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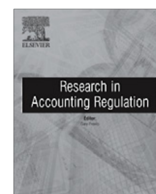

Research Report

The relation between aggressive financial reporting and aggressive tax reporting: Evidence from ex-Arthur Andersen clients

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ABSTRACT

We investigate the economic trade-offs managers face due to conflicting incentives to report high financial statement book income and, at the same time, report low taxable income. Our setting involves Houston clients of Arthur Andersen (AA), who have been shown to exhibit a culture of aggressive financial reporting. Using our sample of AA Houston clients, we test two competing theories: (1) firms which have a culture of aggressive financial reporting are also aggressive in their tax reporting, versus (2) firms which are willing to pay real dollars (taxes) to report higher financial statement earnings. We do not find support for either theory. Instead, our findings suggest a middle-ground: firms may exhibit a culture of aggressive financial reporting without impacting their relative tax reporting. Our findings not only shed light on the intersection of financial and tax reporting, but they also add to the extant literature involving the culture of AA. To the best of our knowledge, this is the first paper to investigate the tax ramifications of AA's culture of aggressive financial reporting.

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Introduction

Financial reporting and tax reporting, in general, are subject to contradictory pressures. Managers face pressures from shareholders and analysts to report high financial income. At the same time, managers have a fiduciary duty to act efficiently in their spending; one way cash may be conserved is by reporting low taxable income. Thus, the intersection of financial and tax reporting allows academics to ponder whether managers will pay (in tax dollars) for higher financial earnings, or, if aggressive reporting is a pervasive trait across both sets of books.

Many studies involving the intersection of financial and tax reporting are conducted in settings of known aggressive financial reporting. The impact of such aggressive financial reporting on taxes is examined within the context of such settings. Findings from these studies yield mixed results. Erickson, Hanlon, and Maydew (2004) study the tax implications of firms which committed financial accounting fraud. By comparing original and restated financial statements, the authors find that the mean (median) income taxes paid on each dollar of overstated earnings was approximately 11 (eight) cents. These findings suggest that firms are willing to pay for overstated income. On the contrary, Frank, Lynch, and Rego (2009), in a larger sample of 49,886 firm-year observations, find that firms which are aggressive in their reporting of financial income are simultaneously aggressive in their reporting of taxable income. Thus, Frank et al.'s findings suggest that aggressive reporting behavior may be a pervasive trait across both sets of books.

Similar to prior studies of the intersection of aggressive financial and tax reporting, we employ a setting where the auditors have been known to allow aggressive financial reporting, and examine relative differences in tax reporting within the context of such setting. Specifically, we examine

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the tax reporting of Houston clients of Arthur Andersen (AA), vis-à-vis a control sample of Houston clients of other Big 5/6[1] audit firms, during the five-year period 1996–2000. As discussed in more detail herein, former AA employees and recent literature on the firm have discussed how the firm's culture changed over the years allowing clients to make aggressive financial reporting decisions. In addition, some partners in the AA Houston office went against mandates of the national AA office (Schmidt, 2002), exhibiting their willingness to tolerate aggressive reporting practices. Furthermore, a recent study finds that AA's Houston clients exhibited relatively less timely loss recognition (Krishnan, 2005) relative to Houston clients of other Big 5/6 auditors during a similar time period.

In our analyses, we find that Houston clients of AA were neither more nor less aggressive in their tax reporting, relative to a control sample of Houston clients of other Big 5/6 firms. Specifically, we find that the level of tax aggressiveness of Houston AA clients was similar to that of geographically close firms. As such, our findings suggest that firms are making financial reporting decisions that do not cost the (relative) tax dollars.

Our study contributes to three branches of literature. Primarily, as mentioned above, we contribute to the literature which examines the intersection of financial and tax reporting, and the economic tradeoffs which are faced in these crossroads. We additionally contribute to the literature which studies the unique culture of AA, as well as the quality of AA's clients' earning reports (see, for example, Chaney & Philipich, 2002; Krishnan, 2005; Cahan & Zhang, 2006). Finally, we extend the literature which investigates the impact of an audit firm on tax reporting (see, for example, Maydew & Shackelford, 2005; Omer, Bedard, & Falsetta, 2006; Lassila, Omer, Shelley, & Smith, 2010; Cook & Omer, 2010).

