6-10

Deductible temporary differences generally arise when (1) revenues or gains are taxable *before* they are recognized in net income (e.g., prepayments of subscriptions) and (2) expenses or losses are deductible on the tax return *after* they reduce net income (e.g., reserves for product warranty or uncollectible accounts). From a balance sheet perspective, a deductible temporary difference generally causes the financial reporting basis of an asset to be less than its corresponding tax basis or the financial reporting basis of a liability to exceed its corresponding tax basis. The future tax benefit associated with a deductible temporary difference is recorded on the balance sheet as a deferred tax asset.

Unfavorable temporary differences that do not have balance sheet accounts, such as net operating loss carryovers, net capital loss carryovers, and charitable contribution carryovers, must be tracked to ensure that the appropriate adjustment is made to a company's deferred tax asset accounts when the carryover is used on a future tax return.

#### Example 6-4

Elise decided to separate PCC's temporary differences as being cumulatively favorable or cumulatively unfavorable (see Exhibit 6-3). What are PCC's taxable (cumulatively favorable) temporary differences?

Answer: PCC has one taxable temporary difference that arises in the current year—the excess of tax depreciation over book depreciation in the amount of \$684,000. The gain on the sale of the fixed asset appears as an unfavorable difference, but it actually represents the reversal of a previously recorded favorable difference, the excess of tax over book depreciation. This “drawdown” of a previously recorded taxable temporary difference is included with the taxable temporary differences arising in the current year. Elise summarized the taxable temporary differences as follows:

<b>Taxable Temporary Differences</b>	<b>Amount</b>
Excess of tax over book depreciation	(\$700,000)
Gain on fixed asset disposition	16,000
Total taxable temporary differences	(\$684,000)

What are PCC's deductible (cumulatively unfavorable) temporary differences?

Answer: The deduction of previously accrued deferred compensation and PCC's use of its net operating loss carryover appear as favorable temporary differences in 2013, but they are actually reversals of prior unfavorable temporary differences and are included with the deductible temporary differences. PCC has total deductible temporary differences of \$267,700, computed as follows:

#### **Deductible Temporary Differences    Amount**

Net capital loss carryforward	\$ 28,000
Deferred compensation	(150,000)
Stock option compensation	100,000
Bad debt expense	70,000
Charitable contribution carryforward	73,700
Warranty expense	170,000
NOL carryforward from prior year	(24,000)
Total deductible temporary differences	\$267,700

For the year, PCC has a net taxable (favorable) temporary difference of \$416,300 [(\$684,000) + \$267,700].

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### Step 3: Compute the Current Income Tax Expense or Benefit

In many respects, the computation of the current portion of a company's tax provision appears to be straightforward. ASC 740 defines the **current income tax expense or benefit** as

The amount of income taxes paid or payable (or refundable) for a year as determined by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues for that year.<sup>18</sup>

To be sure, the major component of a company's current income tax expense or benefit is the income tax liability or refund from its current year operations. However, there are other items that enter into the computation that do not appear on the company's income tax return (Form 1120), which adds to the complexity of the computation.

In practice, the computation of a company's current income tax expense or benefit rarely equals the actual taxes paid on the company's current year tax returns. In particular, the current component of PCC's income tax provision also can be impacted by prior year income tax refunds from current year carrybacks of a net operating loss or net capital loss,<sup>19</sup> IRS audit adjustments from prior year tax returns,<sup>20</sup> windfall tax benefits from the exercise of nonqualified stock options, and changes in the company's **uncertain tax positions** (a company's reserve for taxes it has not paid but could pay in the future for positions taken on the current and prior year income tax returns).<sup>21</sup>

### Example 6-5

Elise used her summary of permanent and temporary differences to verify her previous computation of PCC's taxable income. Does using Elise's summary of PCC's permanent and temporary differences verify her previous computation of PCC's taxable income?

Answer: Yes!

PCC pretax net income	\$6,017,000
Net favorable permanent differences (from Example 6-2)	(450,000)
Net favorable temporary differences (from Example 6-4)	(416,300)
PCC taxable income	\$5,150,700

What is PCC's current income tax expense, assuming a tax rate of 34 percent?

Answer: \$1,751,238, computed as follows:

PCC taxable income	\$5,150,700
	× 34%
PCC federal income tax payable	\$1,751,238

What tax accounting journal entry does PCC make to record its current tax expense?

Answer:

Current income tax expense	1,751,238
Current income taxes payable (or cash)	1,751,238

### THE KEY FACTS

Computing the Deferred Income Tax Expense or Benefits

- **Identify current year changes in taxable and deductible temporary differences.**
- **Determine ending balances in each deferred tax asset and liability balance sheet account.**
- **Identify carryovers (net operating loss, capital loss, charitable contributions) not on the balance sheet.**
- **The current year deferred income tax expense or benefit is the difference between the deferred tax asset and liability balances at the beginning of the year to the end of the year as well as changes in tax carryovers.**

Step 4: Determine the Ending Balances in the Balance Sheet Deferred Tax Asset and Liability Accounts

The FASB could have decided that a company report only the “as-paid” income taxes on its income statement. Investors and policymakers might favor this approach because it would disclose the actual income taxes paid or refunded (cash outflow or inflow) in the current year. Reporting only income taxes currently payable ignores one of the basic premises underlying financial accounting, which is that the accrual method of accounting provides more relevant information to investors and creditors than the cash method of accounting.<sup>23</sup>

The deferred income tax expense or benefit portion of a company's income tax provision reflects the change during the year in a company's balance sheet deferred tax liabilities or assets.<sup>24</sup> This information provides investors and other interested parties with a measure of a company's expected future income tax-related cash inflows or outflows resulting from book-tax differences that are *temporary* in nature or from tax carryovers.

ASC 740 takes an “asset and liability” or balance sheet approach to the computation of the deferred tax expense or benefit. The computations are based on the change in the *cumulative* differences between the financial accounting basis of an asset or liability and its corresponding tax basis from the beginning of the year to the end of the year. Under GAAP, the company is presumed to recover these basis differences over time, resulting in future sacrifices of a company's resources (in the case of liabilities) or future recoveries of a company's resources (in the case of assets). These expected future recoveries of assets or future sacrifices of assets to settle liabilities give rise to future (deferred) tax payments or refunds that are recorded in the income tax provision in the year the differences arise rather than in the year in which the future taxes are paid or recovered.

The future tax cost of a taxable (cumulatively favorable) temporary difference is recorded on the balance sheet as a deferred tax liability. The company computes the deferred tax liability using the **enacted tax rate** that is expected to apply to taxable income in the period(s) in which the deferred tax liability is expected to be settled.<sup>25</sup>

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### Example 6-6

Lacking a formal tax-basis balance sheet, Elise identified the current year temporary differences and adjusted (“rolled forward”) the cumulative differences at the beginning of the year to get the end of the year cumulative book-tax basis differences. She used this change in the cumulative book-tax basis difference to compute the deferred tax expense or benefit for the current year. Elise reviewed her schedules of favorable and unfavorable temporary differences (from Example 6-3). She identified one favorable temporary difference related to an asset recorded on the balance sheet—the excess of tax depreciation over book depreciation. Elise retrieved the fixed asset workpaper and recorded the changes in the financial accounting and tax accumulated depreciation balances of PCC's fixed assets from the beginning of the year to the end of the year related to current year depreciation.

#### *Financial accounting change in accumulated depreciation*

Beginning of the year	\$12,000,000
End of the year	14,400,000
Net change	\$ 2,400,000

#### *Tax accounting change in accumulated depreciation\**

Beginning of the year	\$22,000,000
End of the year	25,100,000
Net change	\$ 3,100,000

\*Not given in the original facts; assumed for purposes of this example.

The net increase in tax accounting accumulated depreciation over the corresponding financial accounting depreciation created a current year \$700,000 favorable (taxable) temporary difference (i.e., the difference between the financial accounting basis of the fixed assets increased by \$700,000 over their corresponding tax basis). This increase in the cumulative favorable temporary difference requires an *increase* in PCC's deferred tax liabilities.

By what amount will PCC increase its deferred tax liabilities as a result of the increase in the book over tax basis in these assets from the beginning of the year to the end of the year?

Answer: \$238,000, computed as  $\$700,000 \times 34$  percent.

What tax accounting journal entry does PCC record related to this transaction?

Answer:

Deferred income tax expense	238,000
Deferred income tax liability	238,000

What if: Assume current year book depreciation exceeded current year tax depreciation by \$700,000. What adjustment to the balance sheet would PCC be required to make?

Answer: PCC would *decrease* its deferred tax liability on the balance sheet by \$238,000.

