Financial Statements and Income Taxes

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User Warning

- This discussion is shaped by the framework I use to think about these concepts and the papers that have most influenced that thinking.

- This is not a comprehensive review of the literature in this area and it is possible (likely) I have omitted some very important papers related to the topics covered in my discussion.

Why do we care about accounting for income taxes?

- This is what we are good at!
- Taxes are a significant cost for most firms.
- Tax accounts are complex and involve considerable discretion.
- Not clear what investors, analysts, creditors understand about disclosures related to income taxes.
- The primary user of disclosed tax information may be an adversarial party – the *tax authority*.
- Potential *political costs* associated with tax planning activities.
- Taxable income is a potentially useful alternative measure of firm performance.

Major Topics

- Taxable income (tax expense) as an alternative or benchmark / measure of firm performance.

- Managerial discretion over accounting for income taxes and the use of the tax expense to manage earnings.

- Searching for evidence (footprint) of aggressive tax avoidance/tax sheltering/income shifting in the financials statements (Skip).

Valuation of Tax Expense

- Thomas and Zhang (2014): The tax expense *should* be negatively associated with firm value.
- Prior research finds mixed results including positive *and* negative values on the tax expense coefficient.
- How can a lower tax expense be bad news?
- Tax expense contains incremental information about underlying profitability.

Valuation of Tax Expense

- Matching Role: Tax expense is fundamentally a cost that represents lost value.

- Proxy-for-profitability role: Tax expense provides incremental information to non-tax variables about future profitability.

- When expectations for future profitability are included in full specifications, the tax expenses for-profitability role is suppressed.

Taxable Income as an alternative performance measure

- Why would taxable income be a useful measure of firm performance?
  - Hanlon and Hietzman (2010) note the differences between GAAP accounting and tax accounting stem from the different objectives of the two systems.
  - Tax Rules result from political process intended to encourage or discourage certain activities
  - GAAP is intended to reflect economics of transactions and help statement users make decisions.

Taxable Income as an alternative performance measure

- Why would taxable income be a useful measure of firm performance?
  - Tax rules are applied more homogeneously than GAAP rules.
  - Managers may have an incentive to manipulate GAAP earnings upward to meet key earnings targets.
  - Ideally in these cases managers would not want to also report higher taxable income. Hence difference between book and tax *might* be indicative of earnings management.

Quick Aside: Taxes paid on fraudulent earnings

- Erickson, Hanlon, and Maydew (2004) Examine a sample of 27 firms accused by the SEC of overstating income. Find firms were willing to pay, on average, 11 cents of additional income taxes per dollar of inflated earnings.

- Find 15 firms total paid taxes on overstated earnings.

Taxable Income as an alternative performance measure

- Why would taxable income be a useful measure of firm performance?
- Mills and Newberry (2001): Firms with incentives to manage earnings report greater book-tax differences (actual book-tax differences)
- Phillips, Pincus, and Rego (2003): Find the *deferred tax expense* is incrementally useful to measures of total and abnormal accruals in detecting earnings management to avoid earnings declines and losses.

Implications of large book-tax differences

- Hanlon (2005): Earnings are less *persistent* for firms with large positive *or* large negative book-tax differences.
- Hanlon also examines whether investors understand the implications of large book-tax differences and finds that they do.
- Lev and Nissim (2004): Find book-tax ratio is predictive of five-year accounting earnings changes and subsequent stock returns.
- Ayers, LaPlante, and McGuire (2010): Find credit rating changes are related to changes in book-tax differences.

Permanent v. Temporary Book-tax Differences

- Point of confusion:
  - Existing studies focus on different aspects of book tax-differences. Some examine the *total difference between book and tax income* (or the ratio of tax and book income) and others focus only on *temporary book-tax differences*.
  - Jackson (2015): Separates book-tax differences into permanent and temporary components. Finds *temporary BTDs* predictive of future changes in pretax income and *permanent BTDs* predictive of future changes in tax expense.

Why are Book-Tax Difference Useful?

- Blaylock, Shevlin, and Wilson (2010): Find when large positive book-tax differences arise from tax avoidance they are a less useful signal about accruals persistence.

- Drake (2015): Proposes that BTDs are related to firm life cycle stage. Finds that controlling for firm life cycle stage weakens the association between large BTDs and lower earnings persistence.

Do investors understand implications of book-tax differences?

- Who knows?
- Hanlon (2005) and Blaylock et al. (2012) generally find investors correctly price the persistence of accruals for large book-tax difference firms.
- Weber (2009): Analysts forecasts are more optimistically biased when book income is high relative to taxable income.
- Chi, Pincus, and Teoh (2014) find mispricing related to the ratio of taxable income to book income.
- Hepfer (2016) working on thesis that finds some mispricing related to book-tax differences.