Background and literature review

The rise and demise of Arthur Andersen

Arthur Andersen was founded by Arthur E. Andersen and Clarence DeLaney, and was originally known as Andersen, Delaney & Company. In 1918, Arthur E. Andersen gained sole ownership of the company due to DeLaney's resignation. The founding principles of AA rested upon the integrity of the firm and the responsibility of the firm to serve investors. The original values of the firm entailed the following three main principles: (1) integrity and honesty; (2) one firm, one voice partnership model; and (3) training to a shared method (Squires, Smith, McDougall, & Yeack, 2003).

Over the years, until his death in 1947, Arthur E. Andersen expanded the company nationally, establishing new offices in every major U.S. city. During the 1970's, the firms consulting services practice grew and created a new challenge for AA, as it struggled to balance the high revenue generating consulting business with the "bread-and-butter" accounting practices. The firm adopted a more sales-focused culture leading to a change in the firm's values, increasing levels of acceptable risk with clients, and raised the potential for conflicts of interest (Squires et al., 2003). There also was an internal competitiveness in the firm that focused on generating revenues. For example, if fees were opposed by the client, "the most likely scenario was a project completed in as short a period of time as possible, with as any inexperienced lower-paid people doing the work as possible" (Toffler & Reingold, 2003).

In sum, there were many factors at play which caused AA to shift from its original values to a more aggressive mentality. It is this later, more aggressive mentality, which became more prominent in the late 1990's, which we study herein. Specifically, we study what impact, if any, this aggressiveness had on tax reports.

Arthur Andersen, Houston and aggressive financial reporting

We conduct our research by examining the levels of aggressive tax reporting of Houston clients of AA, vis-à-vis Houston clients of other Big 5/6 auditors. We have chosen the Houston AA office as our setting for this study for a number of reasons. First of all, empirical research suggests that AA's Houston based clients were more aggressive in financial reporting relative to clients of other auditors and other geographic locations. Krishnan (2005) finds that clients of AA's Houston office delayed recognition of publicly available bad news, relative to a control sample of Houston-based clients audited by other Big 5/6 auditors. In a related, follow-up study, Krishnan (2007) finds that financial statement conservatism increases for former Houston-based AA clients, following the demise of AA.

As noted by Krishnan (2005, 2007), there are additional reasons to focus on Houston-area AA clients when trying to isolate aggressive financial reporting, beyond the empirical findings above. First, some Houston AA partners chose to ignore advice and guidance from AA headquarters, and displayed, at times, aggressive interpretation of accounting rules (Schmidt, 2002). Second, Enron and Waste Management were clients of the Houston AA office. Both firms were charged with massive accounting fraud by the Securities and Exchange Commission (SEC). Enron's restated financials revealed that it overstated income during the years 1997–2000 by approximately $600 million, while Waste Management's restated financials reveal that it overstated income during the years 1992–1996 by approximately $1 billion. Third, Chaney and Philipich (2002) examine stock price changes of AA's clients surrounding AA's admission of document destruction. They find that the largest negative reaction occurred with the Houston office clients. Finally, Francis, Stokes, and Anderson (1999) explore the usefulness of conducting audit research using city-level markets, as opposed to using aggregate national data. The authors find that, within the Big 5/6 auditor group, national data obscures important city-level variations.

In sum, our test setting is similar to that of other studies regarding the financial statement implications of AA's unique culture. Firm chronicles and empirical research

[1] Price Waterhouse merged with Coopers & Lybrand on July 1, 1998, causing the "Big 6" audit firms to become the "Big 5". Our sample period is 1996 through 2000, and thus spans both the Big 6 and Big 5 periods. As such, we refer to the Big 5/6 throughout.

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