Deferred Tax Asset (Non-Recognition)

Companies recognize a deferred tax asset for all deductible temporary differences. However, based on available evidence, a company should reduce a deferred tax asset if it is probable that it will not realize some portion or all of the deferred tax asset. “Probable” means a level of likelihood of at least slightly more than 50 percent.

Assume that Jensen Co. has a deductible temporary difference of €1,000,000 at the end of its first year of operations. Its tax rate is 40 percent, which means it records a deferred tax asset of €400,000 (€1,000,000 × 40%). Assuming €900,000 of income taxes payable, Jensen records income tax expense, the deferred tax asset, and income tax payable as follows.

Income Tax Expense 500,000
Deferred Tax Asset 400,000
Income Tax Payable 900,000

After careful review of all available evidence, Jensen determines that it is probable that it will not realize €100,000 of this deferred tax asset. Jensen records this reduction in asset value as follows.

Income Tax Expense 100,000
Deferred Tax Asset 100,000

This journal entry increases income tax expense in the current period because Jensen does not expect to realize a favorable tax benefit for a portion of the deductible temporary difference. Jensen simultaneously recognizes a reduction in the carrying amount of the deferred tax asset. Jensen then reports a deferred tax asset of €300,000 in its statement of financial position.

Jensen evaluates the deferred tax asset account at the end of each accounting period. If, at the end of the next period, it expects to realize €350,000 of this deferred tax asset, Jensen makes the following entry to adjust this account.

Deferred Tax Asset (€350,000 - €300,000) 50,000
Income Tax Expense 50,000

Jensen should consider all available evidence, both positive and negative, to determine whether, based on the weight of available evidence, it needs to adjust the deferred tax asset. For example, if Jensen has been experiencing a series of loss years, it reasonably assumes that these losses will continue. Therefore, Jensen will lose the benefit of the future deductible amounts.

Generally, sufficient taxable income arises from temporary taxable differences that will reverse in the future or from a tax-planning strategy that will generate taxable income in the future. Illustration 19-1 shows how Ahold (NLD) describes its reporting of deferred assets.

Carryforward (Non-Recognition)

To illustrate non-recognition of a loss carryforward, assume that Groh Inc. has tax benefits of $110,000 associated with a NOL carryback and a potential deferred tax asset of $80,000 associated with an operating loss carryforward of $200,000, assuming a future
A tax rate of 40% ($200,000 × 40%). However, if it is probable that Groh will not realize the entire NOL carryforward in future years, it does not recognize this deferred tax asset. To illustrate, Groh makes the following journal entry in 2010 to record only the tax refund receivable.

**To recognize benefit of loss carryback**

<table>
<thead>
<tr>
<th>Income Tax Refund Receivable</th>
<th>110,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Benefit Due to Loss Carryback (Income Tax Expense)</td>
<td>110,000</td>
</tr>
</tbody>
</table>

Illustration 19-2 shows Groh’s 2010 income statement presentation. In 2011, assuming that Groh has taxable income of $250,000 (before considering the carryforward), subject to a tax rate of 40 percent, it realizes the deferred tax asset. Groh records the following entries.

**To recognize deferred tax asset and loss carryforward**

<table>
<thead>
<tr>
<th>Deferred Tax Asset</th>
<th>80,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Benefit Due to Loss Carryforward (Income Tax Expense)</td>
<td>80,000</td>
</tr>
</tbody>
</table>

**To record current and deferred income taxes**

<table>
<thead>
<tr>
<th>Income Tax Expense</th>
<th>100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred Tax Asset</td>
<td>80,000</td>
</tr>
<tr>
<td>Income Tax Payable</td>
<td>20,000</td>
</tr>
</tbody>
</table>

Groh reports the $80,000 Benefit Due to the Loss Carryforward on the 2011 income statement. The company did not recognize it in 2010 because it was probable that it would not be realized. Assuming that Groh derives the income for 2011 from continuing operations, it prepares the income statement as shown in Illustration 19-3.
Another method is to report only one line for total income tax expense of $20,000 on the face of the income statement and disclose the components of income tax expense in the notes to the financial statements.

Revision of Future Tax Rates

When a change in the tax rate is enacted, companies should record its effect on the existing deferred income tax accounts immediately. A company reports the effect as an adjustment to income tax expense in the period of the change.

