

# *Taxes and Financial Accounting*

2007 American Taxation Association

Doctoral Consortium

Ed Maydew

---

# *Thank You's and Caveats*

---

➤ Thanks to

- John Robinson and organizing committee
- Lil Mills and first organizing committee in '05
- KPMG for funding

➤ Caveats

- This is just one guy's take on the literature
  - More emphasis on Maydew research than warranted
-

---

## *Agenda – Taxes and Financial Accounting*

---

- Discuss the relation to fin acct research
  - Discuss the history of this area and the framework underlying much of it
  - Survey research streams in this area
  - Provide some unanswered questions
  - Think about your comparative advantages and disadvantages as a PhD student
-

---

## *The Good News Is...*

---

- You are interested in tax
  - That makes you different
  - Nationwide production of new accounting PhD's writing tax dissertations is small
  - Ratio of topics / researchers is high in tax
-

---

## *The Bad News Is...*

---

- You are interested in tax
  - That makes you different
  - Nationwide production of new accounting PhD's writing tax dissertations is small
  - You need to be as good at marketing as you are at tax and accounting
-

---

## *Are Taxes Worth Thinking About?*

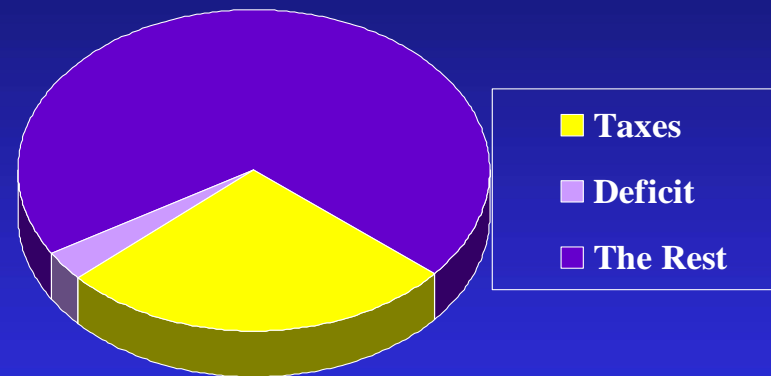
---

- You know what the answer will be!
- Let's look at some data

---

# *Taxes Compared to Gross Domestic Product*

---



- \$10.7 trillion of GDP
- \$2.9 trillion of taxes (federal and state)

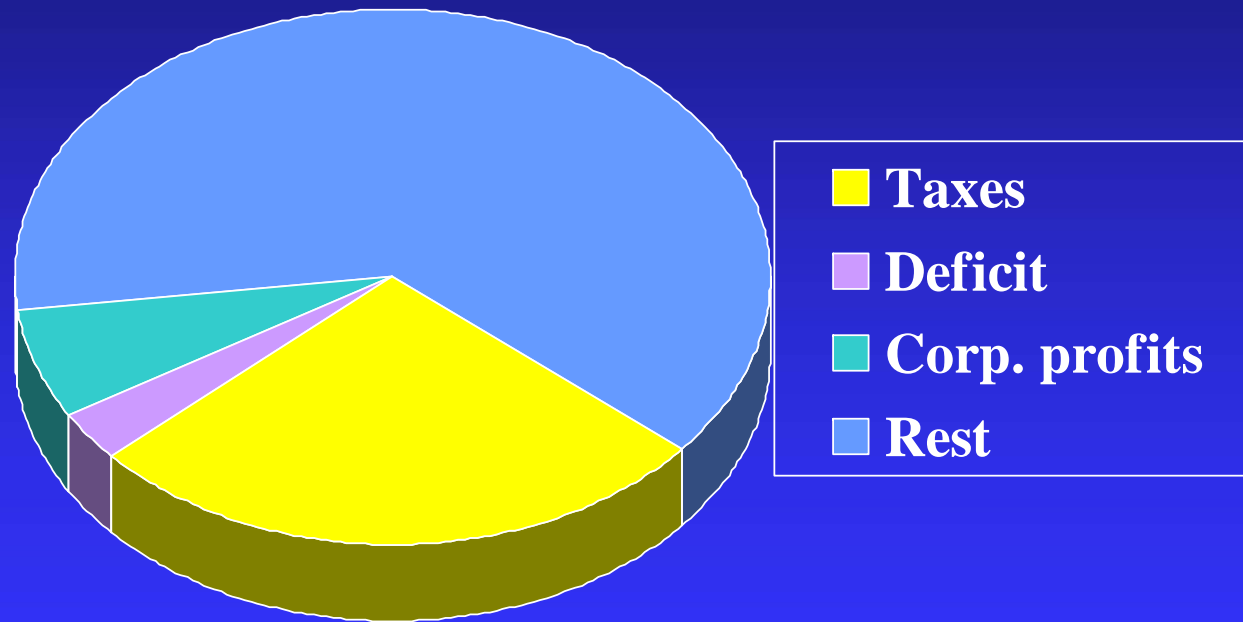
Estimates from Bureau of Economic Analysis, U.S. Dept. of Commerce, 2003.

