Question #1 of 52

Question ID: 1590335

Graphics, Inc. has a deferred tax asset of $4,000,000 on its books. As of December 31, it became more likely than not that $2,000,000 of the asset's value may never be realized because of the uncertainty of future income. Graphics, Inc. should:

A) reduce the asset by establishing a valuation allowance of $2,000,000 against the asset. ✓

B) reverse the asset account permanently by $2,000,000. ✗

C) not make any adjustments until it is certain that the tax benefits will not be realized. ✗

Explanation

If it becomes more likely than not that deferred tax assets will not be fully realized, a valuation allowance that reduces the asset and also reduces income from continuing operations should be established.

(Module 20.3, LOS 20.f)

Question #2 of 52

Question ID: 1590324

Which of the following statements about deferred taxes is *most accurate*? Deferred tax liabilities:

A) arise primarily due to differences between financial and tax accounting. ✓

B) can relate to either permanent or temporary differences. ✗

C) should be treated as debt when calculating financial statement ratios. ✗

Explanation

Deferred tax liabilities result from temporary differences between financial accounting and tax accounting that cause income tax expense for a period to be larger than taxes due. Permanent differences do not result in deferred tax items. Whether to treat deferred tax liabilities as debt or equity depends on whether they are expected to reverse in the foreseeable future.

(Module 20.3, LOS 20.d)

Question #3 of 52

Question ID: 1590314

A dance club purchases new sound equipment for $25,352. It will work for 5 years and has no salvage value. For financial reporting, the straight-line depreciation method is used, but for tax purposes depreciation is 35% of original cost in Years 1 and 2 and the remaining 30% in Year 3. Annual revenues are constant at $14,384 over these five years. A change in the tax law was enacted in Year 3, reducing the tax rate from 41% to 31% for Years 4 and 5. What is the deferred tax liability as of the end of Year 3?

A) $3,144. ✓

B) $1,039. ✗

C) $2,948. ✗

Explanation

Straight-line depreciation = $25,352 / 5 = $5,070. Income (Years 1, 2, and 3) using straight-line depreciation = $14,384 − $5,070 = $9,314.

Accelerated depreciation (Years 1 and 2) = 0.35($25,352) = $8,873. Income (Years 1 and 2) = $14,384 − $8,873 = $5,511.

Accelerated depreciation (Year 3) = 0.3($25,352) = $7,606. Income (Year 3) = $14,384 − $7,606 = $6,778.

Cumulative difference in income at end of Year 3 = 3($9.314) − [2($5,511) + $6,778] = $10,142.

DTL value at new tax rate = 0.31($10,142) = $3,144.

(Module 20.1, LOS 20.b)

Question #4 of 52

Question ID: 1590328

Which of the following factors is *least likely* to cause a difference between a firm's effective tax rate and statutory rate?

A) Non-deductible expenses. ✗

B) Deductible expenses. ✓

C) Tax credits. ✗

Explanation

Permanent tax differences such as tax credits, non-deductible expenses, and tax differences between capital gains and operating income give rise to differences in the effective and statutory tax rates.

(Module 20.3, LOS 20.d)

Question #5 of 52

Question ID: 1590312

Nespa, Inc., has a deferred tax liability on its balance sheet in the amount of $25 million. A change in tax laws has increased future tax rates for Nespa. The impact of this increase in tax rate will be:

A) a decrease in deferred tax liability and an increase in tax expense. ✗

B) a decrease in deferred tax liability and a decrease in tax expense. ✗

C) an increase in deferred tax liability and an increase in tax expense. ✓

Explanation

An increase in tax rates will increase future deferred tax liability, and the impact of the increase in liability will be reflected in the income statement of the year in which the tax rate change is affected.

(Module 20.1, LOS 20.b)

Question #6 of 52

Question ID: 1590284

Hewie, Inc. purchased equipment for $300,000. On its financial statements, Hewie depreciates the equipment over six years using the straight-line method with no residual value. For tax purposes, Hewie uses double-declining balance depreciation over five years. What is the tax base of the asset at the end of Year 1?

A) $250,000. ✗

B) $180,000. ✓

C) $120,000. ✗

Explanation

The tax base is the amount that will be deducted on the tax return in future periods. Year 1 DDB depreciation = (2 / 5)($300,000) = $120,000. Tax base = $300,000 − $120,000 = $180,000.

(Module 20.1, LOS 20.a)

Question #7 of 52

Question ID: 1590321

Firm 1 has a deferred tax liability and Firm 2 has a deferred tax asset. If the tax rate decreases, the balance sheet values of these deferred tax items will:

	Firm 1	Firm 2	
A)	decrease.	decrease.	✓
B)	increase.	decrease.	✗
C)	increase.	increase.	✗

Explanation

A decrease in the future tax rate decreases the balance sheet value of either a deferred tax liability or a deferred tax asset.