### Example 6-7

Elise also saw that accumulated depreciation decreased as a result of PCC's sale of a fixed asset during the year (see Exhibit 6-3). She observed from the workpapers that PCC sold the fixed asset for \$100,000, its original cost (not given in the original facts, assumed for purposes of this example). The book basis of the asset was \$46,000, resulting in a book gain of \$54,000. The tax gain on the sale was \$70,000, which corresponds to a decrease in accumulated tax depreciation of \$70,000 (i.e., the tax basis of the asset was \$30,000). The excess of the reduction in accumulated tax depreciation over accumulated book depreciation of \$16,000 corresponds to the excess of the tax gain over the book gain on the sale.

#### *Financial accounting change in accumulated depreciation on the fixed asset sold*

Beginning of the year	\$54,000
End of the year	0
Net change	\$54,000

#### *Tax accounting change in accumulated depreciation on the fixed asset sold*

Beginning of the year	\$70,000
End of the year	0
Net change	\$70,000

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By what amount will PCC *decrease* its deferred tax liabilities as a result of the decrease in the tax over book basis in this asset from the beginning of the year to the end of the year?

Answer: \$5,440, computed as  $\$16,000 \times 34\%$

What tax accounting journal entry does PCC record *related to this transaction*?

Answer:

Deferred income tax liability 5,440  
 Deferred income tax benefit 5,440

This “drawdown” of the excess of tax accumulated depreciation over book accumulated depreciation requires a reduction in the previously recorded deferred tax liability that resulted from the book-tax difference created by the excess of tax depreciation over book depreciation.

By what amount will PCC increase its current income tax expense as a result of this transaction (the tax gain was \$70,000)?

Answer: \$23,800, computed as  $\$70,000 \times 34\%$

What tax accounting journal entry does PCC record *related to this transaction*?

Answer:

Current income tax expense 23,800  
 Income taxes payable 23,800

What is the net impact of this transaction on PCC's income tax provision?

Answer: A net increase of \$18,360, computed as:

Current income tax expense	\$23,800
Deferred income tax benefit	(5,440)
Net increase in PCC's income tax provision	\$18,360

What do these journal entries accomplish?

Answer: The \$18,360 provision reflects the tax expense related to the book gain of \$54,000, computed as follows:

Book gain on sale of the fixed asset	\$54,000
	× 34%
Net increase in PCC's income tax provision	\$18,360

The recording of a deferred tax liability for years in which tax depreciation exceeded book depreciation anticipated the difference in the book and tax gain that would result when the fixed asset eventually was recovered, either through sale or depreciation of the entire basis.

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Example 6-8

Using her cumulative temporary differences template, Elise recorded the cumulative taxable temporary differences and the corresponding deferred tax liability at the beginning of the year (BOY) and the end of the year (EOY) to determine the change in the deferred tax liability related to accumulated depreciation.

**Premiere Computer Corporation**  
**Temporary Difference Scheduling Template**

**BOY**

<b>Taxable Temporary Differences</b>	<b>Cumulative T/D</b>	<b>Beginning Deferred Taxes (@ 34%)</b>	<b>Current Year Change</b>	<b>T/D</b>	<b>Ending Deferred Taxes (@ 34%)</b>
<i>Noncurrent</i>					
Accumulated Depreciation	(10,000,000)*	(3,400,000)	(684,000)	(10,684,000)	(3,632,560)

\*\$22,000,000 – \$12,000,000, from Example 6-6.

What is the net increase in PCC's deferred tax liability related to fixed assets for 2013?

Answer: \$232,560, the change in the cumulative deferred tax liability from the beginning of the year (\$3,400,000) to the end of the year (\$3,632,560).

This amount corresponds to the increase in the deferred tax liability due to the current year change in the book-tax difference related to depreciation (\$700,000) less the reduction in the deferred tax liability due to the change in the book-tax difference related to accumulated depreciation written off on the sale of the fixed asset (\$16,000).

What tax accounting journal entry does PCC record related to the change in total deferred tax liabilities from the beginning of the year to the end of the year?

Answer:

Deferred income tax expense 232,560

Deferred income tax liability 232,560

Using a template that tracks the cumulative changes in the book-tax differences related to balance sheet accounts becomes especially important when a company's enacted tax rate changes. For example, if PCC's federal income tax rate increased from 34 percent to 35 percent as a result of an increase in its taxable income, and PCC expects to maintain that tax rate in future periods, the company would tax-effect its year-end cumulative book-tax difference related to fixed assets at the new tax rate, 35 percent. The increase in the deferred tax expense related to adjusting the balance sheet will reflect the current year change in the book-tax difference and also an adjustment to revalue the cumulative book-tax difference at the beginning of the year. This discussion points to the fact that the focus of ASC 740 is to have the balance sheet deferred tax accounts reflect the tax that will be due or refunded when the underlying temporary differences reverse in a future period.

#### Example 6-9

What if: Assume PCC's tax rate increased from 34 percent in 2012 to 35 percent in 2013. By what amount would PCC increase or decrease its balance sheet deferred tax liability related to the fixed asset account?

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Answer: PCC *increases* its deferred tax liability related to fixed assets by \$339,400, calculated as follows:

Premiere Computer Corporation Temporary Difference Scheduling Template					
Taxable Temporary Differences	BOY Cumulative T/D	Beginning Deferred Taxes (@ 34%)	Current Year Change	EOY Cumulative T/D	Ending Deferred Taxes (@ 35%)
<i>Noncurrent</i> Accumulated depreciation	(10,000,000)	(3,400,000)	(684,000)	(10,684,000)	<b>(3,739,400)</b>

PCC would use a tax rate of 35 percent to compute the ending balance in its deferred tax liability related to fixed assets. The net increase in the deferred tax liability related to accumulated depreciation is now \$339,400 (\$3,739,400 — \$3,400,000).

What tax accounting journal entry does PCC record *related to fixed assets*?

Answer:

Deferred income tax expense 339,400

Deferred income tax liability 339,400

This amount no longer corresponds to the increase in the deferred income tax liability due to the current year net change in the book-tax difference related to depreciation of \$684,000 times the new applicable tax rate of 35 percent ( $\$684,000 \times 35\% = \$239,400$ ). The \$100,000 difference results from increasing the beginning of the

year cumulative temporary difference of \$10,000,000 times the change in the tax rate of 1 percent (\$10,000,000  $\times$  1% = \$100,000).

### Example 6-10

Returning to her temporary differences template, Elise recorded the deductible (cumulatively unfavorable) temporary differences and the corresponding deferred tax assets at the beginning of the year (BOY) and the end of the year (EOY) to determine the change in PCC's deferred tax assets during the current year.

Premiere Computer Corporation					
Temporary Difference Scheduling Template					
Deductible Temporary Differences	BOY Cumulative T/D	Beginning Deferred Taxes (@ 34%)	Current Year Change	EOY Cumulative T/D	Ending Deferred Taxes (@ 34%)
<b>Current</b>					
Allowance for bad debts	\$ 345,000	\$117,300	\$ 70,000	\$ 415,000	\$141,100
Reserve for warranties	430,000	146,200	170,000	600,000	204,000
Net operating loss	24,000	8,160	(24,000)		0
				0	
<b>Total current</b>	<b>\$ 799,000</b>	<b>\$271,660</b>	<b>\$ 216,000</b>	<b>\$1,015,000</b>	<b>\$345,100</b>
<b>Noncurrent</b>					
Deferred compensation	\$1,200,000	\$408,000	(\$150,000)	\$1,050,000	\$357,000
Stock option compensation	0	0	100,000	100,000	34,000
Net capital loss carryover	0	0	28,000	28,000	9,520
Contribution carryover	0	0	73,700	73,700	25,058
<b>Total noncurrent</b>	<b>\$1,200,000</b>	<b>\$408,000</b>	<b>\$51,700</b>	<b>\$1,251,700</b>	<b>\$425,578</b>
<b>Total</b>	<b>\$1,999,000</b>	<b>\$679,660</b>	<b>\$ 267,700</b>	<b>\$2,266,700</b>	<b>\$770,678</b>

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What is the net increase in PCC's total deferred income tax assets for 2013?

Answer: \$91,018, the change in the cumulative deferred tax asset from the beginning of the year balance of \$679,660 to the end of the year balance of \$770,678.

What tax accounting journal entry does PCC record *related to deferred tax assets*?

Answer:

Deferred income tax assets 91,018

Deferred income tax benefit 91,018

### Example 6-11

What if: Assume PCC's tax rate increased from 34 percent in 2012 to 35 percent in 2013. By what amount would PCC increase or decrease its *total* balance sheet deferred income tax assets?

