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INCOME SMOOTHING BY VALUATION OF REPURCHASE OBLIGATIONS IN THE ANNUAL FINANCIAL STATEMENTS OF CAR DEALERSHIPS

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Abstract

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This paper deals with the accounting patterns of German car dealerships in the period from 2006 to 2010. In connection with the brokerage of passenger car leases the car dealers and lessors agree on hedging the residual values of the lease car returns. Such hedging instruments require accounting for expected losses in case of impairment. The relation of total amount of outstanding repurchase obligations as of balance sheet date to balance sheet totals qualifies the related risk assessment of the hedging instrument to be an outstanding device for artificial income smoothing. Annual financial statements of 42 dealerships were analysed whether accounting for future losses from repurchase obligations is used for income smoothing purposes. The influence of changes in income tax rulings is taken into account.

car dealers, accounting for impairment, hedging instrument, income smoothing

1 INTRODUCTION

German car dealers realize a substantial share of their sales of new cars via leasing. The related business model works by selling the demanded car to a lessor combined with brokering a car lease contract between the car dealer's customer and the lessor. This model includes the conveyance of the lessor's risk of losses from impaired residual value of the car at the end of the fixed lease term to the car dealer via put option at a fixed repurchase price (Wulf and Petzold, 2004). A fixed repurchase price exceeding estimated future fair market value (Plambeck and Braun, 2012) of the lease car plus future expenses for marketing etc. require accrual in the annual financial statements of the car dealer (Wulf and Petzold, 2004). In accordance with the combined application of the accounting principles of individual valuation, imparity and accounting for realized gains only, future losses need to be accrued without being netted against future chances (Wulf and Petzold, 2004). Operating leases of motor vehicles have fixed terms of 36 to 60 months (Loitz, Leuchtenstern and Kroner, 2011). Estimates reaching out such long times open factual valuation options, even if statutory options are absent. Such factual leeway in valuation is not accessible to restrictions of regulatory frameworks and thus impacts the financial statements even if applicable rules require "Neutralität […] 'not slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users'" (Küting, 2011). Accountants have the highest level of acceptability for accounting practices which are questionable, but still legal, especially for (the criterium, the author) 'choosing favourable asset valuation methods to avoid recognizing impairment loss' (Chang, 2012). In this paper it is about accountant's decision for one value within the range of reasonable estimates for future residual values for the lease return car, a situation which does not even require the choice of a method since it is made within one given accounting method. The total of pending repurchase obligations as of balance sheet date approximates the balance sheet total of the reporting entities in the sample drawn for this paper (mean of repurchase volume

to balance sheet total quotient is 0.92, median 0.83 and sd 0.63) and thus provide a high potential to manipulate the reporting entity's presentation of financial position and results of operations. Thus the valuation of repurchase obligations meets all requirements for the perfect device (Copeland, 1968) for artificial (Eckel, 1981) income smoothing, a widespread accounting concept which even applies to non-for-profit organizations (Blasco and Pelegrin, 2006). Not all smoothing motivations for management-controlled companies may be relevant for the owner-controlled car dealerships (none of the firms in the sample is a listed company), but still smoothing in owner-controlled firms was found just relatively more moderate (Ma, 1988). Two reasons for smoothing may be relevant for German car dealerships: Taxation and the "capital markets (which, the author) reward smoother earnings patterns." (Blasco and Pelegrin, 2006). The taxation issue comes in by uncertainties concerning tax deductibility of accounting for impairments of hedging residual values of lease car returns due to conflicting judgements of Tax Court of the city of Bremen (judgement dated Aug. 26, 2004 – 1 K 99/04 (1)) which is adverse and the Federal Tax Court (judgements dated Nov. 10, 2007- IV R 52/04, published Jan. 30, 2008 and Nov. 11, 2010 – I R 83/09, published Feb. 23, 2011) which is pro and interfering communication of the Federal Tax Office, dated Aug. 12, 2009, IV C 6 – S 2137/07/10003 (adverse). It is assumed that the business owner's assessment of the tax deductibility issue has a strong impact on his willingness to follow German GAAP rules which require accrual independently from tax deductibility since accrual in financial statements is preconditioning for tax deductibility (para 5 German Income Tax Act). Capital market aspect comes in with regard to the high average balance sheet total of EUR 34,964,480 per dealer and related equity ratio of 18.8%: The suggested logic of passing the Basel ii framework for risk management with related equity requirements applicable to the financing banks (Blasco and Pelegrin, 2006) down to the borrowing dealerships makes capital market rules relevant for debtors. In 2009 a tax financed accelerated vehicle replacement scheme (AVR) led to 1,932,929 subsidised purchases of passenger cars during the term from January to July 30 (Bundesamt für Wirtschaft und Ausfuhrkontrolle, November 2010) which made scientists expect car dealers to be happy with the particular booming (Dudenhöffer, 2009).