(Module 20.2, LOS 20.c)

Question #8 of 52

Question ID: 1590322

A firm has deferred tax assets of $315,000 and deferred tax liabilities of $190,000. If the tax rate increases, adjusting the value of the firm's deferred tax items will:

A) decrease income tax expense. ✓

B) have no effect on income tax expense. ✗

C) increase income tax expense. ✗

Explanation

An increase in the tax rate increases the values of both DTAs and DTLs. Because the firm's DTAs are greater than its DTLs, the net effect of adjusting their values for an increase in the tax rate will be to decrease income tax expense.

(Module 20.2, LOS 20.c)

Question #9 of 52

Question ID: 1590330

Deferred tax items should be measured based on the:

A) firm's effective tax rate at the time when the temporary difference reverses. ✗

B) statutory tax rate at the time when the temporary difference is recognized. ✗

C) tax rate that will apply when the temporary difference reverses. ✓

Explanation

Measurement of deferred tax items is based on the tax rate that will apply when the temporary difference reverses. In some cases this may depend on how a temporary difference is settled, which determines whether a capital gains tax rate or income tax rate will apply.

(Module 20.3, LOS 20.e)

Question #10 of 52

Question ID: 1590289

Alter Inc. determines that it has $35,000 of accounts receivable outstanding at the end of 20X8. Based on past experience, it recognizes an provision for doubtful debt equal to 10% of its credit sales outstanding. For tax purposes, the doubtful debts cannot be deducted until written off. The tax base of Alter's accounts receivable at the end of 20X8 is *closest* to:

A) $3,500. ✗

B) $31,500. ✗

C) $35,000. ✓

Explanation

For tax purposes, bad debt expense cannot be deducted until the receivables are deemed worthless. Therefore, the tax base is $35,000 since no bad debt expense has been deducted on the tax return. Note that the carrying value would be $31,500 since bad debt expense is reflected on the income statement.

(Module 20.1, LOS 20.a)

Question #11 of 52

Question ID: 1590315

A firm needs to adjust its financial statements for a change in the tax rate. Taxable income is $80,000 and pretax income is $120,000. The current tax rate is 50%, and the new tax rate is 40%. The effect on taxes payable of adjusting the tax rate is *closest* to:

A) $4,000. ✗

B) $8,000. ✓

C) $16,000. ✗

Explanation

"Pretax income" denotes earnings before taxes for financial reporting. "Taxable income" is earnings before taxes for computing taxes payable, where taxes payable refers to the actual tax liability to the government. Since taxable income is $80,000, the difference in taxes payable is ($80,000)(0.5) – ($80,000)(0.4) = $8,000.

(Module 20.1, LOS 20.b)

Question #12 of 52

Question ID: 1590316

A health care company purchased a new MRI machine on 1/1/X3. At year-end the company recorded straight-line depreciation expense of $75,000 for book purposes and accelerated depreciation expense of $94,000 for tax purposes. Management estimates warranty expense related to corrective eye surgeries performed in 20X3 to be $250,000. Actual warranty expenses of $100,000 were incurred in 20X3 related to surgeries performed in 20X2. The company's tax rate for the current year was 35%, but a tax rate of 37% has been enacted into law and will apply in future periods. Assuming these are the only relevant entries for deferred taxes, the company's recorded changes in deferred tax assets and liabilities on 12/31/X3 are *closest to*:

	DTA	DTL	
A)	$55,500	$7,030	✓
B)	$55,500	$6,650	✗
C)	$52,500	$6,650	✗

Explanation

DTL = (tax depreciation – financial statement depreciation) × future tax rate = ($94,000 – $75,000) × 37% = $7,030.

DTA = (estimated warranty expense – actual warranty expense) × future tax rate = ($250,000 – $100,000) × 37% = $55,500.

(Module 20.1, LOS 20.b)

Question #13 of 52

Question ID: 1590313

An analyst has gathered the following tax information:

	Year 1	Year 2
Pretax Income	$60,000	$60,000
Taxable Income	$50,000	$65,000

Assume all the differences between pretax income and taxable income are expected to reverse in the future.

The current tax rate is 40%. The tax rate is reduced to 30% and the change is enacted at the beginning of Year 2.

In year 1, what are the taxes payable and what is the deferred tax liability (DTL)?

	Taxes payable	DTL	
A)	$24,000	$1,500	✗
B)	$20,000	$1,500	✗
C)	$20,000	$3,000	✓

Explanation

Taxes payable = taxable income × current tax rate = $50,000 × 40% = $20,000.

Taxes payable will be based on the current tax rate of 40%.

DTL = (pretax income − taxable income) × 30%

= ($60,000 − 50,000) × 30% = $3,000.

Deferred tax assets and liabilities must reflect the impact of a change in tax rates or tax laws.

(Module 20.1, LOS 20.b)

Question #14 of 52

Question ID: 1590331

In the context of deferred tax items, what is the impact on net income of an increase in the valuation allowance?

A) Decrease net income. ✓

B) No effect on net income.

