What Can We Infer About a Firm's Taxable Income from its Financial Statements?

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Abstract:

In this paper I review and describe the income tax disclosures currently required in firms' financial statements. I discuss many of the problems with trying to estimate a firm's actual tax liabilities and taxable income from the income tax expense and disclosures to the financial statements. In doing so, I reveal the conditions under which taxable income may most accurately be estimated from financial statements as well as those conditions which make this task difficult, if not impossible.

Comments welcome.

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I. Introduction

The short answer: Usually, not much. A common method of estimating taxable income from financial statements is to gross-up the current portion of the tax expense on the income statement by the statutory tax rate.[1] This calculation assumes that the current tax expense represents the actual tax liability on the firm's filed tax return for the period. Many times, however, this is not an accurate assumption.[2]

In this paper I describe three issues that can cause estimates of a firm's tax liabilities and/or taxable income to be incorrect. First, and in my opinion the most problematic, are items that cause the current tax expense to be over- or understated relative to the actual tax liabilities of the firm. This includes the issues associated with the accounting for the stock option deduction, the item known as the tax "cushion," and intraperiod tax allocation. The presence of these items causes inferences about the tax liability and thus the taxable income of the firm to be erroneous. I explain and describe each of these items in detail below.

Second, are problems with the estimate of taxable income calculated by grossing-up the current tax expense. There are problems with this calculation even when the current tax expense is a reasonable approximation of the actual tax liability of the firm. The current tax expense is reported after tax credits. In the presence of credits (e.g., research and development credits, foreign tax credits, etc.), the estimate of taxable income from grossing-up the current tax expense

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[1] Thus, if a firm reports a total tax expense of $1.5 million including a current tax expense of $1 million and the statutory tax rate is 35% the taxable income would be estimated at $2,857,143 ($1,000,000/.35) using this methodology. See Manzon and Plesko (2002), Omer et al. (1991), and Gupta and Newberry (1997) for examples.

[2] In fact, McGill and Outslay (2002) state that "…a correspondence between the reported federal income tax 'payable currently' and the check sent to the Internal Revenue Service would be surprising, if not only coincidental" (p. 1131). Further, Robert Willens, a tax and accounting analyst with Lehman Brothers, stated in a *Business Week* article, "Truth is figuring out how much tax a company actually pays is impossible…Tax disclosure is just inscrutable" (Gleckman et al., 2000, p. 40).

will be measured with error.[3] In addition, for a multinational firm, using the U.S. statutory tax rate to gross-up total current tax expense will not likely yield a correct estimate of taxable income because the income will be subject to tax at different rates in foreign jurisdictions. Finally, the current tax expense is bounded at zero (or the refund available through net operating loss carrybacks) and thus offers little information about taxable income for tax-loss firms.

Third, are the differing consolidation rules for book and tax purposes that cause the financial statements to include a different group of related corporations than the tax return includes. In many cases, these consolidation differences *do not* cause problems with estimating the tax liabilities or the taxable income of the entities as reported on the financial statements. However, because of limited disclosures it is often difficult to decipher that consolidation differences are causing the divergence between book and tax incomes. I explain the issues involved in five consolidation scenarios.

It is important to begin this discussion by considering <u>why</u> we want to infer taxable income from the financial statements. Recently, the business press and some members of Congress have called for better disclosures of taxable income so that investors and the Internal Revenue Service (IRS) can determine, by using one measure of income as a benchmark for the other measure, if firms are under-reporting to the governments (i.e., not paying their "fair share") and/or over-reporting to shareholders.[4] Because tax returns are not publicly available, investors, analysts, governmental agencies, and academics use financial statement information to estimate the tax liabilities and the taxable income of firms. Although this is reasonable, it is important to remember that the current tax expense often used for this estimation is intended to measure the financial accounting expense just as financial accounting measures every other expense on the

[3] I provide a detailed example later in the paper.
[4] See for example Weisman (2002) and Grassley (2002). Evidence that the IRS in some cases will use book income as a benchmark is found in a recent Treasury regulation §1.6011-4T that states if a book-tax difference in excess of $10 million exists this difference must be separately disclosed.

income statement. Thus, while much of my discussion revolves around what the financial statements fail to tell us about the tax liabilities and the taxable income of the firm, in my opinion, in most cases, the book expense does provide a fair and accurate assessment of a firm's tax cost for financial reporting purposes.[5]

To get a better measure of the taxable income and tax liabilities of the firm from financial statements, if that is our objective, additional disclosures will likely be necessary. One suggestion is a new, publicly available schedule M-1.[6] Another is to simply reconcile the current tax expense as recognized for financial accounting to the current cash taxes paid. I propose a simple reconciliation at the end of this discussion to do just that. In addition, more detailed disclosures regarding the composition of the book-tax differences would be useful in order to determine *why* our estimate of taxable income is different from book income. I leave the discussion of whether this information should be publicly available to Lenter, Shackelford, and Slemrod (2003).

I review and describe the items that cause a firm's actual tax liability in a given year to differ from its current tax expense as reported under the current accounting standard governing income tax disclosures, Statement of Financial Accounting Standard No. 109, *Accounting for Income Taxes* (FAS 109). FAS 109 requires firms to disclose both a current and a deferred portion of their income taxes. The sum of these two portions represents the total tax expense related to the financial accounting earnings thereby matching the tax expense with the related revenues. The current portion is intended to represent the actual tax liability for the current

[5] The notable exception being the accounting for the book-tax difference for the stock option deduction. I discuss this later in the paper.
[6] Schedule M-1 is the reconciliation of book income to tax income currently in the corporate tax return Form 1120. See Mills and Plesko (2003) and Canellos and Kleinbard (2002).

year.[7] The deferred portion is the amount that will be payable or receivable in a future period as a result of certain income items or deductions reportable for tax and book purposes in different periods (i.e., temporary differences).

The difference between income for tax and for book purposes has attracted much attention in recent years with the suspected explosion of corporate tax shelters as well as financial accounting scandals where some firms reported high earnings to shareholders while paying very little in tax (e.g., Enron). There are several reasons why taxable income does not equal financial accounting (book) earnings. The primary reason is that the objectives of the financial accounting and the tax accounting systems are different. Financial accounting is meant to provide financial statement users with information on which to base decisions. Financial accounting accruals are intended to overcome measurement problems over finite intervals and provide a signal of managers' private information about firm performance (Dechow 1994). In contrast, the objectives of the Internal Revenue Code are 1) to provide a framework for efficient and equitable determination of tax liabilities and the subsequent collection of revenue and 2) to provide incentives for firms to engage in particular activities (Scholes, Wolfson, Erickson, Maydew and Shevlin 2002, Manzon and Plesko 2002). Thus, the incomes are determined under different sets of rules and are expected to be dissimilar.

Another source of book-tax differences is opportunistic reporting under either or both systems. For example, firms can engage in tax planning strategies, legal or otherwise, that lower taxable income relative to book income. Similarly, a firm can opportunistically manage financial accounting earnings upward, which increases book income relative to taxable income, if the firm

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[7] This does not mean that this tax liability is from an actual tax return that is filed, but rather a tax liability for a tax return that *would be* filed if the entities included in the filing of the annual report were identical to those covered by the tax return. This is not always the case, and thus the interpretation that the current tax expense is the tax liability from a tax return is problematic. I discuss the specific issues regarding consolidation later but, throughout the paper prior to that, I assume that there are no consolidation issues for the firm and, as a result, the actual tax liability I refer to can be thought of as one from the firm's filed tax return.

does not pay tax on the managed earnings.[8] It is this type of book-tax difference that investors, analysts, and the IRS are likely interested in when analyzing book versus taxable incomes.

What follows is not intended to describe all of the sources of differences between financial accounting income and taxable income. Rather, this paper focuses on how transparent financial accounting disclosures are about 1) the firm's tax liabilities and taxable income and 2) the differences between book and tax incomes. The paper proceeds as follows. Section II describes the income tax expense, the related disclosures under FAS 109, and the limitations of the disclosures. Section III examines in detail the most important items that cause discrepancies between the current tax expense and the actual tax liability of the firm. Section IV discusses problems with estimating taxable income by grossing-up current tax expense even when the current tax expense is the actual tax liability of the firm. Section V discusses the issues regarding consolidations, including foreign subsidiaries and special purpose entities, and how these affect inferences about taxable income, if at all. Section VI provides a suggestion for additional disclosure and Section VII concludes.

II. Disclosures under FAS 109

The primary objectives of the accounting for income taxes as stated in FAS 109 are 1) to recognize the amount of taxes payable or refundable for the current year and 2) to recognize deferred tax liabilities and assets for the (expected) future tax consequences of events that have been recognized in a company's financial statements or tax returns.[9] Thus, the firm includes a tax expense on the income statement that consists of both current and deferred portions and recognizes deferred tax assets and liabilities on the balance sheet related to future deductions and

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[8] Firms can also manage financial accounting earnings downward, for example with "cookie-jar" reserves, in order to preserve steady growth in earnings in future years.
[9] FAS 109, para. 6 and 7.

future tax expenses. Additional disclosures regarding both the expense and the balance sheet amounts are required in the notes that accompany the financial statements. While the current tax expense is often used by financial statement users to estimate taxable income, it is the additional disclosures in the notes to the financial statements that can provide insights into *why* taxable income is different from book income (i.e., the sources of the book-tax differences). I discuss the components of the required disclosures below and use the financial statements and notes of three firms in Exhibits 1-3 to illustrate the issues.

Calculation and Disclosure of the Current Tax Expense

FAS 109 requires the disclosure of a current tax expense. This amount is intended to reflect the amount of income taxes payable or refundable to all the taxing authorities (e.g., U.S., foreign, state and local) for the current year. Thus, in a simple setting (i.e., a publicly traded corporation without subsidiaries or significant holdings in other companies, stock options, tax cushion, extraordinary items or discontinued operations), the current tax expense would be calculated by determining taxable income at the time the financial statements are completed and computing the tax liability on this amount.

One complication immediately arises. Because the book accounting for income taxes generally occurs approximately six months before the tax return is filed, the current tax expense will not exactly equal the tax liability on a tax return. For example, publicly traded firms are required to file their annual report within 90 days of their fiscal year-end. However, the tax return is not due until eight and a half months after year-end, including extensions. As a result, generally firms do not *know* their tax liabilities with perfect accuracy at the time the financial statements are completed. Thus, even without any of the more serious issues I describe below, the current tax expense will not exactly equal the tax liability on the tax return. However, absent

these more serious issues, the current tax expense should represent management's best estimate of the taxes currently payable.