Answer: PCC *increases* its total deferred tax asset balance by \$113,685, calculated as follows:

<b>Premiere Computer Corporation</b> <b>Temporary Difference Scheduling Template</b>					
<b>Deductible Temporary Differences</b>	<b>BOY Cumulative T/D</b>	<b>Beginning Deferred Taxes (@ 34%)</b>	<b>Current Year Change</b>	<b>EOY Cumulative T/D</b>	<b>Ending Deferred Taxes (@ 35%)</b>
<b>Current</b>					
Allowance for bad debts	\$ 345,000	\$117,300	\$ 70,000	\$ 415,000	\$145,250
Reserve for warranties	430,000	146,200	170,000	600,000	210,000
Net operating loss	24,000	8,160	(24,000)	0	0
<b>Total current</b>	<b>\$ 799,000</b>	<b>\$271,660</b>	<b>\$ 216,000</b>	<b>\$1,015,000</b>	<b>\$355,250</b>
<b>Noncurrent</b>					
Deferred compensation	\$1,200,000	\$408,000	(\$150,000)	\$1,050,000	\$367,500
Stock option compensation	0	0	100,000	100,000	35,000
Net capital loss carryover	0	0	28,000	28,000	9,800
Contribution carryover	0	0	73,700	73,700	25,795
<b>Total noncurrent</b>	<b>\$1,200,000</b>	<b>\$408,000</b>	<b>\$51,700</b>	<b>\$1,251,700</b>	<b>\$438,095</b>
<b>Total</b>	<b>\$1,999,000</b>	<b>\$679,660</b>	<b>\$ 267,700</b>	<b>\$2,266,700</b>	<b>\$793,345</b>

PCC would use a tax rate of 35 percent to compute the ending balance in each of its deferred tax asset accounts. The net increase in total deferred tax assets is now \$113,685 (\$793,345 — \$679,660).

What tax accounting journal entry does PCC record to reflect the change in its *total* deferred tax assets?

Answer:

Deferred income tax assets	113,685
Deferred income tax benefit	113,685

This amount no longer corresponds to the increase in total deferred tax assets due to the current year change in cumulative deductible temporary differences of \$267,700 times the new applicable tax rate of 35 percent ( $\$267,700 \times 35\% = \$93,695$ ). The \$19,990 difference results from increasing the beginning of the year cumulative temporary difference of \$1,999,000 times the change in the tax rate of 1 percent ( $\$1,999,000 \times 1\% = \$19,990$ ).

<sup>12</sup>The windfall tax benefit from a nonqualified stock option deduction that is not treated as a temporary difference is recorded in additional paid-in capital (refer back to the previous discussion of stock option deductions in Chapter 5).

<sup>13</sup>ASC 740-10-20 Glossary.

<sup>14</sup>Consistent with the terminology introduced in Chapter 5, a “favorable” book-tax adjustment is one that reduces current year taxable income compared to current year net income.

<sup>15</sup>Consistent with the terminology introduced in Chapter 5, an “unfavorable” book-tax adjustment is one that increases current year taxable income compared to current year net income.

<sup>16</sup>ASC 740-10-25-23.

<sup>17</sup>ASC 740-10-25-23.

<sup>18</sup>ASC 740-10-20 Glossary.

<sup>19</sup>Requested on Form 1139 or Form 1120X.

<sup>20</sup>Agreed to on Form 5701.

<sup>21</sup>Calculated in the uncertain tax position workpapers.

<sup>23</sup>ASC 230, *Statement of Cash Flows*, requires an enterprise to separately disclose income taxes paid as part of the statement itself or in a note to the financial statements (usually the income taxes note or a supplemental cash flow note).

<sup>24</sup>ASC 740-10-20 Glossary.

<sup>25</sup>ASC 740-10-30-2. For federal income tax provision purposes, a corporation applies the regular tax rate in computing its deferred tax assets and liabilities. The alternative minimum tax is treated as a prepaid income tax and reported as a deferred tax asset on the balance sheet.

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## DETERMINING WHETHER A VALUATION ALLOWANCE IS NEEDED

LO 6-3

## Step 5: Evaluate the Need for a Valuation Allowance for Gross Deferred Tax Assets

ASC 740 specifically precludes PCC or any company from discounting (recording the present value of) the deferred tax liability or asset related to a temporary difference based on when the asset is expected to be recovered or the liability settled. The FASB debated whether discounting deferred tax assets and liabilities would provide more relevant information to investors, but ultimately it decided that the complexity and cost of making the computation outweighed any benefits investors and creditors might receive from the computation.<sup>26</sup>

## THE KEY FACTS

## Determining if a Valuation Allowance Is Needed

- A valuation allowance is required if it is more likely than not that some or all of the deferred tax asset will not be realized in the future.
- To make this determination, a company must determine its sources of future (or past) taxable income.
  - Taxable income in carryback years.
  - Reversing taxable temporary differences in future years.
  - Expected taxable income in future years from other than reversing taxable temporary differences.
  - Expected taxable income in future taxable years from implementing tax planning strategies.
- A company must evaluate (weigh) positive and negative evidence in deciding whether a valuation allowance is needed.
- A company must monitor whether increases or decreases should be made to the valuation allowance account every quarter.

In lieu of discounting, ASC 740 requires that a company evaluate each of its gross deferred tax assets on the balance sheet and assess the likelihood the expected tax benefit will be realized in a future period. The income tax benefits reflected in the deferred tax assets can only be *realized* (converted into cash) if the company expects to have sufficient taxable income or tax liability in the future or carryback period to absorb the unused tax deductions or credits before they expire.

## Determining the Need for a Valuation Allowance

Under ASC 740, if a company determines that it is *more likely than not* (a likelihood greater than 50 percent) that some portion or all of the deferred tax assets will not be realized in a future period, it must offset the deferred tax assets with a **valuation allowance** to reflect the amount the company does not expect to realize in the future.<sup>27</sup> Valuation allowances operate as *contra accounts* to the deferred tax assets on the balance sheet, much like the allowance for bad debts a company must estimate for its accounts receivable. Companies usually

disclose the amount of the valuation allowance in the income tax footnote to the financial statements.

Management must assess whether it is more likely than not that a deferred tax asset will *not* be realized in the future based on all available evidence, both positive and negative. ASC 740 identifies four sources of potential future taxable income, two of which are objective and two of which are subjective (i.e., determined by management judgment).<sup>28</sup> The objective sources include (1) future reversals of existing taxable temporary differences and (2) taxable income in prior carryback year(s). The subjective sources include (1) expected future taxable income exclusive of reversing temporary differences and carryforwards and (2) tax planning strategies.

**Future Reversals of Existing Taxable Temporary Differences** Existing taxable (cumulatively favorable) temporary differences provide taxable income when they are recovered in a future period. For example, the recovery of the excess of an asset's financial accounting basis over its tax basis, whether through sale or depreciation, will cause taxable income to be higher than net income in the periods in which the excess financial accounting basis is recovered. If the reversing taxable temporary differences provide sufficient future taxable income to absorb the reversing deductible temporary differences, the company does not record a valuation allowance against the deferred tax asset.

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**Taxable Income in Prior Carryback Year(s)** The company does not record a valuation allowance if the tax benefit from the realization of a deferred tax asset can be carried back to a prior year that has sufficient taxable income (or capital gain net income in the case of a net capital loss carryback) to absorb the realized tax benefit.

**Expected Future Taxable Income Exclusive of Reversing Temporary Differences and Carryforwards** ASC 740 allows a company to consider taxable income it expects to earn in future periods in determining whether a valuation allowance is necessary. The company might support its predictions of future taxable income with evidence of existing contracts or a sales backlog that will produce enough taxable income to realize the deferred tax asset when it reverses. In addition, the company might demonstrate that it has a strong earnings history if a deferred tax asset arises from a loss that could be considered out of the ordinary and not from a continuing condition. Cyclical industries such as automobile manufacturers and airlines traditionally have cited a history of past income as evidence of expected future income.

**Tax Planning Strategies** The most subjective source of future taxable income to support the realization of a deferred tax asset involves the company's ability and willingness to employ tax strategies in those future periods to create the taxable income needed to absorb the deferred tax asset. ASC 740 allows a company to consider actions it might take to create sufficient taxable income to absorb a deferred tax asset, provided such actions (1) are prudent and feasible; (2) are actions an enterprise might not take, but would take to prevent an operating loss or tax credit carryforward from expiring unused; and (3) would result in realization of the deferred tax assets. The company does not have to implement the strategy to avoid recording a valuation allowance, but management must be willing and able to execute the strategy if the need arises. Tax planning strategies could include (1) selling and leasing back operating assets, (2) changing inventory accounting methods (e.g., from LIFO to FIFO), (3) refraining from making voluntary contributions to the company pension plan, (4) electing to capitalize certain expenditures (e.g., research and development costs) rather than deduct them currently, (5) selling noncore assets, and (6) electing the alternative depreciation system (straight line instead of declining balance).

