FA Module 12: Accounting for income taxes (overview)

(The attached PDF file has better formatting.)

This course covers accounting for taxes on financial statements, not tax accounting. Taxes are specific to the country: nothing in the textbook or the discussion forum explains tax accounting. Some final exam problems give the tax liabilities and refunds, the current tax assets and liabilities, and the deferred tax assets and liabilities, and derives the tax expense on the income statement. Other problems may give the income statement entries and the cash flows and derive the balance sheet items, or give the income statement and balance sheet entries and derive the cash flows. The articulation principles are the same as for other entries.

Deferred tax assets and liabilities are confusing, so taxes are covered in two modules. This module covers the basic principles; the next module covers deferred tax assets and liabilities for various scenarios.

Reading: chapter 13

- § 2 differences between accounting profit and taxable income
- § 3 determining the tax base of assets and liabilities
- § 4 temporary and permanent differences between taxable and accounting profit, *excluding*
    - sub-section 4.4 (temporary differences at initial recognition of assets and liabilities)
    - sub-section 4.5 (business combinations and deferred taxes)
    - sub-section 4.6 (investments in subsidiaries, branches, associates, and interests in joint ventures)

Pre-tax income differs from taxable income by permanent or temporary differences:

- permanent tax differences:
    - some income is taxed at lower rates than ordinary income
    - example: many insurers hold tax exempt municipal bonds in the U.S.
    - some expenses are not tax deductible
    - example: lobbying expenses and entertainment expenses may be deductible only in part (if at all)
- temporary (timing) differences:
    - some revenue or expenses allocated to one period by financial accounting may be allocated to other periods by tax accounting
    - example: depreciation schedules may differ for tax accounting and financial accounting
    - some revenue or expenses may be carried forward or back to other tax years
    - example: firms with outstanding losses may offset income of future years

Distinguish the carrying value of an asset or liability on the financial statements from the tax basis on the tax return. Outstanding insurance claims and policy reserves may use one discount rate for financial statements and another discount rate for tax returns.