2 OBJECTIVE

The objective of this paper is to investigate whether valuation of repurchase obligations is used as a device for artificial income smoothing in the financial reporting of non-listed, closely held entities in the German car dealership branch in their annual statutory financial statements for the fiscal years 2006 to 2010.

It is not aimed to assess whether income smoothing policy is in place in the German car dealership branch, since captive entities, entities not subject to publication requirements, entities which do not report data relevant for this work are not covered by the sample or whether or not further smoothing devices are in use.

3 MATERIALS AND METHODS

This work is based on the data presented in the annual statutory financial statements of German car dealers accessible for free in the Electronic Federal Gazetta (www.bundesanzeiger.de). A listing of all German car dealers does not exist. Two sources providing guidance for sample selection were found, the TOP 100 list (Diez and Grimberg, 2011) and a non-scientific, commercial source (www.wer-zu-wem.de). The search for reporting entities based on those sources lead to 235 hits, 42 of them qualifying as sample elements under the criteria

a) comparability without fraction caused by M&A, change from single reporting to group consolidation etc., in the observation period
b) application of German GAAP, not IFRS or other GAAP framework
c) audited and attested without qualification
d) not being captives and not reporting under a profit and loss transfer agreement
e) disclosure of reserve for future losses from repurchase obligations (cars).

A subset of 15 out of these 42 provides supplemental information on the total of repurchase obligation as of balance sheet dates. One firm out of the subset does not provide information relevant for the computation of risk estimate for the balance sheet date 2006. The sample though is drawn from those firms out of an unknown population which are subject to publication requirements, are pre-selected by the above mentioned sources and are presenting in their statements data relevant for this research either on a voluntary basis or in accordance with statutory publication requirements.

The accounting pattern with regard to income smoothing via valuation of repurchase obligations is examined in a time-series analysis (Eckel, 1981) with an observation period being limited upon availability of data as of the years 2006 to 2010 which gives 5 balance sheet dates and 4 observations. Due to this limitation smoothing testing should not be based on the comparison of the raw distribution against a constructed, smoothed by density function of cross-sectional earnings series (Blasco and Pelegrin, 2006) or by an expected normal distribution computed by autoregression models[1] but will follow the conventional concepts

1 (Böckers, Heimeshoff and Müller, 2012)

of Dasher[2], Eckel[3], Ma[4], Das[5] with further citations. Smoothing as the accountant's decision to use factual valuation options concerning future risk from repurchase obligations leads in analogy to (Ma, 1988) to the **hypotheses H** that increasing | *decreasing* profits before risk assessment will lead to the accounting decision for the higher | *lower* future loss values within the range of reasonable forecasts.