Assume that on December 10, 2010, a new income tax act is signed into law that lowers the corporate tax rate from 40 percent to 35 percent, effective January 1, 2012. If Hostel Co. has one temporary difference at the beginning of 2010 related to $3 million of excess tax depreciation, then it has a Deferred Tax Liability account with a balance of $1,200,000 ($3,000,000 \times 40\%) at January 1, 2010. If taxable amounts related to this difference are scheduled to occur equally in 2011, 2012, and 2013, the deferred tax liability at the end of 2010 is $1,100,000, computed as follows.

<table>
<thead>
<tr>
<th></th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Future taxable amounts</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
<td>$3,000,000</td>
</tr>
<tr>
<td>Tax rate</td>
<td>40%</td>
<td>35%</td>
<td>35%</td>
<td></td>
</tr>
<tr>
<td>Deferred tax liability</td>
<td>$ 400,000</td>
<td>$ 350,000</td>
<td>$ 350,000</td>
<td>$1,100,000</td>
</tr>
</tbody>
</table>

Hostel, therefore, recognizes the decrease of $100,000 ($1,200,000 − $1,100,000) at the end of 2010 in the deferred tax liability as follows.

| Deferred Tax Liability | 100,000 |
| Income Tax Expense     | 100,000 |

Corporate tax rates do not change often. Therefore, companies usually employ the current rate. However, tax rates in some jurisdictions change more frequently, and they require adjustments in deferred income taxes accordingly.\(^1\)

Statement of Financial Position

Companies classify taxes receivable or payable as current assets or current liabilities. Although current tax assets and liabilities are separately recognized and measured, they are often offset in the statement of financial position. The offset occurs because companies normally have a legally enforceable right to set off a current tax asset (Taxes Receivable) against a current tax liability (Taxes Payable) when they relate to income taxes levied by the same taxation authority.\(^1\) Deferred tax assets and deferred tax liabilities are also separately recognized and measured but may be offset in the statement of financial position.\(^2\) The net deferred tax asset or net deferred tax liability is reported in the non-current section of the statement of financial position.\(^3\)

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1 Tax rate changes nearly always will substantially impact income numbers and the reporting of deferred income taxes on the statement of financial position. As a result, you can expect to hear an economic consequences argument every time that a legislature decides to change the tax rates. For example, when one country raised the corporate rate from 34 percent to 35 percent, companies took an additional “hit” to earnings if they were in a deferred tax liability position.

2 Companies are permitted to offset deferred tax assets and deferred tax liabilities if, and only if: (1) the company has a legally enforceable right to set off current tax assets against current tax liabilities; and (2) the deferred tax assets and the deferred tax liabilities relate to income taxes levied by the same tax authority and for the same company.\(^2\)

3 Deferred tax amounts should not be discounted. The IASB apparently considers discounting to be an unnecessary complication even if the effects are material.\(^3\)
To illustrate, assume that K. Scott Company has four deferred tax items at December 31, 2011, as shown in Illustration 19-5.

<table>
<thead>
<tr>
<th>Temporary Difference</th>
<th>Resulting Deferred Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Rent collected in advance: recognized when earned for accounting purposes and when received for tax purposes.</td>
<td>$(42,000)</td>
</tr>
<tr>
<td>2. Use of straight-line depreciation for accounting purposes and accelerated depreciation for tax purposes.</td>
<td>$214,000</td>
</tr>
<tr>
<td>3. Recognition of profits on installment sales during period of sale for accounting purposes and during period of collection for tax purposes.</td>
<td>45,000</td>
</tr>
<tr>
<td>4. Warranty liabilities: recognized for accounting purposes at time of sale; for tax purposes at time paid.</td>
<td>$(12,000)</td>
</tr>
<tr>
<td>Totals</td>
<td>$(54,000)</td>
</tr>
</tbody>
</table>

As indicated, K. Scott has a total deferred tax asset of $54,000 and a total deferred tax liability of $259,000. Assuming these two items can be offset, K. Scott reports a deferred tax liability of $205,000 ($259,000 − $54,000) in the non-current liability section of its statement of financial position.

**Tax Reconciliation**

Another important disclosure is the reconciliation between actual tax expense and the applicable tax rate. Companies either provide:

- A numerical reconciliation between tax expense (benefit) and the product of accounting profit multiplied by the applicable tax rate(s), disclosing also the basis on which the applicable tax rate(s) is (are) computed; or
- A numerical reconciliation between the average effective tax rate and the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed.