**Negative Evidence That a Valuation Allowance Is Needed** ASC 740 requires that a company consider *negative*

*evidence* as well as *positive evidence* in determining whether it is more likely than not that a deferred tax asset will not be realized in the future. Negative evidence could include (1) cumulative (book) losses in recent years, (2) a history of net operating (capital) losses and credits expiring unused, (3) an expectation of losses in the near future, and (4) unsettled circumstances that, if resolved unfavorably, will result in losses from continuing operations in future years (e.g., the loss of a patent <sup>c</sup> a highly profitable drug).<sup>29</sup> As a general rule, public accounting firms interpret “recent years” with regard to cumulative book <sup>c</sup> losses as a rolling 12 quarters (i.e., three years). As with all general rules, there are exceptions depending on the industry.

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### Taxes in the Real World *AIG's \$17.7 Billion “Fantasy” Profit*

On February 23, 2012, American International Group, Inc. (AIG) announced net income of \$19.8 billion for the full year 2011. Closer inspection of the announcement revealed that \$17.7 billion of the amount was due to the company's release of a portion of its valuation allowance related to its deferred tax assets. The company's CEO stated that, “In 2011, we began to prosper once again. We have a high degree of confidence in our future earnings prospects, which is a critical element in our assessment supporting the release of the deferred tax asset valuation allowance.”<sup>a</sup> In its Form 10-K, the company explained the rationale for releasing the valuation allowance as follows:

The evaluation of the recoverability of the deferred tax asset and the need for a valuation allowance requires AIG to weigh all positive and negative evidence to reach a conclusion that it is more likely than not that all or some portion of the deferred tax asset will not be realized. The weight given to the evidence is commensurate with the extent to which it can be objectively verified. The more negative evidence that exists, the more positive evidence is necessary and the more difficult it is to support a conclusion that a valuation allowance is not needed. During 2011, AIG's level of profitability, excluding the \$3.3 billion loss on extinguishment of debt in January confirmed its return to sustainable operating profit for the full year. This, together with the emergence from cumulative losses in recent years and projections of sufficient future taxable income, represent significant positive evidence. As of December 31, 2011, the cumulative positive evidence outweighed the historical negative evidence regarding the likelihood that the deferred tax asset for AIG's U.S. consolidated income tax group (other than the life-insurance-business capital loss carryforwards) will be realized.<sup>b</sup>

Not everyone was impressed with AIG's “whopping” profit. A writer for the *New York Times* referred to the profit as “pure fantasy.” What do you think?<sup>c</sup>

<sup>a</sup>Form 8-K, issued 2/23/12. Available at <http://sec.gov>.

<sup>b</sup>Form 10-K, page 357. Available at <http://sec.gov>.

<sup>c</sup>Andrew Ross Sorkin, “Bending the Tax Code, and Lifting A.I.G.'s Profit,” *New York Times*, February 23, 2102, (blog).

### Example 6-12

Elise created a workpaper that listed PCC's ending balances in its deferred tax assets and liabilities at December 31, 2013 (from Examples 6-8 and 6-10), as follows:

**PCC Deferred Tax Accounts at 12/31/2013**

<b>Deferred Tax Assets</b>	
Allowance for bad debts	\$ 141,100
Reserve for warranties	204,000
Net operating loss carryforward	0
Deferred compensation	357,000
Stock option compensation	34,000
Capital loss carryforward	9,520
Contribution carryforward	25,058
<b>Total deferred tax assets</b>	<b>\$ 770,678</b>
<b>Deferred tax liabilities</b>	
Depreciation	(3,632,560)
<b>Total deferred tax liabilities</b>	<b>\$(3,632,560)</b>
<b>Net deferred tax liabilities</b>	<b>\$(2,861,882)</b>

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What *positive* evidence should Elise consider in her evaluation as to whether PCC should record a valuation allowance against some or all of the deferred tax assets?

Answer: PCC has an excess of deferred tax liabilities over deferred tax assets of \$2,861,882. When the book-tax depreciation difference reverses in the future, this will provide PCC with enough taxable income to absorb the reversing deferred tax assets.

What *negative* evidence should Elise consider in her evaluation as to whether PCC should record a valuation allowance against some or all of the deferred tax assets?

Answer: The deferred tax asset related to the charitable contribution carryover has a short carryover expiration date (five years). Elise may need to schedule out when the depreciation differences will reverse to determine if the reversals alone will provide PCC with enough taxable income to absorb the contribution carryover within the next five years.

More problematic, the net capital loss carryover has both a short carryover expiration date (five years) and requires PCC to recognize net capital gains in future periods to absorb the net capital loss. A reversal of the book-tax depreciation temporary difference will not provide PCC with net capital gain to absorb the net capital loss carryover.

What other sources of *positive* evidence should Elise consider in her evaluation as to whether PCC should record a valuation allowance against the deferred tax asset related to the net capital loss carryover?

Answer: Two additional sources of positive evidence are management's projections of future taxable income from sources other than reversing taxable temporary differences and future taxable income from tax planning strategies. Because PCC is in the business of manufacturing and selling computer-related equipment, any additional taxable income it generates from selling additional equipment will produce ordinary income. The company likely will have to rely on an assertion that management has a "prudent" *tax planning strategy* it would be willing to use to generate net capital gain in the future. An example of such a strategy might be management's

willingness to sell a parcel of land held for investment to generate a capital gain sufficient to absorb the net capital loss.

### Example 6-13

What if: Assume PCC has had net book losses of \$5,000,000 and \$2,500,000 in 2011 and 2012, respectively. How might this additional fact influence Elise's assessment about the need for a valuation allowance?

Answer: PCC would have a cumulative book loss of \$1,483,000 over the past 12 quarters at December 31, 2013 (combined book losses of \$7,500,00 in excess of 2013 book income of \$6,017,000 from Exhibit 6-3). ASC 740 states that a cumulative loss "in recent years" is considered objective negative evidence that may be hard to overcome. Elise would have to consider other sources of positive evidence that will outweigh the "significant" negative evidence in this situation.

### Example 6-14

What if: Assume PCC just lost a big account to its competitor, but the company had reported cumulative net income in the current and prior two years. How might this additional fact influence Elise's assessment about the need for a valuation allowance?

Answer: Expectations of future events can outweigh historic results. In this case, Elise would have to seriously consider whether a valuation allowance would be required to the extent that reversing taxable temporary differences would not absorb expected future losses.

### Page 6-22

Step 6: Calculate the Deferred Income Tax Expense or Benefit

### Example 6-15

After discussing with management its assessment of the company's sources of future taxable income, Elise concurred with management that the company did not need to record a valuation allowance for 2013. Elise now had the pieces to determine PCC's deferred income tax expense or benefit for 2013. What is PCC's deferred income tax provision for 2013 (use the solutions from Examples 6-8 and 6-10)?

Answer: \$141,542 net deferred tax expense, computed as follows:

Gross deferred tax expense	\$232,560[Example 6-8]
Gross deferred tax benefit	(91,018)[Example 6-10]
Net deferred tax expense	\$141,542

What is PCC's total income tax provision for 2013? (also use the solution from Example 6-5).

Answer: \$1,892,780 income tax expense, computed as follows:

Current tax expense	\$1,751,238[Example 6-5]
Gross deferred tax expense	232,560
Gross deferred tax benefit	(91,018)
Income tax expense	\$1,892,780

There is a straightforward “back-of-the-envelope” method of verifying the ASC 740 approach to calculating PCC's total tax provision. Under the assumption that all temporary differences will appear on a tax return in a current or future period, the total tax provision should reflect the tax that ultimately will be paid on pretax net income adjusted for *permanent differences*. Remember from Example 6-3 that this amount is sometimes referred to as a company's book equivalent of taxable income. The total income tax provision should equal the company's tax rate times its book equivalent of taxable income. We would emphasize that this approach to computing a company's income tax provision is not in accordance with GAAP and will not provide the correct answer when there are changes in a company's income tax rate.

#### Example 6-16

Elise retrieved her computation of PCC's book equivalent of taxable income (from Example 6-3), as follows:

PCC pretax net income	\$6,017,000
Net favorable permanent difference	(450,000)
PCC book equivalent to taxable income	\$5,567,000

What is PCC's total tax provision using book equivalent of taxable income as a base?

Answer: \$1,892,780, computed as follows:

PCC book equivalent to taxable income	\$5,567,000
	×34%
PCC book equivalent to taxable income	\$1,892,780

This computation confirms the computation made under ASC 740 from Example 6-15.

<sup>26</sup>FAS 109, ¶¶198–199. (These paragraphs were not codified in ASC 740.)

<sup>27</sup>ASC 740-10-30-5(e).

<sup>28</sup>ASC 740-10-30-18.

<sup>29</sup>ASC 740-10-30-21.

