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Looking at Accounting for Income Taxes: Do Managers Play "Truth or Dare" with Tax Accruals?

The income tax has made liars out of more Americans than golf. {Will Rogers}

Do managers use tax accruals to manage earnings? A general definition of earnings management is "the purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain."[1] Given the pressure on public companies to hit earnings targets, accounting and tax researchers have examined this question. The purpose of many practices that are considered earnings management may be attributable to a desire to achieve short-term earnings benchmarks (such as analyst forecasts), avoid small losses that could lead to a significant loss of market capitalization, or to smooth earnings to create the impression of stable performance and steady growth.

Until the recent release of FASB Interpretation No. 48 - Accounting for Uncertainty in Income Taxes (FIN 48), the accounting for income taxes was primarily governed by SFAS No. 109 -Accounting for Income Taxes, with added guidance found in SFAS No. 5 - Accounting for Contingencies, Accounting Principle Board Opinion No. 23 -Accounting for Income Taxes-Special Areas, and APB No. 28 - Interim Financial Reporting. These standards were perceived to allow a degree of flexibility and discretion by managers such that tax-related accruals and accounts could potentially be used as a source of earnings management. Part of the justification for issuing FIN 48 was to close some of the perceived gaps in existing standards that could possibly be used to manage earnings.

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[1] Schipper, K. 1989. Commentary on Earnings Management. *Accounting Horizons* 3 (4): 91–102.

In spite of changes in standards, the question remains: "Do/did managers use tax accruals to manage earnings"? A steady stream of research has shed some light on this question, focusing on five main areas:

- Accounting for deferred tax assets and the related valuation allowance.
- Using SFAS No. 5 to build "cookie jar" reserves in the tax accrual.
- Classifying overseas earnings as permanently reinvested.
- Deciphering deferred tax accounts for indications of earnings management.
- Analyzing responses to the adoption of FIN 48.

Deferred Tax Assets and the Valuation Allowance

Early studies examined links between the valuation allowance for deferred tax assets and earnings management after the issuance of SFAS No. 109. The early results suggested that variations in the valuation allowance for deferred tax assets could be reasonably explained by (1) managers' expectations about the future realizability of the assets based on the likelihood of future taxable income, (2) the presence of taxable temporary differences as evidenced by deferred tax liabilities, and (3) the presence of net operating losses, credit and other carry-forward positions.[2, 3] In other words, accounting variations were consistent with economic circumstances, suggesting that managers did not use the flexibility provided by SFAS No. 109 to opportunistically manage earnings, at least in the initial implementation of the standard.

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[2] Miller, G., and D. Skinner. 1998. Determinants of the valuation allowance for deferred tax assets under SFAS No. 109. *The Accounting Review* 73 (2): 213–33.

[3] Bauman, C.C., M. P. Bauman, and R. F. Halsey. 2001. Do Firms Use the Deferred Tax Asset Valuation Allowance to Manage Earnings? *The Journal of the American Taxation Association* 23 (Supplement): 27-48.

In spite of finding little evidence of earnings management, many early researchers warned that corporate idiosyncrasies make it difficult to interpret statistical averages so the results should not be considered as conclusively demonstrating that such earnings management did not, or would not, occur in some companies or industries. Furthermore, implicit in this warning was the hint that future behavior of managers might be different. Subsequent research found more subtle signs of earnings management than previously observed. Evidence suggested that over time firms reduced the valuation allowance as a percentage of the gross deferred tax asset in order to increase current earnings and avoid reporting lower profits.[4] More specifically, firms that just avoided reporting small losses were observed to adjust the valuation allowance account in a manner that was inconsistent with expected future profitability, i.e., realistic expectations of future earnings did not necessarily justify the reduction in the valuation allowance. In the specific case of commercial banks, evidence suggested that bank managers initially established the valuation allowance in accordance with the guidelines established by SFAS No. 109.[5] However, in subsequent periods, well-capitalized banks with incentives to manage earnings used adjustments in the valuation allowance to smooth earnings. Taken together, the research on the valuation of deferred tax assets indicates that SFAS No. 109 probably did not initially lead to earnings management but, given opportunity and incentives, managers began to adjust the valuation allowance to achieve short-term earnings benchmarks.

Uncertain Tax Positions, Cookie Jar Reserves, and Valuation

[4] Burgstahler, D. C., W. Elliott, and M. Hanlon. 2003. How firms avoid losses: Evidence of use of the net deferred tax asset account. Working Paper, University of Washington.
[5] Schrand, C., and M. H. F. Wong. 2003. Earnings management using the valuation allowance for deferred tax assets under SFAS No. 109. *Contemporary Accounting Research* 20: 579–611.

Another manifestation of earnings management is to use a reserve for uncertain tax positions to achieve analyst forecasts, i.e., a "tax cushion" became a form of cookie jar reserve that could be reversed on demand. For example, analysis of the behavior of income tax expense from the third to the fourth quarter of the fiscal year suggests that firms experience larger reductions in income tax expense in cases where the company would miss analyst forecasts if they kept the tax expense at the level reported in the third quarter.[6] Additionally, analysis of taxes on a quarterly basis suggests that managers build slack into income tax expense in the first quarter of the fiscal year that can be released in later quarters if the firm risks missing analyst forecasts.[7] However, there is also evidence that the market is aware of this potential behavior and discounts the significance of meeting analysts' expectations under these conditions.[8] Thus, while managers may try to cushion earnings through the tax accrual, it is not clear that the market is influenced by such efforts.

