

House Committee on Ways and Means

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Introduction

Mr. Chairman and distinguished members of this subcommittee, I appreciate the invitation to comment on corporate tax reform. My comments will address the interplay of financial reporting and taxation and proposals for conforming book and taxable income. I applaud this subcommittee for studying these issues. They reflect the growing appreciation for the impact of financial reporting on tax policy.

The Demand for Financial Reporting

Many (investors, creditors, customers, suppliers, regulators, rating services and the government, among others) need financial information from firms. For purposes of this testimony, I will limit my focus to current and potential shareholders.

Managers report financial information to shareholders to reduce the asymmetric information problems that otherwise would limit their ability to attract external capital. Asymmetric information exists when one party knows more than another party does. For example, in the equity markets, managers know more about the firm than outside investors know. Problems arise for managers when the external investors fear that the differences in information enable the managers to take advantage of them. The accounting information provided in financial reports allows managers to reduce the asymmetry and thus attract capital from outside investors.

For example, consider research and development about a new drug at a pharmaceutical company. Insiders know the probability of success far better than outside investors do. Through financial reports, managers can convey some of their knowledge to the outside investing community. This accounting information enables outsiders to better forecast the profitability of the drug, reducing their uncertainty about the future of the firm and increasing their willingness to invest in the company. In brief, the demand for financial reporting comes from the need to reduce differences in knowledge between inside management and outside supplies of capital.

Accounting Standard Setters

Generally Accepted Accounting Principles (GAAP) provides guidance about the information that firms can provide through their financial reports to shareholders. GAAP has evolved over decades into accounting conventions that provide a structure for identifying, evaluating, and reporting the firm's activities. The Financial Accounting Standards Board (FASB), with oversight from the Security and Exchange Commission (SEC), is the primary standard setter of GAAP. The American Institute of Certified Public Accountants, the Emerging Issues Task Force, and the SEC itself also contribute to GAAP. Each body promulgates statements to guide the accountants who produce the financial reports. Some standards mandate specific accounting treatment for a transaction. Other pronouncements suggest

an approach or a structure for reporting transactions. The goal is financial reports that present relevant, reliable, comparable, and consistent information about the affairs of the company.

At the same time, the standard setters recognize the impossibility of specifying the precise treatment for every transaction, and they rely heavily on firms to judge the appropriate approach within bounds for specific transactions. As a result, two firms with identical activities could produce different financial reports without violating GAAP. For example, suppose the same customers bought the same goods on credit from two retailers. One retailer might expect higher collections than the other retailer does. Consequently, the first retailer would report higher net income than the second retailer does—the sole difference being a judgment about future collections. Neither retailer violates GAAP. They simply disagree about future collections.

This element of discretion enables managers to better communicate their expectations to investors. However, this flexibility also enables managers to manage their reports in a manner that reflects well on them. Continuing the example, the first retailer's expectations may not differ from the same retailer's expectations. However, the imprecision of financial reporting enables the first to report higher accounting profits. Of course, the markets are aware of this potential for earnings management. However, the evidence is mixed about whether investors can fully adjust their forecasts for earnings management. Nonetheless, managers behave as though they believe that investors cannot fully adjust for earnings management

The Demand for Tax Information

Compared with financial reporting, the demand for tax information is relatively simple. The government needs each firm to report its taxable income in accordance with the existing tax law because self-reporting is an efficient means of gathering the information to compute the tax liability. By comparison with accounting standards, the tax law is intentionally rigid and, to the extent possible, attempts to specify the appropriate treatment for every transaction.

Whereas standard setters intend financial accounting to be a flexible, evolving, conceptual framework that guides accountants in their judgments, Congress writes the tax law to provide as much certainty as possible about the tax treatment of a transaction. The Treasury Department adds to this certainty with regulations that interpret the law. The courts add to this certainty when they resolve differences between the government and the taxpayers. Although GAAP itself is becoming more rules-oriented over time, it remains far less certain and binding than the tax law. In the starkest terms, financial accountants use judgments to report a firm's profitability while tax accountants apply the law to compute taxable income.