C) Increase net income.

Explanation

The valuation allowance is a contra asset account that reduces the value of a deferred tax asset. This increases income tax expense and decreases net income. Valuation allowances are used to reduce the asset when future taxable income is deemed to be insufficient to fully use the DTA.

(Module 20.3, LOS 20.f)

Question #15 of 52

Question ID: 1590311

A company purchases a new pizza oven for $12,675. It will work for 5 years and have no salvage value. The company will depreciate the oven over 5 years using the straight-line method for financial reporting, and over 3 years for tax reporting. If the tax rate for years 4 and 5 changes from 41% to 31%, the deferred tax liability as of the end of year 3 is *closest* to:

A) $1,570.

B) $2,080.

C) $1,040.

Explanation

At the end of year 3, the oven has a tax base of zero (it has been fully depreciated for tax reporting) and a carrying value on the balance sheet of $12,675 – 3(0.2)($12,675) = $5,070. The deferred tax liability, valued at the 31% tax rate that will apply when the temporary difference reverses, is ($5,070 – $0)(0.31) = $1,571.70.

(Module 20.1, LOS 20.b)

Question #16 of 52

Question ID: 1590327

Deferred tax liabilities may result from:

A) pretax income greater than taxable income due to permanent differences.

B) pretax income greater than taxable income due to temporary differences.

C) pretax income less than taxable income due to temporary differences.

Explanation

Deferred tax liabilities result from temporary differences that cause pretax income and income tax expense (on the income statement) to be greater than taxable income and taxes due (on the firm's tax form). Temporary differences that cause pretax income to be less than taxable income are recognized as deferred tax assets. Permanent differences do not result in deferred tax items; instead they cause the effective tax rate to differ from the statutory tax rate.

(Module 20.3, LOS 20.d)

Question #17 of 52

Question ID: 1590320

Habel Inc. owns equipment with a tax base of $400,000 and a carrying value of $600,000. Habel also has a tax loss carryforward of $200,000 that is expected to be utilized in the foreseeable future. Deferred tax items on the balance sheet are based on a tax rate of 30%. Based only on this information, an increase in future tax rates to 35% will cause Habel's total equity to:

A) decrease.

B) remain unchanged.

C) increase.

Explanation

The $200,000 difference between the tax base and the carrying value of the equipment gives rise to a taxable temporary difference, which leads to a deferred tax liability of $200,000 × 30% = $60,000. The tax loss carryforward of $200,000 leads to a deferred tax asset of $200,000 × 30% = $60,000.

Because these amounts are equal, the increase in the tax rate will increase the associated DTA and DTL by the same amounts, leaving equity unchanged.

(Module 20.2, LOS 20.c)

Question #18 of 52

Question ID: 1590303

An analyst gathered the following information about a company:

- Taxable income = $100,000.
- Pretax income = $120,000.
- Current tax rate = 20%.

Assuming the difference between taxable income and pretax income will reverse in the future, the effect these events on the company's financial statements will be to report income tax expense of:

A) $24,000 and an addition to deferred tax liabilities of $4,000. ✓

B) $24,000 and a decrease in deferred tax assets of $4,000. ✗

C) $22,000 with no change in deferred tax items. ✗

Explanation

Deferred tax liability = (120,000 − 100,000) × 0.2 = 4,000

Tax expense = current tax rate × taxable income + change in deferred tax liability

0.2 × 100,000 + 4,000 = 24,000

(Module 20.1, LOS 20.b)

Question #19 of 52

Question ID: 1590300

Year ending 31 December:	*2002*	*2003*	*2004*
Income Statement:			
Revenues after all expenses other than depreciation	$200	$300	$400
Depreciation expense	50	50	50
Income before income taxes	$150	$250	$350
Tax return:			
Taxable income before depreciation expense	$200	$300	$400
Depreciation expense	75	50	25
Taxable income	$125	$250	$375

Assume an income tax rate of 40% and zero deferred tax liability on 31 December 2001.

The deferred tax liability to be shown in the 31 December 2003, balance sheet and the 31 December 2004 balance sheet, is:

2003	2004

A)	$0	$10	✗
B)	$10	$0	✓
C)	$25	$20	✗

Explanation

First, for 2003, remember that the deferred tax liability (DTL) is cumulative so, it includes the balance from prior years, (assume 2002 in this example since we have no other information).

> DTL cumulative = (tax return depreciation – financial statement depreciation) × tax rate + DTL from previous year

- DTL for 2002: (75 – 50) × 0.4 + 0 = 10
- DTL for 2003: (50 – 50) × 0.4 + 10 = 10
- DTL for 2004: (25 – 50) × 0.4 + 10 = 0

(Module 20.1, LOS 20.b)

Question #20 of 52

Question ID: 1590292

Xanos Corporation faced a 50% marginal tax rate last year and showed the following financial and tax reporting information:

- Deferred tax asset of 1,000.
- Deferred tax liability of 5,000.

