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BOOK REVIEWS

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JOHN R. GRAHAM, JANA S. RAEDY, and DOUGLAS A. SHACKELFORD, *Accounting for Income Taxes: Primer, Extant Research, and Future Directions,* Foundations and Trends® in Finance (Hanover, MA: now Publishers Inc., 2012, ISBN: 978-1-60198-612-2, vol. 7, nos. 1–2, pp. xi, 163).

This monograph provides researchers with an introduction to accounting for income taxes (AFIT) and a review of several topics in the AFIT academic literature, including the use of tax accounts for earnings management and the relation between a firm's tax disclosures and asset prices. A recurring theme is that the measurement of income for financial accounting and tax purposes provides financial statement users with two complementary signals regarding the profitability of the firm. The first signal is in the financial statements themselves; the financial accounting for income taxes allows the user to estimate the second signal, as the tax return itself is not publicly available.

The authors motivate their study of AFIT in Sections 1 and 2 on the basis of academic research, pointing out that nearly half of the papers published in *The Accounting Review, Journal of Accounting Research,* and *Journal of Accounting and Economics* from 2009–2011 address AFIT issues. If anything, this motivation understates the importance of their study, as AFIT has also become quite important in the teaching of taxation. A comparison of Scholes and Wolfson (1992) to Scholes, Wolfson, Erickson, Maydew, and Shevlin (2009) shows how much more attention we give to the financial accounting aspects of taxation now than we did 20 years ago. Although the authors do not motivate their discussion of AFIT rules in Sections 3 and 4 in terms of teaching, that material will be at least as useful to our teaching as it is to our research. This is as it should be, for research and teaching are complementary activities (Demski and Zimmerman 2000).

Sections 3 and 4 provide an overview of the rules underlying AFIT. The authors begin by describing AFIT in a setting in which pretax book income and taxable income are the same, then go on to describe both permanent and temporary differences, with particular emphasis on the GAAP effective tax rate (ETR). They go on to discuss deferred tax assets and liabilities, as well as the valuation allowance for deferred tax assets. Overall, the authors provide a useful introduction to the AFIT rules.

Anyone writing such a primer faces a difficult balancing act between providing too much detail and too little. In this case, I can imagine that someone unfamiliar with AFIT would have some misconceptions after reading these sections. For example, the reader is told on page 33 that, under current law, goodwill is "occasionally" deductible for tax purposes. Later, in Appendix C, the reader is told that goodwill is a temporary difference. The problem is that goodwill is often created for financial reporting purposes but not for tax purposes, which generates a permanent difference if the goodwill is impaired. Only when goodwill is created for both book and tax purposes is the difference between impairment and the 15-year tax amortization period a temporary difference. Similarly, the AFIT issues associated with stock options are referred to but never really explained, even in a simple setting. They refer to the issue often enough (e.g., on pages 49 and 100) so that the reader knows that the issue is important, but the characterization of stock option deductions as a permanent difference with a cryptic reference to "recent change in book" in Appendix C fails to convey the issues of first-order importance. In fact, prior to the revision of SFAS 123 in 2004, non-qualified stock options were an odd sort of permanent difference in that they reduced taxable income, did not reduce financial accounting income, yet did not affect a firm's effective tax rate. In my view, inserting some "plain vanilla" examples illustrating the typical effects of goodwill and stock options would have significantly improved Sections 3 and 4.

The authors then summarize descriptive studies regarding book-tax differences, providing the reader with a good sense of both the magnitude and source of these differences, as well as how they have evolved over time. Section 3 also describes the current rules regarding the disclosure of contingent tax liabilities, along with a helpful discussion of how these liabilities were disclosed prior to the FASB's FIN 48. Section 3 concludes with a description of whether and how U.S. taxes on unrepatriated foreign earnings are recorded, with particular emphasis on permanently reinvested earnings (PRE) and the repatriations that occurred due to the "tax holiday" provided by the American Jobs Creation Act of 2004. The authors identify PRE for specific firms, which makes this subsection particularly useful for classroom use. I would have liked to see even more concrete examples of AFIT issues in this monograph.

Section 4 addresses two issues. The first is why the tax information in the financial statements does not necessarily correspond to the information in the tax return. The discussion focuses on the difference between the tax expense shown on the income statement and the tax liability shown on the tax return. Their description of the differences in consolidation rules for financial reporting and tax purposes is particularly helpful. The second issue is why a low GAAP ETR is not evidence of tax planning effectiveness, as it does not reflect the opportunity costs (implicit taxes and non-tax costs) of tax planning strategies. Furthermore, the GAAP ETR treats current tax payments and deferred tax payments as the same, ignoring time value of money considerations that drive many tax planning strategies. Anyone interested in using financial statement data to evaluate either corporate tax planning effectiveness or public policy would do well to study Section 4 carefully.