---

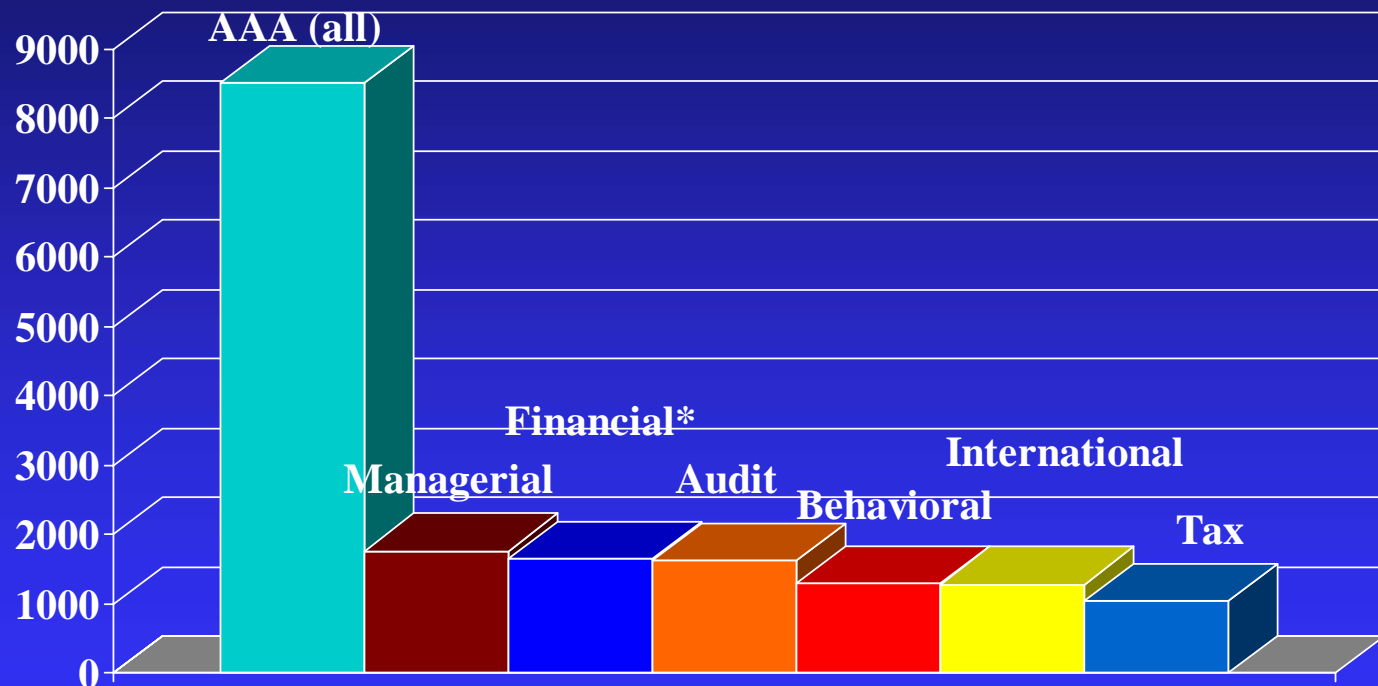
---

# *Taxes Compared to Aggregate Corporate Profits (Relative to Total GDP)*

---



# *Membership in Sections of the American Accounting Association*



\*Likely undercounts financial accountants.

---

## *Why Study Taxes and Financial Accounting?*

---

- As tax accountants, we have a comparative advantage
  - Financial accountants find interesting
  - Economists find interesting / puzzling
-

---

## *A Brief History of “Modern” Tax Research in Accounting*

---

- Big bang for empirical financial in 1968
    - Ball and Brown (1968), Beaver (1968)
  - Big bang for empirical tax late 1980s early 1990s
    - Scholes, Wilson, and Wolfson (1990)
    - Scholes & Wolfson *Taxes and Business Strategy* (1992)
  - Development of Scholes – Wolfson framework
    - Led to tax trade-offs literature
    - Meshed nicely with financial accounting / capital markets
-

