Earnings management

Corporate manipulation of tax rate changes?

By Dr. Kenny Z. Lin

China provides comprehensive tax incentive schemes for foreign-funded enterprises, which includes a five-year tax concession for firms involved in manufacturing and planning to operate on the mainland for at least 10 years. These firms are exempt from enterprise income tax in the first two profit-making years and receive a 50 percent tax reduction over the next three years.

When the concession period ends, the standard 30 percent tax rate applies.

Before tax rate increases		After tax rate increases
	Income shifting	
Years 1-2 (0 percent)	←	Years 3-4 (15 percent)
Year 5 (15 percent)	←	Year 6 (30 percent)
Increase accruals through revenue accelerations or expense deferrals		Decrease (reverse) accruals

Tax-induced earnings management

Firms in the tax concession period will be motivated to recognize revenue quickly to capitalize expenditure, whereas firms in the post-concession period will exaggerate expenses and losses.

For example, switching one dollar of taxable income from a year in which it would be taxed at 30 percent to a year in which it would be taxed at 15 percent would be equivalent to earning 21 percent. If maximizing the firm's value by minimizing tax costs, this tax rate change provides an incentive to shift the recognition of revenue and expenses across periods *(see chart)*.

Anticipating a future tax rate increase, firms would accelerate revenue from years three and six to years two and five, or defer expenses from low-rate to high-rate years. This can be achieved by structuring activities to influence the timing of income and expense recognition.

Higher earnings are generated when decreasing bad debt provision and inventory write-offs, and delaying the purchase of expensive inventory at year end when LIFO (last in, first out) is applied. Other strategies include deferring research and development and advertising expenditure, and classifying more manufacturing overhead costs to be inventorial costs rather than period costs, or treating revenue expenditure as capital expenditure.

However, a firm needs to trade-off resultant tax savings with non-tax costs associated with these actions. For example, inventory holding costs could increase, and the ensuing report of low levels of accounting income may violate debt covenant restrictions.

Earnings management and accounting accruals

Earnings management exists because the Chinese generally accepted accounting principles (GAAP) permit discretion in reporting decisions. Although the acceleration of revenue and the deferral of expenses fall within GAAP, the recording of fictitious sales, the backdating of sales invoices and the recording of sales before they have been realized violates GAAP and the law.

Earnings can be managed by using discretionary accruals, implementing changes in accounting methods or capital structure, or the proper management of the timing of non-recurring transactions. Compared to the changing of accounting methods – from FIFO (first in, first out) to LIFO – discretionary accruals allow leeway in the reported amounts and are less visible and likely to be undone by the taxing authority.

The tracing of income differences caused by discretionary accruals can be difficult because the enforcing agency may not have enough information to make the adjustments. GAAP allows a firm to structure financial transactions that affect the timing of income and cash flows to produce a more appropriate accounting figure for tax purposes.

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Measure of discretionary accruals

Earnings management can be measured through current accruals, which are captured by annual changes in accounts receivable and inventory minus annual changes in accounts payable and accrued expenses. Based on this equation, increasing accounts receivable and inventory to accelerate revenue or decrease accounts payable and accrued expenses to defer expenses (or both) will cause accruals to be positive. When using accruals to accelerate financial statement income in anticipation of a tax rate increase, current accruals in the year immediately before the year of the rate increase will be positive.

Evidence

To find out whether firms engage in tax-induced earnings management, 112 foreign-funded enterprises in China were analyzed. The results of the study were published in *The International Journal of Accounting*, issue 41, and are summarized below.

The results suggest that these firms report mean current accruals of seven percent of assets for the years before the increase in tax rates, which is about five percent higher than the accruals that are reported for the years in which tax rate increases are in effect. The firms reported significantly higher discretionary current accruals before the tax rate increase.

The magnitude of accruals is related to the level of tax rate in a way that is consistent with tax-motivated income shifting behaviour. The results indicate that firms in the years before the tax rate increase report discretionary accruals that are, on average, one percent higher than the discretionary accruals that are reported in the years in which the tax rate increased.

In terms of economic effects, a 15 percent spread in tax rates allows firms to save taxes that equate to approximately 0.15 percent of their total assets. These results demonstrate that firms manage earnings upward to take advantage of lower tax rates that are available in certain years.

Tax concessions are the most popular type of tax inducement to be employed in developing economies. Concern has long been expressed that developing countries forego too much revenue through tax concessions, and the ability of corporate managers to avoid taxes through earnings management creates additional constraints on the fiscal revenue of these countries.

The study may be of interest to tax policymakers in enforcing rules that are designed to prevent abusive tax avoidance. For example, given that changes in tax rates create incentives for firms to record transactions in one period rather than another, government tax inspectors should closely scrutinize the exact timing of transactions in the periods surrounding the tax rate revision.

The results also have implications for external auditors, who often face conflicting demands by being asked to give tax minimization advice and detect material cases of earnings management.

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