Based only on this information and the news that the tax rate will decline to 40%, Xanos Corporation's deferred tax:

A)	asset will be reduced by 200 and income tax expense will be reduced by 1,000.	✗
B)	liability will be reduced by 1,000 and income tax expense will be reduced by 800.	✓
C)	asset will be reduced by 400 and deferred tax liability will be reduced by 2,000.	✗

Explanation

There is a 20% reduction in the tax rate [(40% − 50%) / 50% = –0.2]. Hence, the deferred tax asset will be 800 = 1,000(1 − 0.2), the deferred tax liability will be 4,000 = 5,000(1 − 0.2), and the income tax expense will fall by the net amount of the decline in the asset and liability balances (1,000 – 200 = 800).

(Module 20.1, LOS 20.b)

Question #21 of 52

Question ID: 1590309

Fred Company has a deferred tax liability of $1,200,000. If Fred's tax rate increases from 30% to 40%, the impact of this tax rate change will:

A) increase Fred's income tax expense by $120,000. ✗

B) increase Fred's income tax expense by $400,000. ✓

C) decrease Fred's income tax expense by $120,000. ✗

Explanation

The change in Fred's rates causes its deferred tax liability to increase [(40 − 30) / 30] × $1,200,000 = $400,000. This is reported on the income statement as an increase in current income tax expense.

(Module 20.1, LOS 20.b)

Question #22 of 52

Question ID: 1590333

Which of the following statements *best* justifies analyst scrutiny of valuation allowances?

A) Changes in valuation allowances can be used to manage reported net income. ✓

B) Increases in valuation allowances may be a signal that management expects earnings to improve in the future. ✗

C) If differences in taxable and pretax incomes are never expected to reverse, a company's equity may be understated. ✗

Explanation

A valuation allowance is a contra account (offset) against deferred tax assets that reflects the likelihood that the deferred tax assets will never be realized. Changes in the valuation allowance have a direct impact on reported income. Because management has discretion with regard to the amount and timing of a valuation allowance, changes in the valuation allowance give management significant opportunity to manage earnings.

(Module 20.3, LOS 20.f)

Question #23 of 52

Question ID: 1590298

Camphor Associates uses accrual basis for financial reporting purposes and cash basis for tax purposes. Cash collections from customers is $238,000, and accrued revenue is only $188,000. Assume expenses at 50% in both cases (i.e., $119,000 on cash basis and $94,000 on accrual basis), and a tax rate of 34%. What is the deferred tax asset/liability in this case? A deferred tax:

A) asset of $48,960.

B) liability of $8,500.

C) asset of $8,500.

Explanation

Since taxable income ($119,000) exceeds pretax income ($94,000), Camphor will have a deferred tax asset of $8,500 = [($119,000 − $94,000)(0.34)].

(Module 20.1, LOS 20.b)

Question #24 of 52

Question ID: 1590308

A company purchased a new pizza oven for $12,676. It will work for 5 years and has no salvage value. The tax rate is 41%, and annual revenues are constant at $7,192. For financial reporting, the straight-line depreciation method is used, but for tax purposes depreciation is 35% of original cost in years 1 and 2 and the remaining 30% in Year 3. For this question ignore all expenses other than depreciation.

What is the deferred tax liability as of the end of year three?

A) $2,079.

B) $780.

C) $1,029.

Explanation

For tax purposes the machine is 100% depreciated at the end of year three, while for financial reporting it is only 60% depreciated.

The difference in depreciation is $12,676 × (1.00 − 0.60) = $5,070.

> Deferred tax liability = difference in depreciation × tax rate = $5,070 × 0.41 = $2,079.

(Module 20.1, LOS 20.b)

Question #25 of 52

Question ID: 1590302

The Puchalski Company reported the following:

	Year 1	*Year 2*	*Year 3*	*Year 4*
Income before taxes	$1,000	$1,000	$900	$800
Taxable income	$800	$900	$900	$1,000

Puchalski has no deferred tax asset or liability prior to Year 1. If the tax rate is 40%, what is the amount of the deferred tax asset or liability reported at the end of Year 3?

A) Asset of $120.

B) Asset of $80.

C) Liability of $120.

Explanation

	Year 1	*Year 2*	*Year 3*
Income tax expense	$400	$400	$360
Taxes paid	$320	$360	$360
Deferred tax liability	$80	$120	$120

(Module 20.1, LOS 20.b)

Question #26 of 52

Question ID: 1590326

Permanent differences between taxable and pretax income:

A) can be deferred in some cases. ✗

B) are not addressed specifically in the financial statements. ✗

C) are considered as changes in the effective tax rate. ✓

Explanation

The permanent differences are never deferred but are considered increases or decreases in the effective tax rate. The financial statements include an effective tax rate reconciliation that addresses permanent differences between pretax and taxable income. If the only difference between the taxable and pretax incomes were a permanent difference, then tax expense would simply be taxes payable.

