Question #1 of 32

Question ID: 1573643

Which of the following statements about tax deferrals is NOT correct?

A) A deferred tax liability is expected to result in future cash outflow.

B) Income tax paid can include payments or refunds for other years.

C) Taxes payable are determined by pretax income and the tax rate.

Explanation

Taxes payable are the taxes due to the government and are determined by taxable income and the tax rate. Note that pretax income is income before tax expense and is used for financial reporting. Taxable income is the income based upon IRS rules that determines taxes due and is used for tax reporting.

(Module 37.1, LOS 37.a)

Question #2 of 32

Question ID: 1573646

If a firm uses accelerated depreciation for tax purposes and straight-line depreciation for financial reporting, which of the following results is *least likely*?

A) A permanent difference will result between tax and financial reporting.

B) A temporary difference will result between tax and financial reporting.

C) Income tax expense will be greater than taxes payable.

Explanation

A permanent difference between tax and financial reporting is a difference that is expected to not reverse itself. Under normal circumstances, the effects of the different depreciation methods will reverse.

(Module 37.1, LOS 37.a)

Question #3 of 32

Question ID: 1573645

A tax loss carryforward is *best* described as the:

A) net taxable loss that can be used to reduce taxable income in the future.

B) net taxable loss that can be used to recover taxes paid previously.

C) difference between deferred tax liabilities and deferred tax assets.

Explanation

A tax loss carryforward is the net taxable loss that can be used to reduce taxable income in the future.

(Module 37.1, LOS 37.a)

Question #4 of 32

Question ID: 1577950

A company's effective tax rate is determined using its:

A) taxable income as shown on its tax filing.

B) income tax expense from the income statement.

C) taxes paid to the government during the period.

Explanation

Effective tax rate = income tax expense / pretax income.

(Module 37.3, LOS 37.c)

Question #5 of 32

Question ID: 1573648

A current or past loss in a tax return *most likely* will result in a:

A) deferred tax asset.

B) deferred tax liability.

C) neither a deferred tax asset nor a deferred tax liability.

Explanation

A tax loss carryforward can offset future taxable income, thereby reducing taxes payable. This will be recorded as a deferred tax asset to the extent that the firm expects this to reverse in the future.

(Module 37.1, LOS 37.a)

Question #6 of 32

Question ID: 1577949

The ratio of taxes paid to pretax income is a company's:

A) cash tax rate.

B) effective tax rate.

C) statutory tax rate.

Explanation

Cash tax rate = cash taxes paid / pretax income.

(Module 37.3, LOS 37.c)

Question #7 of 32

Question ID: 1573660

Which of the following financial ratios is *least likely* to be affected by classification of deferred taxes as a liability or equity?

A) Return on equity (ROE).

B) Leverage ratio.

C) Return on assets (ROA).

Explanation

The ROA will not be affected by the classification of the deferred taxes. The total assets will remain the same regardless of whether the deferred taxes are classified as a liability or equity. Return on equity and the leverage ratio (assets/equity) would both be affected.

(Module 37.2, LOS 37.b)

Question #8 of 32

Question ID: 1573668

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

A) Effective tax rate.

B) Statutory tax rate.

C) Cash tax rate.

Explanation

Statutory tax rate = enacted rate of 30%. Effective tax rate = income tax expense / pretax income = $47,000 / $150,000 = 31.3%. Cash tax rate = tax paid (cash) / pretax income = $44,000 / $150,000 = 29.3%. In this case, the highest rate was the effective tax rate.

(Module 37.3, LOS 37.c)

Question #9 of 32

Question ID: 1573662

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

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

Assuming a statutory tax rate of 30%, which of the following is closest to the DTL reported in Gator's balance sheet at the end of Year 2?

A) €700.

B) €1,400.

C) €2,100.

Explanation

DTL = (carrying value – tax base) × statutory rate

Year 2 DTL = (€7,000 – €2,333) × 0.3 = €1,400.

(Module 37.2, LOS 37.b)

Question #10 of 32

Question ID: 1573652

Which of the following is *most likely* to result in a deferred tax asset being created?