---

*Scholes – Wolfson:*  
*Four Types of Income Tax Planning*

---

1. Shifting income across time
  2. Shifting income across jurisdictions
  3. Shifting income across types of income
  4. Shifting income across entities
-

---

*Scholes – Wolfson:*  
*Effective Tax Planning Considers*

---

1. All taxes – explicit and implicit taxes
  2. All parties – indirect costs and benefits from shifting tax burdens or benefits onto other parties
  3. All costs – e.g., financial reporting costs
-

---

## *Scholes – Wolfson: Additional Concepts*

---

- Tax clienteles
  - Implicit taxes
  - Marginal versus effective tax rates
-

---

# *Organizing Tax & Financial Accounting Research*

---

- Tax trade-offs literature
    - Probably single largest set of tax research
    - $y = f(X, \text{taxes})$
  - X often includes financial reporting cost / benefit
  - Advantage: quantifying how much willing to pay for financial accounting benefit
-

---

## *Some Early Tax Trade-Off Papers*

---

- Shifting income across time
    - Scholes, Wilson and Wolfson (1992)
    - Guenther (1994)
    - Maydew (1997)
  - Tax, Acct, Regulatory Trade-offs
    - Scholes, Wilson, and Wolfson (1990)
    - Beatty, Chamberlain and Magliolo (1995)
    - Collins, Shackelford, and Wahlen (1995)
  - Loads of papers, see S&S
-

---

## *What Is Established*

---

- Taxes matter for a variety of decisions
    - Hard to get very far documenting one more
    - A high bar at this point
  - Tax planning often affects financial reporting and vice versa
    - But not 1 for 1
-

---

# *Evolving Areas of Taxes and Financial Accounting*

---

- Book-tax conformity / book-tax differences
    - Mills (1998)
    - Guenther, Maydew, Nutter (1997)
    - Hanlon (2005)
    - Hanlon, LaPlante, Shevlin (2005)
    - Hanlon, Maydew, Shevlin (2007)
  - Evolving to look at
    - Capital market consequences
-

---

# *Evolving Areas of Taxes and Financial Accounting*

---

- Conforming / Non-conforming Earnings Management
  - Erickson, Hanlon, Maydew (2004)
  - Badertscher, Phillips, Pincus, Olhoft-Rego (2006)
- Evolving to look at
  - Generally how do firms choose

---

# *Evolving Areas of Taxes and Financial Accounting*

---

## ➤ ETRs

- Krull (2004) – permanently reinvested earnings
- Gleason and Mills (2002) – tax cushion
- Miller and Skinner (1998) – valuation allowance
- Schrand and Wong (2003) – valuation allowance
- Phillips, Pincus, Rego (2003) - valuation allowance
- Schmidt (2006) – persistence of ETRs
- Dyreng, Hanlon and Maydew (2007) – long-run ETRs

## ➤ Evolving to look at (?):

- ETRs and tax avoidance
  - Tax cushion, effects of FIN 48
-

---

## *Some Unanswered or Partially Answered Questions - continued*

---

- Does taxation improve or detract from usefulness of financial accounting information?
  - What would closer book-tax conformity do to tax avoidance?
  - What would closer book-tax conformity do to the usefulness of accounting information?
  - How will FIN 48 affect tax planning?
  - How will FIN 48 affect other aspects of financial reporting?
-

---

## *Some Unanswered or Partially Answered Questions*

---

- Why do firms sometimes sacrifice tax for financial accounting but other times sacrifice financial accounting for tax?
  - How do firms make use of conforming vs. non-conforming items when managing earnings?
  - What information does tax data provide for understanding the firm's financial performance?
  - Is the market efficient with respect to tax disclosures?
  - Is there cross-sectional variation in tax avoidance? Why?
  - Is there intertemporal variation in tax avoidance? Why?
-

---

## *Other Areas of Tax Research to Consider: Taxes and [Various]*

---

- Compensation
    - Matsunaga, Shevlin and Shores (1992)
    - Recent paper on stock option exercise backdating by Dhaliwal, Erickson and Heitzman (2006)
  - Mergers and Acquisitions
    - Erickson (1998)
    - Ayers, Lefanowicz, and Robinson (several)
  - Asset prices
    - Long literature in econ, fin, acct
    - Tax capitalization, Lock-in
    - Dhaliwal, Krull, Li, Moser (200X)
    - Di, Maydew, Shackelford, Zhang (2007)
-

