

Additional Evidence of Firms' Willingness to Pay Taxes on Apparent Fictitious Earnings

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This paper attempts to answer the question of whether firm's who are actively engaged in earnings management and reporting fictitious earnings, are willing to pay the additional taxes on these fictitious earnings. Two methods were used. One found that 76 out of 87 firms that reported fictitious earnings and restated their statements were willing to pay 10.9% more taxes. In the second method, the effective tax rates (ETR) before, after and during the year fictitious earnings were compared. The results also indicate that some firms were willing to pay taxes on fictitious earnings.

INTRODUCTION

According to the Association of Certified Fraud Examiner's (ACFE) bi-annual survey of global companies: "Report to the Nation 2014", companies lose five percent of their revenue to fraud. Nine percent of the total fraud reported by its respondents was categorized as financial statement fraud with the highest median loss of \$1,000,000 (and as much as \$4,000,000 in 2010). The other categories: asset misappropriation occurred in more than 85% of the reported cases had a median loss of \$150,000 and corruption occurred in over 35% of the cases had a median loss \$200,000. Several fraud cases included schemes in more than one category.

Publicly traded companies commit financial statement fraud to manage their earnings and misrepresent their financial information to the users and creditors. Earnings management is usually accomplished by deferring or accelerating revenue or expense transactions, changing or using specific accounting methods, and/or recognizing one-time non-recurring transaction items (Giroux 2004). There are three main reasons why firms participate in earnings management: meet debt obligations, executive bonuses, and meet stock analyst's expectations.

According to Whistleblower Today (2014), forty percent of all financial statement fraud involves revenue recognition schemes. Are companies willing to pay higher taxes on their fictitious earnings? Erickson et.al. (2004) found evidence that 27 out of 140 corporations who were accused by the SEC of fraudulent earnings paid \$11.84 million on taxes on \$124.5 million in overstated earnings. One would think that companies would want to maximize their earnings by manipulating revenues as well as expenses, in particular, tax expense. Dhaliwal et al (2004) contend that decreasing tax expense is the "last chance" to manipulate earnings. They found estimated tax rates (ETR) decreased when firms failed to meet targets. On the other hand reporting a comparatively low tax expense on inflated earnings could raise the suspicion of investors and analysts as concluded by Mills and Newberry (2001). In addition, financial analysts are comparing actual effective tax rates with expected effective tax rates (ETR). Cloyd (1995), Mills and Newberry (2001) and Erickson et.al. (2004) believed that publicly listed corporations'

main incentive is to report higher earnings at the expense of paying higher taxes. In contrast, others found that directors of private companies choose to underreport their taxable accounting earnings. Kourdoumpalou and Karagiorgos (2012) noted that several large publicly traded companies involved in accounting scandals such as Enron, WorldCom, Xerox and Tyco have shown that some firms manage to evade taxes on inflated earnings through the use of tax shelters. On the other hand the use of tax shelters usually results in higher deferred taxes and could provide a red flag to the Internal Revenue Service of possible tax fraud of companies that are missing analysts' consensus forecast (Dhaliwal 2004). Crutchley et.al. (2007) found companies that manipulate their earnings have a higher level of deferred taxes. Hoopes et.al. (2012) concluded that IRS monitoring constrains corporate tax avoidance when they found that raising the probability by 18 percent of an IRS audit increases the cash ETR of companies by 7 percent.

This study will extend Erickson's by including companies that manipulated earnings, according to the SEC, up till 2014. This study will add an additional 12 years data to the sample. Erickson's study was limited to companies that restated their earnings. This study will include companies that did not restate their earnings by examining the effective tax rates (ETR). The annual ETR of each firm will be compared to the third quarter as well as with the ETR one year before, during and one year after the earnings manipulation. Both methods found evidence that there are firms are willing to pay taxes on fictitious earnings.