Deferred Taxes

Under FAS 109, the deferred tax expense (benefit) for the year is measured as the current year change in the deferred tax assets and liabilities. A deferred tax asset represents a future deductible amount and a deferred tax liability represents a future taxable amount. In general, a deferred tax asset or liability represents the tax effects of basis differences in assets or liabilities for book and tax purposes (see example below for further explanation). These differences in book and tax asset bases are created from temporary differences between book and taxable incomes.[10] A temporary difference is an item of income or expense that will appear in both taxable income and book income but will appear in two different reporting periods.

The simplest example of a temporary difference and the resulting deferred tax liability is when an asset is depreciated under the straight-line method for book purposes and under the accelerated method for tax purposes. Because tax depreciation is greater than book depreciation early in the asset's life, the asset has a larger book basis than tax basis during this period. For example, assume a firm buys an asset that costs $100 and in the first year deducts tax depreciation of $40 and expenses book depreciation of $20. Thus, the asset's basis for tax purposes is $60 ($100 cost less $40 depreciation). For financial accounting purposes, the asset's basis is $80 ($100 cost less $20 depreciation). Thus, the book basis of the asset is greater than the tax basis. The difference in bases (here $20= $80-$60) is a future taxable amount because over the life of the asset both tax and book total depreciation can be no greater than the cost of the asset and thus in the latter part of the asset's life the tax depreciation will be less than book depreciation (making taxable income greater than book income in those later years). Thus, the

[10] In addition, tax loss carryforwards are a deferred tax asset because they provide future deductions.

accelerated depreciation creates a deferred tax liability in the early years in the sense that it is the early deduction now that forces a future situation where taxable income will be greater than book income (i.e., a future tax liability). The deferred tax liability that should be recorded is the basis difference multiplied by the tax rate expected to be in effect upon reversal (e.g., .35X$20=$8.75).

Under FAS 109, both deferred liabilities and assets are recognized on the balance sheet. The exception to recognition is when based on the weight of all available evidence, it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets (i.e., future deductions) will not be realized. In this case the firm must establish a valuation allowance (a reserve) against the deferred tax asset so that only the amount that is likely to be realized (i.e., future tax deductions that will reduce future taxes) is recognized.

FAS 109 also requires the disclosure of the deferred assets and liabilities in the notes to the financial statements. Paragraph 43 of FAS 109 requires disclosures of 1) the total of all deferred tax liabilities, 2) the total of all deferred tax assets, 3) the total valuation allowance, and 4) the net change in the valuation allowance for the year. In addition, a public enterprise "shall discuss the approximate effect of each type of temporary difference and carryforward that gives rise to a significant portion of the deferred tax liability and deferred tax asset." FAS 109 does not, however, contain guidance as to what is material and, as a result, the disclosures are inconsistent in terms of the level of detail provided across firms.[11]

The difference in the level of disclosures can be seen by examining the three firms in Exhibits 1-3. Exhibit 1 Panel D shows Cisco System, Inc.'s (Cisco) deferred tax assets and liabilities for the years ended July 2001 and 2002. Cisco separately lists eight items plus an "other" category for its deferred tax assets and details two classes of deferred tax liabilities plus

[11] In addition, which temporary differences belong to which jurisdictions is not disclosed. For example, a deferred tax liability for depreciation differences is for worldwide differences in asset bases. Thus, for multinational firms, the portion related to U.S. income and the portion related to foreign-sourced income cannot be determined from financial statement disclosures.

an "other" category. Cisco describes their valuation allowance, but does not show it netted against the deferred tax assets in the schedule. In contrast, Exhibit 2 Panel D shows Microsoft Corporation's (Microsoft) disclosures of its deferred tax assets and liabilities for its years ended June 2001 and 2002. Under deferred tax assets, Microsoft only lists three separate categories--two of which are labeled "revenue items" and "expense items" rather than a more specific description and the third is labeled "impaired investments". Under deferred tax liabilities there are two separate categories and one "other" item listed. Finally, Exhibit 3 Panel C lists the deferred tax assets and liabilities for General Motors (GM) for the years 2000 and 2001. GM lists seven separate line items for both deferred tax assets and liabilities together. In addition, GM shows the netting of the valuation allowance with the gross deferred tax assets.

Thus, as is evident from examining the financial statements of these three firms, the level of detail in the disclosures varies a great deal from company to company. Often it is difficult to infer what causes the specific book-tax differences. For example, we cannot tell what is included in the "other" category. Further, even when itemized, the descriptions are often short and non-standardized.[12]

[12] Two other items can cause confusion when looking at the tax note. First, often the change in the deferred tax assets and liabilities listed in the notes is not equal to the deferred expense or benefit. For example, Exhibit 3 for GM reveals a net change from 2000 to 2001 in the net deferred tax assets and liabilities of approximately $6,828 million (increase in net deferred tax assets of $7,300 million netted against a net increase in deferred tax liabilities of $472 million); however, the deferred tax benefit for the year 2001 is $604 million. Such a discrepancy is often due to merger and acquisition activity during the year because under certain types of mergers and acquisitions, the deferred tax assets and liabilities of the merged/acquired firm are combined with the deferred tax assets and liabilities of the acquiring firm. In this case, the current year deferred tax expense will not equal the apparent change from the prior year deferred tax assets and liabilities to the current year deferred tax assets and liabilities. Intraperiod tax allocation (discussed below) may also cause the deferred tax expense to be different from the change in the deferred tax liabilities and assets as reported in the notes. Second, the total deferred tax assets and liabilities in the notes to the financial statement will not generally be traceable to the balance sheet of the firm. FAS 109 paragraph 41 requires the deferred tax assets and liabilities to be separated into a current and non-current portion. Because many firms net the current portion with other current liabilities, the total in the note is generally not the same amount shown on the balance sheet.

Total Tax Expense

The total tax expense reported on the financial statement is the sum of the current and deferred taxes (see Exhibit 1 Panel A). The firm is required to provide a reconciliation (using percentages or dollar amounts) from the hypothetical income tax expense that would result from applying the federal statutory tax rate to pre-tax income from continuing operations to the actual total income tax expense recorded on the income statement for the year. This is known as the rate reconciliation or the "rate rec." This reconciliation is to disclose the estimated amount and nature of each "significant" reconciling item. The reconciling items include those such as permanent book-tax differences (e.g., municipal bond interest included in book income but never taxable), the impact of state and local taxes, the rate differential of earnings taxed in foreign jurisdictions, tax credits, and other items.[13]

SEC Regulation S-X Rule 4-08(h) deals with the income tax disclosures required by companies subject to SEC regulation and provides additional guidance on the rate reconciliation and other tax disclosures. Rule 4-08(h)(2) states that reconciling items in the rate reconciliation should be stated separately if they equal or exceed 5 percent of the "hypothetical tax expense" (income before taxes times the applicable statutory federal income tax rate – currently 35% for U.S. domiciled companies). No reconciliation is required if the total reconciling differences are less than 5% of the hypothetical tax unless the reconciliation would be "significant in appraising the trend in earnings." Thus, items are often grouped together or netted against one another, potentially limiting the information provided by the disclosures.

For example, Cisco's rate reconciliation is in Exhibit 1 Panel C and GM's is in Exhibit 3 Panel B. Cisco reconciles its tax rate in percentages and GM reconciles its tax expense in dollar

[13] The term "permanent difference" is not included in FAS 109. However, because the treatment of items such as municipal bond interest is treated similarly to the treatment before FAS 109, I use the term permanent in reference to these types of items, i.e., the items included in one calculation but never in the other. However, note that some items which were previously "permanent" are temporary under FAS 109, these are beyond the scope of this paper.

amounts. Note that tax credits are mixed with the tax effects of deductions. Each firm provides short line item descriptions for the differences (in only one case is the item more fully described with a footnote to the table) and there is an aggregate "other" line that is sometimes the largest item (e.g., GM for the year 2000). In contrast to the disclosures for Cisco and GM, Microsoft's disclosure is in paragraph form in Panel C of Exhibit 2. These three disclosures illustrate that the level of detail provided in rate reconciliations varies widely across firms.

The limited disclosure of specific items in the rate reconciliation is especially important in light of the suspected recent increase in corporate tax shelters. The ideal tax shelter reduces taxable income without reducing the financial accounting earnings on the income statement. Thus, the ideal tax shelter involves a permanent difference. As a researcher who has personally tried to find footprints of tax shelters in the financial statement disclosures even after the shelter was exposed in the press and/or tax court cases, I can attest that tax shelters are very difficult, in fact, many times impossible, to uncover using financial statement disclosures. Clear descriptions of specific book-tax differences are often just not provided.

The other disclosure requirements imposed by Regulation S-X Rule 4-08(h) include the separate disclosure of income (loss) before income tax expense (benefit) as being either domestic or foreign. Foreign income (loss) is defined as income (loss) that is generated from a registrant's operations located outside its home country. In addition, companies are required to separately state the portion of income tax expense related to the federal income taxes, foreign income taxes, and other income taxes (state and local).[14] Again, from the three attached exhibits it is clear firms vary in how they deal with this requirement. For example, Microsoft combines federal and state taxes in their disclosures of the current income tax, and do not separately state their

[14] Paragraph 42 of FAS 109 also states "…an enterprise shall not offset deferred tax liabilities and assets attributable to different tax-paying components of the enterprise or to different tax jurisdictions."

deferred taxes for any jurisdiction (see Exhibit 2 Panel A). The other two companies separately disclose the amount of both the current and deferred expenses for each of the three jurisdictions.

In sum, the required tax disclosures include 1) the current and deferred portions of the tax expense 2) the U.S., foreign and state allocations, 3) a listing of deferred tax assets (and related valuation allowance, if any) and liabilities and 4) a reconciliation of the tax computed at the statutory federal rate to the tax computed at the firm's effective rate. However, the disclosures given by firms are often not very detailed and are inconsistent across firms making them difficult to interpret. CFO Magazine's S. L. Mintz observed that "While tax information is readily available – as provisions on income statements, as deferred assets and liabilities on balance sheets, as cash taxes on statements of cash flows, and often footnoted items – the data resists comprehensive analysis. Further, little of it is reported in a consistent manner, even within industry groups" (p. 62).

A relatively simple task should be to find the current year tax liability associated with the reported financial accounting earnings, as this avoids the difficulties related to deferred tax assets and liabilities and the assessment of whether the deferred tax assets will be realized. However, even this task is often exceedingly difficult. I now turn my discussion to the specific problems associated with inferring a firm's current period tax liabilities and taxable income from the current tax expense on its financial statements.

