

### 9 Analysis of Tax reporting

**Objectives of Financial statements:**

For firm	For Government
Accrual Accounting	
Periodic reporting	
Usefulness of information	Usefulness of information (?)

**Objectives of Tax Accounting :**

For firm	For Government
Minimize taxes	Policy
	Want more collections
	Ease of auditing

1

### Analysis of Tax reporting

**Financial Statements:**

Year	1	2	3
Revenue	5,000	5,000	5,000
Depreciation	2,000	2,000	2,000
Warranty expense	500	500	500
Pretax Income	2,500	2,500	2,500
Tax Expense	[*]800	[*]800	[*]1,400
Post Tax Income	1,700	1,700	1,100
Implied tax rate	32.00%	32.00%	56.00%

**Method rejected by all**

3

### Example – Tax Reporting

Asset Cost \$6,000; Three year product life.  
Warranty expense: 10.00% of revenues; all in year 3

Year	1	2	3
Revenue	5,000	5,000	5,000
Depreciation	3,000	3,000	
Warranty expense			1,500
Taxable Income	2,000	2,000	3,500
Current Tax Expense (= Taxes payable) 40%	[*]800	[*]800	[*]1,400
Post Tax Income	1,200	1,200	2,100

2

### Tax reporting- GAAP

**Financial Statements: (US GAAP based on SFAS 109)**

Year	1	2	3
Revenue	5,000	5,000	5,000
Depreciation	2,000	2,000	2,000
Warranty expense	500	500	500
Pretax Income	2,500	2,500	2,500
Income Tax Expense: 40%	1,000	1,000	1,000
Net Income	1,500	1,500	1,500
Implied tax rate	40.00%	40.00%	40.00%

4

## Reversals

Year	1		2		3		
	Debit	Credit	Debit	Credit	Debit	Credit	
Income Tax Expense	1,000		1,000		1,000		
Current Tax Expense (Taxes payable)		800		800		1,400	
Deferred Tax Liability = Tax Rate x (Deducted Expense - Reported Expense)		400		400	800		
Deferred tax asset = Tax rate x (Reported expense - Deducted Expense)	200		200		400		5

## Deferred Tax Liabilities

Do the deferred tax liabilities at the end of years of 1 and 2 actually represent a liability ?  
 Is it a Liability or \_\_\_\_\_ ?  
 Keeps growing if company grows.  
 Tax rate changes, inflation rate changes.

	Debt	Capital	Equity
Conservative Interpretation	x	x	
Liberal Interpretation		x	x
S & P		x	
Market favors incorporation		Nowhere	

## Deferred Tax Assets

### Deferred tax asset and the valuation allowance

Management must defend recognition of all deferred tax assets

A valuation allowance required if it is more likely than not that some portion of the deferred tax asset will not be realized.

### Operating Losses

Considered as Deferred Tax Assets

Less Valuation Allowance If Recoverability Is Unlikely.

See: Balance Sheet (p 46) , Note 13 (p 76) [Amazon 02-AR](#)

[The Lure of Sirius: Tax Losses](#)

[Rite Aid Struggles with Tax Break Prescription](#)

## Sun

SUN MICROSYSTEMS TO RECOGNIZE NON-CASH CHARGE FOR THE FOURTH QUARTER OF FISCAL YEAR 2003

SANTA CLARA, CALIF. - September 29, 2003 - Sun Microsystems today announced that it will recognize a \$1,051 million non-cash charge in its fourth quarter of fiscal 2003 to increase a valuation allowance for its net deferred tax assets in accordance with the Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes." As a result of this non-cash charge, Sun has determined that it will recognize a revised net loss for the fourth quarter of fiscal 2003 of \$1,039 million, or a net loss per share of \$.32  
<http://www.sun.com/aboutsun/investor/>



**Valuation Allowance - increases**

Which is better?

<b>A: Year</b>	<b>1</b>	<b>2</b>
Earnings Before Taxes	-100	+100
Provision for income taxes	40	-40
Net Income	- 60	60

<b>B: Year</b>	<b>1</b>	<b>2</b>
Earnings Before Taxes	-100	+100
Provision for income taxes	0	0
Net Income	- 100	100

9

**Valuation Allowance - Entries**
**Year 1**

Deferred tax asset	40	
Provision for taxes		40
Provision for taxes	40	
Valuation Allowance Deferred tax asset		40

**Year 2**

Valuation Allowance Deferred tax asset	40	
Provision for taxes		40
Provision for taxes	40	
Deferred tax asset		40

10

**Where do they come from ?**
**Deferred Tax Asset**

- Restructuring charges
- Post-retirement benefits
- Impairment of assets
- Operating loss carry-forwards

**Deferred Tax Liability**

- Depreciation
- Unremitted earnings of non-US subsidiaries

11

**Rates**

Where are the deferred tax items reported ?

FAS 109 asks for specific disclosure deferred tax assets and liabilities.

Reported Effective Tax Rate

$$= \frac{\text{Income tax expense}}{\text{Pretax income}}$$

Alternates

$$= \frac{\text{Taxes payable}}{\text{Pretax income}}$$

$$= \frac{\text{Income taxes paid}}{\text{Pretax income}}$$

12

**Permanent Differences**

Tax rate itself is different as some income statement items are taxed at a different rate

- + Tax exempt bonds
- Premiums paid on officer's life insurance
- Excessive compensation
- Amortization of Goodwill (some cases)
- + R & D, Fuels Credit
- + Indefinite reversals
- ± Foreign tax rate differences
- + US Possessions
- State taxes

13

**State tax rates - Permanent differences**

Pretax income \$1,000; **US** 80.00%  
Assume State taxes are only for US income

US Pretax income		800
State Tax Rate	5.00%	
State Taxes		40

Pretax income for US federal tax		760
US tax rate	35.00%	
US taxes		266

Paid	266 + 40	=	306
at US rate	35.00% x 800	=	280
State Tax, net of federal income tax benefit			26

14

**Foreign taxes**

**Foreign** 20.00% of income

Pretax income		200
Foreign tax rate	45.00%	
Foreign taxes		90

Foreign taxes at US rate	35.00% x 200 =	70
Effect of international operations on tax	90 - 70 =	20

Effect of international operations on tax rate	20 / 1,000	2.00%
--	------------	-------

**Provision for taxes**

40 + 266 + 90	=	396
---------------	---	-----

15

**All we will see is**

**Income Statement**

Pretax income	1,000
Provision for taxes	396
Net income	604

**Note: Taxes**

A reconciliation of the significant differences between the effective income tax rate and the federal statutory rate on pretax income follows:

Statutory tax rate	35.00%
State income taxes, net of federal income tax benefit	2.60%
Effect of international operations	2.00%

39.60%<sub>16</sub>

<b>Analysis</b>
-----------------

**OR**

Statutory taxes	\$ 350.00
State income taxes, net of federal income tax benefit	\$ 26.00
Effect of international operations	\$ 20.00
	<hr/>
	\$ 396.00

Assume State taxes are only for US income

**Analysis**

State tax rate: $[\$ 26 / 65.00\%] / [1,000 \times 80.00\%] =$	5.00%
Foreign tax rate: $(35.00\% \times \$ 200) + \$ 20 = \$ 90$	
$\$ 90 / \$ 200 =$	45.00%

17