(Module 20.3, LOS 20.d)

Question #27 of 52

Question ID: 1590323

Which of the following statements regarding deferred taxes is *least* accurate?

A) A deferred tax asset is created when a temporary difference results in taxable income that exceeds pretax income. ✗

B) A permanent difference is a difference between taxable income and pretax income that will not reverse. ✗

C) Deferred tax assets and liabilities are not adjusted for changes in tax rates. ✓

Explanation

Deferred tax assets and liabilities are adjusted for changes in expected tax rates under the liability method.

(Module 20.2, LOS 20.c)

Question #28 of 52

Question ID: 1590285

Which of the following is the *most accurate* definition of a liability's tax base?

A) Carrying amount of the liability minus the amount that will not be deductible in the future.

B) Amount of tax payable by the company at year-end.

C) Carrying amount of the liability minus the amount that will be deductible in the future.

Explanation

The tax base of a liability is the carrying value of the liability on the balance sheet less the amount that will be deductible on the tax return in the future. When revenue is received in advance, the tax base liability is the carrying value of the liability less the amount that will not be taxed in the future.

(Module 20.1, LOS 20.a)

Question #29 of 52

Question ID: 1590288

In 20X8, Oliver Ltd. received $80,000 cash from a customer for goods that it could not deliver until the next year and established a liability for unearned revenue. Oliver reports under U.S. GAAP, faces a 40% tax rate, and is located in a tax jurisdiction where unearned revenue is taxed as received. On their balance sheet for 20X8, what change in deferred tax should Oliver record as a result of this transaction?

A) A deferred tax asset of $32,000.

B) A deferred tax liability of $32,000.

C) There is no effect on deferred tax items from this transaction.

Explanation

Oliver has paid tax on the $80,000 revenue in 20X8, but has not recorded the revenue on it for financial statement purposes. This results in a temporary difference of $32,000, which is a deferred tax asset. The tax asset will be realized when the company recognizes the revenue on its financial statements in the subsequent period.

(Module 20.1, LOS 20.a)

Question #30 of 52

Question ID: 1590305

Given the following data regarding two firms under different scenarios, determine the amount of any deferred tax liability or asset.

Firm 1:

Tax Reporting		*Financial Reporting*	
Revenue	$500,000	Revenue	$500,000
Depreciation	$100,000	Depreciation	$50,000
Taxable income	$400,000	Pretax income	$450,000
Taxes payable	$160,000	Tax expense	$180,000
Net income	$240,000	Net income	$270,000

Firm 2:

Tax Reporting		*Financial Reporting*	
Revenue	$500,000	Revenue	$500,000
Warranty expense	$0	Warranty expense	$10,000
Taxable income	$500,000	Pretax income	$490,000
Taxes payable	$200,000	Tax expense	$196,000
Net income	$300,000	Net income	$294,000

	Firm 1 Deferred Tax	Firm 2 Deferred Tax	
A)	$20,000 Liability	$4,000 Asset	✓
B)	$20,000 Asset	$6,000 Liability	✗
C)	$30,000 Asset	$6,000 Asset	✗

Explanation

A deferred tax liability and asset is created when an income or expense item is treated differently on financial statements than it is on the company's tax returns.

A deferred tax liability is when that difference results in greater tax expense on the financial statements than taxes payable on the tax return.

The deferred tax liability for firm 1 = $180,000 tax expense - $160,000 taxes payable = $20,000

A deferred tax asset is when that difference results in lower taxes payable on the financial statements than on the tax return.

The deferred tax asset for firm 2 = $200,000 taxes payable - $196,000 tax expense = $4,000

(Module 20.1, LOS 20.b)

Question #31 of 52

Question ID: 1590290

A firm buys an asset with an estimated useful life of five years for $100,000 at the beginning of the year. The firm will depreciate the asset on a straight-line basis with no salvage value on its financial statements and will use double declining balance depreciation for tax. The tax base for this asset at the end of the first year is *closest* to:

A) $80,000. ✗

B) $60,000. ✓

C) $40,000. ✗

Explanation

The asset's tax base is reduced by the DDB depreciation (2/5 × 100,000 = 40,000) from $100,000 to $60,000.

(Module 20.1, LOS 20.a)

Question #32 of 52

Question ID: 1590318

Inka Corporation has deferred tax assets of $20 million and deferred tax liabilities of $50 million. The corporate tax rate decreases from 40% to 35%. What effect will the tax rate change have on net income?

A) No effect on net income. ✗

B) Increase net income.

C) Decrease net income.

Explanation

The reduction in the tax rate decreases the values of both the deferred tax asset and the deferred tax liability. A decrease in the value of a DTL decreases income tax expense, and a decrease in the value of a DTA increases income tax expense. Because Inka's DTL is larger than its DTA, the net effect will be a decrease in income tax expense, which increases net income.