III. Why the Current Tax Expense Does Not Equal the Actual Tax Liability

In this section I discuss the primary discrepancies between the current tax expense and the tax liability on the tax return even under the assumption that the firm has a simple legal structure with no consolidation issues.

Employee Stock Options[15]

The accounting for the tax benefits related to non-qualified employee stock options (NQOs) often results in the current tax expense being overstated relative to the firm's actual tax liabilities.[16] For financial accounting purposes, an expense for stock option compensation is not required. FAS 123, *Accounting for Stock-Based Compensation*, encourages firms to recognize as compensation expense the fair value (i.e, the value determined from an option pricing model such as the Black-Scholes model or the binomial option pricing model) of employee stock options (ESOs) at the measurement date (the date on which both the exercise price and number of options are known), but allows firms to continue accounting for ESOs under APB No. 25, *Accounting for Stock Issued to Employees.* Under APB No. 25, compensation expense equals the "intrinsic value" of the options, i.e., the difference between the stock price and exercise price of the option, on the measurement date. For fixed option grants (where the number of options granted is fixed), the measurement date is the grant date, while for performance-based grants (number of options to be granted varies based on performance), the measurement date is the date on which the performance criteria are met. Because most firms grant a fixed number of options with an exercise price equal to the stock price on the grant date, the grant date becomes the measurement date and both the intrinsic value and compensation expense are zero. Firms that continue to apply APB No. 25 must disclose in the notes the effects of fair value accounting of ESOs on reported earnings and earnings per share. Because almost all firms apply APB No. 25

[15] Much of the stock option discussion is taken from Hanlon and Shevlin (2002).

[16] A nonqualified employee stock option is one of two types of employee stock option (ESO). The other type is an incentive stock option (ISO), or qualified option. An ISO is an option that qualifies for treatment under IRC sections 421-424. Nonqualified options constitute the vast majority of stock option grants.

accounting with note disclosure, the recognized ESO compensation expense for financial accounting is zero for most firms.[17]

In contrast, for tax purposes, NQOs entitle the granting firm to a deduction equal to the amount of ordinary income recognized by the employee on the exercise date.[18] The ESO tax deduction equals the intrinsic value (market price less the strike price) upon exercise.

As a result, for NQOs the firm obtains a tax deduction in the exercise year but, under APB No. 25 treatment, never recognizes compensation expense for financial reporting purposes. Thus, a difference exists between book and taxable income. The normal treatment for most items that create a difference between book and taxable incomes that will never reverse is to treat the item as a permanent difference and show its impact on the effective tax rate of the firm in the rate reconciliation. However, APB No. 25 requires that the tax benefits related to NQOs be accounted for as a credit to additional paid-in capital (APIC) (paragraphs 16, 17) with an offsetting debit to income taxes payable (thus, no reduction to tax expense).[19] As a result of this accounting treatment, the current tax expense overstates the actual taxes due on the firms' current period income by the amount of the ESO tax benefit.

It is important to note that even if firms elect to expense stock options for financial accounting purposes, there is still a difference in the timing and amount for book versus tax treatment. Under FAS 123, a firm records compensation expense related to the stock options for financial accounting over the service period of the employee. The firm does not, however, obtain the tax deduction until the date of exercise. Thus this creates a temporary book-tax

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[17] Prior to the recent surge in firms electing to expense their option costs, there were only two firms in the Fortune 500 that recognized compensation expense related to ESOs: Boeing and Winn Dixie. However, since the recent accounting scandals several firms, such as Coca-Cola, Wal-Mart, Ford Motor Company, Home Depot, and Bank One, have elected to account for their stock options using the fair value method.

[18] This deduction is provided for in Internal Revenue Code § 83(h) as a deductible expense as defined in Section 162.

[19] The Board's reasoning was that the tax benefits are related to a capital transaction with the owners of the company rather than a transaction related to income (see APB No. 25 para. 17).

difference and the firm would recognize a deferred tax asset in the year of the expense for financial accounting purposes. However, to the extent that the future tax deduction at the date of exercise is greater than the financial accounting expense there will still be an amount credited to APIC that does not reduce the reported current tax expense even though it does reduce the amount currently payable to the taxing authorities.[20] Thus, this issue will not go away entirely even when firms elect to expense stock option compensation for financial accounting.

In some cases financial statement users can make adjustments for the tax benefits of ESOs in order to better approximate the actual tax liabilities of the firm. For example, if material, the amount of tax benefits recognized as a credit to APIC is separately disclosed in the statement of shareholder's equity. The actual cash tax benefits realized, if any, are disclosed in the cash flow statement of the firm, if material enough to warrant separate disclosure.[21]

Complexities arise when firms have tax net operating losses and assess valuation allowances on these losses. In the presence of losses, the amount recognized in APIC will likely differ from the amount realized in the cash flow statement and neither number will, in general, provide a good number to use to estimate the actual deduction. As a result, for firms with losses a better source of information is the stock option note regarding the number of options exercised, the average current year market price, and the average strike price for exercised options to estimate the deduction.[22] However, it should be noted that this is very much an estimate because

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[20] To the extent the deduction is less than the expense, the difference will go to first reduce APIC additions since the fair value method was adopted and then to reduce the related deferred tax asset.

[21] EITF Issue No. 00-15 requires the cash flow benefits to be disclosed in the operating section of the cash flow statement in periods ending after July 20, 2000. If the firm considers the amount immaterial, no disclosure of the tax benefits will be separately stated on the cash flow statement or statement of shareholders' equity. For example, Dell Computer Corp. reported ESO tax benefits on its statement of shareholders' equity in 1997 and 1998 of $37 million and $164 million, respectively, but did not do so on its cash flow statement. When the amount apparently became material in 1999, Dell reported $444 million in its cash flow statement and reported the above 1997 and 1998 amounts as well (Hanlon and Shevlin 2002).

[22] Several studies have used the option note information to adjust the current tax expense to a more accurate representation of the taxes for the firm. For examples, see Desai (2002), Yin (2001), Graham, Lang and Shackelford (2003).

we do not have the actual market price on the date of exercise or the actual exercise price for each option exercised.

McGill and Outslay (2002) show the effect of the stock option deduction on estimates of Enron's tax liabilities for the year 2000 and exemplify the difficulties from these disclosures. They obtain estimates of a deduction that range from $1,114 million, using the firm's disclosure of tax benefits, to $1,470 million, using the disclosed grant and exercise prices, to $1,892 million using a weighted average stock price. The difference in the company's disclosure and the estimates is likely due to Enron being in a tax loss situation, but the difference between the two numbers using option note information is due to volatility in the stock price and the use of different estimates of the price in the calculations.

Cisco's disclosures regarding their stock option deductions are included with their tax note in Exhibit 1. Their federal current tax expense as disclosed (Panel A) for the years ended June 2002, 2001, and 2000 is $929 million, $581 million, and $1,843 million, respectively, and their effective tax rate (i.e., total tax expense divided by pre-tax book income) is 30.1%, 16% and 38.6% (Panel C), respectively. Thus, from the tax note disclosure it seems that a substantial amount of tax liabilities are being incurred by the company.

However, if we look elsewhere in the financial statements we can see the firm obtained substantial tax benefits as a result of the deductions taken for its stock option compensation in each of these years. The cash flow statement for the same years (Panel E) discloses that the firm received "tax benefits from employee stock option plans" of $61 million, $1,397 million, and $2,495 million, respectively. These amounts represent the cash actually saved by the firm from the deduction. The statement of shareholders' equity (Panel F) reports "tax benefits from employee stock option plans" of $61 million, $1,755 million, and $3,077 million, respectively. Recall that the amounts in the equity statement represent the amount of tax benefits recognized

by Cisco for financial accounting purposes (i.e., the deduction to the extent of otherwise taxable income plus the deferred tax asset (NOL) recognized, against which no valuation allowance is established). These will be greater than the cash benefits received (as is the case in 2000 and 2001 for Cisco) when the firm does not have enough taxable income against which to take these deductions and actually receive the cash benefits. Thus, from these disclosures it appears that the tax deduction was so large in 2000 and 2001 that it created net operating losses for Cisco even though they report a positive effective tax rate and positive current tax expense.[23]

Even though the current tax expense and the effective tax rate are clearly overstated, Cisco, as compared to other firms, provides relatively complete disclosures about the tax benefits from their stock options. In the tax note there are three paragraphs that deal with the stock option deduction, its calculation, the benefits received, and the losses it has created. In contrast, Microsoft's disclosure in Exhibit 2, is much more limited. Although Microsoft is a heavy user of stock options and the tax benefits are disclosed in the cash flow statement (Panel E) and the statement of shareholders' equity (Panel F), there is no discussion in the tax note about the effect of the stock option deduction on the firm's income tax expense. It appears that Microsoft's stock option deduction absorbed all of its otherwise taxable income and thus Microsoft paid no U.S. tax, at least in the year 2000, because the current tax expense is less than the tax benefits from the options ($4,744 million of U.S. and state current tax expense less tax benefits of stock options of $5,535 million for an estimated tax loss of $2,260 million and corresponding refund of $791 million).[24]

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[23] In fact, the tax note reveals that Cisco established a valuation allowance against some of the tax loss carryforwards because "of uncertainty regarding their realizability due to expectation of future employee stock options exercises." Thus, the expectation of future deductions for the stock options was so great that Cisco did not expect to have enough future taxable income to absorb these tax loss carryforwards.

[24] Because Microsoft combines its federal and state taxes it is possible the company paid some state income taxes for the year. In addition, because this estimate is made from financial statement data, consistent with the theme of this

In sum, firms that use stock options in their compensation structure often report a current tax expense that is overstated relative to the actual taxes for the current period. While there are methods of estimating an adjustment to the current tax expense so that it more closely approximates taxable income, for many firms these estimates are subject to error because of the lack of specific stock price data for the options exercised.

The Tax "Cushion"

When a firm takes an aggressive position for tax reporting that it thinks may not stand under future IRS scrutiny, the firm can accrue an additional amount of tax expense on its income statement in order to reflect this liability. This accrual is consistent with the conservatism and matching principles of financial accounting and is similar to many other types of accruals for expenses incurred currently but where the cash outlay will not occur until a future period. Under FAS 109, this additional reserve, or "tax cushion," is generally booked to current tax expense because there is no deferred tax liability or asset to which it is related and thus it cannot go through the deferred expense or benefit. As a result, the current tax expense as shown on the financial statement will overstate the current tax liability by the amount of this tax cushion. While the overstatement due to the stock option deduction can be estimated, estimating the overstatement due to the tax cushion is nearly impossible.[25]

Statement of Financial Accounting Standards No. 5 (FAS 5) provides the rules regarding accounting for loss contingencies. FAS 5 requires a firm to accrue a contingent loss if it is probable the liability has been incurred at the date of the financial statement and the amount is estimable. If the loss is only possible the loss should be disclosed in the accompanying notes to

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paper, the estimate is potentially measured with error. In addition, Microsoft reports that it paid some foreign taxes for the year.

