

Week 3 - DQ 1

Why are there differences between taxable and financial income? What are some examples of permanent and temporary differences? Why do these differences exist? How do they affect the financial statements? What experience do you have with either taxable and financial income and/or permanent and temporary differences in your organization or an organization that you are familiar with?

Response #1 There are differences between taxable and financial income because taxable income is used to compute income tax payable and uses IRS tax code. Financial income is used to provide useful information to investors and creditors and follows GAAP. Permanent differences result from items that enter into pretax financial income but never into taxable income, or enter into taxable income but never into pre tax financial income. Temporary differences are when revenues or gains are taxable after they are recognized in financial income; expenses or losses are deductible after they are recognized in financial income; revenues or gains are taxable before they are recognized in financial income; and expenses or losses are deductible before they are recognized in financial income.

Response #2 Taxable income relates to income tax payable. As per our chapter readings, "Companies determine taxable income according to the Internal Revenue Code (the tax code)" (Kieso, Weygandt, & Warfield, 2007, p. 964). The taxes collected from income are used in the benefit of the government to be used as support for their operations. Financial income relates to pretax income. As per our chapter readings, "Companies determine pretax financial income according to GAAP" (Kieso, Weygandt, & Warfield, 2007, p. 964). This method assists with providing investors and creditors making financial decision. Another difference is that companies use the financial income under accrual method while the taxable income method is cash basis. An example of a temporary difference is revenues that occur after they are distinguished on the financial income. An example of a permanent difference is recognizable items on the financial statements that are not for taxable purposes. When I do payroll, I deal with taxable income. I do not handle the financial for the company because we have an accounting firm that handles that for us. I have no experience in this area, but plan to in the future.

Reference

Kieso, D. E., Weygandt, J. J., & Warfield, T. D. (2007). Intermediate accounting, (12th ed.). Hoboken, NJ: John Wiley & Sons.

Response #3 Taxable income is tax that is payable to the IRS according to their regulations. Financial income is a pretax amount for creditors and investors. An example of a

permanent difference is meal expenses for companies. Only 50 percent of the deduction is allowed on tax returns however 100 percent of meal expenses are reported. A company would not receive the benefit of the other 50 percent which creates a permanent difference. Depreciation is an example of a temporary difference because the tax is deferred to future years. These differences exist to assess the financial position of a company. The affect on financial statements is the income will be under or overstated. The only experience I have had has to do with meal expenses and this was many years ago. I would be reimbursed for lunches when I would help at other stores. This was not a frequent event so I did not have to pay taxes on it. I believe the people within my organization that have expense accounts have to pay taxes on their expense accounts.

Response #4 Taxable income is used in determining income tax payable, whereas pretax financial income determines income tax expense. Taxable revenues could actually be lower one year, accounting for a lower taxable income, therefore accounting for a lower income tax payable liability to the IRS on the balance sheet. According to our text, a temporary difference could be accounts receivable. In other words pretax financial income can include accounts receivable, but taxable income would not because accounts receivable is not taxable. For example, proceeds from life insurance carried by the company on key officers or employees where the company is the beneficiary would be recognized for financial reporting purposes only and not for tax purposes ever. Whereas with temporary differences, the taxable income is temporarily deferred, such items as this insurance example would stay permanent and never become taxable. These differences exist because it is important to financially report such differences within the financial statements, yet when calculating income tax payable, companies want to ensure they are not paying excess taxes for non-taxable items. Based on the revenues and expenses, tax expense will be calculated and will affect the income statement accordingly. And although one would then think tax payable would match tax expense, tax payable within the balance sheet may be less or more in any given year to account for any deferred taxes.