

Taxes and the Statement of Cash Flows

- All operating activity line items on the SCF are shown pre-tax

(\$000's)

Year ended Dec. 31:	2009	2010	2011
Net Income	1,470	3,028	5,071
Depreciation	2,372	4,537	7,191
Doubtful Accts.	12	48	48
Changes in:			
Accounts Receivable	4,594	(7,357)	(660)
Inventories	1,481	(13,179)	(7,872)
Deferred Taxes	8	178	587
Prepaid, other	(1)	179	14
Accounts Payable	(3,927)	5,084	86
Accrued Wages	99	708	232
Other Current Liabs.	110	464	(23)
Taxes Payable	(502)	816	278
Cash Flow from Operations	5,716	(5,494)	4,952

- All tax effects are reflected in:
 - Changes in Deferred Taxes
 - Changes in Income Tax Payable

Taxes and the SCF: Example

- **Company increases book Depreciation Expense by \$100 in 2011**
 - **Pre-tax income down by \$100**
 - Income Tax Expense down by \$35 ($100 \times .35$)
 - Net Income down by \$65 ($100 - 35$)
 - **Tax Depreciation is unaffected**
 - Taxable Income unaffected; Income Tax Payable unaffected
 - **Balance these differences with a reduction in Deferred Tax Liability of \$35**

- **Journal entries**

Dr. Depreciation Expense (+E)	100	
Cr. Accumulated Depreciation (+XA)		100
Dr. Deferred Tax Liability (-L)	35	
Cr. Income Tax Expense (-E)		35 ($100 \times .35$)

SCF: Cash Flows from Operating Activities

(\$000's)			Old	New	
Year ended Dec. 31:	2009	2010	2011	2011	Chg.
Net Income	1,470	3,028	5,071	5,006	(65)
Depreciation	2,372	4,537	7,191	7,291	100
Doubtful Accts.	12	48	48	48	
Changes in:					
Accounts Receivable	4,594	(7,357)	(660)	(660)	
Inventories	1,481	(13,179)	(7,872)	(7,872)	
Deferred Taxes	8	178	587	552	(35)
Prepaid, other	(1)	179	14	14	
Accounts Payable	(3,927)	5,084	86	86	
Accrued Wages	99	708	232	232	
Other Current Liabs.	110	464	(23)	(23)	
Taxes Payable	(502)	816	278	278	0
Cash Flow from Operations	5,716	(5,494)	4,952	4,952	0

Taxes and Marketable Securities

- **Gains or losses on Marketable Securities are taxed only when sold**
 - Tax is based on the difference between the sales price and the purchase price
- **Trading Securities**
 - Unrealized gains/losses from mark-to-market are carried on the Income Statement
 - Create a Deferred Tax Asset or Liability
- **Available for Sale Securities**
 - Unrealized gains/losses for AFS securities are stored up in AOCI
 - Accumulated Other Comprehensive Income must be carried on an after-tax basis
 - Create a DTA or DTL to reflect the tax effect of the unrealized gains/losses in AOCI

Example: Mark-to-market on balance sheet date - Trading

- At quarter end, Bott Bank's investment in TK stock is now worth \$129 (Bott bought the stock for \$100)

- Journal entries:

Dr. Marketable Securities (+A)	29	
Cr. Gain on Investments (+R)		29
Dr. Income Tax Expense (+E)	10	(29 x 0.35)
Cr. Deferred Tax Liability (+L)		10

- Note: No Income Tax Payable because taxes are only paid when the security is sold

Example: Sale of investment - Trading

- After quarter end, Bott Bank sells its TK stock for \$109
- Journal entries:

Dr. Cash (+A)	109	
Dr. Loss on investment (+E)	20	
Cr. Marketable Securities (-A)		129
Dr. Deferred Tax Liability (-L)	10	
Cr. Income Tax Expense (-E)	7	(20 x 0.35)
Cr. Income Tax Payable (+L)	3	((109-100) x 0.35)

- Note: Income Tax Payable is based on the Realized Gain computed using the original cost (109 – 100)

Example: Mark-to-market on balance sheet date - AFS

- At quarter end, Meyer Co.'s investment in TK stock is now worth \$129 (Meyer bought the stock for \$100)

- Journal entries:

Dr. Marketable Securities (+A)	29
Cr. AOCI (+SE)	29
Dr. AOCI (-SE)	10
Cr. Deferred Tax Liability (+L)	10

AOCI (SE)			
DTL eff	10	29	Qtr end
		19	

- Note: Instead of debiting Income Tax Expense, as we would if this went on the Income Statement, we debit AOCI

Example: Sale of investment - AFS

- After quarter end, Meyer Co. sells its TK stock for \$109
- Journal entries:

Dr. Cash (+A)	109	
Dr. AOCI (-SE)	29	
Cr. Gain on investment (+R, +SE)	9	
Cr. Marketable Securities (-A)	129	
Dr. Income Tax Expense (+E)	3	(9 x 0.35)
Cr. Income Tax Payable (+L)	3	
Dr. Deferred Tax Liability (-L)	10	
Cr. AOCI (+SE)	10	

AOCI (SE)			
Tax eff	10	29	Qtr end
Sale	29	10	Sale Tx
		0	