ACCOUNTING FOR AND PERCEPTIONS OF EXPENSING

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Main Questions:

1. What are the effects on financial accounting statements from full expensing under current rules?

2. Would full expensing change the accounting outcomes?

3. What evidence is in the literature about the managerial tradeoff between accounting outcomes and tax outcomes?

Example

- A company with taxable income before depreciation of $11,000.
- Only book-tax difference is depreciation.
- Purchase a five-year asset for $5,000.
- Tax depreciation is $2,000 (ignore half-year convention)
- Accounting depreciation is $1,000.
- Tax rate is 30%.

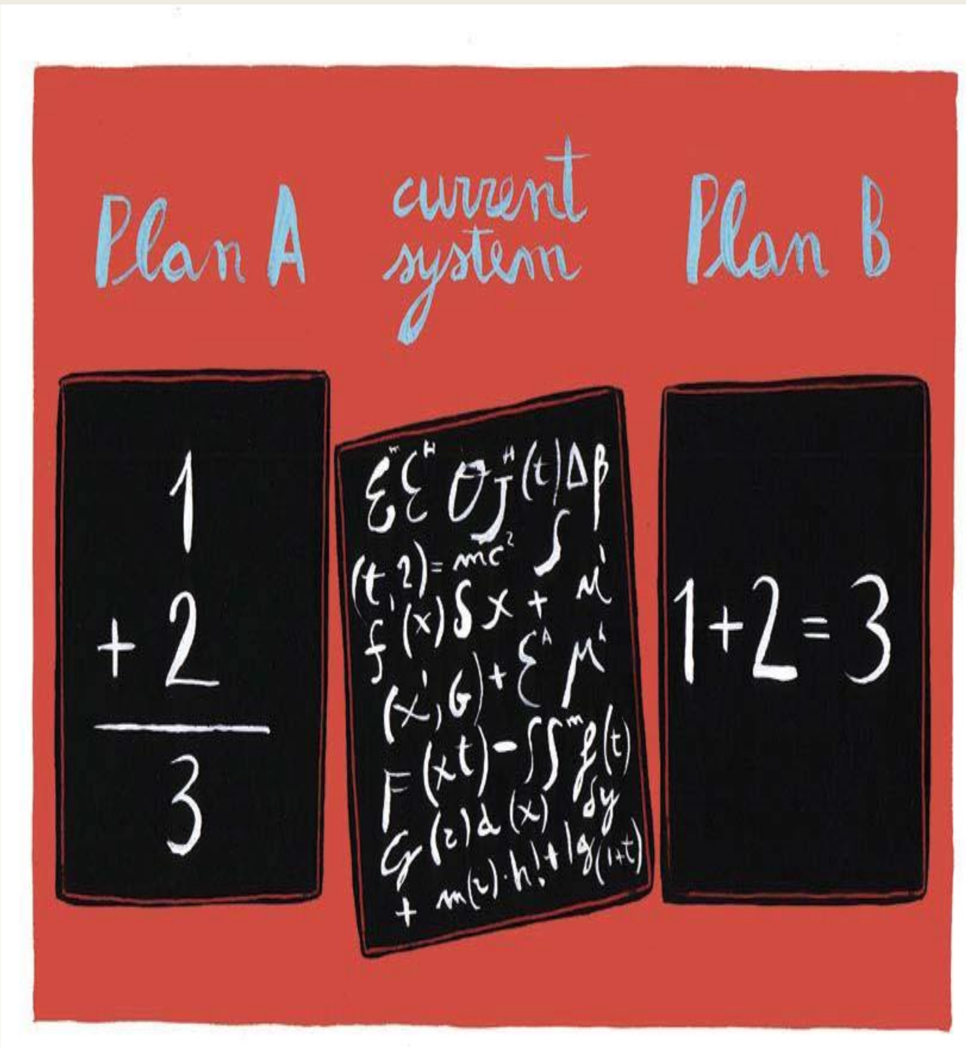
Example – Current Rules

	Tax	Accounting
Income before depreciation	11,000	11,000
Depreciation expense	2,000	1,000
Taxable income and pre-tax accounting income	9,000	10,000
Tax rate	30%	
Tax	**2,700**	
Accounting income tax expense		
Current tax expense		2,700
Deferred tax expense (BTD of $1,000 * 30%)		300
Total tax expense for accounting purposes		**3,000**
Net income		7,000