H_0 is the negation of H and to be rejected or accepted by correlation of values for Δ profit$_{i,t}$ (= Δ adjusted profit$_{i,t}$), Δ risk estimate$_{i,t}$ and Δ reserve$_{i,t}$ on a $\alpha = 0.05$ level, for i = 1 … 15 (subset), alt. 1 … 42 (full sample), t = 2007 … 2010:

$$\Delta \text{ adjusted profit}_{i,t} =$$

$$= \frac{\text{adjusted profit}_{i,t} - \text{adjusted profit}_{i,t-1}}{\text{MAX (adjusted profit}_{i,T}) - \text{MIN (adjusted profit}_{i,T})}$$

with

$$\text{adjusted profit}_{i,t} =$$

$$= \text{profit}_{i,t} + (\text{reserve}_{i,t} - \text{reserve}_{i,t-1}) + \text{income taxes}_{i,t};$$

$$\Delta \text{ reserve}_{i,t} =$$

$$= \frac{\text{reserve}_{i,t} - \text{reserve}_{i,t-1}}{\text{MAX (adjusted profit}_{i,T}) - \text{MIN (adjusted profit}_{i,T})}$$

$$\Delta \text{ risk estimate}_{i,t} =$$

$$= \frac{\text{quotient reserve}_{i,t} - \text{quotient reserve}_{i,t-1}}{\text{MAX (quotient reserve}_{i,T}) - \text{MIN (quotient reserve}_{i,T})}$$

with

$$\text{quotient reserve}_{i,t} =$$

$$= \frac{\text{reserve for future loss from repurchase obligation}_{i,t}}{\text{total of repurchase obligations}_{i,t}}$$

Correlation between Δ reserve$_{i,t}$ and Δ risk estimate$_{i,t}$ is tested because Δ reserve$_{i,t}$ depends on the total of repurchase obligation$_{i,t}$ as second factor.

Identical signs between Δ profit$_{i,t}$ and Δ risk estimate$_{i,t}$ **represent** income smoothing whereas such between Δ profit$_{i,t}$ and Δ reserve$_{i,t}$ **indicate** income smoothing, provided increasing profits are not a priori tied to the expectations of impairments of residual values of used cars. Assigning 0 to "identical signs" (IS$_i$) between two variables and 1 to "no reaction or adverse signs" (AS$_i$) for dealer i, the result of

$$\frac{\sum_{i=1}^{n} AS}{n}$$

gives the measure for income smoothing (MS) in a group if is$_{i,t}$, as$_{i,t}$ refer to Δ risk assessment$_{i,t}$ respectively for indication of income smoothing (INDS) if is$_{i,t}$, as$_{i,t}$ refer to Δ reserve$_{i,t}$; MS respectively INDS = 0.5 means independence of variables.

4 RESULTS

The subset of 15 firms deliver 59 firm-year observations, the distributions of which are displayed in Fig. 2. The data are centered with the negative numbers on the ordinate giving the number of deltas with negative signs.

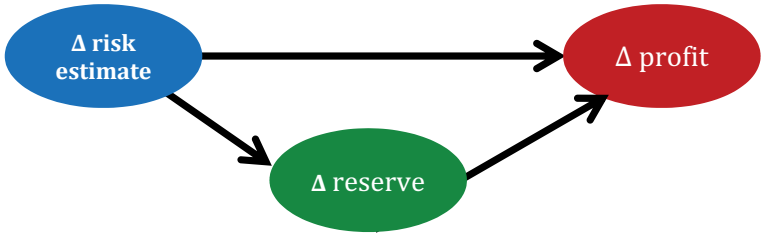
Statistics for the subset of 15 companies are presented in table 1 in a comparative format for all (59) and for *non tax-pattern (50)* firm-year observations. As tax pattern an accounting behaviour is denoted according to which a firm enters the observation period without accrual for future losses from repurchase obligations and continues accruing once having started within T.

The statistical interpretation is to reject H_0 for the 3 correlations and both n.

With respect to the skewness depicted in Fig. 2 and Tab. I the sample data are divided into groups of positive and negative Δ profit values. The related statistics are presented in Tab. II for the subset in a comparative format for positive | *negative* Δ profit values.