## ACCOUNTING FOR UNCERTAINTY IN INCOME TAX POSITIONS

### LO 6-4

As you have learned in your study of the U.S. income tax laws, the answer to every tax question is not always certain. Taxpayers and the IRS can differ in their opinions as to whether an expenditure is deductible or must be capitalized or whether income is taxable or is deferred or exempt from taxation. When irresolvable disputes arise, the taxpayer can petition the courts to resolve the tax treatment of a transaction. Taxpayers and the IRS can appeal decisions of the lower courts to the appellate courts and ultimately to the Supreme Court. Taxpayers also take tax positions that can be disputed by state and local taxing authorities and international tax authorities. For example, the taxpayer and a state (international) tax authority may differ on whether the taxpayer has earned income in that jurisdiction and should pay tax on such income. The courts may not resolve this issue for many years after the original transaction takes place. If the courts do not resolve the issue in the taxpayer's favor, the taxpayer will be subject to interest and possible penalties on the tax owed.

### THE KEY FACTS

#### Accounting for Uncertain Tax Positions

- ASC 740 requires a two-step process in determining if a tax benefit can be recognized in the financial statements.
  - A company first determines if it is more likely than not that its tax position on a particular account will be sustained on IRS examination based on its technical merits.
  - A company then determines the amount it expects to be able to recognize.
- The measurement process requires the company to make a cumulative probability assessment of all likely outcomes of the audit and litigation process.
  - The company recognizes the amount that has a greater than 50 percent probability of being sustained on examination and subsequent litigation.
  - The amount not recognized is recorded as a liability on the balance sheet.

For financial accounting purposes, a company must determine whether it can record the current or future tax benefits from an “uncertain” tax position in its financial statement for the period in which the transaction takes place, knowing that the ultimate resolution of the tax position may not be known until some time in the future.

FAS 109 as originally written provided no specific guidance on how to deal with uncertain tax positions. As a result, companies generally applied the principles of FAS 5, *Accounting for Contingencies* (codified as ASC 450), to uncertain tax positions. The FASB became concerned that companies were not applying FAS 5 uniformly, leading to diversity in practice and financial statements that were not comparable. After much debate, the FASB issued FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes—An Interpretation of FASB Statement No. 109*, in July 2006, effective for years beginning after December 15, 2006. FIN 48 has been codified in ASC 740. The objective of FIN 48 is to provide a uniform approach to recording and disclosing tax benefits resulting from tax positions that are considered to be uncertain.

ASC 740 (FIN 48) applies a two-step process to evaluating tax positions. ASC 740 refers to the first step as *recognition*.<sup>30</sup> A company must determine whether it is *more likely than not* (a greater than 50 percent probability) that a tax position will be sustained on examination by the IRS or other taxing authority, including resolution of any appeals within the court system, based on the technical merits of the position. In making this determination, the company must presume that the taxing authority (IRS) will examine the tax position with full knowledge of all relevant information. In other words, the company cannot take into account the possibility that the taxing authority will not audit the uncertain tax position (play the “audit lottery”).

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The second step is referred to as *measurement*.<sup>31</sup> If the tax position meets the more-likely-than-not threshold (a subjective determination), the company must determine the amount of the benefit to record in the financial statements, or from an ASC 740 perspective, how much of its claimed tax benefit the company is not allowed to recognize. (ASC 740 refers to this unclaimed amount as “unrecognized tax benefits.”) Under ASC 740, the company records the largest amount of the benefit, as calculated on a cumulative probability basis, which is more likely than not to be realized on the ultimate settlement of the tax position.

### Application of ASC 740 to Uncertain Tax Positions

ASC 740 applies to all *tax positions* dealing with income taxes. As a result, ASC 740 pertains to tax positions taken on a current or previously filed *tax return* or a tax position that will be taken on a future tax return that is reflected in the financial statements as a deferred tax asset or liability. ASC 740 also applies to tax positions that result in permanent differences (e.g., the domestic production activities deduction and credits) and to decisions not to file a tax return in a particular jurisdiction. For example, assume a company deducts an expenditure on its current tax return, which the IRS may challenge on audit in a future period. The deduction produces a net operating loss that will be carried forward and offset against future taxable income. ASC 740 addresses whether the company can *recognize* the deferred tax asset related to the NOL carryforward on its *balance sheet*. Once the recognition hurdle is overcome, the company must then evaluate whether it is more likely than not that the deferred tax asset will be *realized* in the future period (i.e., whether a valuation allowance should be recorded).

**Step 1: Recognition** A company first must determine if it is more likely than not that its tax position on a particular account will be sustained on IRS examination based on its technical merits. If the company believes this threshold has been met, the company can record (recognize) the tax benefit of the tax position on its financial statements as a reduction in its current tax expense or an increase in its deferred tax benefit. The company must presume that the IRS will examine this tax position with full knowledge of all relevant information. However, in determining if the more-likely-than-not threshold has been met, the company can take into account how the tax position might be resolved if litigated. This requires the company to evaluate the sources of authority that address this issue (i.e., the *tax law*, regulations, legislative history, IRS rulings, and court opinions).

**Step 2: Measurement** After the *company* determines that the more-likely-than-not recognition threshold has been met, it must compute the amount of the tax benefit to recognize in its financial statements. ASC 740 states that the tax position is to be measured as

the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information.<sup>32</sup>

This measurement process requires the company to make a cumulative probability assessment of all likely

outcomes of the audit and litigation process. The company then recognizes the amount that has a greater than 50 percent probability of being sustained on examination and subsequent litigation.

The amount of the tax benefit that is not recognized (“unrecognized tax benefit”) is recorded as a liability on the balance sheet (usually labeled as “Income Taxes Payable”). The corresponding “debit” to record the balance sheet liability is to *current* income tax expense (or a decrease in income tax benefit). If the company expects the uncertain tax position to be resolved in the next 12 months, the balance sheet payable is characterized as current. Otherwise, the payable is characterized as being noncurrent. The increase in tax expense is added to the current portion of the provision under the theory that this is an on-demand liability.

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Example 6-17

Elise saw in the domestic production activities deduction (DPAD) workpapers that PCC claimed \$465,000 of DPAD on its tax return, computed as 9 percent times \$5,166,667 of qualified production activity income (from Example 5-1). She noted that there was mention in the uncertain tax position (UTP) workpapers that there was uncertainty as to whether \$1,000,000 of the \$5,166,667 met the definition of qualified production activity income (QPAI). This tax position provided PCC with a current year tax benefit of \$30,600 ( $\$1,000,000 \times 9\% \times 34\%$ ).

What threshold must be met before PCC can *recognize* any of the tax benefit from the “uncertain” portion of the DPAD on its financial statements?

Answer: PCC must determine that it is more likely than not that its tax position on the DPAD will be sustained by the IRS on examination based on its technical merits.

Example 6-18

PCC determined that it was more likely than not that the tax position would be sustained on audit and litigation. The tax department calculated the probability of receiving a full or partial benefit after resolution of the issue as follows:

Potential Estimated Individual Probability Cumulative Probability of		
Tax Benefit of Being Realized (%)		Being Realized (%)
\$30,600	60	60
\$22,500	25	85
\$18,000	10	95
0	5	100

Based on these probabilities, how much of the uncertain tax benefit of \$30,600 can PCC recognize?

Answer: \$30,600. PCC can recognize all \$30,600 of the DPAD tax benefit because this amount is the largest amount that has a greater than 50 percent cumulative probability of being realized on the ultimate settlement of the tax position.

Example 6-19

What if: Assume PCC's tax department had assessed the cumulative probabilities of sustaining the DPAD tax

benefit as follows:

<b>Potential Estimated Individual Probability Cumulative Probability</b>		
<b>Tax Benefit of Being Realized (%) of Being Realized (%)</b>		
\$30,600	40	40
\$22,500	30	70
\$18,000	20	90
0	10	100

Based on these probabilities, how much of the uncertain tax benefit of \$30,600 can PCC recognize?

Answer: \$22,500. PCC can recognize \$22,500 of the DPAD tax benefit because this amount is the largest amount that has a greater than 50 percent cumulative probability of being realized on the ultimate settlement of the tax position.

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What would be PCC's journal entry to record the portion of the tax benefit that cannot be recognized?

Answer: PCC would establish a liability for the \$8,100 difference between the amount of the benefit received on the current year tax return (\$30,600) and the amount the company ultimately expects to receive (\$22,500). PCC would record the following journal entry:

Current income tax expense	8,100
Income taxes payable	8,100

The income taxes payable account is characterized as noncurrent on the balance sheet if PCC does not expect the UTP to be resolved within the next 12 months.

### Subsequent Events

ASC 740 requires a company to monitor subsequent events (e.g., the issuance of new regulations, rulings, court opinions) that might change the company's assessment that a tax position will be sustained on audit and litigation. As facts and circumstances change, a company must reevaluate the tax benefit amount they expect to realize in the future. For example, the Treasury might issue a regulation or ruling that clarifies its tax position on a particular item. This regulation could change a company's assessment that its tax position meets the more-likely-than-not threshold required for recognition.

