Real Earnings Management and Tax Considerations: A Conceptual Analysis

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Abstract

This study analyses the relevance of tax consideration in earnings management (EM) by proposing a framework that integrates tax planning and tax disclosure aspects, in real earnings management (REM) model. Tax planning plays a core part in EM, whereby both tax planning and EM attempt to minimize the tax expenses. The quality of tax disclosure mitigates the agency problem, thus reducing the EM. In line with the political cost hypothesis, prior studies concluded that companies with a high tax burden tended to manage earnings; therefore, a positive relationship between tax planning and REM exists. However, increasing the transparency in the tax disclosure would likely mitigate the problem of information asymmetry, and thus, according to the Agency Theory, there is an inverse relationship between the REM and tax disclosure. It is hoped that tax consideration would add to EM literature and enhance a better understanding of EM in the real world.

Keywords: Real earnings management, Tax planning, Tax disclosure

1. Introduction

During the firms' scandals within the last decade, such as WorldCom, Enron, Qwest and Tyco, etc., accounting information presented to investors has undergone more scrutiny. One field that has attracted a special focus has been the accounting for tax because of worries concerning the absence of transparency and the perceived violations in tax considerations (Gupta, Laux, & Lynch, 2016) In this regard, Robert Herz (the senior member of Financial Accounting Standards Board, FASB) reported that the variety in practice and opacity of revealing the possible tax liabilities presented an opportunity to manage the earnings (as cited in Gupta et al., 2016). Several accounting researches worldwide have indicated that managers have strong motives to engage in tax and earnings management. For instance, firms manage earnings to satisfy the requirements of debt covenants, compensation contracts, government and stock exchange regulations, stock market pricing (Healy & Wahlen, 1999; Fields, Lys, & Vincent, 2001), as well as amplifying the stockholders' wealth (Blouin, 2014; Graham, Hanlon, Shevlin, & Shroff, 2014), decreasing the political cost and tax scrutiny's risk (Watts & Zimmerman, 1978; Fields et al., 2001), and meeting tax-based contract motivations like post-tax compensation plans (Phillip, 2003). Hence, discovering tax planning and earnings management activities is necessary in studying the management behaviour and estimating the quality of earnings (Tang & Firth, 2011). Previous accounting studies have provided evidence that companies utilize the accrual for income taxes and include the reserve for income taxes to manipulate earnings with the aim of meeting the expectations of the analyst (Dhaliwal, Gleason & Mills, 2004; Frank & Rego, 2006; Gupta et al., 2016).

Regarding tax disclosure, it has an impact on firms’ performance, cash flow, and earnings, which could be also a manner to reduce any political costs. Hence, the political cost hypothesis demonstrates why many firms perform voluntary social and environmental disclosures in their annual statements (Mgammal & Ku Ismail, 2015). Further, the political cost hypothesis also interprets why other stakeholders, who need more information related to the corporate tax policies and requirements for raising scale of disclosure for pioneer firms, adopted tax disclosure strategies (Deegan & Hallam, 1991).

Some studies have exhibited that improving the disclosure by the management will minimize the risk of bad practices (Omar, Rahman, Danbatta, & Sulaiman, 2014), and that disclosure regulation would alleviate the magnitude of the discretionary accruals (Hwang, Chiou, & Wang, 2013), whereby the magnitude of the information disclosure is negatively associated with earnings management (Lin & Rong, 2012; Cassell, Myers, & Seidel, 2015; Lakhal, 2015; Liu, Hsu, & Li, 2015). Other studies have examined the relationship between earnings management and various factors, such as environmental disclosure (Patten & Trompeter, 2003; Sun, Salama, Hussainey, & Habbash, 2010), voluntary disclosure (Kasznik, 1999; Jog & McConomy, 2003), mandatory disclosure of auditor fees (Chen, 2016), internal control information disclosure quality (Ying, 2016), internal control weakness disclosure (Ji, Lu, & Qu, 2017) and corporate social responsibility disclosure (Prior, Surroca, & Tribó, 2008; Cahan, 2011). However, only few limited studies have investigated the effect of tax planning and tax disclosure on real earnings management.

