

15.515 RECITATION AGENDA – SESSION 6

TAXES

- Summary of taxes
- Tax practice problems
- Summary of marketable securities
- Marketable securities practice problem
- Questions

ACCOUNTING FOR INCOME TAXES

- **Permanent Differences:**
 - Scope differences
 - Differences between financial statement (“pretax”) GAAP income and taxable income that will **never** be recaptured/reversed, e.g. Government Fines, Tax-Exempt Revenue.
- **Temporary Timing Differences** – Differences between pretax GAAP income and taxable income that will be **recaptured/reversed** at some point in the future. Temporary differences create *Deferred Tax Liabilities* and *Deferred Tax Assets*
- **Deferred Tax Liabilities (DTL)**
 - Taxable Income < Pretax GAAP Income
 - Taxes Payable < GAAP Income Tax Expense
 - Taxpayer pays lower taxes today. A liability must be recorded to account for the added taxes to be paid at some point in the future.
- **Deferred Tax Asset (DTA)**
 - Taxable Income > Pretax GAAP Income
 - Taxes Payable > GAAP Income Tax Expense
 - Taxpayer pays higher taxes today. An asset must be recorded to account for the value of lower taxes to be paid at some point in the future.

TIMING DIFFERENCES – BALANCE SHEET EQUATION

If transaction creates a **Deferred Tax Liability**:

GAAP Income Tax Expense = Taxes Payable to Governmental Agency + Δ Deferred Tax Liability
 (Current expense) (Deferred tax expense)

| Assets | = | Liabilities | + | Retained Earnings |
|---------------|---|---|---|--------------------------|
| 0 | | Taxes Payable ↑ Deferred Tax Liability ↑ | | Income Tax Expense ↓ OE |

If transaction creates a **Deferred Tax Asset**:

GAAP Income Tax Expense = Taxes Payable to Governmental Agency - Δ Deferred Tax Asset
 (Current expense) (Deferred tax expense)

| Assets | = | Liabilities | + | Retained Earnings |
|----------------------|---|--------------------|---|--------------------------|
| Deferred Tax Asset ↑ | | Taxes Payable ↑ | | Income Tax Expense ↓ OE |

OTHER IMPORTANT CONCEPTS

- **Effective Tax Rate** = GAAP Income Tax Expense / GAAP Pretax Income
- **Net Operating Losses**
 - Carryback 2 years
 - Carryforward 20 years
 - Recorded as deferred tax assets
- **Valuation Allowance** - If benefits of a deferred tax asset (*never* for a deferred tax liability) are not likely to be realized, the value of the deferred tax asset balance should be reduced by a “valuation amount”
- **Financial Statement Disclosure for Accounting for Taxes**
 - Income statement ⇒ Income tax expense
 - Balance sheet ⇒ Deferred tax assets and liabilities, Income tax payable
 - SCF ⇒ Note changes in DTA/DTL in Operating section
 - Notes ⇒ More explanation

TAX PROBLEM (PRATT E10-11)

See Problem E10-11 in the course textbook.

Ford Motor Company's Tax Footnote

For this information, see the "deferred tax assets" and "deferred tax liabilities" sections for 2002 and 2001 in Ford Motor Company's 2002 Annual Report (page 68).

Questions Related to Ford's Deferred Tax Footnote:

a) Which was greater during FY 2002: depreciation/amortization expense for financial reporting purposes or depreciation/amortization deducted for tax purposes?

b) Will future tax deductions for employee benefit plans be greater or less than future GAAP expenses for employee benefit plans?

MARKETABLE SECURITIES

- Readily marketable – convertible to CASH on DEMAND

Classified

- **Trading securities** – Objective is profit from short term price change
 - Current asset
- **Available-for-sale** - Investments not classified as ‘trading securities’
 - Current or non-current asset depending on management’s intent

Recorded Purchase Price include

- Direct costs
- Incidental Acquisition costs

Mark-to-market rule

Readily marketable securities are to be carried at market price.

Recording of gains and losses (or price increase/decrease):

| | Sales of securities | Price change – not sold yet |
|---------------------|--|---|
| Trading securities | IS – Realized gains/losses from beginning of fiscal period | IS – Unrealized/Holding gains/losses |
| Available-for-sales | IS - Realized gains/losses from date of acquisition | SE – Unrealized price increase/decrease |