In its 2009 Annual Report, Cisco Systems Inc. disclosed that it took a tax charge of approximately \$174 million in the fourth quarter of fiscal 2009 after the U.S. Court of Appeals for the Ninth Circuit overturned a 2005 U.S. Tax Court ruling in *Xilinx, Inc. v. Commissioner*. The company increased its unrecognized tax benefits even though it was not named as a party to the case because it had the same issue on its tax returns (the deduction of share-based compensation expenses for the purpose of determining intangible development costs under a company's research and development cost sharing arrangement). This increase in the company's prior period unrecognized tax benefits increased its effective tax rate by 2.3 percentage points in fiscal 2009.

In its 2010 Annual Report, Cisco reported that the Ninth Circuit withdrew its prior holding and reaffirmed the 2005 U.S. Tax Court ruling in *Xilinx, Inc. v. Commissioner*. As a result of this final decision, the company

decreased the amount of gross unrecognized tax benefits by approximately \$220 million and decreased the amount of accrued interest by \$218 million. This adjustment decreased Cisco's effective tax rate by 1.7 percentage points.

## Interest and Penalties

ASC 740 requires a company to accrue interest and any applicable penalties on liabilities it establishes for potential future tax obligations. The interest (net of the tax benefit from deducting it on a future tax return when paid) and penalties (which are not tax deductible) can be treated as part of the company's UTP-related income tax expense and income tax payable or can be recognized as interest or penalties separate from the UTP-related income tax expense. ASC 740 only requires that the company apply its election consistently from period to period. This election creates the potential for diversity in practice. For example, General Motors Corporation treats accrued interest and penalties on its uncertain tax positions as part of its selling, general, and administrative expenses, while Ford Motor Company treats accrued interest and penalties on its uncertain tax positions as part of its income tax provision.

## Disclosures of Uncertain Tax Positions

One of the most controversial aspects of ASC 740 is its expansion of the disclosure requirements related to liabilities recorded due to uncertain tax positions. ASC 740 requires the company to roll forward all unrecognized tax benefits (UTBs) on a worldwide aggregated basis. Specific line items must disclose (1) the gross amounts of increases and decreases in liabilities related to uncertain tax positions as a result of tax positions taken during a prior period, (2) the gross amounts of increases and decreases in liabilities related to uncertain tax positions as a result of tax positions taken during the current period, (3) the amounts of decreases in liabilities related to uncertain tax positions relating to settlements with taxing authorities, and (4) reductions in liabilities related to uncertain tax positions as a result of a lapse of the applicable statute of limitations (the taxing authority can no longer audit the tax return on which the tax position was taken). The UTP disclosure by Microsoft Corporation is illustrated in Exhibit 6-6.

The aggregate changes in the balance of unrecognized tax benefits were as follows:

	(In millions)		
Year Ended June 30	2012	2011	2010
Balance, beginning of year	\$6,935	\$6,542	\$5,403
Decreases related to settlements	(16)	(632)	(57)
Increases for tax positions related to the current year	481	739	1,012
Increases for tax positions related to prior years	118	405	364
Decreases for tax positions related to prior years	(292)	(119)	(166)
Decreases due to lapsed statute of limitations	(24)	0	(14)
Balance, end of year	\$7,202	\$6,935	\$6,542

### EXHIBIT 6-6

The UTP Disclosure of Microsoft Corporation

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FIN 48 became effective for years beginning after December 15, 2006. The FASB required adopters to record their initial FIN 48 cumulative effect adjustment (in the first quarter after adoption) to retained earnings or other

balance sheet account rather than to the income tax provision. Subsequent adjustments must be reported as part of the income tax provision.

Opponents of FIN 48 worried that the FIN 48 disclosures would provide a “roadmap” to the IRS to a company's uncertain tax positions.<sup>33</sup> The FIN 48 disclosures have not provided the IRS with the hoped-for details because the UTP disclosure does not identify the tax jurisdictions to which the uncertain tax positions relate.

### Schedule UTP (Uncertain Tax Position Statement)

In January 2010, Commissioner Shulman announced that the IRS would begin asking large corporations to report their financial statement uncertain tax positions on new Schedule UTP beginning in tax year 2010. The commissioner stated that the goals of the new schedule would be to increase transparency and efficiency in identifying audit issues and help the IRS prioritize the selection of issues and taxpayers for audit. Schedule UTP requires corporations to report any federal income tax position for which an unrecognized tax benefit has been recorded in an audited financial statement. A corporation must identify the IRC section or sections relating to the position, indicate whether the position involves a temporary or permanent difference, identify whether the tax position is a major tax position (10 percent or more of the total), rank the tax positions by size, and provide a “concise” description of the UTP. Corporations with assets of \$100 million or more must file Schedule UTP beginning in the 2010 tax year, corporations with assets of \$50 million or more must file beginning in the 2012 tax year, and corporations with assets of \$10 million or more must file beginning in the 2014 tax year. An analysis of the first round of filed Schedule UTPs revealed that approximately 1,900 taxpayers filed the schedule and reported approximately 4,000 issues. The top three issues involved transfer pricing, the research credit, and business expenses.<sup>34</sup>

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Ethics

Pete Cooper, senior manager in the tax group in the Boston office of Bean Counters LLP, an international professional services firm, was reviewing the workpapers related to the uncertain tax positions prepared by his biggest client, Pro Vision Inc. Pete noticed that the client took the position that it did not need to record an uncertain tax benefit for a significant transaction because it had a “should level” opinion from its law firm. When Pete asked to see the tax opinion, he was told by the firm's tax director that the company did not want to disclose the item for fear the IRS also would ask to see the opinion. Pete has always had a good working relationship with the tax staff at Pro Vision and trusts their integrity.

Should Pete take the tax director's word when auditing the company's reserve for uncertain tax positions? What would you do if you were in Pete's position?

<sup>30</sup>ASC 740-10-25-5 through 25-7.

<sup>31</sup>ASC 740-10-30-7.

<sup>32</sup>ASC 740-10-30-7.

<sup>33</sup>Jesse Drucker, “Lifting the Veil on Tax Risk—New Accounting Rule Lays Bare a Firm's Liability if

Transaction Is Later Disallowed by the IRS,” *The Wall Street Journal*, May 25, 2007.

<sup>34</sup>See written testimony of Douglas H. Shulman before the House Ways & Means Subcommittee on Oversight, March 22, 2012, available at <http://waysandmeans.house.gov>.

# FINANCIAL STATEMENT DISCLOSURE AND THE COMPUTATION OF A CORPORATION'S EFFECTIVE TAX RATE

LO 6-5

## **Balance Sheet** Classification

ASC 740 requires publicly traded and privately held companies to disclose their deferred tax assets and liabilities on their balance sheets and classify them as either current or noncurrent.<sup>35</sup> A company classifies its deferred tax assets and liabilities based on the classification of the asset or liability to which the deferred tax account relates. For example, a deferred tax liability related to a long-term asset (e.g., depreciation of a fixed asset) is classified as noncurrent because the related asset is classified as noncurrent on the balance sheet. Deferred tax liabilities and assets not related to a specific asset (e.g., a net operating loss carryover or organizational expenditures capitalized for tax purposes) are classified based on the expected reversal date of the temporary difference.

ASC 740 requires companies to net deferred tax assets and liabilities based on their classification (current with current, noncurrent with noncurrent) and present the net amount on the balance sheet.<sup>36</sup> ASC 740 does not permit netting of deferred tax assets and liabilities that are attributable to different tax jurisdictions. For example, PCC cannot offset a noncurrent deferred tax asset related to a net operating loss incurred in Germany against a noncurrent deferred tax liability arising from depreciation of fixed assets within the United States. Exhibit 6-7 provides the balance sheet classification for common deferred tax assets and liabilities.

Current Deferred Account	Related Balance Sheet Account
Allowance for Bad Debts	Accounts Receivable
Reserve for Warranties	Warranty Payable (liability)
Inventory §263A Adjustment	Inventory
Revenue Recognition	Unearned Revenue (liability)
Noncurrent Deferred Account	Related Balance Sheet Account
Accumulated Depreciation	Fixed Assets
Amortization	Goodwill or Other Intangible
Deferred Compensation	Deferred Compensation (liability)

Deferred tax assets related to net operating loss carryovers, net capital loss carryovers, and charitable contribution are classified based on when the temporary difference is expected to reverse (be deducted on a future tax return).

### EXHIBIT 6-7

#### Classification of Common Deferred Tax Assets and Liabilities

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Example 6-20

Elise reviewed her temporary difference templates (see Examples 6-8 and 6-10). What will be the ending balance in PCC's net current deferred tax assets or liabilities at December 31, 2013?