The current paper provides a theoretical discussion on the relationship between tax disclosure and tax planning with real earnings management. Hence, a conceptual framework taking into account the relationship between tax disclosure and tax planning with real earnings management is proposed. This research area implies great significance since taxation is a critical matter. In this regard, Revsine, Collins and Johnson (2002) reported that an increase in a deferred tax liability could signal an impairment of the quality of the earnings. In addition, the authors reported that the analysts can utilize tax footnotes to extract information which is not clearly revealed in the financial reports in order to better understand the company's performance and future outlooks. Moreover, Powers, Robinson, and Stomberg (2016) stated that managers basically focus on tax policies that decrease gross tax expense with only a secondary concern in policies that decrease cash outflow. Further, Dhaliwal et al. (2004) indicated that because the income tax expense is closed when the date of the profits is about to be announced, it gives managers an ultimate chance to manipulate the earnings. Therefore, some recent studies have suggested that the investigation of firms' reactions to the changes in the tax rate under the earnings management practices could probably represent an interesting research area (e.g. Yamada, 2016; Sundvik, 2016). Similarly, Powers (2016) recommends examining the role of corporate governance (CG) in deterring earnings management by considering the tax effect. In addition, Widiatmoko and Mayangsari (2016) and Sundvik (2017) recommended conducting further researches on the relationship between tax planning and earnings management by expanding the scope of the study and using different techniques of earnings management instead of accrual-based earnings management. Due to the importance of the current research area, this study would possibly draw the attention of researchers, academics as well as the company's auditors and lawmakers.

The current study is organized as follows. The next section highlights the relevant literature on earnings management, tax considerations and their relationships. Section three presents the proposed framework and the concluding remarks are given at the end.

2. Literature Review

2.1 Real Earnings Management

Earnings management takes place when the management manipulates its judgment in the preparation of the financial statements, and rearranges transactions to change accounting reports to either misguide stakeholders about the underlying financial position of the firm or impact the contractual results that rely on accounting outcomes significantly (Healy & Wahlen, 1999). However, such practices are not against the regulations (Defond & Zhang, 2014) and are motivated by managerial opportunism to get advantages of the compensation plans (DeAngelo, 1988; Jiraporn, Miller, Yoon, & Kim, 2008; Blacconiere, Frederickson, Johnson, & Lewis, 2011). Managers tended to maximize the reported earnings in order to portray the company's outperformance and gain incentive payments such as remunerations or reduce the current share price in order to get more interests from the employees' stock option plan (Tangjitprom, 2013). Consequently, earnings management is a widespread phenomenon; therefore, it has attracted the interest of several studies to highlight the earnings management activities (e.g. Dechow & Sloan, 1991; Roychowdhury, 2006; Cohen, Dey, & Lys, 2008; Zang, 2012; Ipino & Parbonetti, 2016). These studies have showed how the earnings management misrepresented the financial reporting available to stakeholders, thus negatively impacting their decision making (e.g. Healy & Wahlen, 1999; Cohen et al., 2008; Zang, 2012) and the firm's value (Graham, Harvey & Rajgopal, 2005; Badertscher, 2011; Tangjitprom, 2013). Since the earnings management was at the core of the financial scandals of early 2000, these scandals have led the investors to lose confidence in the financial information prepared by the companies (Saleem, Alifiah & Tahir, 2016).

Previous researches have provided evidence that firms have switched from utilizing Accrual-based Earnings Management (AEM) to Real Earnings Management (REM) (Ewert & Wagenhofer, 2005; Graham et al., 2005; Roychowdhury, 2006; Lin & Chien, 2016). In this regard, Cohen and Zarowin (2010) defined REM as the manager's procedures that deviate from normal transactions activities. However, the best definition of REM is presented by Roychowdhury (2006) who calls it as such “management actions that deviate from normal business practices, undertaken with the primary objective of meeting certain earnings”. REM, as Roychowdhury (2006) added, may also mean the violation of normal operational activities that aimed at misguiding the stakeholders and getting the approval of certain financial reporting objectives. Following this definition, certain techniques can be used to manipulate the earnings by real activities, including discretionary expenditures reduction, announcing a major percentage of discounts on sales, optimally under certain economic circumstances.