[25] Firms do not wish to disclose the fact that they have taken aggressive tax positions which the IRS may overturn in the future. This would clearly be a tip to the Service that the firm does not want to give them.

the financial statements. However, whether the loss is either disclosed or accrued is subject to materiality judgments on the part of firm management.

Gleason and Mills (2002) examine the financial statement disclosures regarding tax loss contingencies of 100 large manufacturing firms over a nine-year period. The authors estimate the tax cushion by subtracting the tax liability from the tax return from the current tax expense as disclosed for financial accounting purposes.[26] They find that "The firms in our sample disclose very little about tax audits. Only 27 percent of firms make any disclosure of contingent tax liabilities and only 30 percent of firms that do disclose a tax contingency provide the detailed information required by SFAS No. 5" (page 319).[27]

The notes to the financial statements of the firms in Exhibits 1-3 all have a paragraph of discussion about their tax loss contingencies. Two of the firms, Cisco Systems (Exhibit 1 Panel D) and GM (Exhibit 3 Panel A), provide that some amount has been accrued. Cisco states that "adequate amounts have been reserved for any adjustments that may ultimately result from these examinations" and GM's note provides that "annual tax provisions include amounts considered sufficient to pay assessments that may result from examination of prior year returns." Thus, for these two firms it is clear that the tax expense includes (or did include in a prior year) an extra reserve for potential tax loss contingencies, but the amounts of these reserves or any other information is not disclosed. In contrast, Microsoft reveals that its returns are under audit but

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[26] The amount of cushion is very difficult to estimate, however. The resulting difference between current tax expense and the tax liability from the tax return will include stock option deduction amounts and thus overstate the amount of cushion to the extent the firm has a deduction for stock options or similar items. In addition, because this exercise involves the comparison of a tax return to a financial statement, the estimate of cushion will potentially be erroneous to the extent that the tax return includes an entity not included in the financial accounting report (e.g., an SPE), an issue I discuss below. The authors note these potential measurement problems in their paper.

[27] Gleason and Mills (2002) find that the likelihood of disclosure increases with the amount of the claim and/or the expected loss. In addition, they find that disclosures are more likely in litigious industries, consistent with Skinner's (1994) conclusion that disclosure reduces the cost of potential litigation.

says that any adjustments required will not be material (Exhibit 2 Panel D). They do not explicitly state whether any accrual is recorded.

Thus, tax loss contingency amounts overstate the tax provision relative to the amount currently owed on the earnings as reported. However, unlike the stock option expense, disclosures are rarely explicit enough to allow a financial statement user to adjust the tax expense to the amount excluding the loss contingency.

Intraperiod Tax Allocation

Paragraphs 35 and 36 of FAS 109 indicate that income tax expense or benefit should be allocated to four categories. The first three are continuing operations, discontinued operations, and extraordinary items. Thus, this allocation of the tax expense (benefit) means that the current tax expense is not the tax expense on all types of earnings of the firm; rather, it is only the tax on the continuing operations of the firm. Items reported separately below continuing operations, such as discontinued operations and extraordinary items, are reported net of their respective tax effects. To obtain the total tax of the firm, the tax expense (benefit) related to these items would also have be added to current tax expense. However, sometimes the related tax amounts are not disclosed nor is the current and deferred portions disclosed separately. For example, see GM's income statement (Exhibit 3 Panel E). GM has income from discontinued operations of $426 million in 1999. In the first note to its financial statements GM discloses that this amount is net of income tax expense of $314 million, but that is all the disclosure provided regarding this item. Disclosure regarding any allocation between deferred taxes and current taxes is not provided.

The fourth category consists of items charged or credited directly to shareholders' equity. This includes the tax effects of the stock option deduction as discussed above as well as several other items accounted for similarly. These items are more technical in nature and are generally not as common or as large as the stock option deduction. These items are described in paragraph

36 of FAS 109, and include 1) adjustments to retained earnings for certain changes in accounting principles or corrections of errors, 2) gains and losses included in comprehensive income but excluded from net income (e.g., translation adjustments, changes in carrying amounts of marketable securities), 3) increases or decreases in contributed capital, such as certain deductible expenditures reported as a reduction of the proceeds from issuing capital stock for financial reporting purposes, 4) dividends paid on unallocated shares held by an employee stock ownership plan (ESOP) that are charged to retained earnings for financial accounting purposes, and 5) deductible temporary differences and carryforwards that existed at the date of certain quasi reorganizations.[28] Thus, intraperiod tax allocation requires that the tax expense (benefit) be allocated to several places in the financial statements and, as a result, the current tax expense does not reflect the total tax owed for the firm but rather only the portion of tax on the firm's continuing earnings portion of the income statement.

These items – the stock option deduction, the tax cushion, and intraperiod tax allocation—are, in my opinion, the most serious issues a financial statement user encounters when trying to calculate a firm's tax liabilities and taxable income from its financial statement disclosures. These issues cause the current tax expense to be an incorrect approximation of the tax liability of the firm. As a result, using this number to infer taxable income will result in an incorrect estimate of taxable income.

[28] An additional item which is no longer an issue but was prior to the elimination of the pooling of interests method of accounting for business combinations, is an increase in the tax basis of assets acquired in a taxable business combination accounted for as a pooling of interests and for which a tax benefit is recognized at the date of the business combination. The tax effects of this item were also charged to equity rather than as a reduction to tax expense.

IV. Using the Gross-up Calculation to Estimate Taxable Income

As stated above, a common method of estimating taxable income from firm's financial statements is to gross-up the current tax expense by the highest U.S. statutory tax rate.[29] However, there are problems with this measure of estimated taxable income even when the current tax expense is a reasonable approximation of the actual tax liabilities of the firm (i.e., it does not have the issues described in section III above).

The first issue is that the current tax expense is the tax expense after tax credits.[30] As a simple example, suppose a firm has financial accounting pre-tax income of $1,000. Also, assume the firm only has one book-tax difference of -$300, and thus the taxable income of the firm is $700. For simplicity again, let's assume the top statutory tax rate is 30%. Thus, the tax liability before credits is $210 ($700*.30). Now let's assume the firm has a $40 tax credit. As a result, the final tax liability is $170. Assuming none of the issues in section III above, the current portion of the tax expense recognized on the firm's income statement is $170. However, if we gross up this number by the statutory tax rate, 30% in this example, we will estimate taxable income at $567 ($170/.30) rather than the reported taxable income of the firm, $700. In effect, this method of computation provides a taxable income estimate that would be correct if there had been a book-tax difference causing the same tax effect as the credit. In this example, there seems to be an extra $133 ($40/.30) of book-tax differences because of the estimation method in the presence of tax credits. If the credit is material and separately disclosed in the rate reconciliation, a financial statement user aware of this issue can adjust their estimates

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[29] Another method is to gross-up the deferred tax expense by the top statutory tax rate and subtract this from book income (e.g., Shevlin 1990 and Graham 1996). Although this method provides a reasonable approximation of temporary book-tax differences and the taxable income after taking temporary book-tax differences into account, this method ignores all permanent differences, credits, and the book-tax difference for the stock option deduction.
[30] For example, research and development credits, foreign tax credits, etc.

appropriately.[31] However, many times the credits are not separately disclosed and thus pose a potential problem with inferences. For example, if the difference between book and tax incomes (estimated from the financial statements) is assumed to be entirely caused by book-tax differences and unaccounted for book-tax differences are assumed to be from tax sheltering, this effect could cause estimates of corporate tax shelters to be overstated.

A second issue is that the gross-up is usually done using the top statutory U.S. tax rate. For multinational firms with both U.S. and foreign-sourced incomes, however, this will not be the correct rate at which the worldwide taxable income was taxed (i.e., foreign sourced income may be taxed at rates greater or less than the U.S. rate). Although, if the U.S. current tax is separately disclosed, as it should be, the U.S. rate can be used on the U.S. current tax expense, to derive an estimate of U.S. taxable income which can then be compared to U.S. sourced financial accounting income. However, many times the rate with which to gross-up the foreign current tax expense is unknown and thus a similar comparison can rarely be done on the foreign portion of the current tax expense and income.

Finally, another problem with the gross-up calculation is that for firms that have tax losses, the current tax expense will be truncated at zero or the amount of refund available from prior taxes paid. Thus, for those interested in the taxable income including current year losses (e.g., those benchmarking financial accounting earnings quality), this calculation will not yield the full amount of the tax loss.

V. Consolidation Issues and Their Effects on the Current Income Tax Expense

The rules for consolidation of entities differs between tax and book. These rules have been discussed extensively elsewhere in the literature (see Mills, Newberry and Trautman 2002,

[31] Although I note this would have to be done by hand because there is no electronic data source that codes the tax note detail.

McGill and Outslay 2002, Mills and Plesko 2003) and I do not go into great detail here. However, I briefly describe the rules and then focus the discussion on how these affect inferences about the tax liabilities and taxable income of the firm. In many cases, inferences about the tax liabilities and taxable income are not affected by the differing consolidation rules. The differing rules create a book-tax difference and this difference is accounted for as such. However, there are conditions, for example, a special purpose entity, under which management may use the rules to structure the firm to get the best of both worlds (i.e., high book income and low tax income), and in these cases our inferences in some sense are likely affected.[32] However, in my opinion, this is not an issue of accounting for income taxes, but rather of the accounting for the consolidation itself. The tax expense on the income statement cannot be expected to reflect the taxes of entities that are not included on that income statement. I explain several consolidation scenarios below. This discussion is not meant to be an exhaustive review of every possible case, but rather an illumination of the issues involved.

Consolidation Rules for Financial Accounting and Tax Purposes

For financial accounting purposes, if an entity controls another entity the two entities are required to be consolidated. Level of ownership is generally used as the measure of control but if a parent has control of a subsidiary while owning less than that provided in the tests, consolidation is still required. The rules using ownership as the guide are as follows.