Answer: \$345,100 net current deferred tax assets. PCC does not have any current deferred tax liabilities to offset against its current deferred tax assets.

What will be the ending balance in PCC's net noncurrent deferred tax assets or liabilities at December 31, 2013?

Answer: (\$3,206,982) net noncurrent deferred tax liability.

Because PCC's deferred tax accounts relate to the same tax jurisdiction (United States), PCC can net the noncurrent deferred tax liabilities of \$3,632,560 with the noncurrent deferred tax assets of \$425,578, resulting in a net noncurrent deferred tax liability of \$3,206,982.

#### Example 6-21

What if: Assume the noncurrent deferred tax asset related to deferred compensation arose in Canada. What will be the ending balance in PCC's net noncurrent deferred tax assets or liabilities at December 31, 2013?

Answer: \$357,000 noncurrent deferred tax asset and \$3,563,982 net noncurrent deferred tax liability (\$3,632,560 – \$68,578).

PCC cannot net the deferred tax asset that relates to Canada with the other noncurrent deferred tax accounts that relate to the United States.

#### Income Tax Footnote Disclosure

In addition to the above balance sheet disclosure requirements, ASC 740 mandates that a company disclose the components of the net deferred tax assets and liabilities reported on its balance sheet and the total valuation allowance recognized for deferred tax assets.<sup>37</sup> Most companies provide this information in a footnote to the financial statements (often referred to as the *income tax footnote*). Publicly traded companies must disclose the approximate “tax effect” of each type of temporary difference and carryforward that gives rise to a *significant* portion of the net deferred tax liabilities and deferred tax assets.<sup>38</sup> Privately held (nonpublic) companies only need to disclose the types of significant temporary differences without disclosing the tax effects of each type. ASC 740 does not define the term *significant*, although the SEC requires a publicly traded company to disclose separately the components of its total deferred tax assets and liabilities that are 5 percent or more of the total balance.<sup>39</sup> Exhibit 6-8 provides the disclosure of PCC's deferred tax accounts in its income tax footnote.

**NOTE 5 INCOME TAXES**

The Company's income (loss) from continuing operations before the income tax provision by taxing jurisdiction is as follows:

	<b>2013</b>
United States	<u>\$6,017,000</u>

The provision (benefit) for income taxes is as follows:

Current tax provision (benefit)	
Federal (U.S.)	\$1,751,238
Deferred tax expense (benefit)	
Federal (U.S.)	141,542
Income tax provision	<u>\$1,892,780</u>

Deferred tax assets and liabilities are classified as current or noncurrent according to the classification of the related asset or liability. The significant components of the Company's deferred tax assets and liabilities as of December 31, 2013, are as follows:

	<b>2013</b>
Deferred tax assets	
Allowance for bad debts	\$ 141,100
Reserve for warranties	204,000
Deferred compensation	357,000
Stock option compensation	34,000
Capital loss carryover	9,520
Contribution carryforward	25,058
Total deferred tax assets	\$ 770,678
Valuation allowance	0
Net deferred tax assets	<u>\$ 770,678</u>
Deferred tax liabilities	
Depreciation	(\$3,632,560)
Total deferred tax liabilities	(\$3,632,560)
Net deferred tax liabilities	<u>(\$2,861,882)</u>

The capital loss carryforward and the contribution carryforward expire in 2018 if unused.

A reconciliation of income taxes computed by applying the statutory U.S. income tax rate to the Company's income before income taxes to the income tax provision is as follows:

	<b>2013</b>
Amount computed at the statutory U.S. tax rate (34 percent)	\$2,045,780
Tax-exempt income	(4,080)
Nondeductible meals and entertainment	4,760
Nondeductible life insurance premiums	11,560
Dividends received deduction	(7,140)
Domestic production activities deduction	(158,100)
Income tax provision	<u>\$1,892,780</u>

Cash amounts paid during 2013 for income taxes, net of refunds, was \$1,751,238.

**EXHIBIT 6-8****PCC's Income Tax Note to Its Financial Statements**

ASC 740 also requires publicly traded companies to disclose the significant components of its income tax provision (expense or benefit) attributable to continuing operations in either the financial statements or a note thereto.<sup>40</sup> These components include the (1) current tax expense or benefit, (2) deferred tax expense or benefit, (3) the benefits of operating loss carryforwards, (4) adjustments of a deferred tax liability or asset for enacted changes in tax laws or rates, and (5) adjustments of the beginning-of-the-year balance of a valuation allowance because of a change in circumstances that causes a change in management's judgment about the realizability of the recognized deferred tax assets.

## Page 6-31

Computation and Reconciliation of the Income Tax Provision with a Company's *Hypothetical* Tax Provision  
ASC 740 requires a company to reconcile its (a) reported income tax provision attributable to continuing operations with (b) the amount of income tax expense that would result from applying its U.S. statutory tax rate to its pretax net income or loss from continuing operations.<sup>41</sup> Alternatively, a company can present the reconciliation in terms of tax rates, comparing its statutory tax rate with its effective tax rate (income tax provision/pretax income from continuing operations).

Differences between a company's income tax provision and its hypothetical tax provision can arise from several sources. Income taxes paid to a state or municipality increase a company's total income tax provision over its hypothetical income tax expense. Income taxes paid to a jurisdiction outside the United States can increase or decrease a company's total income tax provision over its hypothetical income tax expense depending on whether the jurisdiction taxes the company's income at more or less than the U.S. statutory rate. Permanent differences also affect the computation of PCC's income tax provision. Favorable permanent differences (e.g., tax-exempt income) decrease the income tax provision relative to the hypothetical income tax provision. Unfavorable permanent differences (e.g., nondeductible fines and penalties) increase the income tax provision relative to the hypothetical income tax provision.

ASC 740 requires a publicly traded company to disclose the estimated amount and nature of each significant reconciling item, which the SEC defines as an amount equal to or greater than 5 percent of the hypothetical provision. The SEC requires nonpublicly traded companies to disclose the nature of significant reconciling items but not the reconciling amount.

### Example 6-22

Elise used her schedule of permanent differences (from Example 6-2) to reconcile PCC's income tax provision (\$1,892,780, from Example 6-15) with the company's hypothetical income tax provision. The permanent differences from Example 6-2 are reproduced below:

<b>Permanent Differences</b>	<b>Favorable (Unfavorable)</b>
Tax exempt interest income	\$12,000
Meals and entertainment	\$(14,000)
Life insurance premiums	\$(34,000)
Dividends received deduction	\$21,000
Domestic production activities deduction	\$465,000

PCC's pretax net income from continuing operations in 2013 is \$6,017,000.

What is PCC's *hypothetical* income tax provision for 2013?

Answer: \$2,045,780, computed as \$6,017,000 × 34 percent.

What is PCC's *effective tax rate* for 2013?

Answer: 31.5 percent, computed as \$1,892,780/\$6,017,000.

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Provide a reconciliation of PCC's hypothetical income tax provision with its actual income tax provision in 2013. The tax cost or benefit from each permanent difference is computed by multiplying the permanent difference (from above) times 34 percent.

Answer:

### 2013

Amount computed at statutory U.S. tax rate (34%)	\$2,045,780
Tax-exempt income	(4,080)
Nondeductible meals and entertainment	4,760
Nondeductible life insurance premiums	11,560
Dividends received deduction	(7,140)
Domestic production activities deduction	(158,100)
Income tax provision	\$1,892,780

The SEC requires its registrants to separately disclose only those components of their effective tax rate reconciliations that equal or exceed 5 percent of the “hypothetical” tax expense. In the above reconciliation, PCC would only be required to separately disclose the items that equal or exceed \$102,289 (\$2,045,780 × 5%), which, in this example, would be the domestic production activities deduction. The other items could be netted in the reconciliation.

Provide a reconciliation of PCC's statutory income tax rate (34 percent) with its actual effective tax rate (31.5 percent) in 2013. The percentage effect of each permanent difference is computed by dividing the tax cost or benefit from the item (from above) by PCC's pretax net income (\$6,017,000).

Answer:

### 2013

Statutory U.S. tax rate	34.0%
Tax-exempt income	(0.0)
Nondeductible meals and entertainment	0.0
Nondeductible life insurance premiums	0.2
Dividends received deduction	(0.1)
Domestic production activities deduction	(2.6)
Effective tax rate	31.5%

Exhibit 6-8 provides the disclosure of PCC's reconciliation of its effective tax rate in its income tax footnote.