Example – Full Expensing

	Tax	Accounting
Income before depreciation	11,000	11,000
Depreciation expense	5,000	1,000
Taxable income and pre-tax accounting income	6,000	10,000
Tax rate	30%	
Tax	**1,800**	
Accounting income tax expense		
Current tax expense		1,800
Deferred tax expense (BTD of $4,000 * 30%)		1,200
Total tax expense for accounting purposes		**3,000**
Net income		7,000

President Bush's Tax Reform Panel



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Two (or more) Possible Outcomes for Accounting Standards (my opinion)

- It is possible, depending on the details, that FASB would consider such an overhaul a consumption tax.
  - The tax would then be outside of the scope of ASC 740 (SFAS 109) and the new tax would not be accounted for as an income tax.
  - FASB has a subset of staff designated to evaluate tax reform and consider the possible necessary accounting standard changes.
- It is possible FASB would consider discounting deferred tax assets and liabilities to reflect time value of money.

My Best Guess...

- It will really depend on the details of the reform. Will the new regime be an income tax or a consumption tax?
- If we stay with an income tax, discounting is possible, but it would be complicated.
  - When SFAS 109 was put in place, discounting was mentioned.
    - “Most respondents …opposed discounting deferred income taxes.”
    - “Conceptual issues, such as whether discounting is appropriate, and implementation issues associated with discounting income taxes are numerous and complex. Implementation issues include selection of the discount rate(s) and determination of the future years in which amounts will be taxable or deductible.”

Question then...

- Because publicly traded corporations still have to show a tax expense -- indeed, an undiscounted tax expense, on their income statement -- does this temper (eliminate?) the investment incentives provided by the tax policy of full expensing?

Based on my research and that of others my conclusion to this is: YES!
The accounting effects mitigate the incentives and this varies across types of firms and maybe across time.

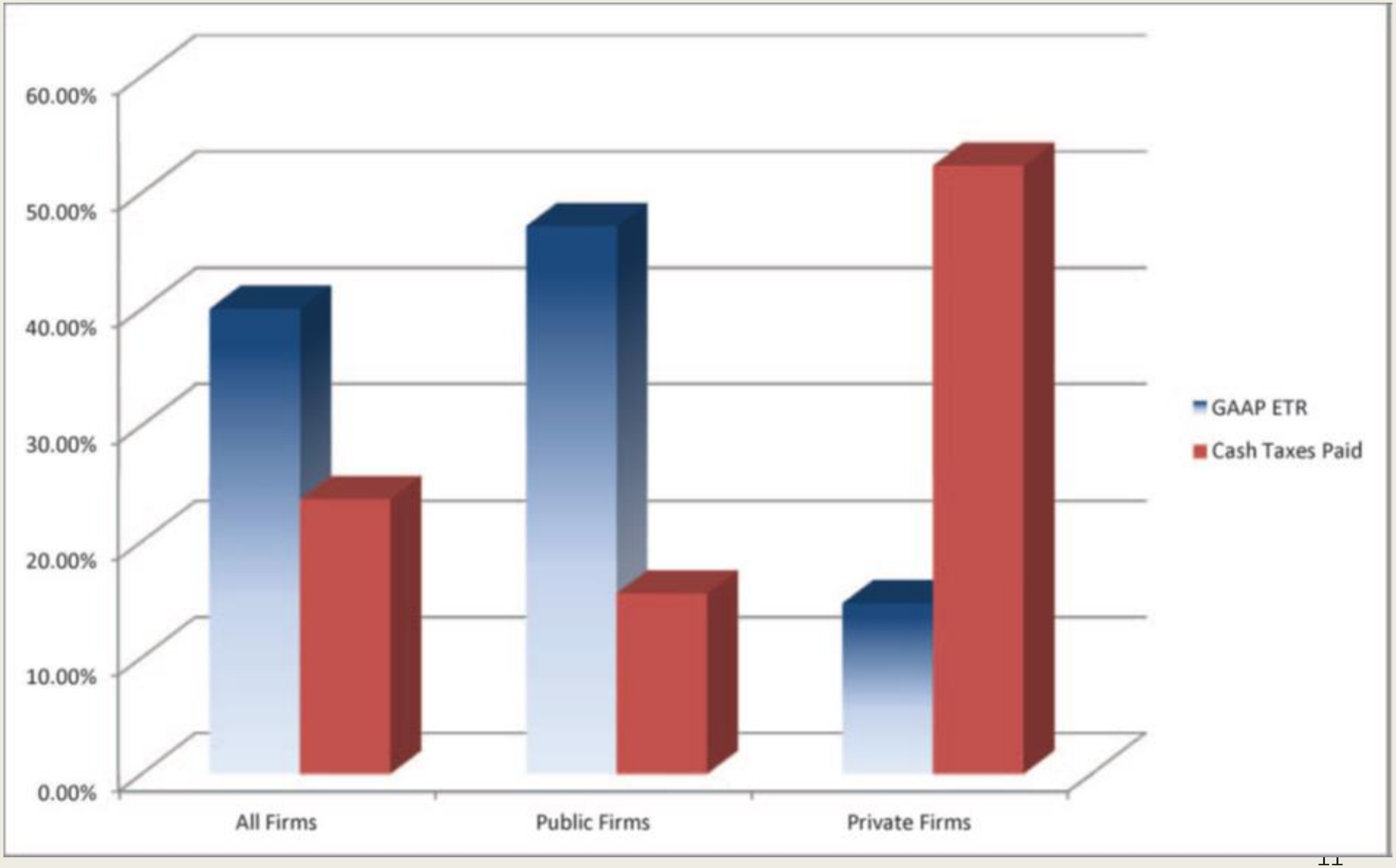
Accountants have known this general result for a long time