A) Depreciation.

B) A decrease in the enacted tax rate.

C) Unearned revenue.

Explanation

Unearned revenue is usually taxable at the point of sale, even if not recognized in the income statement until a later period—resulting in higher current taxes payable, and a deferred tax asset being created. Depreciation commonly results in a deferred tax liability (e.g., when the tax return uses accelerated depreciation, while the income statement uses straight-line depreciation), although it could result in either a DTA or a DTL, depending on the method used. A decrease in the enacted tax rate will only decrease any *existing* deferred tax asset or liability.

(Module 37.1, LOS 37.a)

Question #11 of 32

Question ID: 1573650

Harding Industrials, Inc., has a deferred tax asset of $300,000 and a deferred tax liability of $450,000 at the end of the reporting period, based on a tax rate of 20%. If the tax rate increases to 25%, what will be the *most likely* impact on the income statement?

A) Decrease in net income by $37,500.

B) Increase in net income by $7,500.

C) Increase in tax expense by $237,500.

Explanation

Deferred taxes are recognized at the enacted tax rate (25%). This will give a deferred tax liability of $562,500 ($450,000 / 0.2 × 0.25) and a deferred tax asset of $375,000 ($300,000 / 0.2 × 0.25). So, the tax expense = tax payable + ΔDTL – ΔDTA, the increase in the DTL will increase the tax expense on the income statement by $112,500, and the increase in the DTA will decrease the tax expense by $75,000. Overall, the tax expense will increase, and the net income will decrease by $37,500.

(Module 37.1, LOS 37.a)

Question #12 of 32

Question ID: 1573664

An analyst gathered the following information about a company:

- Pretax income = $10,000.
- Taxes payable = $2,500.
- Deferred taxes = $500.
- Tax expense = $3,000.

What is the firm's reported effective tax rate?

A) 5%.

B) 30%.

C) 25%.

Explanation

Reported effective tax rate = Income tax expense / pretax income

= $3,000 / $10,000

= 30%

(Module 37.3, LOS 37.d)

Question #13 of 32

Question ID: 1573661

For purposes of financial analysis, an analyst should:

A) always consider deferred tax liabilities as a liability.

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

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

Explanation

For financial analysis, an analyst must decide on the appropriate treatment of deferred taxes on a case-by-case basis. These can be classified as liabilities or stockholder's equity, depending on various factors. Sometimes, deferred taxes are just ignored altogether.

(Module 37.2, LOS 37.b)

Question #14 of 32

Question ID: 1573670

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

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

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

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

Explanation

An increase in the actual cash paid will change the cash tax rate, but it will not cause the statutory and effective tax rates to differ. Any changes in deferred tax assets and liabilities are because of temporary timing differences, which typically do not cause the statutory and effective tax rates to differ. Permanent differences, such as tax-exempt income, do cause these rates to differ.

(Module 37.3, LOS 37.c)

Question #15 of 32

Question ID: 1573657

Which of the following statements regarding deferred taxes is NOT correct?

A) Only those components of deferred tax liabilities that are likely to reverse should be considered a liability.

B) If deferred tax liabilities are not included in equity, debt-to-equity ratio will be reduced.

C) If deferred taxes are not expected to reverse in the future then they should be classified as equity.

Explanation

When deferred tax liabilities are included in equity, it will reduce the debt-to-equity ratio (by increasing the denominator), in some cases considerably.

(Module 37.2, LOS 37.b)

Question #16 of 32

Question ID: 1573659

For analytical purposes, if a deferred tax liability is expected to not be reversed, it should be treated as a(n):

A) an addition to equity.

B) immaterial amount and ignored.

C) liability.

Explanation

If deferred tax liabilities are expected to never reverse, they should be treated as equity for analytical purposes.

(Module 37.2, LOS 37.b)

Question #17 of 32

Question ID: 1573649

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

A) ΔDTL = tax expense – tax payable + ΔDTA.

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

C) ΔDTA = tax payable – tax expense – ΔDTL.

Explanation

Tax expense = tax payable + ΔDTL – ΔDTA. Once rearranged, the correct answer is ΔDTL = tax expense – tax payable + ΔDTA.