In explaining the relationship between tax expense (benefit) and accounting income, companies use an applicable tax rate that provides the most meaningful information to the users of its financial statements.4

**Authoritative Literature References**


4Often, the most meaningful rate is the domestic rate of tax in the country in which the company is located, aggregating the tax rate applied for national taxes, with the rates applied for any local taxes, which are computed on a substantially similar level of taxable profit (tax loss). However, for a company operating in several jurisdictions, it may be more meaningful to aggregate separate reconciliations prepared using the domestic rate in each individual jurisdiction.
**Chapter 19 Accounting for Income Taxes**

### QUESTIONS

1. What is the difference between a future taxable amount and a future deductible amount? When is it not appropriate to recognize a portion or all of a deferred tax asset?

2. How are deferred tax assets and deferred tax liabilities reported on the statement of financial position?

3. Describe the procedure(s) involved in classifying deferred tax amounts on the statement of financial position.

### BRIEF EXERCISES

**BE19-1** At December 31, 2010, Hillyard Corporation has a deferred tax asset of $200,000. After a careful review of all available evidence, it is determined that it is probable that $60,000 of this deferred tax asset will not be realized. Prepare the necessary journal entry.

**BE19-2** Rode Inc. incurred a net operating loss of €500,000 in 2010. Combined income for 2008 and 2009 was €350,000. The tax rate for all years is 40%. Rode elects the carryback option. Prepare the journal entries to record the benefits of the loss carryback and the loss carryforward.

**BE19-3** Use the information for Rode Inc. given in BE19-2. Assume that it is probable that the entire net operating loss carryforward will not be realized in future years. Prepare the journal entry(ies) necessary at the end of 2010.

**BE19-4** Youngman Corporation has temporary differences at December 31, 2010, that result in the following deferred taxes.

<table>
<thead>
<tr>
<th>Deferred tax asset</th>
<th>$24,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred tax liability</td>
<td>$69,000</td>
</tr>
</tbody>
</table>

Indicate how these balances would be presented in Youngman’s December 31, 2010, statement of financial position.

### EXERCISES

**E19-1** (Three Differences, Classify Deferred Taxes) At December 31, 2010, Cascade Company had a net deferred tax liability of $450,000. An explanation of the items that compose this balance is as follows.

<table>
<thead>
<tr>
<th>Temporary Differences</th>
<th>Resulting Balances in Deferred Taxes</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Excess of tax depreciation over book depreciation</td>
<td>$200,000</td>
</tr>
<tr>
<td>2. Accrual, for book purposes, of estimated loss contingency from pending lawsuit that is expected to be settled in 2011. The loss will be deducted on the tax return when paid.</td>
<td>(50,000)</td>
</tr>
<tr>
<td>3. Accrual method used for book purposes and installment method used for tax purposes for an isolated installment sale of an investment.</td>
<td>$300,000</td>
</tr>
</tbody>
</table>

In analyzing the temporary differences, you find that $30,000 of the depreciation temporary difference will reverse in 2011, and $120,000 of the temporary difference due to the installment sale will reverse in 2011. The tax rate for all years is 40%.

**Instructions**

Indicate the manner in which deferred taxes should be presented on Cascade Company’s December 31, 2010, statement of financial position.
E19-2 (Deferred Tax Asset)  Callaway Corp. has a deferred tax asset account with a balance of $150,000 at the end of 2010 due to a single cumulative temporary difference of $375,000. At the end of 2011, this same temporary difference has increased to a cumulative amount of $500,000. Taxable income for 2011 is $850,000. The tax rate is 40% for all years.

**Instructions**

(a) Record income tax expense, deferred income taxes, and income taxes payable for 2011, assuming that it is probable that the deferred tax asset will be realized.

(b) Assuming that it is probable that $30,000 of the deferred tax asset will not be realized, prepare the journal entry at the end of 2011 to recognize this probability.

E19-3 (Deferred Tax Asset)  Assume the same information as in E19-2 for Callaway Corp.

**Instructions**

(a) Record income tax expense, deferred income taxes, and income taxes payable for 2011, assuming that it is probable that $20,000 of the deferred tax asset will be realized in full.

(b) Record income tax expense, deferred income taxes, and income taxes payable for 2011, assuming that it is probable that none of the deferred tax asset will be realized.

E19-4 (NOL Carryback and Carryforward, Recognition versus Non-Recognition)  Sondgeroth Inc. reports the following pretax income (loss) for both financial reporting purposes and tax purposes. (Assume the carryback provision is used for a net operating loss.)