- Long-line of literature – book-tax tradeoff literature
  - LIFO/FIFO studies (also inventory capitalization)
  - ISO disqualifications
  - TRUPS/MIPS
  - Firms willing to pay taxes on fraudulently reported earnings

- Firms make accounting method, reporting, and real choices to maximize accounting earnings rather than, or in addition to, doing so to save taxes. In other words, firms will pay taxes (and/or other costs) to report higher accounting earnings.

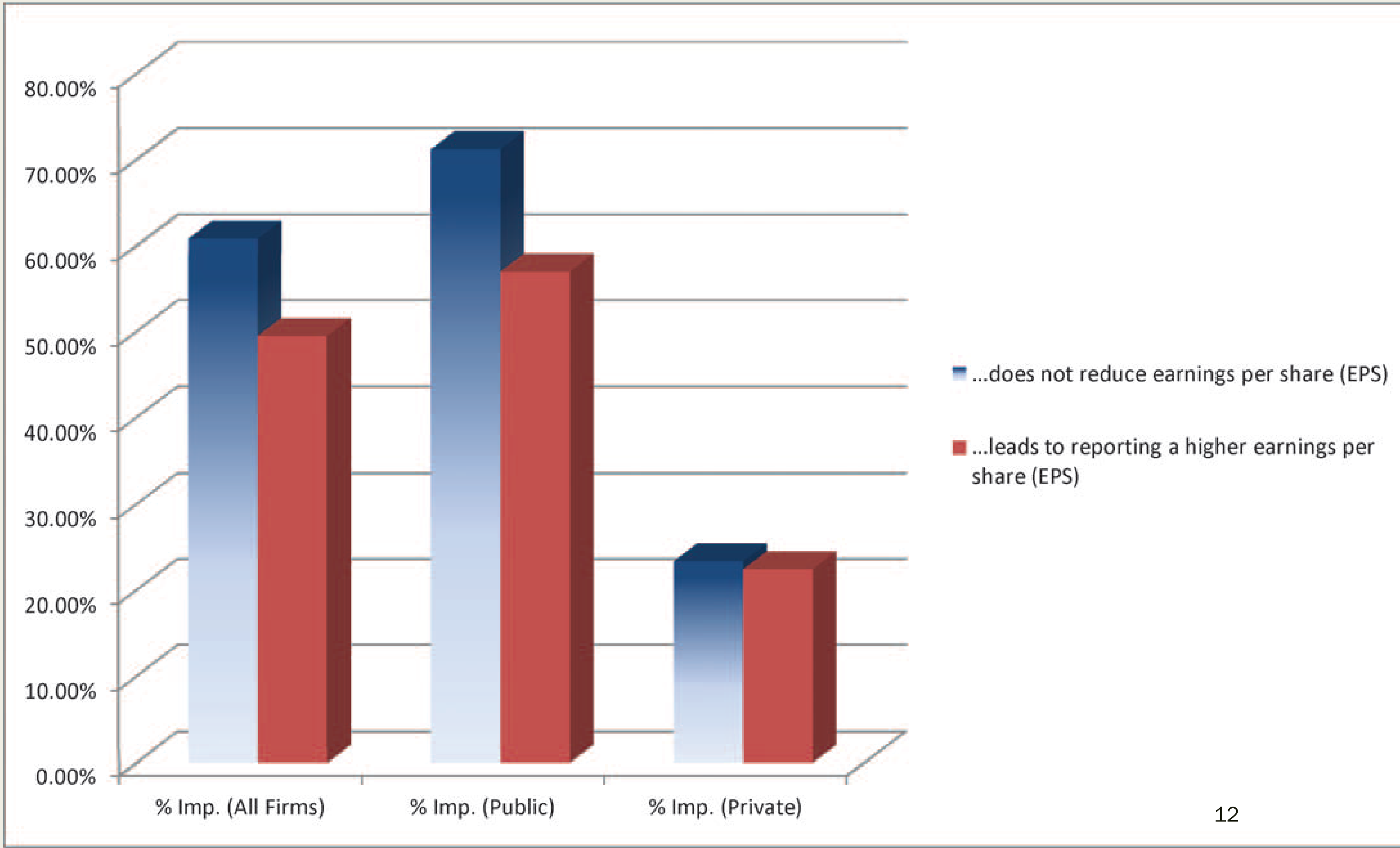
Survey of Corporate Tax Executives (Graham, Hanlon, Shevlin and Shroff (2 papers)):