**Importance of a Company's Effective Tax Rate** The effective tax rate often serves as a benchmark for companies in the same industry. However, nonrecurring events can sometimes have a significant impact on the effective tax

rate. To mitigate the impact of such aberrational events, companies and their investors may use (at least for internal purposes) a different measure of effective tax rate that backs out one-time and nonrecurring events. This effective tax rate is referred to as the company's **structural tax rate**. The structural effective tax rate often is viewed as more representative of the company's effective tax rate from its normal (recurring) operations. In our example, PCC does not appear to have any nonrecurring reconciling items, which would make its effective tax rate and its structural tax rate the same.

Analysts often compute a company's **cash tax rate** (cash taxes paid divided by pretax book income) in their evaluation of the company's tax status. As the name implies, the cash tax rate excludes deferred taxes. PCC's cash tax rate in 2013 is 29.1 percent (\$1,751,238/\$6,017,000). Companies earning income in low-tax jurisdictions outside the United States or that have significant favorable permanent differences can have a cash tax rate that is much lower than their accounting effective tax rate. For example, Amazon.com Inc. reported an accounting effective tax rate of 31.1 percent and a cash tax rate of 3.5 percent in 2011!

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### Interim Period Effective Tax Rates

In addition to annual reports (Form 10-K), PCC also must report earnings on a quarterly basis (Form 10-Q). ASC 740-270, *Interim Reporting*, governs the preparation of these quarterly statements. ASC 740-270-30-6, states that “*at the end of each interim period the entity should make its best estimate of the effective tax rate expected to be applicable for the full fiscal year*” and apply this rate to the income reported in the quarterly statement. A company must reconsider its estimate of the annual rate each quarter. When the estimate changes, the company must adjust the cumulative tax provision for the year-to-date earnings to reflect the new expected annual rate. The adjusting amount becomes the company's income tax provision for the quarter.

<sup>35</sup>ASC 740-10-45-4.

<sup>36</sup>ASC 740-10-45-6.

<sup>37</sup>ASC 740-10-50-2.



<sup>38</sup>ASC 740-10-50-6.


<sup>39</sup>ASC 740-10-50-8 and SEC Regulation S-X, §210.4-08(h).

<sup>40</sup>ASC 740-10-50-9.


<sup>41</sup>ASC 740-10-50-12. The income tax provision computed using the statutory tax rate is often referred to as the *hypothetical* income tax expense.

## CONVERGENCE OF ASC 740 WITH **INTERNATIONAL** FINANCIAL REPORTING STANDARDS

In 2002, the FASB and the International Accounting Standards Board (IASB) announced they would work together to develop common accounting standards for the world's capital markets. Included in this project was an effort to converge ASC 740 with its International Financial Reporting  Standards (IFRS) counterpart, IAS 12, *Income Taxes*. The convergence project was put on hold by the FASB after the SEC announced that it was considering allowing the adoption of all IFRS standards by U.S. companies. In March 2009, the IASB issued a proposed revision of IAS 12 that incorporated some convergence with ASC 740. IAS 12 and ASC 740 share many commonalities. The differences relate primarily to issues beyond the scope of this chapter, although there are some disclosure and measurement differences (e.g., IAS 12 does not separate deferred tax accounts between current and noncurrent and does not specifically address accounting for uncertain tax positions). The FASB and IASB have not announced a resumption of the convergence project, and the IASB withdrew its proposed revision of IAS 12. The European Financial Reporting Advisory Group recently issued a thoughtful discussion paper on  Improving the financial reporting of income taxes.<sup>42</sup>

<sup>42</sup>European Financial Reporting  Advisory Group, Improving the *Financial Reporting of Income Taxes*, Discussion Paper, December 2011. Available at <http://www.efrag.org>.

## CONCLUSION

In this chapter we discussed the basic rules that govern the computation of a company's U.S. income tax provision. As a result of increased SEC and PCAOB scrutiny, the need for individuals who understand these rules has increased dramatically. The FASB requires a company to take a balance sheet  approach to computing its current and future (deferred) tax liabilities or benefits (assets). The income tax provision that appears on a company's income statement becomes the amount necessary to adjust the beginning balances of these accounts to their appropriate ending balances. The FASB and SEC also impose disclosure requirements for how a company reports its tax accounts in the financial statement amounts and notes to the financial statements.

**SUMMARY**

## LO 6–1

Explain the objectives behind FASB ASC Topic 740, *Income Taxes*, and the income tax provision process.

- Objectives of ASC 740:
  - To recognize a current income tax liability or asset for the company's taxes payable or refundable in the current year.
  - To recognize a deferred income tax liability or asset for the income tax effects of the company's temporary differences and carryovers.
- The income tax provision process consists of six steps:
  - Adjust net income before income taxes for all permanent differences.
  - Identify all temporary differences and tax carryforward amounts.
  - Calculate the current income tax expense or benefit (refund).
  - Determine the ending balances in the balance sheet deferred tax asset and liability accounts.
  - Evaluate the need for a valuation allowance for gross deferred tax assets.
  - Calculate the deferred income tax expense or benefit.

## LO 6–2


Calculate the current and deferred income tax expense or benefit components of a company's income tax provision.

- The company first adjusts its pretax net income or loss for permanent and temporary book-tax differences to compute taxable income or loss. The company then applies the appropriate tax rate to taxable income (loss) to compute the tax return current tax expense or benefit.
- The company adjusts its tax return income tax liability or benefit for audit refunds or deficiencies from prior year tax returns, and income tax benefits from stock option exercises treated as permanent differences.
- A company computes its deferred income tax expense or benefit by applying the applicable tax rate to the change in the cumulative balance sheet temporary differences between the financial accounting basis of an asset or liability and its corresponding tax basis from the beginning of the year to the end of the year.
- The future tax benefits from deductible (cumulatively unfavorable) temporary differences are recorded as deferred tax assets.


- The future tax costs of favorable taxable (cumulatively favorable) temporary differences are recorded as deferred tax liabilities.

## LO 6–3

Recall what a valuation allowance represents and describe the process by which it is determined.

- If a company determines that it is more likely than not (a greater than 50 percent probability) that some portion or all of the deferred tax assets will not be realized in a future period, it must offset the deferred tax assets with a valuation allowance to reflect the amount the company does not expect to realize in the future.
- The determination as to whether it is more  likely than not that a deferred tax asset will not be realized in the future must be based on all available evidence, both positive and negative.
- ASC 740 identifies four sources of prior and future taxable income to consider: (1) future reversals of existing taxable temporary differences, (2) taxable income in prior carryback year(s), (3) expected future taxable income exclusive of reversing temporary differences and carryforwards, and (4) expected income from tax strategies.

## LO 6–4

Explain how a company  accounts for its uncertain income tax positions under FASB ASC 740.

- A company must determine whether it can record the tax benefits from an “uncertain” tax position in its financial statement for the period in which the transaction takes place, knowing that the ultimate resolution of the tax position may not be known until some future period.




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- ASC 740 applies a two-step process to evaluating uncertain tax positions:
  - Recognition: A company must determine whether it is more likely than not (a greater than 50 percent probability) that a tax position will be sustained upon examination by the IRS or other taxing authority, including resolution of any appeals within the court system, based on the technical merits of the position.
  - Measurement: If the tax position meets the more-likely-than-not threshold (a subjective determination), the company must determine the amount of the benefit to record in the financial statements.
- Under ASC 740, the amount to be recorded is the largest amount of the benefit, as calculated on a cumulative probability basis, which is more likely than not to be realized on the ultimate settlement of the tax position.

## LO 6–5

Recognize the different components of a company's disclosure of its income tax accounts in the financial

statements and footnotes and comprehend how a company computes and discloses the components of its “effective tax rate.”

- ASC 740 requires a company to disclose and separate its deferred tax liabilities and assets into a current amount and a noncurrent amount on its balance sheet .
- A company also is required to present the “significant” components of the income tax provision (expense or benefit) attributable to continuing operations .
- ASC 740 requires publicly traded companies to reconcile their reported income tax expense (benefit) from continuing operations with the *hypothetical* tax expense that would have resulted from applying the domestic federal statutory rate to pretax income from continuing operations. Alternatively, the company can compute an *effective tax rate* from its continuing operations and reconcile it with the domestic federal statutory rate (34 percent or 35 percent).
- A company computes its effective tax rate by dividing its income tax provision (benefit) from continuing operations by its pretax net income from continuing operations.
- Items that cause the effective tax rate to differ from the statutory tax rate include permanent differences, audit adjustments, state and local taxes, and international  taxes.

## KEY TERMS

**book equivalent of taxable income (6-8)**

**cash tax rate (6-32)**

**current income tax expense or benefit (6-11)**

**current tax liability or asset (6-4)**

**deductible temporary difference (6-9)**

**deferred tax asset (6-2)**

**deferred tax liability (6-2)**

**effective tax rate (6-7)**

**enacted tax rate (6-12)**

**permanent differences (6-6)**

**structural tax rate (6-32)**

**tax accounting balance sheet (6-12)**

**tax carryforwards (6-4)**