<table>
<thead>
<tr>
<th>Year</th>
<th>Pretax Income (Loss)</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>€110,000</td>
<td>34%</td>
</tr>
<tr>
<td>2010</td>
<td>90,000</td>
<td>34%</td>
</tr>
<tr>
<td>2011</td>
<td>(260,000)</td>
<td>38%</td>
</tr>
<tr>
<td>2012</td>
<td>220,000</td>
<td>38%</td>
</tr>
</tbody>
</table>

The tax rates listed were all enacted by the beginning of 2009.

**Instructions**

(a) Prepare the journal entries for the years 2009–2012 to record income tax expense (benefit) and income tax payable (refundable) and the tax effects of the loss carryback and carryforward, assuming that at the end of 2011 it is probable that the benefits of the loss carryforward will be realized in the future.

(b) Using the assumption in (a), prepare the income tax section of the 2011 income statement, beginning with the line “Operating loss before income taxes.”

(c) Prepare the journal entries for 2011 and 2012, assuming that based on the weight of available evidence, it is probable that one-fourth of the benefits of the loss carryforward will not be realized.

(d) Using the assumption in (c), prepare the income tax section of the 2011 income statement, beginning with the line “Operating loss before income taxes.”

E19-5 (NOL Carryback and Carryforward, Non-Recognition)  Nielson Inc. reports the following pretax income (loss) for both book and tax purposes. (Assume the carryback provision is used where possible for a net operating loss.)

<table>
<thead>
<tr>
<th>Year</th>
<th>Pretax Income (Loss)</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>€100,000</td>
<td>40%</td>
</tr>
<tr>
<td>2010</td>
<td>90,000</td>
<td>40%</td>
</tr>
<tr>
<td>2011</td>
<td>(240,000)</td>
<td>45%</td>
</tr>
<tr>
<td>2012</td>
<td>120,000</td>
<td>45%</td>
</tr>
</tbody>
</table>

The tax rates listed were all enacted by the beginning of 2009.

**Instructions**

(a) Prepare the journal entries for years 2009–2012 to record income tax expense (benefit) and income tax payable (refundable), and the tax effects of the loss carryback and loss carryforward, assuming that based on the weight of available evidence it is probable that one-half of the benefits of the loss carryforward will not be realized.

(b) Prepare the income tax section of the 2011 income statement, beginning with the line “Operating loss before income taxes.”

(c) Prepare the income tax section of the 2012 income statement, beginning with the line “Income before income taxes.”
Chapter 19 Accounting for Income Taxes

USING YOUR JUDGMENT

FINANCIAL REPORTING

Financial Reporting Problem

Marks and Spencer plc (M&S)

The financial statements of M&S can be accessed at the book’s companion website, www.wiley.com/college/kiesoifrs.

Instructions

Refer to M&S’s financial statements and the accompanying notes to answer the following questions.

(a) What amounts relative to income taxes does M&S report in its:
    (1) 2008 income statement?
    (2) 29 March 2008 balance sheet?
    (3) 2008 statement of cash flows?

(b) M&S’s provision for income taxes in 2007 and 2008 was computed at what effective tax rates? (See the notes to the financial statements.)

(c) How much of M&S’s 2008 total provision for income taxes was current tax expense, and how much was deferred tax expense?

(d) What did M&S report as the significant components (the details) of its 29 March, 2008 deferred tax assets and liabilities?

BRIDGE TO THE PROFESSION

Professional Research

Kleckner Company started operations in 2007, and although it has grown steadily, the company reported accumulated operating losses of $450,000 in its first four years in business. In the most recent year (2011), Kleckner appears to have turned the corner and reported modest taxable income of $30,000. In addition to a deferred tax asset related to its net operating loss, Kleckner has recorded a deferred tax asset related to product warranties and a deferred tax liability related to accelerated depreciation.

Given its past operating results, Kleckner has determined that it is not probable that it will realize any of the deferred tax assets. However, given its improved performance, Kleckner management wonders whether there are any accounting consequences for its deferred tax assets. They would like you to conduct some research on the accounting for recognition of its deferred tax asset.

Instructions

Access the IFRS authoritative literature at the IASB website (http://eifrs.iasb.org/). When you have accessed the documents, you can use the search tool in your Internet browser to respond to the following questions. (Provide paragraph citations.)

(a) Briefly explain to Kleckner management the importance of future taxable income as it relates to the recognition of deferred tax assets.

(b) What are the sources of income that may be relied upon in assessing realization of a deferred tax asset?

(c) What are tax-planning strategies? From the information provided, does it appear that Kleckner could employ a tax-planning strategy in evaluating its deferred tax asset?