Permanently Reinvested Earnings

Under APB No. 23, firms can delay financial statement recognition of U.S. taxes on repatriations by designating foreign subsidiary earnings as ''permanently reinvested.'' Permanently reinvested earnings have been found to increase when foreign returns on assets exceed U.S. after-tax returns, meaning that the more superior overseas performance is relative to the United States, the more earnings are likely to be permanently reinvested. Also, permanently reinvested earnings have been found to increase as effective foreign tax rates

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[6] Dhaliwal, D., C. A. Gleason, and L. F. Mills. 2004. Last-chance earnings management: Using the tax expense to meet analysts' forecasts. *Contemporary Accounting Research* 21 (2): 431–459.
[7] Schmidt, A. 2006. The persistence, Forecasting, and Valuation Implications of the Tax Change Component of Earnings. *The Accounting Review* 81 (3): 589–616.
[8] Gleason, C. and L. Mills. 2005. Evidence of Differing Market Responses to Meeting or Beating Targets Through Tax Expense Management. Working Paper, University of Iowa.

decline. Both these findings suggest that the classification of permanently reinvested earnings is a function of underlying economic factors. However, other analyses have indicated that firms may use the classification to manage earnings to meet analyst forecasts. Specifically, empirical evidence reveals patterns of year-to-year changes in amounts reported as permanently reinvested which are related to the difference between analyst forecasts and pre-managed earnings.[9]

Deciphering Deferred Taxes

In a slightly different line of research, deferred tax expense and liability accounts have been analyzed to assist in the identification of the active managing of earnings by a company relative to specific benchmarks. The underlying assumption in these studies is that accruals that increase income will generate temporary differences that affect deferred taxes. Statistical models that incorporate deferred tax expense are incrementally more useful for detecting earnings management than models based on receivables and payables only.[10] For example, the portion of deferred taxes related to revenue and expense accruals can be used to predict when earnings management is used to avoid an earnings decline. Deferred taxes are also indicative of subsequent earnings restatements.[11] Taken together, these results indicate that the information contained in the deferred tax accrual and related disclosures is useful for

[9] Krull, L., 2004. Taxes and the Reinvestment of Foreign Subsidiary Earnings. *The Accounting Review* 79 (3): 745-767.
[10] Phillips, J., M. Pincus, and S. Rego. 2003. Earnings management: new evidence based on deferred tax expense. *The Accounting Review* 78(2): 491-521.
[11] Badertscher, B., J. Phillips, M. P. K. Pincus, and S. O. Rego. 2006. Is Deferred Tax Expense Useful in Detecting Earnings Management in Earnings Restatements? Working Paper, University of Iowa.
Available at SSRN: http://ssrn.com/abstract=884258

identifying when a company may be managing earnings for the purpose of meeting analyst forecasts or pumping up profits.

Responses to FIN 48 enactment and adoption

FIN 48 became effective for fiscal years beginning after December 15, 2006. Research regarding disclosures about tax reserves prior to and after FIN 48's adoption indicates that large non-financial companies were more aggressive about implementing FIN 48 than small companies. In 2005, just prior to FIN 48's adoption, the release of tax reserves increased in frequency, but not in magnitude, for the largest firms. FIN 48 disclosures available after January 1, 2007, indicate that the largest firms in the study had unrecognized tax benefits of $78 billion (1.8 percent of total assets) as of the end of 2006. Furthermore, large firms increased stockholders' equity by approximately $2 billion to reflect a decrease in reserves after the adoption of FIN 48. In contrast, smaller firms did not exhibit unusual changes in the frequency, amount or overall level of reserves either before or after the adoption of FIN 48.[12] Finally, firms with estimated excess reserves were more likely to release those reserves into earnings in the quarters between the enactment of FIN 48 and its adoption.[13] The release of reserves was also associated with an increase in settlements with the IRS, suggesting that firms with excess reserves leaned towards resolving tax uncertainties before the adoption of FIN 48 when the outcome of such settlements could still be recognized in earnings rather than as an adjustments to stockholders' equity.

[12] Blouin, J., C. Gleason, L. Mills and S. Sikes. 2007. What can we learn about uncertain tax benefits from FIN 48? *National Tax Journal* 60 (3): 521-535.
[13] Blouin, J., C. Gleason, L. Mills and S. Sikes. 2008. Changes in Tax Reserves in Anticipation of FIN 48. Working Paper, Duke University: The Fuqua School of Business.

Summary and Conclusion

The general conclusion of the researchers in this area is that managers do adjust the tax accounts to achieve short-term earnings benchmarks. There is also some evidence that the market is able to see through those actions. The findings also suggest that the tax accounts provide a tool to identify whether the economic reality portrayed in the financial statements converge to that portrayed to the IRS. Therefore, the tax accounting academic literature has provided evidence that supports some of the concerns that led to the implementation of FIN 48 to provide better information to financial statement users by curbing the use of tax accounts to smooth earnings patterns, although it seems that in the time between the enactment to the adoption of the standard firms were able to enhance their earnings by releasing their excess tax reserves.