(Module 20.2, LOS 20.c)

Question #33 of 52

Question ID: 1590286

Noonan, Ltd. estimates that a warranty provision of $20,000 will be required on goods already sold. On the tax return, warranties are not deductible until the warranty work has been performed. What is the tax base of the warranty liability?

A) $20,000.

B) $0.

C) $10,000.

Explanation

Tax base of a liability = carrying value – amount to be deducted in future tax returns. Warranty expenses are deducted in the tax returns at the time of the expenditure but in the financial statements at the time of the sale. An expense and liability will be created in the accounts for $20,000. The $20,000 will be deducted in the tax returns in a future period when the warranty expenditure is incurred. Tax base of liability = $20,000 – $20,000 = $0.

(Module 20.1, LOS 20.a)

Question #34 of 52

Question ID: 1590332

Which of the following situations will *most likely* require a company to record a valuation allowance on its balance sheet?

A) A firm has differences between taxable and pretax income that are never expected to reverse.

B) To report depreciation, a firm uses the double-declining balance method for tax purposes and the straight-line method for financial reporting purposes.

C) A firm is unlikely to have future taxable income that would enable it to take advantage of deferred tax assets.

Explanation

A valuation allowance is a contra account (offset) against deferred tax assets that reflects the likelihood that the deferred tax assets will never be realized. If a firm is unlikely to have future taxable income, it would be unlikely to ever use its deferred tax assets, and therefore must record a valuation allowance.

(Module 20.3, LOS 20.f)

Question #35 of 52

Question ID: 1590334

Which of the following statements *best* describes the impact of a valuation allowance on the financial statements? A valuation allowance:

A) increases reported income, reduces assets, and reduces equity.

B) reduces reported income, increases liabilities, and reduces equity.

C) reduces reported income, reduces assets, and reduces equity.

Explanation

A valuation allowance is a contra account (offset) against deferred tax assets that reflects the likelihood that the deferred tax assets will never be realized. The establishment of a valuation allowance reduces reported income, offsets (reduces) assets, and reduces equity.

(Module 20.3, LOS 20.f)

Question #36 of 52

Question ID: 1590304

The Puchalski Company reported the following:

	Year 1	*Year 2*	*Year 3*	*Year 4*
Income before taxes	$1,000	$1,000	$900	$800
Taxable income	$800	$900	$900	$1,000

The differences between income before taxes and taxable income are the result of using accelerated depreciation for tax purposes on an asset purchased in Year 1. Puchalski had no deferred tax liability prior to Year 1. If the tax rate is 40%, what is the amount of the deferred tax liability reported at the end of Year 4?

A) $40.

B) $80.

C) $120.

Explanation

	Year 1	*Year 2*	*Year 3*	*Year 4*
Income tax expense	$400	$400	$360	$320
Taxes paid	$320	$360	$360	$400
Deferred tax liability	$80	$120	$120	$40

(Module 20.1, LOS 20.b)

Question #37 of 52

Question ID: 1590325

Which of the following statements regarding differences between taxable and pretax income is *most* accurate? Differences between taxable and pretax income that:

A) result in deferred tax assets or liabilities are called temporary differences.

B) are not reversed for five or more years are called permanent differences.

C) increase or decrease the effective tax rate are called temporary differences.

Explanation

Temporary differences between taxable income (for tax reporting) and pretax income (for financial statement reporting) result in deferred tax assets or liabilities. Permanent differences result in a company's effective tax rate being different from the statutory tax rate. There is no time limit on temporary differences to reverse.

(Module 20.3, LOS 20.d)

Question #38 of 52

Question ID: 1590293

Corcoran Corp acquired an asset on 1 January 2004, for $500,000. For financial reporting, Corcoran will depreciate the asset using the straight-line method over a 10-year period with no salvage value. For tax purposes the asset will be depreciated straight line for five years and Corcoran's effective tax rate is 30%. Corcoran's deferred tax liability for 2004 will:

A) decrease by $15,000. ✗

B) decrease by $50,000. ✗

C) increase by $15,000. ✓

Explanation

Straight-line depreciation per financial reports = 500,000 / 10 = $50,000

Tax depreciation = 500,000 / 5 = $100,000

Temporary difference = 100,000 − 50,000 = $50,000

Deferred tax liability will increase by $50,000 × 30% = $15,000

(Module 20.1, LOS 20.b)

Question #39 of 52

Question ID: 1590287

At the end of 20X8, Martin Inc. estimates that $26,000 of warranty repairs will be required in the future on goods already sold. For tax purposes, warranty expense is not deductible until the work is actually performed. The firm believes that the warranty work will be required over the next two years. The tax base of the warranty liability at the end of 20X8 is:

A) $26,000.

B) $13,000.

C) zero.

Explanation

The carrying value of the warranty liability is $26,000 (the same amount is recorded as a liability on the balance sheet and as an expense on the income statement). The tax base is equal to the carrying value less any amounts deductible in the future. Therefore, the tax base is $0 ($26,000 − $26,000) since the warranty expense will be deductible when the work is performed next year.