BACKGROUND AND RELATED RESEARCH

DeZoort et.al. (2012) found that \$305 billion in 2010 was lost due to tax fraud. This represents 24% of the budget deficit of \$1.29 trillion. Tax fraud is the intentional evasion of paying taxes that are legally due. U.S. firms keep two sets of financial statements, one reports book profits to the capital markets according to GAAP and the other reports tax profits. According to Yin (2004), large differences between GAAP and taxable income invite IRS scrutiny. Most studies on earnings management focus on US firms where accounting and taxable income are completely separated. Kourdoumpalou and Karagiorgos (2012) studied Greek firms where accounting and taxable income are the same and found that the firms were only compliant with their taxes the year before and during an initial public offering (IPO). Desai and Dharmapala (2009) explored the beneficial effects of having greater accounting and tax alignment to the investors and tax authorities.

Erickson et.al. (2004) identified their sample through the SEC's Accounting and Auditing Enforcement Release (AAER) from January 1, 1996 to June 30, 2002 as overstating earnings. They calculated the amount of taxes paid on overstated earnings by comparing reported tax expense to restated tax expense on restated earnings. Erickson et.al.'s (2004) study was limited to 27 firms because they included only companies that reported a restatement of their financial statements as well as tax expenses. This study will extend the Erickson et.al. (2004) study in a couple of ways. First, the sample size will be extended to AAERs issued up to December 31, 2014. A comparison will be made of income tax expense before and after the restatement of earnings. As mentioned earlier, Hanlon (2003) concludes that the taxes expense in the financial statements includes both current and deferred portions and is based on management's best estimate. There are several complications that should be considered: namely, subsidiaries, stock options, tax cushions, tax havens, and extraordinary items. The level of disclosure by firms is varied and which makes it difficult to more accurately infer current tax expense. This study will base its conclusions mainly comparing the reported and restated income tax expense.

According to Hanlon (2003), the taxes deducted from net operating income, provide a "fair and accurate assessment for firm's tax cost for financial reporting purposes." Firms are required by FAS 109 to include both current and deferred taxes in the taxes expense on the income statement. The taxes are normally paid 8 ½ months later while financial statements are due within 90 days of the end of the year. Taxes expense in the financial statements is the best estimate of the taxes currently due.

Yin (2003) studied the ETR of the S&P 500 over the period of 1995-2000 and found that the ETR of sample corporations declined from 30.1% to 28%. They also found an increasing gap between GAAP and tax profits. Desai (2005) studied the ETR of Xerox which declined from 36% in 1996 to 27% in 1998.

Hoopes et al (2012) found that tax avoidance is less when the IRS imposes enforcement by examining ETR of firms. Dyreng et.al. (2008) examined cash effective tax rates – ratio of taxes paid across all jurisdictions (federal, state, city, foreign) to the firm’s worldwide pretax book income to determine the extent that companies are able to avoid taxes over a period of ten years. Dhaliwal et.al. (2004) hypothesized that firms manage their tax expense to reach an earnings target. It is one of the last accounts finalized prior to earnings releases and thus serves as a cookie jar reserve to manage earnings when pre-tax accruals fail to achieve their target earnings.

Effective tax rates (ETR) are examined to determine whether tax expense was used to manage earnings to meet analysts’ forecast. The first of these studies, Dhaliwal et.al. (2004) studied third- to fourth-quarter ETR and analysts’ forecast. They found that a lower ETR was reported in the fourth-quarter when earnings forecast will be missed and a higher ETR when earnings exceed the earnings forecast. Cook et.al. (2008) and Comprix et.al. (2012) support Dhaliwal et.al.’s (2004) findings. In addition, Cook et al (2008) found that reductions in ETR in the fourth-quarter were associated with higher tax planning fees paid to auditors. Comprix et.al. (2012) provide some evidence that quarterly overstatement in ETR in quarterly statements were associated with earnings management. All prior studies examined changes in ETR to establish the use of tax expense in earnings management. This study will look at ETR to provide evidence that corporations are willing to pay taxes on fictitious earnings. The ETR of companies in the year that they are accused of earnings manipulation will be compared to the ETR in the third quarter, and years prior and after. If ETR is the same, this would provide some evidence that corporations accused of reporting fictitious earnings are willing to pay taxes and that the understatement of tax expense is not part of their earnings management scheme.

