1. Identify the correct answer about the purposes of Schedules M–1 and M–3.

|  |  |  |
| --- | --- | --- |
|  | **Reconciles Book Income (Loss) with Income per Return** | **Distinguishes Between Permanent and Temporary Differences** |
| a) | Both Schedule M-1 and Schedule M-3 | Neither Schedule M-1 nor M-3 |
| b) | Both Schedule M-1 and Schedule M-3 | Schedule M-1 Only |
| c) | Schedule M-1 Only | Both Schedule M-1 and Schedule M-3 |
| d) | Both Schedule M-1 and Schedule M-3 | Schedule M-3 Only |

a) Incorrect. Both schedules M-1 and M-3 reconcile a corporation’s book income to its taxable income. Schedule M-3, which is for corporations with total assets of $10 million or more, also differentiates between temporary differences and permanent differences, a distinction not made on schedule M-1.

b) Incorrect. Both schedules M-1 and M-3 reconcile a corporation’s book income to its taxable income. Schedule M-3, which is for corporations with total assets of $10 million or more, also differentiates between temporary differences and permanent differences, a distinction not made on schedule M-1.

c) Incorrect. Both schedules M-1 and M-3 reconcile a corporation’s book income to its taxable income. Schedule M-3, which is for corporations with total assets of $10 million or more, also differentiates between temporary differences and permanent differences, a distinction not made on schedule M-1.

**d) Correct!** Both schedules M-1 and M-3 reconcile a corporation’s book income to its taxable income. Schedule M-3, which is for corporations with total assets of $10 million or more, also differentiates between temporary differences and permanent differences, a distinction not made on schedule M-1.

1. Kelsey Corporation is an accrual-basis, calendar-year domestic corporation which is not part of a consolidated group. In the current tax year, Kelsey recorded over $10 million in gross receipts and ended the year with $9 million in total assets. Which reconciliation schedule—Schedule M–1 or Schedule M–3—should Kelsey file along with its corporate tax return for the current year?
2. Only Schedule M–1 is required, but Schedule M–3 may be substituted instead.
3. Only Schedule M–1 can be filed.
4. Schedule M–3 is required.

Depends on how many years the corporation has been in existence.

a) **Correct!** A corporation with total assets of $10 million or more is required to file a schedule M-3 to reconcile its financial statement income to its taxable income. A corporation with total assets of less than $10 million is only required to use schedule M-1 but may substitute schedule M-3 since it provides all of the information in a schedule M-1, just with an additional level of detail, such as differentiating between permanent and temporary differences.

b) Incorrect. A corporation with total assets of $10 million or more is required to file a schedule M-3 to reconcile its financial statement income to its taxable income. A corporation with total assets of less than $10 million is only required to use schedule M-1 but may substitute schedule M-3 since it provides all of the information in a schedule M-1, just with an additional level of detail, such as differentiating between permanent and temporary differences.

c) Incorrect. A corporation with total assets of $10 million or more is required to file a schedule M-3 to reconcile its financial statement income to its taxable income. A corporation with total assets of less than $10 million is only required to use schedule M-1 but may substitute schedule M-3 since it provides all of the information in a schedule M-1, just with an additional level of detail, such as differentiating between permanent and temporary differences.

**d)** Incorrect. A corporation with total assets of $10 million or more is required to file a schedule M-3 to reconcile its financial statement income to its taxable income. A corporation with total assets of less than $10 million is only required to use schedule M-1 but may substitute schedule M-3 since it provides all of the information in a schedule M-1, just with an additional level of detail, such as differentiating between permanent and temporary differences.

1. Indicate for each of the following financial statement items whether it would cause no adjustment, or whether its absolute value would be either added to or subtracted from net income per books, when computing taxable income on the Schedule M–1.

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Municipal Bond Interest Earned** | **Excess of Capital Losses Over Capital Gains** | **Interest Expense Associated with Purchase of Municipal Bonds** |
| a) | Subtracted from | No adjustment | No adjustment |
| b) | Added to | No adjustment | Subtracted from |
| c) | Subtracted from | Added to | Added to |
| d) | Subtracted from | No adjustment | Added to |

a) Incorrect. Municipal bond interest earned is included in financial statement income but must be subtracted since it is not taxable. A corporation may not deduct capital losses in excess of capital gains so, although included in financial statement income, the losses must be added to reconcile to taxable income. Since interest income on municipal bonds is not taxable, interest expense associated with the purchase of the bonds is not deductible. Since it is a deduction from financial statement income, it must be added back to reconcile to taxable income.

b) Incorrect. Municipal bond interest earned is included in financial statement income but must be subtracted since it is not taxable. A corporation may not deduct capital losses in excess of capital gains so, although included in financial statement income, the losses must be added to reconcile to taxable income. Since interest income on municipal bonds is not taxable, interest expense associated with the purchase of the bonds is not deductible. Since it is a deduction from financial statement income, it must be added back to reconcile to taxable income.

**c) Correct!** Municipal bond interest earned is included in financial statement income but must be subtracted since it is not taxable. A corporation may not deduct capital losses in excess of capital gains so, although included in financial statement income, the losses must be added to reconcile to taxable income. Since interest income on municipal bonds is not taxable, interest expense associated with the purchase of the bonds is not deductible. Since it is a deduction from financial statement income, it must be added back to reconcile to taxable income.

d) Incorrect. Municipal bond interest earned is included in financial statement income but must be subtracted since it is not taxable. A corporation may not deduct capital losses in excess of capital gains so, although included in financial statement income, the losses must be added to reconcile to taxable income. Since interest income on municipal bonds is not taxable, interest expense associated with the purchase of the bonds is not deductible. Since it is a deduction from financial statement income, it must be added back to reconcile to taxable income.