(Module 20.1, LOS 20.a)

Question #40 of 52

Question ID: 1590307

A company purchased a new pizza oven for $12,676. It will work for 5 years and has no salvage value. The tax rate is 41%, and annual revenues are constant at $7,192. For financial reporting, the straight-line depreciation method is used, but for tax purposes depreciation is 35% of original cost in years 1 and 2 and the remaining 30% in Year 3. For this question ignore all expenses other than depreciation.

What is the deferred tax liability as of the end of year one?

A) $780.

B) $1,129.

C) $1,909.

Explanation

Pretax Income = $7,192 − $2,535 = $4,657

Taxable Income = $7,192 − $4,437 = $2,755

Deferred Tax liability = ($4,657 − $2,755)(0.41) = $780.

Alternative solution:

Difference in depreciation at the end of year one is $12,676 × (0.35 − 0.20) = $1,901

Deferred tax liability = difference in depreciation × tax rate = $1,901 × 0.41 = $780.

(Module 20.1, LOS 20.b)

Question #41 of 52

Question ID: 1590329

For the year ended 31 December 2004, Pick Co's pretax financial statement income was $400,000 and its taxable income was $300,000. The difference is due to the following:

Interest on tax-exempt municipal bonds	$140,000
Premium expense on key person life insurance	$(40,000)
Total	$100,000

Pick's statutory income tax rate is 30 percent. In its 2004 income statement, what amount should Pick report as current provision for tax payable?

A) $102,000.

B) $90,000.

C) $120,000.

Explanation

According to SFAS 109, Current provision = statutory rate × taxable income

30% = Taxes Payable / $300,000

= 0.30 × $300,000

= $90,000

(Module 20.3, LOS 20.d)

Question #42 of 52

Question ID: 1590297

This year, Blue Horizon has recorded $390,000 in revenue for financial reporting purposes, but, on a cash basis, revenue was only $262,000. Assume expenses at 50% in both cases (i.e., $195,000 on accrual basis and $131,000 on cash basis), and a tax rate of 34%. What is the deferred tax liability or asset? A deferred tax:

A) liability of $21,760.

B) asset of $21,760.

C) liability of $16,320.

Explanation

Since pretax income ($195,000) exceeds the taxable income ($131,000), Blue Horizon will have a deferred tax liability of $21,760 [($195,000 − $131,000)(0.34)].

(Module 20.1, LOS 20.b)

Question #43 of 52

Question ID: 1590299

A firm purchased a piece of equipment for $6,000 with the following information provided:

- Revenue will increase by $15,000 per year.
- The equipment has a 3-year life expectancy and no salvage value.
- The firm's tax rate is 30%.
- Straight-line depreciation is used for financial reporting and double declining is used for tax purposes.

What will the firm report for deferred taxes on the balance sheet for years 1 and 2?

	Year 1	Year 2	
A)	$3,900	$3,900	✗
B)	$3,300	$4,100	✗
C)	$600	$400	✓

Explanation

Using DDB:

	Yr. 1	*Yr. 2*
Revenue	15,000	15,000
Dep.	4,000	1,333
Taxable Inc	11,000	13,667
Taxes Pay	3,300	4,100

Using SL:

	Yr. 1	*Yr. 2*
Revenue	15,000	15,000
Dep.	2,000	2,000
Pretax Inc	13,000	13,000
Tax Exp	3,900	3,900

Deferred taxes year 1 = 3,900 – 3,300 = 600

Deferred taxes year 2 = 3,900 – 4,100 + previously deferred taxes = -200 + 600 = 400

(Module 20.1, LOS 20.b)

Question #44 of 52

Question ID: 1590295

Kruger Associates uses an accrual basis for financial reporting purposes and cash basis for tax purposes. Cash collections from customers are $476,000, and accrued revenue is only $376,000. Assume expenses at 50% in both cases (i.e., $238,000 on cash basis and $188,000 on accrual basis), and a tax rate of 34%. What is the deferred tax asset or liability? A deferred tax:

A) liability of $17,000.

B) asset of $17,000.

C) asset of $48,960.

Explanation

Since taxable income ($238,000) exceeds pretax income ($188,000), Kruger will have a deferred tax asset of $17,000 [($238,000 − $188,000)(0.34)].

(Module 20.1, LOS 20.b)

Question #45 of 52

Question ID: 1590301

All-Star Enterprises purchased a machine on January 1. The company uses straight-line depreciation for financial reporting and accelerated depreciation for tax purposes. Depreciation for tax purposes during the year was $36,000 greater than depreciation for financial reporting. Assuming a 30% tax rate will apply in the future, how much will be recorded as a deferred tax liability during the year?

A) $10,800.

B) $25,200.

C) $36,000.

Explanation

Deferred tax liability = $36,000 × 30% = $10,800.