Book-Tax Conformity

- Hanlon, Laplante, Shevlin (2005): Respond to calls for increased conformity. Examine relative and incremental information content of book income and taxable income. Find book income has greater explanatory power, *but* taxable income provides incremental information.

- Hanlon, Maydew, Shevlin (2008): Examine sample of firms changing from cash to accrual method for tax purposes. Change represents an increase in conformity and leads to a reduction in earnings informativeness.

Book-Tax Conformity (Continued)

- Atwood, Drake, and Myers (2010): Develop a measure of book-tax conformity and find that the level of book-tax conformity in a country is associated with lower earnings persistence.

- Blaylock, Gaertner, and Shevlin (2014): Find higher book-tax conformity is associated with ***more*** and not less earnings management.

Do investors understand implications of changes in Valuation Allowance?

- Dhaliwal, Kaplan, Laux, and Weisbrod (2013): Changes in the valuation allowance contain information about the persistence of losses. Find investors do not appear to fully understand the implications for loss firm-years with positive taxable income.

- Edwards (2015): Finds positive association between increases in valuation allowance and the cost of debt.

Earnings Management

- Managers have considerable discretion over three areas of accounting for income taxes.
  - Decision over whether (and how much) of a *valuation allowance* to record.
  - Decision to designate foreign earnings as *permanently reinvested abroad*.
  - Accounting for *uncertain tax benefits* (tax reserves or tax cushion)

Earnings Management

- <u>Dhaliwal, Gleason, and Mills (2004):</u> Tax account is a powerful setting because it is the last account closed prior to earnings announcement.
- Innovative measure of unmanaged earnings. They use the ETR reported in the third quarter.
- Find firms lower their ETR when they would otherwise miss the consensus analysts forecast.
- Results could be driven by all three forms of tax accrual earnings management.

Earnings Management –Valuation Allowance

- Visvanathan (1998) and Miller and Skinner (1998) test whether managers use changes in the valuation allowance to smooth earnings. Find no evidence this is the case.
- Frank and Rego (2006): find evidence the valuation allowance is used to meet analysts' forecasts.
- Schrand and Wong (2003): examine banks and find they use the valuation allowance to meet analysts' forecast targets.

Permanently Reinvested Earnings

- If managers designate foreign earnings as permanently reinvested then they can avoid recording a deferred tax liability associated with potential future repatriation taxes.

- <u>Krull (2004): </u>Examines whether managers use discretion over this designation to manage earnings. Finds changes in permanently reinvested foreign earnings are positively related to the difference between analysts forecasts and a measure of pre-managed earnings.

Permanently Reinvested Earnings

- Financial reporting incentives can also have a direct effect on the repatriation decision itself.

- Blouin, Krull, and Robinson (2012): Use confidential foreign affiliate data and find reporting incentives reduce repatriations by 17 to 21 percent annually.

Earnings Management – Tax Reserves

- Examining earnings management through the tax reserves is difficult for a variety of reasons.
- First, firms typically did not disclose any information about tax reserves or tax cushion prior to FIN 48 being implemented in 2007.
- Gleason and Mills (2002) use IRS data and find firms often do not disclose IRS deficiency claims in excess of 5 percent of income.
- Difficult to estimate the discretionary component of changes in the tax reserve.

Prior to FIN 48

- Blouin, Gleason, Mills, and Sikes (2010): Find that prior to adoption of FIN 48 firms report more settlements and release reserves more frequently.

Earnings Management – Tax Reserves

- Gupta, Laux, and Lynch (2015): Find evidence firms use tax reserves to meet analysts' forecast prior to FIN 48, but no evidence post-FIN 48.

- Cazier, Rego, Tian, and Wilson (2015): Find no evidence that either SOX or the introduction of FIN 48 reduced earnings management through the tax reserve.

What can we learn from UTB disclosures?

- De Simone, Robinson, and Stomberg (2014): Examine 19 paper companies that received refundable excise taxes in 2009. Find firms are not consistent in either their tax treatment of the refund or the decision to record a tax reserve.
- Robinson, Stomberg, and Towery (2015): Use IRS data to examine how much of the reserves translate to settlements. Find that 24 cents of every dollar unwinds via settlement over a three year period.
- Ciconte, Donohoe, Lisowsky, and Mayberry (2016): Find UTBs are predictive of future tax cash outflows. Find no change in informativeness under FIN 48 relative to SFAS 5.

What is left?

- What about determinants of tax disclosure quality?
  - Geographic earnings data
  - Location and amount of cash held abroad
  - Potential tax liability associated with permanently reinvested earnings.
- What are determinants of decision to designate foreign earnings as PRE?
  - What about firms that only designate part of their foreign earnings as PRE?