---

## *Do firms pay taxes on overstated financial accounting earnings?*

---

- Erickson, Hanlon, Maydew (2004)
  - We know from prior research that firms sometimes sacrifice tax to change timing of earnings
  - How far would some firms go? Would some firms actually sacrifice real cash flow (taxes) to inflate non-cash, allegedly fraudulent earnings?
-

---

## *Do firms pay taxes on overstated financial accounting earnings?*

---

- Why they might not
    - Costly – taxes reduce cash flow
    - Tax avoidance
  - Why they might
    - Avoid detection
      - Differences between book and tax show up on both financial statements and tax return
    - Have an net operating loss for tax
    - Mistake
-

---

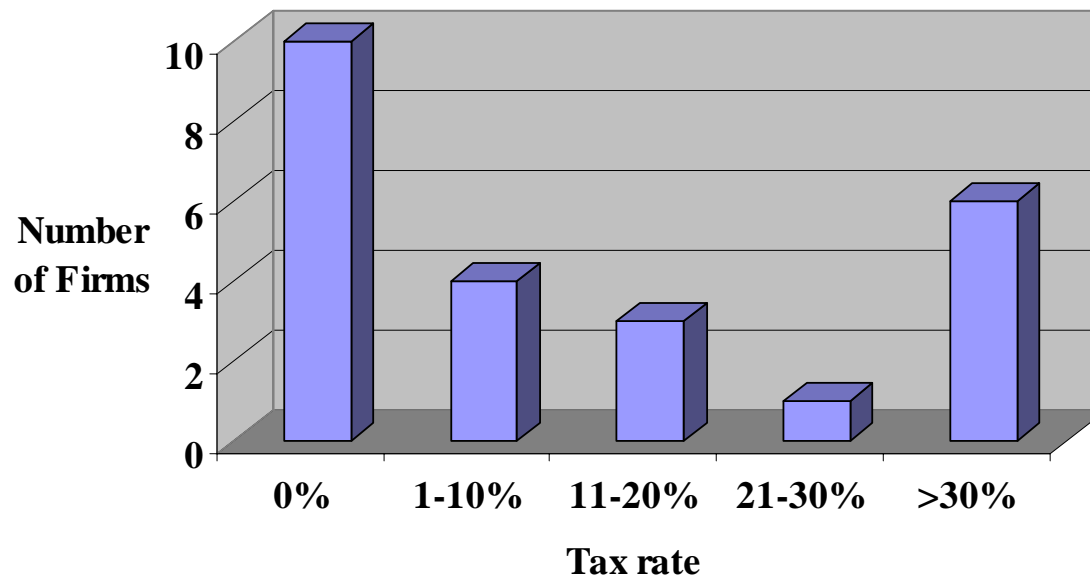
## *Do firms pay taxes on overstated financial accounting earnings?*

---

- Examine sample of firms 1996-2002 that the SEC alleged engaged in accounting fraud
  - Examine those that have restated their financial statements
  - Estimate \$327 million taxes paid on \$3.36 billion in overstated earnings
-

# *Do firms pay taxes on overstated financial accounting earnings?*

**Fig. 2.- Number of Firms Paying Current Taxes on Earnings Overstatements at Various Rates**



---

## *Do firms pay taxes on overstated financial accounting earnings?*

---

### **Excerpt from Centennial Technology's 10-K/A (4/18/1998)**

*“As outlined in the criminal indictment of Centennial's former Chief Executive Officer, the Company's sales figures were inflated in previous periods. This inflation was achieved by various means, including shipping empty PC card housings; billing customers for non-existent products; using the delivery of non-product materials to generate shipping documents, which were then used to create fictitious invoices; and the payment of these invoices with funds apparently provided by the Company's former Chief Executive Officer.”*

*“As a result of the adjustments made to the Company's financial statements in connection with its financial review, previous provisions for income taxes have been reversed and the associated payments of approximately \$7.4 million are classified as recoverable income taxes at March 31, 1997. Approximately \$6.1 million of these tax refunds were received as of June 30, 1997, and substantially all of the remaining refunds are expected to be received by the end of August 1997.”*

---

---

## *Your Competitive Advantages as a PhD Student*

---

- Knowledge of financial accounting literature
  - Data skills
    - Econometrics
    - Programming
  - Time: A year or so to write essentially one paper
-

---

## *Your Competitive Disadvantages as a PhD Student*

---

- Knowing when you have a good RQ
  - Writing the front - end
  - Getting from A to B without too many dead-ends
  - Time: Dissertations take a long time to complete
    - Avoid research question de jour, race-to-the-finish topics
-

---

## *The Best News Is....*

---

- You will find a topic
  - You will finish your dissertation
  - You will get a job
  - You will love being a professor
-