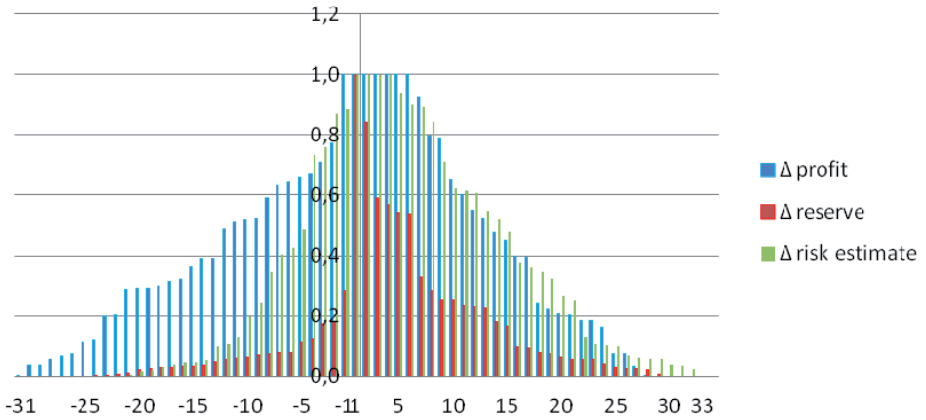
Accept H_0 for the dependence of Δ reserve on Δ profit; reject H_0 for the dependence of Δ risk estimate on positive Δ profits and accept H_0 for negative Δ profits; reject H_0 for the dependence of Δ reserve on Δ risk estimate.

Tab. III presents the results of the identical sign counts for MS and INDS in the subset which is divided into separate layers for Δ profit. The layers



1: *Profit manipulation by risk estimation via adjustment of reserveabsent*

2 (Dascher and Malcom, 1970)
3 (Eckel, 1981)
4 (Ma, 1988)
5 (Das, Vaish and Goel, 2012)



2: *Distribution sample values of subset, centered*
Source: Own graphic

I: *Statistics for subset*

	Δ profit	**Δ reserve**	**Δ risk estimate**
n	59 | *50*	59 | *50*	59 | *50*
mean	0.0436 | *0.0437*	0.0903 | *0.0942*	0.1095 | *0.0789*
median	–0.0342 | *–0,0355*	0.0000 | *0.0140*	0.0342 | *0.0480*
sd	0.,5370 | *0.5345*	0.2377 | *0.2543*	0.4758 | *0.4812*
		Correlations	
	Δ profit with Δ reserve	**Δ profit with Δ risk estimate**	**Δ risk estimate with Δ reserve**
r	0.3370 | *0.3137*	0.4559 | *0.4322*	0.6123 | *0.6222*
p value	0.0091 | *0.0265*	0.0003 | *0.0017*	0.0000 | *0.0000*
		Nonparametric Correlations	
	Δ profit with Δ reserve	**Δ profit with Δ risk estimate**	**Δ risk estimate with Δ reserve**
Spearman's rho	0.3844 | *0.3359*	0.4986 | *0.4604*	0.7995 | *0.7901*
p value	0.0026 | *0.0171*	0.0001 | *0.0008*	0.0000 | *0.0000*

Source: Own table

II: *Statistics for separated positive and negative Δ profit values in subset*

	Δ profit	**Δ reserve**	**Δ risk estimate**
	positive | *negative*	**positive / *negative***	**positive | *negative***
n	28 | *31*	28 | *31*	28 | *31*
mean	0.5058 | *–0.3740*	0.1776 | *0.0114*	0.2573 | *–0.0240*
median	0.4627 | *–0.3192*	0.0621 |*–0.0013*	0.2587 | *–0.0051*
sd	0.3529 | *0.2565*	0.2905 | *0.1406*	0.5403 | *0.3691*
		Correlations	
	Δ profit with Δ reserve	**Δ profit with Δ risk estimate**	**Δ risk estimate with Δ reserve**
r	0.1531 / *–0.0738*	0,4571 | *0.2681*	0.5575 | *0,6208*
p value	0.4368 | *0.6933*	0.0145 | *0.1447*	0.0021 | *0.0002*
		Nonparametric Correlations	
	Δ profit with Δ reserve	**Δ profit with Δ risk estimate**	**Δ risk estimate with Δ reserve**
Spearman's rho	0.3080 | *0.0974*	0.4336 | *0.3495*	0.7404 | *0.6907*
p value	0.1108 | *0.6023*	0.0212 | *0.0540*	0.0000 | *0.0000*

Source: Own table

do not primarily represent statistical conventions (e.g. quartils), but rather are proposals for an economic view under the idea of levels of changes that might trigger income smoothing decisions.

