**Case 2-4**

**Shifty Industries**

Shifty Industries is a small business that sells home beauty products in the San Luis Obispo, California area. The company has experienced a cash crunch and is unable to pay its bills on a timely basis. A great deal of pressure exists to minimize cash outflows such as income tax payments to the IRS by interpreting income tax regulations as liberally as possible. You are the tax accountant at the company and report to the controller. You are concerned about the fact that the controller approved the Income Statement below for the company at December 31, 2012 for financial reporting purposes. Your concern relates to the accounting treatment of depreciation in light of IRS Section 179 depreciation regulations that are in Exhibit 1. The depreciation relates to the purchase of one item of office machinery in 2012 for $40,000. The asset is expected to have a five-year useful life with no salvage value and the company uses the straight-line method of depreciation for all office machinery in its financial reports. You reviewed the income statement to help prepare the income tax return for the company that will be filed on April 30, 2013.

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| **Shifty Industries** | | |
| **Income Statement** | | |
| **For the Year Ended December 31, 2012** | | |
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| Sales Revenue: | |  |
| Total Sales | $137,460 |  |
| Less: Sales Returns | (2,060) |  |
| Sales Discounts | (5,190) |  |
| Net Sales Revenue | | $130,210 |
| Less: Cost of Goods Sold: | |  |
| Beginning Inventory | $ 12,300 |  |
| Add: Purchases | 67,310 |  |
| Freight-In | 4,450 $ 84,060 |  |
| Less: Purchase Discounts | (3,900) |  |
| Purchase Returns | (1,000) (4,900) |  |
| Less: Ending Inventory | (16,170) |  |
| Cost of Goods Sold | | 62,990 |
| Gross Profit | | $67,220 |
| Operating Expenses | |  |
| Selling Expenses: | |  |
| Freight-Out | $ 6,150 |  |
| Advertising Expense | 5,790 |  |
| Sales Commissions Expense | 3,470 |  |
| Administrative Expenses: | |  |
| Office Salaries Expense | 18,510 |  |
| Office Rent Expense | 14,000 |  |
| Office Supplies Expense | 5,330 |  |
| Depreciation of Office Machinery 40,000  Total Operating Expenses | | (93,250) |
| Operating Loss | | $(26,030) |
| Other Incomes and Expenses: | |  |
| Gains on Sale Equipment | $2,430 |  |
| Less: Loss on Sales of Investments | (1,640) |  |
| Interest Expense | (930) (2,570) |  |
| Net Other Incomes and Expenses | | (140) |
| Net Loss | | ($26,170) |
|  | |  |

A special rule known as "expensing" lets small businesses write off the entire cost of certain depreciable assets in the year they are purchased.

In other words, you get to treat the cost as a business expense (hence "expensing"), such as salary paid or utilities rather than an asset that has to be depreciated over a number of years. Property that qualifies for this tax break includes machinery, tools, furniture, fixtures, computers, software and vehicles. (This special rule often goes by the alias "the Section 179 deduction" to give homage to the section of the tax law that allows it.)

This deduction is limited in several ways:

* **Dollar limit**. For assets placed in service in 2012, you can take a maximum expensing deduction of $500,000 —a higher-than-normal level approved by Congress to help the struggling economy.
* **Investment limit**. As a way to focus this tax break on smaller businesses, firms whose investment in new property exceeds a threshold amount gradually lose the right to expensing. For 2012, the investment threshold is $2,000,000. For example, if you purchased $2,020,000 of otherwise eligible equipment in 2012, you can't expense more than $480,000 ($500,000 expensing maximum minus the excess investment of $20,000).
* **Taxable income limit**. Your total first-year expensing deduction cannot exceed your business's taxable income. Say, for example, that you bought $40,000 of property eligible for expensing in 2012, but your firm's taxable income before taking expensing into account is just $20,000. That means your expensing deduction is limited to $20,000; you can carry over the disallowed $20,000 to 2012 and claim an expensing deduction then, assuming you have sufficient business income.

**Questions**

Consider professional and ethical standards and ethical reasoning methods discussed in Chapters 1 and 2 in answering the following questions.

1. **Has the company properly handled the depreciation of the one item of machinery reflected on its income statement for the year-ended December 31, 2012? Why or why not?**

The company has not handled the depreciation of the machine correctly for financial reporting purposes. The company policy for financial reporting is straight line depreciation. Thus, for financial reporting, the depreciation for the machine should be $8,000, and the net loss would become a net income of $5,830 [$40,000-$8,000 ($40,000/5) –$26,170].

1. **How would you handle the depreciation deduction for income tax purposes?**

The company should take $13,830 of depreciation (the $8,000 depreciation for financial reporting plus an additional $5,830 of section 179 depreciation to bring income to zero) for 2012 and a carry forward of $26,170 of section 179 depreciation to 2013. The additional $5,830 of tax depreciation is a timing difference and will be a factor of deferred taxes.

1. **How should the controller handle the matter, assuming the financial reports have not been issued as yet, and that he reasons at stages 3, 4, and 5 in Kohlberg’s model?**

The controller should make adjusting entries so that the depreciation expense is $8,000, which will result in a net income of $5,830. However, in reasoning at stage 3, the tax accountant will want to satisfy the controller and company’s interests. At stage 4, the controller is motivated by law and order considerations and would insist on proper tax and financial reporting. At stage 5, the controller might use utilitarian theory to weigh the harms and benefits of alternative actions and conclude the potential damage to the c company of improper accounting, and the tax accountant’s professionalism, outweigh any perceived benefits of improperly concealing the true effects of the depreciation.

Other considerations include that at stage 3, the tax accountant might be reluctant to go along with total expense of the machine but may compromise to depreciation expense of $13,830 and net income of zero, to match the tax depreciation. In reasoning at stage 4, the controller will want to follow the tax law, the IRS regulations and the company policy on depreciation. He would argue for depreciation expense of $13,830 and net income of zero. He would view this as his duty and in the best interests of society and would not want to violate the law. In reasoning at stage 5, the controller would consider the alternative courses of action by evaluating how each of the stakeholder groups is affected by the different depreciation expense amounts. For instance, the company might benefit in the short term by depreciating the full amount of the machine which would generate a loss, which might be carried back for a refund. The cash flows would be improved; the controller might be rewarded for this action. On the other hand, the IRS would notice that the section 179 expense of the machine generated a loss and would deny the deduction. The controller would weigh these consequences, which would include penalties and interest owed to the IRS. The controller would conclude that the harms of penalties, interest, and potential loss of reputation are greater than the benefits.