Several motives have led the managers to switch from accrual-based to real earnings management. In this context, according to Gunny (2010), some reasons lie behind managers’ preference for using REM instead of AEM. For instance, (1) an aggressive accrual-based method may result in subsequent litigation and regulatory scrutiny. Second, (2) firms have a few choices in manipulating earnings to report discretionary accruals, and finally (3), an accrual-earnings management must take place at the quarter or end of the financial year, and managers encounter uncertainty regarding which accounting methods the auditor will permit at that time. In addition, Zang (2012) indicates that firms choose REM according to the relative costs of each method. However, Evans, Houston, Peters and Pratt (2015) report that managers of U.S. companies that adopt the Generally Accepted Accounting Principles (GAAP) prefer to use AEM, whereas the study that was conducted in the Tunisian context showed that the companies use AEM and REM interchangeably (Chouaibi & Harres, 2016).

Managers can use three strategies of real earnings management (Roychowdhury, 2006), namely (i) avoiding earnings decline and decreasing the reported cost of goods sold by overproduction, (ii) reducing other operating expenses through decreasing the discretionary expenditures, and (iii) increasing sales value temporarily by boosting discounts percentage or offering more lenient credit terms. These strategies can control a firm’s discretionary expenditures, its cash flow from operations, and manage the production costs to deviate from their actual levels. Each of the sales manipulation and overproduction causes abnormal high production costs relative to the value of sales and lessens the discretionary expenditures, thus leading to decrease the discretionary expenditures compared to sales (Zhao, Chen, Zhang, & Davis, 2012).

Numerous studies have indicated that the corporate governance mechanisms are among the major factors that alleviate the level of REM (Osma, 2008; Zhao et al., 2012; Ge & Kim, 2014; Chen, Cheng, Lo, & Wang, 2015; Cheng, Lee, & Shevlin, 2016). Other determinants of REM were revealed by previous studies. For example, Cohen et al. (2008) suggested that strict financial reporting standards lead the managers to engage in REM. Similarly, in the Chinese capital market, Ho, Liao and Taylor (2015) indicated that the International Financial Reporting Standards (IFRS) adoption alleviates the extent of discretionary accruals but when encountered with earnings pressure, managers switched to use REM as a substitute. Hence, companies audited by a big audit firm tend to engage more in REM (Chi, Lisic and Pevzner, 2011), whereas lessening the analyst’s coverage stimulates the managers to use less REM (Irani & Oesch, 2016). Though several studies have been conducted to investigate the numerous factors influencing REM activities, the effect of tax considerations still needs further examination and confirmation.

2.2 Tax Considerations

Tax planning and tax disclosure are the two main tax considerations that could be linked to earnings management. Tax planning is defined as tactics, whereby transactions are restructured or reordered to boost either net profit after-tax or net cash flow. These procedures need a high level of experience to understand and identify potential financial effects as well as to ensure an appropriate accounting treatment (McGuire, Omer & Wang, 2012). According to Hoffman (1961), tax planning is defined as the taxpayer’s ability to structure his/her financial transactions in a way that reduces the expense of tax. Tax planning is theoretically known as the effective tax planning that a person must try to get tax savings through the procedure of tax avoidance systematically in accordance with the tax laws (Ifada & Wulandari, 2015). Although tax planning activities are mostly legal, some tax planning activities might fall into a grey zone in terms of legal definitions, such as using unlawful procedures of tax evasion, understating the taxable income or overstating the deductions (Bruce, Deskins & Fox, 2007). Since tax planning is a continuous process to minimise the tax expenditures as much as possible, such process does not mean to escape from taxes or decrease them directly.