Which metric is more important to top management at your company?
U.S. Companies (N=595)



Survey of Corporate Tax Executives (Graham, Hanlon, Shevlin and Shroff (2 papers)):

When evaluating a tax planning strategy that saves cash taxes, how important is it that the tax planning strategy. . .



Foreign Investment and Repatriation

- We also asked tax executives about the importance of the deferral of U.S. cash taxes and the financial accounting expense deferral under APB 23 when deciding where to locate operations and whether to repatriate foreign earnings.
  - The two factors are equally important in our sample.

- Anecdotal evidence: James Tisch, CEO of Loews, wrote a letter to the editor of the *Wall Street Journal* stating that, "…The results of the interaction of our repatriation tax laws and the GAAP accounting rules is that very little in the way of foreign earnings are repatriated….The accounting penalty for repatriating even a penny of foreign profits is so great that those foreign funds will not come back to the U.S.…" (July 5, 2008).

We also asked: What is the primary tax rate your company uses to incorporate taxes into each of the following forecasts or decision making processes?

	U.S. Statutory Tax Rate (STR)	GAAP ETR	Jurisdiction Specific STR	Jurisdiction Specific ETR	Marginal Tax Rate	Other	N
Merger &Acquisition Decisions	21.1%	24.9%	20.3%	20.1%	10.1%	3.4%	497
Capital Structure (debt vs equity)	25.9%	29.7%	14.5%	15.3%	12.0%	2.7%	491
Investment Decisions	22.9%	24.5%	21.1%	16.0%	12.5%	3.1%	489
Decision to Purchase vs. Lease	23.9%	23.7%	20.3%	16.4%	12.3%	3.5%	489
Weighted Average Cost of Capital	25.4%	34.3%	13.4%	12.6%	11.8%	2.5%	484
Where to Locate New Facilities	17.0%	16.6%	28.8%	25.9%	8.8%	2.9%	487
Compensation	25.7%	27.2%	19.1%	12.9%	10.6%	4.6%	482

New Survey of Manufacturers

- Very preliminary – not closed yet
- Roughly half public and half private firms
- Number 1 response in terms of tax priorities: lower the statutory rate
- Not until we get to third – fifth most important priorities for tax reform do we get to anything about expensing:
  - 4 out of 32 companies mentioned Bonus, Section 179, or immediate expensing
  - 5 out of 32 said to retain interest expense deduction
- Asked them to focus in on how important immediate expensing is on its own, ignoring interest expense deduction and all else.
  - 80% said important or very important to them
  - Asked why not – companies said:
    - No accounting benefit because of deferred accounting
    - Will lead to tax losses
- Would full expensing lead to more investment:
  - 50% said yes, 26% said no, 24% not sure

Conclusions

- Accounting matters.

- Evidence suggests that responsiveness to tax policy would be greater if policy is designed such that the tax benefits can be recorded for financial accounting.
  - Target permanent differences in designing tax policy rather than temporary differences.
    - ITC versus accelerated depreciation (e.g., Edgerton, 2012).
    - Dividends paid deduction (SFC).
  - Focus on a lower STR.