ETR is calculated by tax expense divided by accumulated GAAP pre-tax income (Comprix et.al. 2012). Dyreng et.al. (2008) measured GAAP effective tax rate by dividing tax expense by pretax income. Hanna (2009) asserts that the GAAP income tax expense includes both current and deferred tax expense, a corporation’s tax expense is not affected by temporary differences in deferred tax expense. Lee et al (2014) list down five proxies for tax avoidance and tax evasion: “Generally Accepted Accounting Principles (GAAP) effective tax rate, a cash effective tax rate, total book-tax differences, permanent book –tax differences, discretionary book-tax difference and reportable transactions.” Reportable transactions are designed to evade taxes and therefore considered to be the most aggressive tax avoidance strategy. GAAP ETR is on the other end of the spectrum considered to be the least tax avoidance strategy because it captures all tax avoidance strategies. GAAP ETR information is readily available from corporate financial statements reported to the SEC.

Dhaliwal et.al. (2004), Cook et.al., (2008) and Comprix et.al. (2012) provided evidence that firms use tax expense to manage earnings. Firms that do not meet their earnings targets significantly lowered their projected effective tax rates in the fourth quarter. They compared the ETR in the third quarter to the ETR in the fourth quarter. All prior studies examined changes in ETR to establish the use of tax expense in earnings management. This study will look at ETR to provide evidence that corporations are willing to pay taxes on fictitious earnings. The ETR of companies in the year that they are accused of fictitious earnings and compared to the ETR in the years prior and after. If ETR is significantly unchanged, this would provide some evidence that corporations accused of reporting fictitious earnings are willing to pay taxes and that the understatement of tax expense is not part of their earnings management scheme.

DATA SELECTION

Restated Financial Statements

Bonner (1998), Erickson et.al. (2004), and Roxas (2011) used the SEC’s Accounting and Auditing Enforcement Releases (AAER) to identify companies with fraudulent financial reporting. Bonner (1998) found that 80 percent of bankrupt public companies with fraud and auditor litigation have SEC enforcement actions. This research examined AAERs from October 18, 1999 to December 31, 2014 (AAER numbers 1190 to 3618) and identified 284 firms that participated in fraudulent financial reporting. Each company’s financial statements during the period of fraudulent financial reporting were examined

for restatements. Thirty five companies did not have financial statements available and another fifty-three companies did not provide restated financial statements. Erickson et.al. (2004) presume that these companies were probably financially distressed and went to bankruptcy or liquidated. Eighty-two of the companies that restated their statements had originally reported losses and were also excluded from the study. The following table summarizes the sample included in this study:

TABLE 1
SUMMARY OF SAMPLE—RESTATED FINANCIAL STATEMENTS

Restated financial statements	
Reported income and restated loss	27
Reported income and restated income	87
Total restated financial statements	114
No restated financial statements	53
Companies reporting losses	82
No financial data	35
Total number of companies from SEC AAERs	<u>284</u>

The first part of the study takes a look at the companies that restated their income to determine if the income tax expense decreases when net income is restated.

Effective Tax Rate

In an attempt to include companies that did not have available restated earnings as well as to support and extend Erickson's et.al. (2004) study, this study examined the ETR's of SEC sanctioned companies. The second part of the study will look at the original reported financial statements. Table 2 summarizes the sample included in this part of the study:

TABLE 2
SUMMARY OF SAMPLE—ESTIMATED TAX RATE

Restated financial statements	114
Plus: Companies with no restated financial statements	<u>53</u>
Total	167
Less companies that reported no tax	<u>37</u>
Companies in sample	<u>130</u>

Fifty three companies that were excluded from the first part of the study because they did not have restated financial statements were included and data was gathered on each company's ETR during the 3rd quarter, 1st-3rd quarter, the year earnings (y) management took place and the year before (y-1) and the year after (y+1) earnings management. Thirty seven more companies were excluded because the financial statement information was either incomplete or did not report any taxes.

