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Economic View

# Why Let the I.R.S. See What the S.E.C. Doesn't?

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IMAGINE a company that makes a practice of keeping two sets of accounts. One version is revealed to the public through periodic Securities and Exchange Commission filings and public announcements. The other is never made public and conveys a markedly different picture.

Does it sound scandalous? Actually, it's common practice.

It isn't as if companies are breaking the law. Public companies are required by the S.E.C. to keep their books in accordance with generally accepted accounting principles, or GAAP, and to announce their results each quarter. At the same time, companies keep a separate and confidential set of books according to rules established by the Internal Revenue Service. These accounts seldom match. After all, companies typically have an incentive to state the highest possible earnings under GAAP and the lowest possible under tax rules.

Economists have long understood that profits reported to the I.R.S. may be a more reliable guide than those reported to the S.E.C. and scrutinized on Wall Street. The public presentation of accounts involves the exercise of an accountant's judgment on such topics as the useful life of assets, the probability of uncertain events and the fair value of property. Each exercise of judgment, on which reasonable people may differ, offers a degree of flexibility in the final reporting of results.

In general, tax rules are less lenient. That is because allowing companies too much leeway in stating how much tax they owe would make collecting taxes difficult. So when economists analyze corporate profits, they tend to focus on a measure derived from corporate tax returns. Unfortunately, the government publishes only aggregate data, so it is impossible to know what any particular company made, or paid, under I.R.S. rules.

It doesn't have to be that way. Companies already have basic tax information at hand that could be released to the public without imposing significant costs. And some experts say they believe that the benefits to investors, regulators and the overall tax system could be substantial.

A study published in 2003 concluded that the benefits of disclosing additional tax information would outweigh any costs. It was conducted by David L. Lenter, a lawyer now on the staff of the Congressional Joint Committee on Taxation; Joel B. Slemrod, an economist at the University of Michigan; and Douglas A. Shackelford, an accountant at the University of North Carolina.

In the study, published in the *National Tax Journal*, they quickly agreed that corporate tax returns, which can run into thousands of pages, should not be exposed in their entirety. That could reveal sensitive information that companies have a legitimate need to keep private, they said.

But a simple presentation of summary information — the bottom-line numbers, for example — would have many attractions. Even better, companies could release a simplified version of a schedule that they already prepare. The I.R.S. currently requires companies to reconcile the differences between the numbers on their financial reports and the corresponding amounts on their tax return, but so far those reconciliations have not been made public.

Greater disclosure of tax information would allow investors and analysts to better appreciate the true economic condition of a company. More transparent tax figures would also give analysts a tool to cut through the sometimes confusing tax disclosures currently provided under S.E.C. rules. Even more significantly, investors could track a company's performance under an accounting system believed to be less susceptible to manipulation than GAAP. Together, these effects would permit investors to value securities with greater confidence. Over all, the researchers say they believe that it would help financial markets function more efficiently.

Another significant benefit could be to improve the transparency of the tax system to the voting public. Despite all the information embedded in accounting footnotes, some basic questions go unanswered. Under current S.E.C. rules, a public company does not have to reveal precisely what it paid in taxes for a specific year. "Right now the tax numbers companies release can contain things like taxes on audits 20 years ago," Professor Shackelford said. "What they don't tell us is how much they paid the government in taxes in 2005, for instance. You can't find that anywhere."

The study argued that if companies revealed that figure, it would help clarify how much tax a company was paying relative to its income and relative to other companies. And that would yield positive benefits. For instance, the study says, it could put pressure on legislators to improve the tax system. And it could discourage corporations from aggressive tax-reduction strategies if they feared public criticism.

THERE is good cause for trying to understand what is really going on with corporate taxes, company by company. The aggregate figures suggest a disturbing trend. While companies have reported rising profits in recent years, corporate tax receipts have been dwindling. In the late 1990's, corporate tax receipts hovered between 2 percent and 2.2 percent of the country's overall gross domestic product. But from 2000 to 2004, the last year for which figures are available, the ratio of corporate tax receipts to G.D.P. has dropped, ranging between 1.2 and 2 percent.

Without reliable tax information, we can only guess at what companies are really up to. During the late 1990's, company profits based on tax return information — the profit figure most watched by economists — grew at a much slower rate than reported profits. The divergence between the two measures implied that either companies were finding new ways to minimize their tax bills or they were finding new ways to overstate their accounting earnings. We now know that at least some companies were indeed bolstering their earnings, through both legal and illegal maneuvers.

After a brief reconciliation in 2001 and 2002, reported earnings and taxed earnings are again diverging. While disclosing some basic tax information won't by itself prevent the kinds of abuses that multiplied in the 1990's, it is a step in the right direction. And that's what good public policy is all about.

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