Of course, since the taxpayer and the government take adversarial positions in the interpretation of the law, conflicts arise continually about the tax treatment of specific transactions. However, if tax rules were based on the guidelines, approaches, discretion, and judgments that underlie financial accounting, the differences in opinions would be far more extensive than we currently observe in the tax arena. In fact, if the tax law had the flexibility of GAAP, administration of the tax law would be impossible as tax cases flooded the courts. Instead, under the current tax system, both taxpayers and the government benefit from "bright-line" provisions in the tax law that specify the treatment of particular transactions as precisely as possible, reducing the uncertainty about the ultimate resolution of an event's tax treatment.

The Interplay of Financial Reporting and Tax Disclosures

Many transactions are treated the same for financial reporting (or book) and tax purposes. Transactions receiving the same treatment create a tension between book and tax considerations. For book purposes, managers may wish to present the event to investors in a favorable light, e.g., in a manner that increases accounting earnings or lowers earnings volatility. For tax purposes, managers wish to present the event in a manner that reduces the firm's tax liability.

For example, if a firm uses LIFO (last-in, first-out) to compute the costs of its inventory for tax purposes, it also must use LIFO for book purposes. During inflationary times, LIFO reduces both book and taxable income. Thus, when firms choose LIFO, they are demonstrating a willingness to sacrifice the profitability that they report to outside investors in order to lower their tax liability. Conversely, when firms choose other inventory costing methods, e.g., FIFO (first-in, first-out), they are choosing to report higher earnings at the expense of higher taxes.

Researchers have studied the trade-offs between book and tax reporting extensively.^[1] To the surprise of those who are unfamiliar with the importance of financial reporting, many studies find that book considerations dominate tax considerations. In other words, some firms structure their activities in a way that boosts earnings, even though they have to pay for the higher earnings through higher taxes. For example, many firms in inflationary times used FIFO. As expected, the companies that rely most heavily on outsiders for their capital (and thus face the greatest asymmetric information problems) are the ones that are most likely to enhance earnings at the cost of higher taxes.

To demonstrate, suppose you are the sole shareholder, lender, and employee in your business. You have no need to provide information to outside investors. Thus, there is no tension between your financial reporting considerations and your tax choices. You will always report your affairs in a tax-minimizing manner.

Conversely, suppose you are the CEO of a company owned by outside investors. The shareholders observe your financial reports, but not your tax return, and have access to little financial information about the firm, except the information that you provide them. In that case, the financial reports play a critical role in the firm's ability to raise capital.

For example, suppose the market uses a simple price-earnings ratio to value stock. If a firm's price-earnings ratio is 20, then every dollar of (permanent) accounting earnings boosts the firm's capitalization by \$20. Conversely, if saving one dollar of taxes does not increase the firm's book earnings, and thus cannot be observed by outside investors, then the tax savings have no effect on the stock price. In such an environment, it is entirely rational that a firm would forgo tax savings to communicate a more favorable message about its future profitability.

Consequently, managers of widely held public companies are very concerned with the book considerations of transactions. In fact, managers in these types of firms often forgo tax opportunities because they have adverse book effects or even because they have no favorable impact on book earnings. On the other hand, managers may undertake a tax strategy that has minimal reduction in their tax liability, but provides a boost to earnings. In short, financial reporting considerations often dominate tax concerns for managers of public corporations with asymmetric information problems.

The importance that corporations place on the financial reporting considerations of changes in tax policy can puzzle policymakers. If the policymakers underestimate the importance of financial reporting in allaying asymmetric information problems, they may be surprised when widely held public companies show little interest in tax reductions that adversely affect their financial reports. They sometimes even have limited interest in tax reductions that do not benefit accounting earnings.

One example of the importance placed on accounting earnings concerns recent proposals for replacing depreciation with immediate expensing. Immediate expensing likely would reduce the tax bill for many firms and certainly would reduce taxes in the short-run. However, expensing would have no effect on accounting profits. The reason is that the timing of the deductions for tax purposes (up front with expensing versus over time with depreciation) is irrelevant for computing accounting earnings. Because expensing carries no book benefit, many managers of widely held public companies likely will have little interest in switching the tax law from depreciation to immediate expensing.

Book-tax Conformity

Recently some have suggested adoption of book-tax conformity. By book-tax conformity, I mean taxing the accounting earnings that companies report to their shareholders. On the surface, conformity makes sense. Companies report income to their shareholders, and companies report income to the taxing authorities. Conformity simplifies the process by having companies report the same amount of income to both shareholders and the government. Furthermore, with conformity, the tendency to overstate income to shareholders would offset the tendency to understate income to the government, providing better measures for both shareholders and the government.