If a corporation owns more than 50% of the voting interest of another corporation, foreign or domestic, the two entities are required to consolidate (FAS 94). If such a subsidiary is not wholly owned by the parent corporation (i.e., the ownership percentage is greater than 50% but less than 100%), the total net income of the subsidiary is included in the consolidated income statement for financial accounting but is then reduced by the portion of income attributable to the

[32] I discuss this in more detail below.

minority interest owners. If a corporation owns at least 20 percent but not greater than 50 percent of another corporation, the equity method of accounting is generally used. Under this method, the parent corporation reports its share of the investee corporation's net income or loss in its income statement in the year earned. Generally, this is done via a line item on the income statement entitled "net equity of unconsolidated subsidiaries" or something similar. Finally, when the parent corporation owns less than 20% of another corporation, the investment is accounted for using the cost method.[33] The cost method requires the recording of income only when received as a dividend.

For tax purposes, consolidation onto a single return can be elected, but is not required, when ownership, direct or indirect, of a domestic subsidiary is at least eighty percent in terms of voting power and value.[34] Foreign subsidiaries are not included, regardless of ownership percentage, because the U.S. tax system does not generally tax foreign-sourced income until repatriated as dividends to the U.S. parent corporation.[35]

As a result of the differences in the consolidation rules for book and taxable incomes, the entities, and thus the incomes, reported on financial statements will often differ from the incomes included on the firm's tax return. For example, financial accounting includes 1) the income of domestic subsidiaries owned from between 50% and 80%, 2) the earnings of foreign subsidiaries with more than 50% ownership, and 3) the representative share of the income for subsidiaries owned from between 20% and 50%. The tax return will include none of these amounts.

The tax return, however, will include some amounts not included for financial accounting purposes. For example, dividends paid by each of these entities to the parent corporation will

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[33] Unless the security is classified as a trading security in which case the change in market value is included in income. Discussion of these types of securities is beyond the scope of this paper.
[34] Consolidation rules for tax purposes are contained in IRC §1501-1504 and related regulations thereunder.
[35] Of course, there are exceptions to this general rule. These exceptions (e.g. Sub-Part F rules, etc.) are beyond the scope of this paper.

constitute taxable income in the year received.[36] In addition, taxable income will not include a reduction for the minority interest ownership when firms are greater than 80% but less than 100% owned. Thus, unless consolidated (i.e., ownership is greater than 80%) the cost method is applied for tax purposes (i.e., only dividends received are included in income).

Example 1: The Case of the Equity Method

Assume Company 1 owns 40% of Company 2. Both firms are publicly traded. The rest of Company 2 is widely held. The entities are not consolidated for financial accounting or tax purposes because the ownership tests are not met.[37] As a result, there will be two 10-k's filed with the SEC and two tax returns filed with the IRS.[38] The investment for financial accounting purposes is adjusted for the investor's share of the undistributed earnings or losses of the investee. As a result, the 10-k for Company 1 will include 40% of Company 2's after-tax income. The 10-k for Company 2 will include the entire earnings or losses of Company 2. The tax return of Company 1 will only include any dividends paid by Company 2 to Company 1, subject to the dividends received deduction.[39] Company 2's tax return will include all the income of Company 2 with no deduction for dividends paid to Company 1 because dividends are non-deductible. The difference between the dividends received by Company 1 included on its tax return and the 40% of the after-tax income included in Company 1's 10-k is a book-tax difference accounted for as such under FAS 109. The associated basis difference in the

[36] The parent corporation is, however, allowed a dividends received deduction (DRD) for dividends received. The DRD is intended to eliminate triple taxation of earnings. The rules for the DRD are as follows: for ownership less than 20%, the parent gets a 70% deduction, for ownership greater than 20% but less than 80% the parent gets a deduction of 80%, and for ownership of greater than 80%, the parent is entitled to a 100% DRD.
[37] Assuming here Company 1 does not control Company 2.
[38] Although I use the annual filings of both firms as the examples, this would be applicable to other filings by the firms as well (e.g., quarterly earnings reports, estimated tax payments, etc.)
[39] The dividend received deduction should be reflected in the rate reconciliation of the firm if the amount is material enough to warrant separate disclosure.

investment for book and tax purposes is a deferred tax liability that will result in future taxable amounts.[40]

Inferences about the tax liabilities and taxable incomes of these firms are not affected because for both of these firms the current tax expense reflects the actual tax liabilities, assuming none of the problems outlined above are present. However, similar to many book-tax differences of the firm, the disclosures with regard to this difference may be limited (e.g., not disclosed separately on the deferred tax schedule, not disclosed consistently across firms, and no disclosure of how the future taxable amounts will be received). Thus, the taxable income estimate is obtainable in this case (assuming none of the issues from sections III and IV above), but the disclosure as to *why* it is different than book income may not be clear.

Example 2: The Case of Financial Accounting Consolidation Only

Assume for this case that Company 1 owns 60% of Company 2. In this case, Company 1 will consolidate Company 2 into its financial accounting statements because the ownership exceeds the 50% threshold.[41] The income statement for Company 1 will include all of the earnings of Company 2 and will show a reduction for the minority interest held by other parties (i.e., the remaining 40%). It is important to note however that if Company 2 is publicly traded Company 2 will still have to file its own reports with the SEC. Thus, in this scenario there will be two 10-k's filed—one for Company 1 which consolidates Company 2, and one for Company 2 as a stand-alone company showing all of the earnings of Company 2. For tax purposes, the ownership test of 80% is not met and, as a result, two tax returns are filed. The tax return of Company 1 includes only the dividends paid from Company 2 to Company 1. As before, the

[40] Paragraph 237 of FAS 109 indicates that deferred taxes are measured based on the expected type of taxable amounts in future years. Future taxable amounts may result from 1) dividends (including consideration of the dividends received deduction) 2) liquidation of investee, or 3) sale of the investment, and thus may be subject to something less than the highest tax rate of the firm.

[41] Prior to the issuance of FAS 144 if the control was temporary consolidation was not required even when ownership exceeded 50%. However, FAS 144 eliminates this exception.

difference between the earnings of Company 2 included in the income statement of Company 1 and the dividends received by Company 1 from Company 2 is a book-tax difference for which a deferred tax liability is recorded in a manner similar to the case above. The minority interest share of after-tax income is then subtracted from the after tax earnings of the firm.[42]

Thus, the effects are much the same as in case one where the current tax expense disclosed on both firms' income statements represents the actual tax from the current year tax return, assuming none of the problems from sections III and IV.

Example 3: Consolidation for Book and Tax Purposes

Now let's assume that Company 1 owns at least 80% of Company 2. For a more concrete example, consider the case of Philip Morris, Inc.'s (PM) ownership of Kraft Foods, Inc. (Kraft).[43] As of the 2002 fiscal year-end, PM owns 83.9% of Kraft. As a result, PM and Kraft are required to file consolidated financial statements and may elect to file consolidated tax returns.[44] PM's 10-k includes all of Kraft's earnings for the year and shows a corresponding reduction for minority interest in earnings (see Exhibit 4 Panel A). Kraft also files a 10-k showing all of its earnings because the remaining 16.1% is held by investors trading in the stock market.

Because the 80% test is met for tax purposes, the firms are permitted to file one consolidated tax return. Thus, these firms file one tax return and two 10-k's — the consolidated

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[42] See the General Motors income statement (Exhibit 3 Panel E) for an example. Note that some firms may report the equity earnings in subsidiaries and the minority interest share of income lines prior to the calculation of the income tax expense (for an example, see Enron's income statements). In this case, the related taxes associated with these earnings would be part of the book-tax differences listed in the deferred tax liabilities schedule or the rate reconciliation if the differences are permanent in nature rather than netted against the income (loss) after the income tax expense on the income statement.

[43] As of January 27, 2003 Philip Morris's name is now Altria Group, Inc.

[44] Note Philip Morris elected to file its tax return on a consolidated basis. Filing consolidated tax returns is an election not a requirement. (Indeed, Enron is reported to have filed 2,486 tax returns, 713 of which were for the tax affiliated group, with the IRS in the year 2000.) However, if not consolidated, the separate returns would add up to the income of the consolidated entity, unlike the financial accounting situation where the same income can be reported on more than one 10-k.

10-k of PM and the 10-k of Kraft. Note that there is no adding-up rule for financial accounting. The income of Kraft is reported on two separate financial statements. Thus, to match tax returns to annual reports, if one wanted to engage in such an exercise, the 10-k of PM corresponds to the tax return of PM but there is no separate tax return filed for Kraft that will correspond to Kraft's separately filed 10-k. The current portion of the tax expense for PM is the tax for the entire consolidated firm. Their tax note reveals no book-tax differences related to this consolidation issue, nor should it. The current tax expense, again barring any of the issues in section III above, will be the tax on the firm's consolidated tax return.

For the 10-k of Kraft, paragraph 49 of FAS 109 states, "…An entity that is a member of a group that files a consolidated tax return shall disclose in its separately issued financial statements 1) the aggregate amount of current and deferred tax expense for each statement of earnings presented and the amount of any tax-related balances due to or from affiliates as of the date of each statement of financial position presented and 2) the principal provisions of the method by which the consolidated amount of current and deferred tax expense is allocated to members of the group and the nature and effect of any changes in that method." Thus, Kraft's 10-k also shows the tax expense (both current and deferred) related to the earnings reported on its (i.e., Kraft's) income statement. Kraft includes disclosures as required by paragraph 49 in its Summary of Significant Accounting Policies Note to the financial statement (Exhibit 4 Panel B) and its income tax disclosures in a separate note just like any other firm.

For this case the current tax expense again poses no problems per se with inferring the taxable income of the firms (again absent the problems discussed in sections III and IV). However, if comparison to tax returns is desired, one should be cognizant that there will be only one tax return and it will be for the PM group including Kraft.

Example 4: Foreign Subsidiaries

As mentioned above, multinational corporations include the income of foreign subsidiaries in financial accounting income when ownership is greater than fifty percent. This income is taxed in the foreign jurisdiction at the time the income is earned and is taxable in the U.S. at the time the earnings are repatriated back to the U.S. The U.S. taxes are assessed at the U.S. domestic rates subject to a tax credit for the foreign income and withholding taxes paid.[45] For financial accounting purposes, firms recognize income tax expense and record a deferred tax liability for repatriation taxes at the time the income is earned in the foreign country under the assumption that all funds will eventually be repatriated.[46]

In sum, the income of majority-owned foreign subsidiaries is included in the parent's income for financial accounting purposes but is not included in taxable income until repatriated as dividends back to the U.S. However, the current federal and current foreign tax amounts are not over- or understated relative to the firm's tax liability on the tax returns. Again this is simply a book-tax difference. The U.S. government avoids the double taxation of income of foreign subsidiaries in the U.S. by delaying U.S. taxation until the dividends are paid and allowing for a tax credit for the foreign taxes paid (or deemed paid) at that time. For financial

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[45] Foreign withholding taxes are taxes withheld by the foreign jurisdiction at the time a dividend is paid to a party outside of the country. Further detail is beyond the scope of this paper.