Rather, it involves attempts to set a plan in order to reduce the real amount of the tax, which is accomplished by deferring its payment in order to avail benefit from the time value of cash (Alduneibat, Altawalbeh, & Rawhi Hashem, 2017).

As for tax disclosure, it refers to the information that relates to the amount of tax paid by companies which emerges from the calls of activists around the globe (Christians, 2012). Tax disclosure has been also defined as an index used to describe two isolated cases, “The first is the legal requirement to provide current taxation information to relevant party, the second is related to transactions that may be viewed as tax sheltering that must be disclosed to the government” (Francois, 2015). Broadly speaking, financial tax disclosure involves financial reporting. It reveals the income tax benefits and expenditure of a firm, who also interprets the timing of disclosing expenses and benefits. Financial reporting also involves disclosures related to the value of tax incurred at the end of the taxable year and the gross revenue in that year. In addition, the financial reporting involves the effective tax rate and the way it is utilized by the firm in calculating the taxable value (Marian, 2014).

2.3. Tax Planning and Real Earnings Management

The political cost hypothesis that was developed by Watts and Zimmerman (1978) implies that bigger firms undergo more scrutiny, and therefore, manage earnings downwards to decrease the regulatory and political costs. In other words, the state legislation is connected to taxation. Consequently, if a big firm minimizes its earnings, the firm tax will supposedly reduce as well. In addition, the management has fewer motives to pay little tax (Phillips, Pincus & Rego, 2003). In this regard, there is a conflict of interests occurring in the firms.

Several studies have provided evidence that the earnings management is affected by the tax planning, that is consistent with political cost hypothesis. Northcut and Vines (1998) indicated that the political investigation of the effective tax rate represents a motive that impacts discretionary accounting choices. Hence, Wijaya and Martani (2011) concluded that tax incentives, such as net deferred tax liabilities and tax planning, influence earnings management activities engaged by profit-firms. Likewise, firms engage in tax planning activities to avoid the decline of income (Aditama & Purwaningsih, 2014). Several studies have indicated that there are significant interactions between earnings management and tax planning practices (Haw, Hu, Hwang, & Wu, 2004; Desai & Dharmapala, 2009; Hemmelgarn & Teichmann, 2014; Watrin, Ebert, & Thomsen, 2014; Blaylock, Gaertner, & Shevlin, 2015; Ji, 2016; Li, Wang, Wu, & Xiao, 2016). It was, therefore, concluded that the tax planning plays a key part in earnings management decisions. Due to these facts, tax planning can be found linked to the manipulation activity of work and transactions while the taxpayer attempts to minimise taxation under law instructions.

Empirical studies on the relationship between earnings management and tax planning are not only limited; rather, they provide conflicting results. For example, Aditama and Purwaningsih (2014) found that the tax planning has no effect on earnings management. Similarly, two Indonesian studies found that the tax planning has no significant effects on the earnings management (Ifada & Wulandari, 2015; Widiatmoko & Mayangsari, 2016). In contrast, some studies found that earnings management has been induced by a tax planning strategy. For instance, Northcut and Vines (1998) found that the government scrutiny of effective tax rates presents motives that affect the discretionary accounting choices. Besides, Dhaliwal et al. (2004) found that the corporate manipulates earnings by changes in the effective tax rates over the third and fourth quarters. Likewise, Ji (2016) found that the firm reduces the fourth quarter effective tax rate to fit the reported earnings of the previous period. Tax expenses may be a favourable means to manage earnings, whereby Frank, Lynch, and Rego (2009) found a positive relationship between managing earnings upward and tax planning activities. On the other hand, Calegari (2000) suggested that tax planning issues acts as a restriction on the kind of accruals that are utilized for earnings management.

Within the Portuguese context, Marques, Rodrigues, and Craig (2011) studied the relationship between tax planning and earnings management in the Portuguese corporate. A new tax law was issued in Portugal requiring companies to pay a specific amount as income tax in advance, which is calculated based on the sales revenue of the previous year called "Special Payment Account" (SPA). Based on the findings of their study, Marques et al. found that the corporates with higher income tax rates have decreased earnings to near zero. Consequently, corporates with higher income tax rates were more probable to manage earnings compared to the other ones.