(Module 37.1, LOS 37.a)

Question #18 of 32

Question ID: 1573647

Which of the following *best* describes valuation allowance? Valuation allowance is a reserve:

A) created when deferred tax assets are greater than deferred tax liabilities.

B) against deferred tax assets based on the likelihood that those assets will not be realized.

C) against deferred tax liabilities based on the likelihood that those liabilities will be paid.

Explanation

Valuation allowance is a reserve against deferred tax assets based on the likelihood that those assets will not be realized. Deferred tax assets reflect the difference in tax expense and taxes payable that are expected to be recovered from future operations.

(Module 37.1, LOS 37.a)

Question #19 of 32

Question ID: 1573658

When analyzing a company's financial leverage, deferred tax liabilities are *best* classified as:

A) a liability or equity, depending on the company's particular situation.

B) a liability.

C) neither as a liability, nor as equity.

Explanation

The recommended analyst treatment of deferred tax liabilities is to treat them as liabilities if they are expected to reverse or as equity if they are not expected to reverse.

(Module 37.2, LOS 37.b)

Question #20 of 32

Question ID: 1573669

Which of the following is an analyst *least likely* to include when analyzing trends in tax rates, given a reconciliation of statutory to effective tax rates?

A) Differing tax rates in different countries.

B) Tax-exempt income.

C) Tax holiday savings.

Explanation

When analyzing trends in tax rates, an analyst should only include reconciliation items that are continuous in nature rather than sporadic. Tax-exempt income and differing tax rates in different countries tend to be continuous, whereas tax holiday savings tend to be sporadic.

(Module 37.3, LOS 37.c)

Question #21 of 32

Question ID: 1573656

If timing differences that give rise to a deferred tax liability are not expected to reverse then the deferred tax:

A) must be reduced by a valuation allowance.

B) should be considered an asset or liability.

C) should be considered an increase in equity.

Explanation

If deferred tax liabilities are expected to reverse in the future, then they should be classified as liabilities. If, however, they are not expected to reverse in the future, then they should be classified as equity.

(Module 37.2, LOS 37.b)

Question #22 of 32

Question ID: 1573671

Last year, Schoenberg AG earned net income of €150,000, an income tax expense of €47,000, and paid tax of €51,000. What was the effective tax rate?

A) 23.9%.

B) 25.9%.

C) 31.3%.

Explanation

Effective tax rate = income tax expense / pretax income = €47,000 / (€150,000 + €47,000) = 23.9%. Note that you are given the net income, so add the tax expense back to find pretax income.

(Module 37.3, LOS 37.c)

Question #23 of 32

Question ID: 1573663

While evaluating the financial statements of Omega, Inc., the analyst observes that the effective tax rate is 7% less than the statutory rate. The source of this difference is determined to be a tax holiday on a manufacturing plant located in South Africa. This item is *most likely* to be:

A) continuous in nature, so the termination date is not relevant.

B) sporadic in nature, and the analyst should try to identify the termination date and determine if taxes will be payable at that time.

C) sporadic in nature, but the effect is typically neutralized by higher home country taxes on the repatriated profits.

Explanation

As the name suggests, a tax holiday is usually a temporary exemption from having to pay taxes in some tax jurisdiction. Because of the temporary nature, the key issue for the analyst is to determine when the holiday will terminate, and how the termination will affect taxes payable in the future.

(Module 37.3, LOS 37.d)

Question #24 of 32

Question ID: 1573654

Under the liability method of accounting for deferred taxes, a decrease in the tax rate at the beginning of the accounting period will:

A) increase taxable income in the current period.

B) decrease a deferred tax liability.

C) increase a deferred tax asset.

Explanation

A decrease in the tax rate will decrease any DTAs and DTLs. This does not affect the current period's taxable income, but it decreases income tax expense in the income statement.

(Module 37.1, LOS 37.a)

Question #25 of 32

Question ID: 1573642

Which of the following statements is CORRECT? Income tax expense:

A) includes taxes payable and deferred income tax expense.

B) is the amount of taxes due to the government.