[46] However, APB No. 23 provides an exception for deferred tax accounting in this case known as the indefinite reversal criteria. Paragraph 12 of APB No. 23 states that if "sufficient evidence shows that the subsidiary has invested or will invest the undistributed earnings indefinitely or that the earnings will be remitted in a tax-free liquidation" the company does not have to accrue income taxes for these earnings. FAS 109 requires disclosure of the amount of the unrecognized deferred tax liability if practicable. A firm is also required to state that estimation of an amount is impracticable if that is the case. To exemplify, each of the firms' tax disclosures in Exhibits 1-3 includes a discussion regarding their foreign earnings. In Exhibit 1, Panel C, Cisco states that U.S. and foreign withholding taxes were not provided for a cumulative total of $1.2 billion of undistributed earnings. In Exhibit 2, Panel D, Microsoft states that it has not provided for U.S. deferred taxes or foreign withholding taxes on $780 million of its undistributed earnings, all of which related to fiscal 2002 earnings. GM states that taxes have not been provided on foreign subsidiaries earnings, which are deemed essentially permanently reinvested, of $13.1 billion at December 31, 2001 and $13.4 billion at December 31, 2000. GM is the only firm that states explicitly that the tax liability is not quantifiable although none of the firms provide an estimate of the deferred taxes on the foreign subsidiaries' earnings. Further, GM and Cisco provide cumulative amounts whereas Microsoft discloses only the current year amount. Thus, the disclosures do not appear to be consistent across firms.

accounting purposes, however, the entire earnings of the firm are included in the financial statements to provide the information to investors and other financial statement users about these foreign activities and prospects. Thus, because of the differing goals of the two systems the incomes are different.

Financial statement users can estimate taxable income of the firm without much difficulty due to this consolidation issue, although one should be aware that part of the difference between the resulting taxable income estimate and the financial statement income reported is due to the differing entities included for the two calculations. With foreign subsidiaries the disclosure is somewhat better than with the domestic consolidation issues because there is (or should be) a separately stated U.S. current tax expense and U.S.-sourced income as well as a foreign current tax expense and foreign sourced income. Thus, using the estimate of taxable income based on the U.S. current tax expense and comparing this to the U.S. sourced income should provide an estimate of the book-tax differences excluding the income of foreign subsidiaries.

Example 5: Special Purpose Entities

Another area that warrants discussion is that of Special Purpose Entities (SPEs). An SPE is often used to access capital and/or manage risk. The entity can be structured as a limited partnership, limited liability company, trust, or corporation (FEI 2002). As long as specific qualifications are met, the assets and corresponding debt and equity of the SPE achieve off-balance sheet treatment with respect to the sponsor's financial statements.[47] In contrast, the entity may be consolidated for tax purposes in which case the interest deductions often generated in these entities offset at least part of the income of the rest of the consolidated group.[48] As a result, this case is the reverse of the situation in Example 4 above. The financial statements are

[47] The detailed provisions of qualifying an SPE for off-balance sheet treatment are beyond the scope of this paper.
[48] Whether the entity is consolidated for tax purposes would depend on elections made by the firm under the check the box regulations. Further discussion of these rules is beyond the scope of this paper.

less inclusive because they do not consolidate these SPE's. Thus, the "parent's" balance sheets do not include the debt nor does the income statement include the interest expense of the SPE.[49] Thus, in this case the firm gets the best of both worlds—higher book income and lower taxable income—just as with the foreign subsidiary case. However, in this case investors are without any information about the related entity and its prospects and the government is seemingly not using the tax code to achieve any social or economic goals. The current tax expense and the resulting estimate of taxable income in this case would offer investors no insight into these additional entities, nor should it be expected to. The current tax expense reported for the firm is the tax liability for the entities included in the financial statement if those entities were to file a tax return. The issue here clearly is not the accounting for income taxes but the financial accounting consolidation rules. Recognizing this, the FASB has issued Interpretation No. 46 *Consolidation of Variable Interest Entities* to improve financial reporting by enterprises involved with variable interest entities.[50] After consolidation for financial accounting purposes, the tax effects of the SPEs will be reflected in the tax expense as disclosed under FAS 109.

Thus, the consolidation rules do not in general pose problems with inferences about taxable income of the firm (defined as the reporting entity for financial accounting purposes). The SPE case is an exception and is caused by financial accounting engineering and is not an accounting for income tax issue. The differing consolidation rules *do* however pose a problem in

[49] Mills, Newberry and Trautman (2002) examine balance sheets for firms as reported for financial accounting and for tax purposes (Schedule L of the corporate tax return form 1120) and find some evidence consistent with firms consolidating SPEs for tax purposes but not for book purposes although they propose additional research is needed in this area.

[50] The FASB does not define or use the term SPE in FIN 46. Instead, FIN 46 defines and uses the term VIE (variable interest entity). Precise definitions (if they exist) are beyond the scope of this paper. However, in general, VIEs have one or both of the characteristics: 1) equity investment at risk is not sufficient to permit the entity to finance its activities without additional financial support from other entities and 2) the equity investors lack one or more of the essential characteristics of a controlling financial interest. Some entities are specifically excepted from FIN 46 such as not-for profit organizations, employee benefit plans, registered investment companies and transferors to qualifying special-purpose entities and "grandfathered" qualifying special purpose entities. If consolidation is not required additional disclosures will be required regarding maximum potential loss the entity could cause.

terms of identifying the source of a divergence between book and tax incomes because little disclosure is offered to describe the book-tax differences generated.

VI. Suggestion for Additional Disclosure

There have been several proposals for rectifying the problems with insufficient tax disclosures. For example, conforming tax and book incomes, disclosing entire tax returns, or disclosing more tax information but not the full return.[51] However, one simple solution may be to provide a reconciliation of the cash paid for taxes which is often disclosed on the cash flow statement or in the notes to the cash flow statement to the current tax expense as reported. This would at least provide disclosure of the items that cause the current tax expense to be different than the cash taxes paid. To be complete, this reconciliation would have to include the items I considered to be the most serious problems with inference about the firm's tax liabilities and its taxable income such as 1) the book-tax difference related to the stock option deduction, 2) the tax cushion, 3) intraperiod tax allocation amounts, and 4) the difference simply due to the timing of the tax payments. In addition, the reconciliation could adjust for SPE-like issues as well.

I have included an example of a possible disclosure for Cisco using this method in Table 1. What is amazing after doing this table is how very little I can determine from financial statement disclosures to reconcile these two amounts. While I recognize that some of this information is not likely to be willingly disclosed by firms (e.g., the tax cushion), I believe this reconciliation would be a useful start to provide financial statement users with more information regarding the tax liabilities and taxable income of the firm.

[51] For example, see Canellos and Kleinbard (2002) and Mills and Plesko (2003) for a suggested new schedule M-1.

VII. Conclusions

In this paper I review and describe the income tax disclosures currently required in firms' financial statements. In addition, I discuss many of the problems with trying to calculate a firm's tax liabilities and taxable income from the tax provision in financial statements. In doing so, I reveal the conditions under which taxable income may most accurately be estimated from financial statements as well as those conditions which make this task difficult, if not impossible.

There are three broad problems with using financial statements to infer the tax liability and/or the taxable income of the firm. First, are the issues outlined in Section III that cause the current tax expense to be a poor approximation of the actual tax liability of the firm. For example, the accounting for stock option deductions and the tax cushion reserves overstate the current tax expense relative to the actual current tax liability of the firm. In addition, intraperiod tax allocation requires that the portion of tax expense (both current and deferred) related to items listed below income from operations on the income statement not be included in the tax expense but rather netted against the item of income or loss. These issues are relevant for both 1) parties interested in the tax liability of the firm (e.g., the IRS and others interested in whether the firm is paying its "fair share) and 2) those interested estimating taxable income to use as a benchmark for accounting earnings (e.g., investors and analysts).

Second, are the issues relevant only for those trying to estimate taxable income using the current tax expense. Even in cases where the current tax expense represents the actual tax liability of the firm, the calculation of taxable income by grossing-up the current tax expense can result in an inaccurate estimate of taxable income in cases where there are tax credits, where the appropriate tax rate to use in the calculation is unknown, and where the firm is a loss firm but the current tax expense disclosed is truncated at zero or the amount of refund available.

Third, is that even if 1) the current tax expense is an accurate representation of the actual tax liability and 2) the estimate of taxable income from the gross-up calculation yields a reasonable approximation of taxable income, the sources of the differences between the taxable income estimate and the financial accounting earnings reported are not clearly disclosed nor standardized across firms. In sum, it would still not be clear *why* book and tax incomes were different. This is crucial for the inferences regarding the activities of the firm. For example, are they engaging in corporate tax shelters, committing financial accounting fraud, or simply following the very different rules and standards set forth by GAAP and the IRC?

In addition to these issues, the differing consolidation rules between book and tax purposes create problems reconciling from the annual report to a tax return. However, FAS 109 was intended to report the tax expense related to financial accounting earnings, *not* the tax liability on a specific tax return. In general the consolidation differences *do not* cause problems with inferences about the tax liability nor the taxable income of the firm. However, book-tax differences generated by the differing consolidation rules are rarely disclosed.

In conclusion, there are a myriad of reasons why even the most basic assumption that the current tax expense is the actual tax liability of the firm is often incorrect (see Table 2 Panel A for a summary). In addition, using the current tax expense to infer taxable income is also fraught with problems even in cases where the current tax expense is without error (See Table 2 Panel B). In order to better approximate the tax liability, taxable income, and the book-tax differences of the firm, if that objective is deemed desirable, additional disclosures will be necessary because the financial statements do not currently provide sufficient information to accomplish this task reliably and consistently.