Besides, Zimmermann and Goncharov (2006) found that Russian corporates manipulate earnings downwards to decrease the current value of taxes, as well as the higher tax rates enhance the level of tax planning. Also, Alduneibat et al. (2017) found that tax planning influences the performance of the manufacturing firms listed in Amman Stock Exchange. It was concluded based on Alabbadi's (2014) study that the high-income tax rate is the underlying reason for engaging in earnings management activities. Hence, firms manage their earnings to decrease the magnitude of the taxable income.

A relation exists between tax shelter transactions and the accounting frauds, as the incentives of tax frauds and accounting frauds are similar to satisfy the earnings growth aims specified by the market "lying to shareholders and lying to the Internal Revenue Service (IRS) are just opposite sides of the same coin" (Murray, 2002 as citied by Whitaker, 2005, p. 695). However, it is notable that the relationship between earnings management and tax planning to some extent represents a problem since both manipulate the earnings generally in different orientations. The earnings management usually manipulates the earnings upwards (Bartov, Givoly, & Hayn, 2002; Burgstahler & Dichev, 1997), whereas tax planning manipulates them downwards (Hoffman, 1961).

In line with the political cost hypothesis, tax evaders are considered more susceptible to manipulate their earnings as they do it through reporting less earnings (Pettersson & Wu, 2015). The influence of labelling firms as tax manipulators does also not change the extent they manage their earnings in the future. Hence, some studies have confirmed the positive association between tax planning and earnings management by providing evidence that tax planning induces earnings management. Therefore, according to Frank et al. (2009), a positive relationship exists between managing earnings upward and tax planning activities.

2.4. Tax Disclosure and Real Earnings Management

Based on The Agency Theory, there is an information asymmetry between the firm's owners (shareholders) and the agents (managers). Hence, the disclosure is efficient in protecting the lender and the shareholders from management discretion. In addition, the information asymmetry is the core of accounting information crisis, which has also given an opportunity for the earnings management. In this regard, a number of studies (Glosten & Milgrom, 1985; Diamond & Verrecchia, 1991; Kim & Verrecchia, 1994) claim that increasing the level of disclosure leads to a decrease in information asymmetries among management and external investors and between various groups of investors. Other researchers in the late 90s (Dye, 1988; Trueman & Titman, 1988) demonstrated that having an information asymmetry among shareholders and managers is the primary factor to induce earnings management. On the other hand, the rise in disclosure might be utilised to "hype the stock." This evidence suggests that some disclosure is not indeed beneficial for the investors (Kiattikulwattana, 2014).

Due to the scarcity of researches on the relationship between tax disclosure and REM, it is possible to explain such relationship based on the results of prior studies which investigated the relationship between REM and other types of disclosure, i.e. voluntary disclosure, disclosure quality, environmental disclosure, social responsibility disclosure. In this regard, a significant negative relationship is evident between disclosure quality and earnings management activities (Alzoubi, 2016; Katmon & Farooque, 2017). Regardless of the major changes in the financial accounting standards for recognizing, derecognizing and calculating tax reserves within Financial Accounting Standards Board Interpretation No. 48, "Accounting for Uncertainty in Income Taxes FIN 48 ", these still represent a possible instrument for earnings management (Cazier, Rego, and Wilson, 201). In addition, some studies have argued that because some forms of the tax disclosure may contain data from income tax returns of companies, it is possible that companies might distort data in their returns as well as in the forms of disclosure to protect the confidential data against their competitors (Mazerov, 2007). In addition, taxpayers are also capable of manipulating taxable income to avoid the disclosure, thus falsifying their taxable income in order to reduce it under the disclosure threshold (Hasegawa, Hoopes, Ishida, & Slemrod, 2013).

