

## **Valuation: Measuring and Managing the Value of Companies**

### **Taxes**

#### **Chapter 25 Problems**

1. Exhibit 25.9 presents tax reconciliation table for ToyCo, a \$5 billion million designer and distributor of children's toys. Convert the tax table from percent to \$ millions. Separate the converted tax table into three groups: taxes attributable to domestic income, other operating taxes, nonoperating taxes. Treat "other, net" as nonoperating.
2. Exhibit 25.5 presents two approaches for estimating operating taxes. Use both methods to determine the operating taxes for ToyCo in Year 3. What are ToyCo's statutory rate, effective tax rate, and operating tax rate (under both approaches)?
3. When a company incorporated in a country with a high tax rates does business in countries with lower tax rates, it will report an effective tax rate below its statutory rate. Is the difference sustainable into the future? What occurs if the company decides to repatriate earnings? How operating taxes should be computed in the year of repatriation? How is ROIC distorted by local taxation and repatriation?
4. Exhibit 25.9 presents deferred tax assets and liabilities for ToyCo. Using Exhibit 25.7 as a guide, reorganize the deferred tax table into three categories net operating deferred tax liabilities (net of operating deferred tax assets), nonoperating deferred tax assets, and nonoperating deferred tax liabilities. In Year 3, ToyCo generated \$200.7 million in operating taxes on \$673.6 million of EBITA. Using this information, what are the cash taxes in Year 3? What is percent of operating taxes that were deferred and what is the operating cash tax rate?
5. ToyCo has working capital of \$400 million, fixed assets equal to \$800 million, and debt equal to \$600 million. Use this data and the reorganized deferred taxes in Question 4 to create invested capital and total funds invested for Year 3. Use equity as the plug to get total fund invested to reconcile.
6. One of the most common deferred tax liabilities occurs because of acceleration depreciation. When is the difference between reported taxes and cash taxes likely to be greatest? When will it be smallest? Can it reverse? i.e. cash taxes are higher than reported taxes?

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**Exhibit 25.9 ToyCo: Tax Reconciliation Table**

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percent

|  | <b>Year 1</b> | <b>Year 2</b> | <b>Year 3</b> |
|--|---------------|---------------|---------------|
| Statutory income tax rate              | 35.0          | 35.0          | 35.0          |
| State and local income taxes, net      | 1.1           | 1.0           | 0.7           |
| Repatriation of foreign earnings       | 0.0           | 3.5           | 0.0           |
| Liabilities settleable in common stock | 3.4           | 0.0           | 0.0           |
| Tax on international earnings          | (6.5)         | (7.9)         | (7.5)         |
| Exam settlements                       | (6.5)         | (0.8)         | (0.5)         |
| Other, net                             | 1.5           | (0.4)         | 1.5           |
| Effective tax rate                     | 28.0          | 30.4          | 29.2          |
| <b>Profits (\$ millions)</b>           |               |               |               |
| Operating profits                      | 587.1         | 572.6         | 673.6         |
| Earnings before taxes                  | 462.3         | 441.1         | 529.7         |

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**Exhibit 25.10 ToyCo: Deferred Tax Assets and Liabilities**

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\$ million

| <b>Deferred tax assets</b>          | <b>Year 1</b> | <b>Year 2</b> | <b>Year 3</b> |
|-------------------------------------|---------------|---------------|---------------|
| Accounts receivable                 | 20.5          | 16.8          | 17.3          |
| Inventories                         | 24.6          | 20.2          | 15.9          |
| Losses and tax credit carryforwards | 39.1          | 34.4          | 29.6          |
| Pension                             | 10.0          | 34.1          | 26.6          |
| Net deferred tax assets             | 94.2          | 105.5         | 89.4          |
| <b>Deferred tax liabilities</b>     |               |               |               |
| Convertible debentures              | 40.2          | 47.6          | 56.8          |
| Depreciation of long-lived assets   | 15.9          | 40.5          | 40.1          |
| Equity method investment            | 0.0           | 0.0           | 26.9          |
| Deferred tax liabilities            | 123.8         | 123.8         | 157.0         |

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