Depreciation and Deferred Taxes

15.511 Corporate Accounting
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Tax and Timing Effects

- Tax Depreciation
  - Accelerated depreciation
  - No judgment in determining depreciation expense

- Tax Reporting ≠ Financial Reporting ==> timing differences in measurement of income
  - Why would a firm prefer accelerated depreciation for tax purposes?
  - Why does government allow this?
  - Why not use the tax method for financial reporting?

- Different depreciation for tax and financial reporting gives rise to *Deferred Taxes*
Is deferred tax expense a line item expense on the income statement?
- No

If not where is it?
- It is a component of reported income tax expense

What is the journal entry?

(Recall: Income tax expense = taxes payable + deferred tax expense)

Dr Income tax expense 15,000
Cr Tax payable 7,800
Cr Deferred tax liability 7,200
Deferred Taxes over Time

Deferred taxes caused by timing differences are temporary; they reverse over time.

<table>
<thead>
<tr>
<th>Year</th>
<th>Financial reporting</th>
<th>Tax reporting</th>
<th>Depreciation difference</th>
<th>Deferred Tax Difference, Expense (EB)</th>
<th>Acc. Depr (EB)</th>
<th>Def Tax Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>30,000</td>
<td>54,000</td>
<td>24,000</td>
<td>7,200</td>
<td>24,000</td>
<td>7,200</td>
</tr>
<tr>
<td>2001</td>
<td>30,000</td>
<td>36,000</td>
<td>6,000</td>
<td>1,800</td>
<td>30,000</td>
<td>9,000</td>
</tr>
<tr>
<td>2002</td>
<td>30,000</td>
<td>-</td>
<td>(30,000)</td>
<td>(9,000)</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

- Timing differences that create / increase deferred taxes are called **originating differences**
- Timing differences that remove / decrease deferred taxes are called **reversing differences**