Be MS ≤ 0.25 the measure for smoothing in place, 3 of the groups with positive Δ profits smooth. No smoothing is observable in the negative Δ profit layers. INDS follows MS as expected (see Tab. I).

10 of 15 firms had positive Δ profits in 2009 and all 3 of those firms in the subset which comply with the tax pattern (see above) started accruing future losses in 2009.

Tab. IV displays the year 2009 in more detail.

The definition of Δ profit-layers was adjusted to size of n; values in brackets refer to the 12 non-tax pattern firms.

Except for the 2 firms with negative Δ profit ≤ 0.33 MS shows smoothers only.

Statistic at α 0.05 for the full sample of 42 firms is presented in comparative format (see Tab. I) in Tab. V.

Reject H_0 for all firms; accept H_0 for the non-tax pattern firms under the Bravais & Pearson correlation, but reject H_0 under the concept of nonparametric correlation.

Tab. VI presents the statistic of identical signs in the full sample in format of Tab. I.

INDS for positive Δ profits is 0.3780 in the full sample and 0.3623 for the non-tax pattern subset; for negative Δ profits the respective values are 0.5814 and 0.4857; the related values for the totals are 0.4821 and 0.4245. Tab. VI shows that all groups of firms with positive Δ profit values are on the

III: *Statistic of identical signs in the subset*

	Δ profit					
	(+)			**(–)**		
layers	**n**	**Δ reserve**	**Δ risk estimate**	**n**	**Δ reserve**	**Δ risk estimate**
Δ profit ≤ 0.10	4	0.7500	0.7500	6	0.6667	0.8333
0.10 < Δ profit ≤ 0.25	7	0.2857	0.1429	4	0.5000	0.5000
0.25 < Δ profit ≤ 0.50	4	0.2500	0.2500	10	0.5000	0.4000
0.50 < Δ profit	13	0.2308	0.1538	11	0.3636	0.3636

Source: Own table

IV: *Statistic of identical signs in the subset for 2009*

	Δ profit					
	(+)			**(–)**		
layers	**n**	**Δ reserve**	**Δ risk estimate**	**n**	**Δ reserve**	**Δ risk estimate**
Δ profit ≤ 0.33	2 (1)	0.0000 (0.0000)	0.0000 (0.0000)	2 (2)	0.5000 (0.5000)	1.0000 (1.0000)
0.33 < Δ profit ≤ 0.66	3 (2)	0.00000 (0.0000)	0.0000 (0.0000)	2 (2)	0.0000 (0.0000)	0.0000 (0.0000)
0.66 < Δ profit	5 (4)	0.20000 (0.2500)	0.2000 (0.2500)	1 (1)	1.00000 (1.0000)	0.0000 (0.0000)

Source: Own table

V: *Statistic for full sample*

	Δ profit	**Δ reserve**
n	168 | *139*	168 | *139*
mean	0.0525 | *0.0614*	0.0735 | *0.0657*
median	–0.0271 | *0.0027*	0.0094 | *0.0189*
sd	0.5369 | *0.5311*	0.2961 | *0.3099*
	Correlation Δ profit with Δ reserve	
r	0.1805 | *0.1655*	
p value	0.0192 | *0.0516*	
	Nonparametric Correlation Δ profit with Δ reserve	
Spearman's rho	0,2683 | *0,2515*	
p value	0,0004 | *0,0028*	