Notwithstanding these claims, I believe that book-tax conformity would adversely affect both financial reporting and the tax system for at least two reasons. First, shareholders and the taxing authorities need different information. Second, even if Congress mandates conformity, it will not be sustainable. In time, the policy will revert to the current system. In the meantime, conformity will damage our capital markets.

Different Users need Different Information

The first problem with conformity is that it ignores the different purposes for book and tax reporting. It assumes that the most useful measure of a firm's profitability for shareholders is also the most useful measure of profitability for the taxing authorities.

To demonstrate that different measures are appropriate for different users, compare the information demands of bondholders and shareholders. Bondholders need information to assess the likelihood that the firm will be able to service its debt. For example, they may want to know the value of the firm under liquidation. Shareholders need information to assess the value of their residual claims. Thus, they need information that assumes that the firm is a going concern, i.e., not facing liquidation.

Similarly, shareholders and the taxing authorities need different information. As mentioned above, shareholders need information from the financial reports about their residual interests. Conversely, the taxing authorities need verifiable information, rooted in law, rather than the judgments. No one would expect two financial accountants to reach the same book earnings for a firm because the process involves extensive judgment. Conversely, an important quality of tax law is that taxable income can be measured the same by both the taxpayer and the government.

Lack of Sustainability

The second problem with conformity is that it is not sustainable. Suppose we did set taxable income equal to book income. The accounting rules would remain the same, and the net income reported to shareholders would be the new tax base. GAAP, those guidelines that have evolved over time to guide the judgments underlying accounting, would replace the rigid Internal Revenue Code. The seven, unelected members of the FASB and other accounting standard setting bodies would replace Congress

as the body that determines the corporate tax base. In short, a consequence of conformity is that Congress would abrogate its authority to write the tax laws.

Consider depreciation under conformity. The current accounting rules permit companies to depreciate equipment in a manner that best reflects its economic deterioration. Thus, if the same plant uses identical forklifts differently, management may depreciate them differently. On the other hand, the current tax law provides specific rules for the depreciation of equipment. For example, a percentage of the cost of the equipment is depreciated in the first year, regardless of the actual decline in the value of the equipment. Under conformity, judgments about the decline in the usefulness of the equipment would replace the certainty of the current tax depreciation rules.

Besides the impossibility of basing a tax system on the judgments of the taxpayer, suppose the economy slows and Congress believes that more rapid depreciation would encourage firms to expand. What would Congress do? Would Congress provide an exception to conformity for depreciation? Would Congress mandate that accelerated depreciation is the only depreciation method acceptable for book and tax? Would Congress pressure the SEC and the FASB to change the accounting rules to mandate accelerated depreciation? Would Congress sit idly by, recognizing that it has delegated taxing authority to the accounting standard setters?

First, let us reject the possibility that Congress will do nothing or leave responsibility of the economy to an unelected body of accounting standard setters. Thus, Congress has two choices. Change depreciation for tax purposes only or mandate that accelerated depreciations is required for both book and tax.

If Congress provides a conformity exception for depreciation, then soon we are back to where we are today. In fact, this path brought us to where we are today. The corporate income tax was originally based on GAAP. Therefore, taxable income began closely linked to book income. Over time, Congress found reasons why tax should differ from book. The reasons include the need to provide incentives, improve efficiency, simplify the tax rules, provide certainty to taxpayers and the taxing authorities, address inequities, aid administration of the law, and raise revenue.

Therefore, over time, book and tax drifted apart. The decoupling is understandable. The purpose of accounting earnings is to provide information to external investors. The purpose of taxable income is to provide a verifiable measure for collecting revenue. It is unreasonable to think that one measure of profitability can achieve both purposes. Naturally, changes that narrow the gap between book and tax without adversely affecting financial reporting or the tax system are desirable, but complete conformity reflects a naivety about the purposes of book and tax information.

Alternatively, to continue our example, when Congress provides accelerated depreciation for tax purposes, suppose it decides to maintain conformity. If so, when Congress changes the tax law, it also will change the reporting methods for book purposes. In other words, Congress will set the tax law and force the book rules to conform.