Regarding the relation between tax disclosure and earnings management, only few studies have examined such relationship. For instance, Caballe and Dumitrescu (2016) indicated that the disclosure of the tax reports is helpful for market performance. In their study that focused on tax disclosure and voluntary financial disclosure, Probohudono, Sudaryono, Sumarta and Ardilas (2015) found that tax disclosure positively affects the financial disclosure, thus enhancing the quality of financial reporting. On the other hand, Cazier et al. (2015) investigated the effect of FIN 48 and Sarbanes–Oxley Act of 2002 on earnings management by income tax reserves and found that neither FIN 48 nor SOX decreased the earnings management. As a result, several empirical studies have confirmed the negative association between the voluntary disclosure and earnings management (Riahi & Ben Arab, 2011; Lin & Rong, 2012; Hwang et al., 2013).

It seems that disclosing information related to tax in the financial statements of firms is more beneficial for investors in comprehending the tax status of the firm and encouraging the public to realize tax returns. In addition, tax disclosure might encourage firms to resist aggressive tax lessening activities (aggressive tax planning) and could make pressure on policymakers to improve the tax system, thus contributing to enhance the performance of the capital markets (Lenter, Shackelford, & Slemrod, 2003; Mgammal & Ku Ismail, 2015)

Besides, Tran (2015) argued that the disclosure of taxable income indirectly or directly in financial reports will assist the corporate regulators and public verify the reliability of the reported book income, restrain aggressive earnings management, and engage in a better performance of the capital markets. Tran's study suggested that tax disclosure assists in enhancing sound tax risk management and promoting the corporate governance. Hoopes and Shroff's (2014) study also reported that the boost of tax authority enforcement decreases the probability engaging in tax avoidance activities. Consequently, increasing the tax authority enforcement may have an indirect impact on the earnings management, thus affecting the financial reports quality.

3. Proposed Research Framework on Earnings Management

As discussed above, several studies have confirmed the interaction between tax planning and earnings management (Haw, Hu, Hwang, & Wu, 2004; Desai & Dharmapala, 2009; Hemmelgarn & Teichmann, 2014; Watrin, et al., 2014; Blaylock, et al., 2015; Ji, 2016; Li, et al., 2016) and tax disclosure with earnings managements (Hasegawa et al., 2013; Cazier et al. 2015). According to Alabbadi (2014), the underlying reasons for earnings management are a high-income tax rate and companies' management of earnings to reduce the amount of taxable income. In Jordan, Alduneibat et al. (2017) suggested that the performance of firms is affected by tax planning. The most recent relevant literature on earnings managements also pointed out that firms' reactions to specific tax changes, such as tax rate changes, represent an interesting area to the researchers (e.g.Yamada, 2016; Sundvik, 2016). Similarly, Powers (2016) recommended researchers to examine the role of corporate governance in deterring earnings management by taking into account the tax expenses. Studying the relationship between tax planning and earnings management has been also recommended by recent studies (Widiatmoko & Mayangsari, 2016; Sundvik, 2017).

Although many studies have been conducted on the relationship between the corporate governance mechanisms and the real earnings management, the role of both tax planning and tax disclosure have been neglected in such relationship. Hence, this study suggests that tax planning and tax disclosure should be considered in examining its relationship with REM.

4. Conclusion

Taxation is doubtlessly necessary for the government and firms at the same time; with both parties have a symmetric attention related to tax. For the government, the tax is considered its source of revenues, whereas tax decreases the net income of firms. Taxation may also negatively impact a company's financial performance, financial position, operational results, cash flows, and liquidity (Dhaliwal, Newberry, & Weaver, 2005). Thus, managers occasionally use earnings management activities to control their earnings (Mulyadi & Anwar, 2015).

Briefly, this study attempts to explain the possible effect of tax planning and tax disclosure on earnings management. There is a notable scarcity of studies not only in developed countries but also in the emerging countries concerning the direct relationship between tax planning and tax disclosure and real earnings management. Hence, this study presents some recommendations. First, future researchers might extend the empirical study to investigate the impacts of tax disclosure and tax planning on REM. Second, future researches may apply the proposed framework in the context of the emerging markets. It is hoped that the findings of such studies would provide empirical evidence on the relevancy of tax considerations to earnings management.

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