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Exhibit 1
Cisco Systems, Inc.
Excerpts from the 10-k filed for fiscal year ended July 27, 2002

Panel A:

Tax Note to the Financial Statement

11. Income Taxes

The provision for income taxes consisted of the following (in millions):

Years Ended	**July 27, 2002**	July 28, 2001	July 29, 2000
Federal:			
Current	**$ 929**	$ 581	$ 1,843
Deferred	**(480)**	(697)	(652)
	449	(116)	1,191
State:			
Current	**117**	157	282
Deferred	**(68)**	(199)	(118)
	49	(42)	164
Foreign:			
Current	**344**	326	332
Deferred	**(25)**	(28)	(12)
	319	298	320
Total	**$ 817**	$ 140	$ 1,675

The Company paid income taxes of $909 million, $48 million, and $327 million in fiscal 2002, 2001, and 2000, respectively.

Panel B:

Income (loss) before provision for income taxes consisted of the following (in millions):

Years Ended	**July 27, 2002**	July 28, 2001	July 29, 2000
United States	**$1,550**	$(1,727)	$2,544
International	**1,160**	853	1,799
Total	**$2,710**	$ (874)	$4,343

Panel C:

The items accounting for the difference between income taxes computed at the federal statutory rate and the provision for income taxes consisted of the following:

Years Ended	**July 27, 2002**	July 28, 2001	July 29, 2000
Federal statutory rate	**35.0%**	(35.0)%	35.0%
Effect of:			
State taxes, net of federal tax benefit	**1.8**	(2.4)	1.9
Foreign sales corporation	**(1.5)**	(1.8)	(1.9)
Foreign income at other than U.S. rates	**(4.9)**	(1.7)	(1.6)
Nondeductible in-process R&D	**0.9**	30.3	7.6
Nondeductible goodwill	**–**	20.9	0.5
Nondeductible deferred stock-based compensation	**1.9**	8.0	–
Tax-exempt interest	**–**	(1.0)	(1.8)
Tax credits	**(3.4)**	(2.5)	(1.6)
Other, net	**0.3**	1.2	0.5
Total	**30.1%**	16.0%	38.6%

U.S. income taxes and foreign withholding taxes were not provided for on a cumulative total of $1.2 billion of undistributed earnings for certain non-U.S. subsidiaries. The Company intends to reinvest these earnings indefinitely in operations outside the United States.

Panel D:

The components of the deferred tax assets (liabilities) are as follows (in millions):

	July 27, 2002	July 28, 2001
ASSETS		
Allowance for doubtful accounts and returns	**$ 247**	$ 466
Lease reserves	**281**	325
Loan reserves	**249**	284
Inventory allowances and capitalization	**340**	706
Investment reserves	**476**	274
In-process R&D, goodwill, and purchased intangible assets	**436**	400
Deferred revenue	**968**	478
Credits and net operating loss carryforwards	**391**	414
Other	**497**	230
Total deferred tax assets	**3,885**	3,577
LIABILITIES		
Purchased intangible assets	**(192)**	(266)
Unrealized gains on investments	–	(1)
Other	–	(187)
Total deferred tax liabilities	**(192)**	(454)
Total	$ **3,693**	$ 3,123

The following table presents the breakdown between current and non-current deferred tax assets (in millions):

	July 27, 2002	July 28, 2001
Current	**$2,030**	$1,809
Non-current	**1,663**	1,314
Total	**$3,693**	$3,123

The non-current portion of the deferred tax assets is included in other assets.

At July 29, 2000, the Company provided a valuation allowance on certain of its deferred tax assets because of uncertainty regarding their realizability due to expectation of future employee stock option exercises. As of July 28, 2001, the Company had removed the valuation allowance because it believed it was more likely than not that all deferred tax assets would be realized in the foreseeable future and was reflected as a credit to shareholders' equity.

As of July 27, 2002, the Company's federal and state net operating loss carryforwards for income tax purposes were $83 million and $14 million, respectively. If not utilized, the federal net operating loss carryforwards will begin to expire in fiscal 2010 and the state net operating loss carryforwards will begin to expire in fiscal 2003. As of July 27, 2002, the Company's federal and state tax credit carryforwards for income tax purposes were $255 million and $164 million, respectively. If not utilized, the federal tax credit carryforwards will begin to expire in fiscal 2005 and state tax credit carryforwards will begin to expire in fiscal 2003.

The Company's income taxes payable for federal, state, and foreign purposes have been reduced, and the deferred tax assets increased, by the tax benefits associated with dispositions of employee stock options. The Company receives an income tax benefit calculated as the difference between the fair market value of the stock issued at the time of exercise and the option price, tax effected. These benefits were credited directly to shareholders' equity and amounted to $61 million, $1.8 billion, and $3.1 billion in fiscal 2002, 2001, and 2000, respectively. Benefits reducing taxes payable amounted to $61 million, $1.4 billion, and $2.5 billion in fiscal 2002, 2001, and 2000, respectively. Benefits increasing gross deferred tax assets amounted to $358 million and $582 million in fiscal 2001 and 2000, respectively.

The Company's federal income tax returns for fiscal years ended July 31, 1999 and July 25, 1998 are under examination and the Internal Revenue Service has proposed certain adjustments. Management believes that adequate amounts have been reserved for any adjustments that may ultimately result from these examinations.

Panel E:

Consolidated Statements of Cash Flows

(In millions)

Years Ended	July 27, 2002	July 28, 2001	July 29, 2000
Cash flows from operating activities:			
Net income (loss)	**$ 1,893**	$ (1,014)	$ 2,668
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization	**1,957**	2,236	863
Provision for doubtful accounts	**91**	268	40
Provision for inventory	**149**	2,775	339
Deferred income taxes	**(573)**	(924)	(782)
Tax benefits from employee stock option plans	**61**	1,397	2,495
Adjustment to conform fiscal year ends of pooled acquisitions	**–**	–	(18)
In-process research and development	**53**	739	1,279
Net (gains) losses on investments and provision for losses	**1,127**	43	(92)
Restructuring costs and other special charges	**–**	501	–
Change in operating assets and liabilities:			
Accounts receivable	**270**	569	(1,043)
Inventories	**673**	(1,644)	(887)
Prepaid expenses and other current assets	**(28)**	(25)	(249)
Accounts payable	**(174)**	(105)	286
Income taxes payable	**389**	(434)	(365)
Accrued compensation	**307**	(256)	576
Deferred revenue	**678**	1,629	662
Other accrued liabilities	**(222)**	251	369
Restructuring liabilities	**(64)**	386	–
Net cash provided by operating activities	**6,587**	6,392	6,141

Panel F:

Consolidated Statements of Shareholders' Equity (In millions)

	Shares of Common Stock	Common Stock and Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
BALANCE AT JULY 31, 1999	6,821	$ 5,731	$ 5,782	$ 298	$ 11,811
Net income	–	–	2,668	–	2,668
Change in net unrealized gains and losses on investments	–	–	–	3,240	3,240
Other	–	–	–	(8)	(8)
Comprehensive income	–	–	–	–	5,900
Issuance of common stock	219	1,564	–	–	1,564
Tax benefits from employee stock option plans	–	3,077	–	–	3,077
Pooling of interests acquisitions	20	75	(74)	–	1
Purchase acquisitions	78	4,162	–	–	4,162
Adjustment to conform fiscal year ends of pooled acquisitions	–	–	(18)	–	(18)
BALANCE AT JULY 29, 2000	7,138	14,609	8,358	3,530	26,497
Net loss	–	–	(1,014)	–	(1,014)
Change in net unrealized gains and losses on investments	–	–	–	(3,812)	(3,812)
Other	–	–	–	7	7
Comprehensive loss	–	–	–	–	(4,819)
Issuance of common stock	140	1,262	–	–	1,262
Tax benefits from employee stock option plans	–	1,755	–	–	1,755
Purchase acquisitions	46	2,163	–	–	2,163
Amortization of deferred stock-based compensation	–	262	–	–	262
BALANCE AT JULY 28, 2001	7,324	20,051	7,344	(275)	27,120
Net income	–	–	1,893	–	1,893
Change in net unrealized gains and losses on investments	–	–	–	224	224
Other	–	–	–	24	24
Comprehensive income	–	–	–	–	2,141
Issuance of common stock	76	655	–	–	655
Repurchase of common stock	(124)	(350)	(1,504)	–	(1,854)
Tax benefits from employee stock option plans	–	61	–	–	61
Purchase acquisitions	27	346	–	–	346
Amortization of deferred stock-based compensation	–	187	–	–	187
BALANCE AT JULY 27, 2002	**7,303**	**$ 20,950**	**$ 7,733**	**$ (27)**	**$ 28,656**

Exhibit 2
Microsoft Corporation
Excerpts from the 10-k filed for fiscal year ended June 30, 2001

Panel A:

Notes to the Financial Statements : NOTE 12 INCOME TAXES

The provision for income taxes consisted of:

In Millions			
Year Ended June 30	2000	2001	2002
Current taxes:			
U.S. and state	4,744	3,243	3,644
International	535	514	575
Current taxes	5,279	3,757	4,219
Deferred taxes	(425)	47	(535)
Provision for income taxes	4,854	3,804	3,684

Panel B:

U.S. and international components of income before income taxes were:

In Millions			
Year Ended June 30	2000	2001	2002
U.S.	11,860	9,189	8,920
International	2,415	2,336	2,593
Income before income taxes	14,275	11,525	11,513

Panel C:

In 2000, the effective tax rate was 34.0%, and included the effect of a 2.5% reduction from the U.S. statutory rate for tax credits and a 1.5% increase for other items. In 2001, the effective tax rate was 33.0%, and included the effect of a 3.1% reduction from the U.S. statutory rate for tax credits and a 1.1% increase for other items. The effective tax rate in 2002 was 32.0%, and included the effect of a 2.4% reduction from the U.S. statutory rate for the extraterritorial income exclusion tax benefit and a 0.6% reduction for other items.

Panel D:

Deferred income taxes were:

In Millions		
June 30	2001	2002
Deferred income tax assets:		
Revenue items	1,469	2,261
Expense items	691	945
Impaired investments	1,070	2,016
Deferred income tax assets	3,230	5,222
Deferred income tax liabilities:		
Unrealized gain on investments	(365)	(887)
International earnings	(1,667)	(1,818)
Other	(55)	(803)
Deferred income tax liabilities	(2,117)	(3,508)

Microsoft has not provided for U.S. deferred income taxes or foreign withholding taxes on $780 million of its undistributed earnings for certain non-U.S. subsidiaries, all of which relate to fiscal 2002 earnings, since these earnings are intended to be reinvested indefinitely.