1. Indicate for each of the following financial statement items whether it would cause no adjustment, or whether its absolute value would be either added to or subtracted from net income per books, when computing taxable income on the Schedule M–1.

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Premiums Paid on Key Employee Life Insurance** | **Excess of Book vs. Tax Depreciation** | **Accrued Warranty Expense** |
| a) | No adjustment | No adjustment | No adjustment |
| b) | Added to | Added to | Added to |
| c) | Subtracted from | Added to | Subtracted from |
| d) | No adjustment | No adjustment | Subtracted from |

a) Incorrect. Premiums paid on key employee life insurance, the excess of book depreciation over tax depreciation, and accrued warranty expense, all reduce financial statement income but are not deductible for tax purposes. As a result, each will be added to financial statement income on schedule M-1 to reconcile to taxable income.

b) **Correct!** Premiums paid on key employee life insurance, the excess of book depreciation over tax depreciation, and accrued warranty expense, all reduce financial statement income but are not deductible for tax purposes. As a result, each will be added to financial statement income on schedule M-1 to reconcile to taxable income.

c) Incorrect. Premiums paid on key employee life insurance, the excess of book depreciation over tax depreciation, and accrued warranty expense, all reduce financial statement income but are not deductible for tax purposes. As a result, each will be added to financial statement income on schedule M-1 to reconcile to taxable income.

d) Incorrect. Premiums paid on key employee life insurance, the excess of book depreciation over tax depreciation, and accrued warranty expense, all reduce financial statement income but are not deductible for tax purposes. As a result, each will be added to financial statement income on schedule M-1 to reconcile to taxable income.

1. Kookaburra Corporation reports net income per books of $575,000 for the current tax year. Included in this amount are the following items.

|  |  |
| --- | --- |
| **Item** | **Amount** |
| Accrued vacation expense | $50,000 |
| Meals and entertainment expense | 40,000 |
| Depreciation expense | 35,000 |
| Inventory shrinkage (accrual based on a percentage of total sales) | 5,000 |

Depreciation reported on the current year tax return is $40,000.

Considering only the above information, what is Kookaburra Corporation’s taxable income for the current tax year?

1. $655,000
2. $650,000
3. $640,000
4. $645,000

a) Incorrect. Accrued vacation expense of $50,000 and inventory shrinkage based on a percentage of sales of $5,000 are both accrued and deducted for financial statement purposes, but cannot be deducted for tax until they are actually incurred; therefore, they must be added back to financial statement income to calculate taxable income. Only ½ of meals and entertainment expense is deductible for tax purposes, requiring that 50%, or $20,000, also be added back to income, resulting in total increases of $50,000 + $5,000 + $20,000 or S75, 000. Tax depreciation of $40,000 exceeds financial statement depreciation of $35,000 by $5,000, which will result in a ($5,000) adjustment in taxable vs. book income. As a result, taxable income will be financial statement income of $575,000 + $75,000 - $5,000, or $645,000.

b) Incorrect. Accrued vacation expense of $50,000 and inventory shrinkage based on a percentage of sales of $5,000 are both accrued and deducted for financial statement purposes, but cannot be deducted for tax until they are actually incurred; therefore, they must be added back to financial statement income to calculate taxable income. Only ½ of meals and entertainment expense is deductible for tax purposes, requiring that 50%, or $20,000, also be added back to income, resulting in total increases of $50,000 + $5,000 + $20,000 or S75, 000. Tax depreciation of $40,000 exceeds financial statement depreciation of $35,000 by $5,000, which will result in a ($5,000) adjustment in taxable vs. book income. As a result, taxable income will be financial statement income of $575,000 + $75,000 - $5,000, or $645,000.

c) Incorrect. Accrued vacation expense of $50,000 and inventory shrinkage based on a percentage of sales of $5,000 are both accrued and deducted for financial statement purposes, but cannot be deducted for tax until they are actually incurred; therefore, they must be added back to financial statement income to calculate taxable income. Only ½ of meals and entertainment expense is deductible for tax purposes, requiring that 50%, or $20,000, also be added back to income, resulting in total increases of $50,000 + $5,000 + $20,000 or S75, 000. Tax depreciation of $40,000 exceeds financial statement depreciation of $35,000 by $5,000, which will result in a ($5,000) adjustment in taxable vs. book income. As a result, taxable income will be financial statement income of $575,000 + $75,000 - $5,000, or $645,000.

**d) Correct!** Accrued vacation expense of $50,000 and inventory shrinkage based on a percentage of sales of $5,000 are both accrued and deducted for financial statement purposes, but cannot be deducted for tax until they are actually incurred; therefore, they must be added back to financial statement income to calculate taxable income. Only ½ of meals and entertainment expense is deductible for tax purposes, requiring that 50%, or $20,000, also be added back to income, resulting in total increases of $50,000 + $5,000 + $20,000 or S75, 000. Tax depreciation of $40,000 exceeds financial statement depreciation of $35,000 by $5,000, which will result in a ($5,000) adjustment in taxable vs. book income. As a result, taxable income will be financial statement income of $575,000 + $75,000 - $5,000, or $645,000.