This option is far more dangerous than providing different treatment for book and tax because it will erode the quality of the information that managers provide to external investors. Congress has a long history of rarely interfering with the evolution of accounting standards. This has enabled accounting to change naturally with economic developments and ensure that managers can best communicate private information about their companies to external investors. The standards provide a delicate balance of certainty (e.g., equipment is depreciated and land is not) and judgment (e.g., companies decide the rate of depreciation). If Congress interferes with this balance, it will have major adverse effects on our

economy.

Financial accounting has contributed mightily to our enjoying the largest and most efficient capital markets in the world. Domestic and foreign investors pour trillions of dollars into American firms led by managers whom they do not know. They invest because they trust the accounting information that the managers communicate about their companies. If Congress begins to restrict the means by which managers can communicate to their investors, e.g., by setting book depreciation methods, then investors will fear that they do not have the information that they need to evaluate companies. Contracting costs will rise. Stock prices will tumble. The damage to the capital markets alone will far exceed any benefits to conformity.

Germany's Experience with Conformity

Some advocates for conformity point to forms of conformity among our trading partners. It is true that some countries, such as Germany, have used conformity. However, these companies are increasingly abandoning conformity, providing further evidence that it would be bad policy for the United States.

Germany historically mandated book-tax conformity. The reason that conformity could exist in Germany was that their corporations raised little capital from external investors and thus had little or no asymmetric information problems. Instead, large banks supplied the capital for German corporations. Through extensive stock cross-holdings, the banks were insiders (using serving on the board of directors) and privy to the private knowledge of management. In other words, conformity could exist in a debt-centered economy, which relied on few external investors.

In contrast, America has equity-centered capital markets with widespread external ownership. Germany is now attempting to build an equity-centered economy. To facilitate the transition from a debt-centered economy to an equity-centered economy, Germany has discontinued conformity for consolidated financial statements, enabling managers to communicate more freely and thoroughly with their external investors. In other words, Germany is leaving conformity in an attempt to create the external capital markets that we already enjoy. Germany recognizes that book-tax conformity is inappropriate in an economy that relies on the equity markets to raise capital from external shareholders. Thus, Germany's abandonment of conformity provides enough further evidence that the U.S. should not adopt conformity as policy.

Unintended Consequences

Let me close with a warning about unintended consequences. Corporate behavior will change with any changes to the tax law or the financial accounting rules. If Congress were to establish book-tax conformity, then firms would begin to alter their behavior in ways that may be unanticipated at the inception of conformity.

For example, legislating conformity will not eliminate the need for information to address asymmetric information problems between insiders and outside investors. Thus, managers in widely held public companies will find other means to communicate private information to outside capital sources. Some firms may go private, but most will continue to rely on the equity markets to supply their capital. External investors will continue to demand information—and firms will find a way to supply that information—because their survival and prosperity depend on attracting external investors. If firms are unable to provide that information through their financial reports without adversely affecting their tax liabilities, then they will find other means of communication. Those other channels likely will be more costly and less effective than the current financial reporting system, but in the end, firms will find a way

to communicate information to investors, which reduces the problems associated with asymmetric information. In short, managers will find a way to decouple any legislated link between financial reporting and taxes.

Closing Remarks

In conclusion, I applaud these hearings and your interest in the coordination of financial and tax reporting. This is an important and often overlooked area of tax policy. Any attempts at corporate tax reform will require a thorough understanding of the effects of financial reporting on tax policy.

As far as book-tax conformity, I strongly oppose it. It is a naïve proposal that fails to appreciate the complex role of financial accounting in our economy. If we adopt conformity, we will inevitably abandon it (albeit after considerable damage to the economy) because Congress will not and should not cede its authority to set tax law. In the meantime, conformity will adversely affect the capital markets for public corporations and force managers to find alternative methods for addressing their inherent asymmetric information problems with external capital suppliers. Doubtlessly some differences between book and tax can be narrowed, but widespread book-tax conformity is bad tax and financial policy.

[1] For a review of the literature, see Shackelford, Douglas, and Terry Shevlin, "Empirical Tax Research in Accounting," *Journal of Accounting and Economics* 31:1-3, September 2001, 321-387.