C) is the reported net of deferred tax assets and liabilities.

Explanation

Income tax expense is defined as expense resulting from current period pretax income. It includes taxes payable and deferred income tax expense. *Taxes payable* are the amount of taxes due the government.

(Module 37.1, LOS 37.a)

Question #26 of 32

Question ID: 1573667

Which of the following statements regarding the disclosure of deferred taxes in a company's balance sheet is *most* accurate?

A) Deferred tax assets and liabilities are classified as noncurrent.

B) There should be a combined disclosure of all deferred tax assets and liabilities that are likely to reverse in the current period.

C) Current deferred tax liability and noncurrent deferred tax asset are netted, resulting in the disclosure of a net noncurrent deferred tax liability or asset.

Explanation

Deferred tax items are classified as noncurrent.

(Module 37.3, LOS 37.d)

Question #27 of 32

Question ID: 1573644

A temporary difference between pretax income reported in a firm's financial statements and taxable income the firm reports to the tax authorities results in:

A) an adjustment to the firm's effective tax rate.

B) a gain or loss in comprehensive income.

C) a deferred tax item.

Explanation

A temporary difference between pretax income for financial reporting and taxable income for tax reporting results in a deferred tax liability if income tax expense (financial reporting) is greater than taxes payable (tax reporting), or a deferred tax asset if income tax expense is less than taxes payable. A permanent difference results in the firm having an effective tax rate that differs from the statutory tax rate. Neither results in a gain or loss.

(Module 37.1, LOS 37.a)

Question #28 of 32

Question ID: 1573653

Compass Company made a donation to a charity and expensed it in the period in which it was made. The country's tax authorities do not allow charitable donations to be deducted for tax purposes. The difference between the treatment of the expense in the accounts and the tax returns will result in:

A) no deferred tax items being created.

B) the creation of a deferred tax asset.

C) the creation of a deferred tax liability.

Explanation

This is an example of a permanent timing difference, as the expense passes through the income statement but is not deducted for tax purposes. Permanent differences do not result in DTAs or DTLs.

(Module 37.1, LOS 37.a)

Question #29 of 32

Question ID: 1573665

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

Assume an income tax rate of 40%.

The company's income tax expense for 2002 is:

A) $0.

B) $50.

C) $60.

Explanation

Effective tax rate = Income tax expense / pretax income

Income tax expense = Effective tax rate × pretax income

= $150(0.40)

= $60

(Module 37.3, LOS 37.d)

Question #30 of 32

Question ID: 1573666

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

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

Calculate taxes payable for years 1 and 2.

	Year 1	Year 2
A)	3,900	3,900
B)	3,300	4,100
C)	600	-200

Explanation

Using DDB:

	Yr. 1	*Yr. 2*
Revenue	15,000	15,000
Depreciation	4,000	1,333
Taxable Income	11,000	13,667
Taxes Payable	3,300	4,100

An asset with a 3-year life would have a straight line depreciation rate of 0.3333 per year. Using DDB the depreciation rate is twice this amount or 0.66667. $2,000 is the amount of depreciation left on the equipment in year 2 ($6,000 − $4,000). Therefore, the amount of depreciation in the 2nd year is (0.66667)(2,000) = $1,333

(Module 37.3, LOS 37.d)

Question #31 of 32

Question ID: 1573651

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

A) $0.

B) $8,480.

C) $42,400.

Explanation

On the balance sheet, a warranty liability of $8,480 (530 × 0.2 × $80) will be recorded. The tax base is equal to the carrying value ($8,480) minus the amount deductible in the future. The tax base is 0 ($8,480 – $8,480), and a deferred tax asset of $8,480 will be recognized.

(Module 37.1, LOS 37.a)

Question #32 of 32

Question ID: 1573655

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

A) no deferred tax items being created.

B) the creation of a deferred tax asset.

C) the creation of a deferred tax liability.

Explanation

Expensing R&D results in a balance sheet carrying value of zero. The tax base of the asset will be the amortization passing through the tax return in future periods. Carrying value less than the tax base results in a DTA. (Module 37.1, LOS 37.a)