(Module 20.1, LOS 20.b)

Question #46 of 52

Question ID: 1590291

In the period when a deferred tax liability reverses, tax expense on the income statement is:

A) less than taxes payable on the tax return.

B) greater than taxes payable on the tax return.

C) equal to taxes payable on the tax return.

Explanation

When a DTL reverses, income statement tax expense is less than taxes payable on the tax return.

(Module 20.1, LOS 20.b)

Question #47 of 52

Question ID: 1590306

A company purchased a new pizza oven for $12,676. It will work for 5 years and has no salvage value. The tax rate is 41%, and annual revenues are constant at $7,192. For financial reporting, the straight-line depreciation method is used, but for tax purposes depreciation is 35% of original cost in years 1 and 2 and the remaining 30% in Year 3. For this question ignore all expenses other than depreciation.

What is the tax payable for year one?

A) $1,130. ✓

B) $779. ✗

C) $1,909. ✗

Explanation

Tax payable for year 1 is = [$7,192 − ($12,676 × 0.35)] × 0.41 = $1,130.

(Module 20.1, LOS 20.b)

Question #48 of 52

Question ID: 1590296

Unit Technologies uses accrual basis for financial reporting purposes and cash accounting for tax purposes. So far this year, Unit Technologies has recorded $195,000 in revenue for financial reporting purposes, but, on a cash basis, revenue was only $131,000. Assume expenses at 50 percent in both cases (i.e., $ 97,500 on accrual basis and $ 65,500 on cash basis), and a tax rate of 34%. What is the deferred tax liability or asset? A deferred tax:

A) liability of $16,320. ✗

B) liability of $10,880. ✓

C) asset of $10,880. ✗

Explanation

Since pretax income ($97,500) exceeds the taxable income ($65,500), United Technologies will have a deferred tax liability of $10,880 = [($97,500 − $65,500)(0.34)]

(Module 20.1, LOS 20.b)

Question #49 of 52

Question ID: 1590310

Laser Tech has net temporary differences between tax and book income resulting in a deferred tax liability of $30.6 million. According to U.S. GAAP, an increase in the tax rate would have what impact on deferred taxes and net income, respectively:

	Deferred Taxes	Net Income	
A)	Increase	Decrease	✓
B)	Increase	No effect	✗
C)	No effect	Decrease	✗

Explanation

If tax rates rise then deferred tax liabilities will also rise. The increase in deferred tax liabilities will increase the current tax expense, and if expenses are increasing the net income will decrease.

(Module 20.1, LOS 20.b)

Question #50 of 52

Question ID: 1590319

A firm with an effective tax rate of 35% uses straight-line depreciation on its financial statements and accelerated depreciation for tax reporting. This results in the following differences:

	Year 1	Year 2	Year 3
Accounting depreciation	4,000	4,000	4,000
Tax depreciation	8,000	2,667	1,333
Timing difference	(4,000)	1,333	2,667

At the end of Year 2, what deferred tax item is the result of these differences?

A) $467 deferred tax liability. ✗

B) $933 deferred tax liability. ✓

C) $467 deferred tax asset. ✗

Explanation

Using accelerated depreciation for tax reporting results in a deferred tax liability. The balance of the DTL in Year 1 is the timing difference multiplied by tax rate: $4,000 × 0.35 = $1,400. In Year 2, tax depreciation is less than financial statement depreciation, so the DTL reverses by the difference in Year 2 multiplied by the tax rate: $1,333 × 0.35 = $467. The DTL balance = $1,400 – $467 = $933.

(Module 20.2, LOS 20.c)

Question #51 of 52

Question ID: 1590317

When an increase in the tax rate is enacted, deferred tax:

A) liability and asset accounts are maintained at historical tax rates until they reverse.

B) assets decrease in value and deferred tax liabilities increase in value.

C) assets and liabilities both increase in value.

Explanation

The liability method (SFAS 109 of U.S. GAAP) takes a balance sheet approach and adjusts deferred tax assets and liabilities to future tax rates. An increase in the tax rate increases the value of both deferred tax assets and deferred tax liabilities.

(Module 20.1, LOS 20.b)

Question #52 of 52

Question ID: 1590294

A company purchased a new pizza oven directly from Italy for $12,676. It will work for 5 years and has no salvage value. The tax rate is 41%, and annual revenues are constant at $7,192. For financial reporting, the straight-line depreciation method is used, but for tax purposes depreciation is accelerated to 35% in years 1 and 2, and 30% in year 3. For purposes of this exercise ignore all expenses other than depreciation.

What is the net income and depreciation expense for year one for financial reporting purposes?

	Net Income	Depreciation Expense
A)	$2,748	$2,535

B) $4,657 $2,748

C) $2,535 $3,169

Explanation

Net income in year 1 for financial reporting purposes will be $2,748 = [($7,192 − $2,535)(1 − 0.41)]

The annual depreciation expense on financial statements will be $2,535 = ($12,676 / 5 years)

(Module 20.1, LOS 20.b)