RESULTS

Restated Financial Statements

There are two indications apparent from the restated financial statements that companies that manage their earnings are willing to pay income taxes on these fraudulent earnings. Twenty seven companies

restated their previously reported net income in to a loss. Together with the reported income, they also reported income tax expense. There were another 8 companies that managed their earnings for more than one year and restated their reported income into positive income in some years and negative income (losses) in others. These eight are included in the 87 companies that reported income and restated into positive income, as indicated in the summary above.

Eleven of the companies that had restated income were not willing to pay income tax on their fraudulent earnings. The income tax expense they reported originally was the same amount that they reported in their restated financial statements. The other 76 companies showed a decrease in income and a decrease in income tax expense in the restated financial statements.

On average, the 76 companies overstated their income by 12.4% and were willing to pay 10.9% more taxes as indicated by their reported earnings. The average effective tax rate on reported earnings was 35% and on restated earnings was 38%. The difference in the effective tax rate on reported and restated earnings for 26 of the companies was below 1%.

Effective Tax Rates (ETR)

Some of the remaining 130 companies in the sample experienced a loss on one of the three years used to analyze their ETR: the year before the earnings management, the year of the earnings management and the year after earnings management. More companies experienced a loss or did not have data available the year after earnings management. ETR was calculated using the reported GAAP income before restatements were made. First, this paper examined the difference in ETR between the 3rd quarter and the end of the year of earnings management as found in prior research performed by Dhaliwal et.al. (2004). Secondly, differences in ETR were calculated between the year before the earnings management and thirdly, differences in ETR between the year of earnings management and the year after.

Forty-six percent of the companies' ETR was the same for the third quarter and at the end of the year of earnings management. Fifty-six percent of the ETR was the same for the 1-3rd quarter and at the end of the year. Almost half of the companies accused of earnings manipulation do not make corresponding changes in tax expense indicating their willingness to pay taxes on manipulated earnings. This is also found when analyzing the difference between the ETR of companies the years before and after earnings manipulation. Forty-nine percent of companies had the same ETR the year before earnings manipulation and the year of earnings manipulation. There were fewer companies that reported positive earnings in the year after earnings manipulation but for those that reported earnings, the ETR of 62.5% of the companies was the same.

CONCLUSION

Several companies were willing to pay taxes on their fraudulent earnings as indicated by examining restated financial statements of companies sanctioned by the SEC for earnings manipulation and comparing the ETR of companies before and after earnings manipulation. This paper provides additional evidence to Erickson et al (2004) that firms accused of fraudulently committing earnings management are willing to pay taxes on these fraudulent earnings. Based on the differences on their reported and restated earnings, they were willing to pay 10.9% more taxes based on 12.4% fraudulent earnings. An examination of the ETR showed a similar pattern. Around 50% of the companies accused of fraudulently committing earnings management had the same ETR before and after earnings management and during earnings management.

Companies who are actively managing earnings and reporting fictitious income, focus on the other items in the income statement and have calculated tax expense accordingly. This could be that they do not want to invite IRS and analyst scrutiny or they know that they can potentially evade actually paying taxes and set up some deferrals and write off deferrals in the future thus engaging in earnings management in the future.

This paper used GAAP earnings and GAAP reported tax expense. Tax expense might be overstated due to stock options, tax cushion, intra-period tax allocation, tax credits (foreign operations, research and

development, etc.), and consolidation (Hanlon 2003, Lee et al 2015). This may cause tax expense to be overstated.

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