Source: Author's computations

VI: *Statistic of identical signs in the full sample*

	Δ profit			
	(+)		(–)	
layers	**n**	**Δ reserve**	**n**	**Δ reserve**
0 < Δ profit ≤ 0.1	10 | *9*	0.5000 | *0.4444*	16 | *10*	0.8125 | *0.7000*
0.1 < Δ profit ≤ 0.25	19 | *16*	0.4211 | *0.3750*	13 | *13*	0.6154 | *0.6154*
0.25 < Δ profit ≤ 0.5	15 | *12*	0.4000 | *0.3333*	26 | *22*	0.3846 | *0.2727*
0.5 < Δ profit	38 | *32*	0.3158 | *0.3438*	31 | *25*	0.6129 | *0.5200*

Source: Own table

smoothing side, except the one group of the full sample with the lowest Δ profit, the variables of which are independent. 6 of the 8 groups with negative Δ profit values are on the side where Δ reserve reinforces Δ profit or does not react to it.

5 DISCUSSION

In the subset of 15 firms an asymmetric distribution of the values for the variables can be observed in a bar chart (Fig. 2), where the values for positive Δ profits and positive Δ risk estimates are similarly distributed, the same applies to the values of positive Δ reserve, but attenuated. This observation is supported by correlation statistic. Statistical support was found for the assumption that Δ reserve is determined by Δ risk estimate rather than by Δ total of repurchase obligations. In the full sample smoothing can be tested by reaction of Δ reserve to Δ profit only. Statistically these variables are not independent; other, if the firms with a tax pattern accounting style are removed from the sample. In this scenario Bravais & Pearson correlation does not support the smoothing – hypothesis. With respect to the sensitive reactions of this correlation to outlier values and the low related r – value the non-parametric correlation is of interest which comes to a contradicting result.

The analysis of levels of smoothing indicated by counts of signs to Δ profits and related Δ risk estimates respectively Δ reserves supports the asymmetry for positive and negative Δ profits. The full sample is on the smoothing side, but very close (INDS = 0.4821) to the neutral point (0.5). Further it comes to the observation that smoothing does not apply to small changes (in contrast to the results found by Blasco and Pelegrin, 2006, concerning the smoothing behavior of Spanish savings banks) in Δ profits.

Income smoothing is observable in groups of firms with high increases in profits net of tax, net of application of smoothing device, whereas such smoothing assumption is not supported for groups of firms with decreases in profits, respectively increases in losses. This finding is decisively influenced by the year 2009 when profits of the car dealerships obviously boosted. The 2009 AVR incentives were granted to consumer conditional upon the scrappage of his used car. Thus the scrappage of 2 million cars would decrease the volume of cars available on the market for used cars in the future. No general pessimism concerning future fair market values of used cars was a priori justified from a 2009, beginning 2010, accounting date perspective. The asymmetric accounting style with smoothing of increased earnings while decreases in earnings tend to be reinforced supports the assumption of an accounting pattern which is more tax and/or prudence rather than smoothing motivated. The interpretation of the findings that prudence is the dominating accounting principle in the sample is supported by the logic presented by Newman (1988) according to which non-smoothing firms have an incentive to disclose their non-smoothing type accounting in order to avoid penalties for smoothers (e.g. higher interest rates), since smoothing is based on circumstances which are unobservable costless: The subset out of the sample which provides substantially more information than the rest of the sample and by this makes accounting policies to a certain extent observable, has a higher level of profit smoothing than the total sample.

SUMMARY

German car dealerships which are facing risks of future losses from repurchase obligations have to account for such risks under German GAAP in accordance with an accrual for impairment concept. Uncertainties tied to future estimates reaching out for long time spaces, here up to 5 years, provide the accountant with factual leeway in valuation and is a perfect device for artificial income smoothing. 168 accounting decisions of 42 firms in the observation period from 2006 to 2010 were statistically tested whether or not year-to-year changes of pre-tax and pre-application of smoothing device profits influence accounting decisions in the direction of manipulation of income reporting with a smoothing purpose. The findings support the assumption of a rather more tax-avoiding and/or prudence oriented than income smoothing accounting pattern. High increases of profits in 2009 had triggered increases in risk assessments for future losses from repurchase obligations.

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