On September 15, 2000, the U.S. Tax Court issued an adverse ruling with respect to Microsoft's claim that the Internal Revenue Service (IRS) incorrectly assessed taxes for 1990 and 1991. The Company has filed an appeal with the Ninth Circuit Court of Appeals on this matter. Income taxes, except for items related to the 1990 and 1991 assessments, have been settled with the IRS for all years through 1996. The IRS is examining the Company's 1997 through 1999 U.S. income tax returns. Management believes any adjustments which may be required will not be material to the financial statements. Income taxes paid were $800 million in 2000, $1.3 billion in 2001, and $1.9 billion in 2002.

Panel E: Excerpt from the Cash Flow Statement

In Millions			
Year Ended June 30	2000	2001	2002
Operations			
Net Income	9,421	7,346	7,829
Cumulative effect of accounting change, net of tax	0	375	0
Depreciation, amortization, and other noncash items	1,250	1,536	1,084
Net recognized (gains)/losses on investments	(1,732)	2,221	2,424
Stock option income tax benefits	5,535	2,066	1,596
Deferred income taxes	(425)	(420)	(416)
Unearned revenue	6,177	6,970	11,152
Recognition of unearned revenue	(5,600)	(6,369)	(8,292)
Accounts receivable	(944)	(418)	(1,623)
Other current assets	(775)	(482)	(264)
Other long-term assets	(864)	(330)	(9)
Other current liabilities	(992)	(774)	1,449
Other long-term liabilities	375	153	216
Net cash from operations	11,426	13,422	14,509

Panel F: Excerpts from Stockholders' Equity Statement

In Millions			
Year Ended June 30	2000	2001	2002
Convertible preferred stock, balance, beginning of year	980	0	0
Conversion of preferred to common stock	(980)	0	0
Balance, end of year	0	0	0
Common stock and paid in capital, balance, beginning of year	13,844	23,195	28,390
Common stock issued	3,554	5,154	1,801
Common stock repurchased	(210)	(394)	(676)
Sales/(repurchases) of put warrants	472	(1,367)	0
Stock option income tax benefits	5,535	2,066	1,596
Other, net	0	(264)	536
Balance, end of year	23,195	28,390	31,647

Exhibit 3
General Motors Corporation
Excerpts from the 10-k filed for fiscal year ended December 31, 2001

Panel A:

Notes to the Financial Statements

NOTE 8. Income Taxes

Income from continuing operations before income taxes and minority interests included the following (dollars in millions):

	Years Ended December 31,		
	2001	**2000**	**1999**
U.S. income (loss)	$(1,190)	$3,019	$4,156
Foreign income	2,708	4,145	4,891
Total	$1,518	$7,164	$9,047

The provision for income taxes was estimated as follows (dollars in millions):

	Years Ended December 31,		
	2001	**2000**	**1999**
Income taxes estimated to be payable currently			
U.S. federal	$34	$45	$156
Foreign	1,347	971	1,368
U.S. state and local	(9)	72	308
Total payable currently	1,372	1,088	1,832
Deferred income tax expense (credit) - net			
U.S. federal	(246)	742	1,008
Foreign	(401)	281	244
U.S. state and local	43	282	34
Total deferred	(604)	1,305	1,286
Total income taxes	$768	$2,393	$3,118

Annual tax provisions include amounts considered sufficient to pay assessments that may result from examination of prior year tax returns; however, the amount ultimately paid upon resolution of issues raised may differ materially from the amount accrued.

Provisions are made for estimated U.S. and foreign income taxes, less available tax credits and deductions, which may be incurred on the remittance of the Corporation's share of subsidiaries' undistributed earnings not deemed to be permanently invested. Taxes have not been provided on foreign subsidiaries' earnings, which are deemed essentially permanently reinvested, of $13.1 billion at December 31, 2001 and $13.4 billion at December 31, 2000. Quantification of the deferred tax liability, if any, associated with permanently reinvested earnings is not practicable.

Panel B:

A reconciliation of the provision for income taxes compared with the amounts at the U.S. federal statutory rate was as follows (dollars in millions):

	Years Ended December 31,		
	2001	**2000**	**1999**
Tax at U.S. federal statutory income tax rate	$485	$2,507	$3,166
Foreign rates other than 35%	134	78	(109)
Taxes on unremitted earnings of subsidiaries	29	-	138
Tax credits	(50)	(45)	(207)
Raytheon settlement (1)	180	-	-
Other adjustments	(10)	(147)	130
Total income tax	$768	$2,393	$3,118

(1) Non-tax deductible settlement with the Raytheon Company on a purchase price adjustment related to Raytheon's 1997 merger with Hughes Defense.

Deferred income tax assets and liabilities for 2001 and 2000 reflect the impact of temporary differences between amounts of assets, liabilities, and equity for financial reporting purposes and the bases of such assets, liabilities, and equity as measured by tax laws, as well as tax loss and tax credit carryforwards.

Panel C:

Temporary differences and carryforwards that gave rise to deferred tax assets and liabilities included the following (dollars in millions):

	2001 Deferred Tax		**2000 Deferred Tax**	
	Assets	Liabilities	Assets	Liabilities
Postretirement benefits other than pensions	$15,057	$-	$14,393	$ -
Employee benefit plans	8,721	8,046	2,884	8,182
Warranties, dealer and customer allowances, claims, and discounts	4,376	-	4,952	-
Depreciation and amortization	412	3,671	652	3,742
Tax carryforwards	3,993	-	3,125	-
Lease transactions	-	4,044	-	3,911
Miscellaneous foreign	4,465	1,463	4,150	1,372
Other	7,683	4,948	7,287	4,493
Subtotal	44,707	22,172	37,443	21,700
Valuation allowances	(604)	-	(640)	-
Total deferred taxes	$44,103	$22,172	$36,803	$21,700

Of the tax carryforwards, approximately 20% relates to the alternativeminimum tax credit (which can be carried forward indefinitely) and approximately 14% relates to the U.S. state net operating loss carryforwards, which will expire in the years 2002-2021 if not used. However, a substantial portion of the U.S. state net operating loss carryforwards will not expire until after the year 2005. The other tax credit carryforwards, consisting primarily of research and experimentation credits, will expire in the years 2004, 2011-2012, and 2018-2021 if not used.

Panel D: Note to Cash Flow Statement

Cash paid for interest and income taxes was as follows:

Interest	$7,239	$8,511	$6,618
Income taxes	$694	$475	$214

Panel E: Income Statement

Total net sales and revenues	$177,260	$184,632	$176,558
Cost of sales and other expenses	143,850	145,664	140,708
Selling, general, and administrative	23,302	22,252	19,053
Interest expense (Note 13)	8,590	9,552	7,750
Total costs and expenses	175,742	177,468	167,511
Income from continuing operations before income taxes and minority interests	1,518	7,164	9,047
Income tax expense (Note 8)	768	2,393	3,118
Equity income (loss) and minority interests	(149)	(319)	(353)
Income from continuing operations	601	4,452	5,576
Income from discontinued operations (Note 1)	-	-	426
Net income	601	4,452	6,002

Exhibit 4
Philip Morris, Inc. and Kraft Foods, Inc.
Excerpts from the 10-k filed for fiscal year ended December 31, 2001

Panel A: Philip Morris's Income Statement

Consolidated Statements of Earnings (in millions of dollars, except per share data) for the years ended December 31,	2001	2000	1999
Operating revenues	$89,924	$80,356	$78,596
Cost of sales	33,267	29,148	29,561
Excise taxes on products	16,980	17,080	16,845
Gross profit	39,677	34,128	32,190
Marketing, administration & research costs	22,961	18,731	17,992
Amortization of goodwill and other intangible assets	1,014	591	582
Operating income	15,702	14,806	13,616
Interest and other debt expense, net	1,418	719	795
Earnings before income taxes, minority interest and cumulative effect of accounting change	14,284	14,087	12,821
Provision for income taxes	5,407	5,450	5,020
Earnings before minority interest and cumulative effect of accounting change	8,877	8,637	7,801
Minority interest in earnings	311	127	126
Earnings before cumulative effect of accounting change	8,566	8,510	7,675
Cumulative effect of accounting change	(6)		
Net earnings	$8,560	$8,510	$7,675

Panel B: Kraft Foods, Inc. Disclosure

Income taxes: The Company accounts for income taxes in accordance with SFAS No. 109, "Accounting for Income Taxes." The accounts of the Company are included in the consolidated federal income tax return of Philip Morris. Income taxes are generally computed on a separate company basis. To the extent that foreign tax credits, capital losses and other credits generated by the Company, which cannot be utilized on a separate company basis, are utilized in Philip Morris' consolidated federal income tax return, the benefit is recognized in the calculation of the Company's provision for income taxes. The Company's provisions for income taxes included in the consolidated statements of earnings for the years ended December 31, 2001, 2000 and 1999 were lower than provisions calculated on a separate return basis by $185 million, $139 million and $107 million, respectively. The Company makes payments to, or is reimbursed by, Philip Morris for the tax effects resulting from its inclusion in Philip Morris' consolidated federal income tax return.

Table 1
Example of a Suggested Reconciliation Between Current Tax Expense and Cash Taxes Paid

Cisco Systems, Inc.
Reconciliation between current tax expense and cash taxes paid
For the year ended July 28, 2001
In millions

	Federal	Foreign	State	Total
Current tax expense	$581	$326	$157	$1,064
Add/Less: Tax allocated to items below the tax expense on the income statement	xxx	xxx	xxx	xxx
Less: Tax benefits of stock option deductions	(xxx)		(xxx)	($1,397)
Less: Current year tax cushion reserved	(xxx)	(xxx)	(xxx)	($xxx)
Less: Payments related to this year not made (or planned to be made) until next year	(xxx)	(xxx)	(xxx)	($xxx)
Add: Payments related to prior years' taxes but paid this year	xxx	xxx	xxx	xxx
Less: Reduction in cash taxes due to consolidation with loss entities	(xxx)	(xxx)	(xxx)	(xxx)
Add/Less: Other				xxx
Cash Taxes Paid	xxx	xxx	xxx	$48

Table 2
Summary of Items that Cause Difficulties in Inferring Tax Liabilities and Taxable Income from the Financial Statements

Panel A: Items that cause the current tax expense to differ from the actual tax liability
Stock option tax deduction
Other items recorded in shareholders' equity or as an offset to goodwill
Tax cushion
Intraperiod tax allocation

Panel B: Potential problems with the gross-up calculation used to estimate taxable income
The current tax expense is net of tax credits, thus in the presence of credits the gross-up calculation underestimates taxable income.
The rate to gross-up the foreign current tax expense is often unknown.
The current tax expense is truncated at zero or the refund amount available and thus for loss firms the full tax loss is not estimable from this calculation.