The remaining sections in this monograph focus on academic research relating to AFIT. Section 5 summarizes research regarding AFIT and earnings management. The authors first discuss three examples of using specific tax accounts—the valuation allowance, the liability for tax contingencies, and PRE—to engage in earnings management. They then discuss studies that examine book-tax expense itself, without relating earnings management to any specific balance sheet account. The studies cited find evidence that managers use the tax provision for purposes of meeting analyst earnings forecasts, but do not find evidence of using the tax provision to achieve other earnings management goals such as smoothing earnings or increasing the magnitude of a "big bath" earnings loss.

The authors go beyond summarizing existing studies. They describe eight unresolved issues involving the interaction between earnings management and AFIT that they believe are worthy of study.

Section 6 provides a brief summary of research that relates current book-tax differences to future earnings characteristics, such as growth or persistence. This section reflects a recurring theme in the monograph, namely, that the pretax financial accounting income and taxable income are two ways of measuring firm performance, and, as such, taxable income provides additional information that is helpful in forecasting future financial accounting earnings. As in Section 5, Section 6 concludes with suggestions for further study.

Section 7 examines the extent to which tax information is reflected in equity values. The authors begin by summarizing the studies that generally find that deferred tax assets and liabilities are reflected in stock price, but in most cases at less than their book value. I found their efforts to relate these findings to the theoretical literature to be confusing, however. After correctly describing the theoretical result that a deferred tax liability (DTL) should be discounted by the ratio of the tax depreciation rate (δ) to the sum of the tax depreciation rate and the cost of capital ($\delta + \rho$), they conclude that this provides "theoretical support for the notion that DTLs should be valued at their full book value" (p. 84), a curious conclusion given that $\delta/(\delta + \rho)$ is less than one except in the special case in which assets are immediately expensed for tax purposes.[1]

In the special case of immediate expensing, the DTL should not be discounted, regardless of whether or how quickly it reverses. To see why, consider the purchase of an asset for K that will generate future pretax

[1] In the constant depreciation rate models used in this literature, expensing is the limiting case as the tax depreciation rate approaches infinity.

cash flows with a present value of K and after-tax cash flows with a present value of $K(1-\tau)$, where τ is the statutory tax rate. The asset is capitalized for financial reporting purposes but expensed for tax purposes: so it is a zero net present value investment because the after-tax cost is also $K(1-\tau)$. The firm recognizes an asset of K and a DTL of τK, where τ is the tax rate. The net book value of the asset less the DTL, $K(1-\tau)$, equals the present value of the after-tax cash flows that the asset will generate after the cash flows from the tax deduction are received. So the book value and market value of the deferred tax liability are the same in this case. Whether and how quickly this liability reverses depends on the book depreciation rate and whether the firm reinvests in the asset as it wears out. The former has no value relevance because it does not affect cash flows; the latter has no value relevance because a zero net present value investment does not affect firm value.

More generally, whether and by how much a deferred tax asset or liability should be discounted depends on the circumstances: context matters. For example, a deferred tax asset associated with the liability for post-retirement health care benefits under SFAS 106 should not be discounted, because the associated liability has already been discounted to its present value.

The authors argue that these theoretical results "stand in contrast to the empirical results that the timing of reversal matters" (p. 85). But the empirical results simply associate certain deferred tax assets and liabilities with equity values; attributing discounts to book value to the likelihood of reversal is an interpretation of the result, not the result itself.

Next, the authors review the literature on the value of contingent tax liabilities. All of the cited papers find that the liabilities increase firm value, suggesting that investors value aggressive tax planning that leads to the recognition of such liabilities.

The authors then review the literature that relates current taxable income or book-tax differences to current or future returns. Both unexpected pretax financial accounting income and unexpected taxable income are associated with current returns, which is consistent with the authors' theme of pretax financial income and taxable income as complementary measures of firm performance. In addition, current taxable income is associated with future abnormal returns, an anomaly that is not yet fully understood. The authors conclude Section 7 with a discussion of six topics for further study.

Section 8 explores the issue of book-tax conformity, in which taxable income is redefined as pretax financial accounting income. After describing the arguments for and against book-tax conformity, the authors review the empirical work that has studied how firms respond to particular cases in which book-tax conformity is required under current law. What little evidence there is suggests that firms respond to book-tax conformity by changing their financial accounting income to reduce taxes, which would likely reduce the information content of financial accounting income.

The monograph concludes with two sections devoted to future research. Section 9 describes five AFIT issues for academic researchers to explore in the future. In contrast to the specific research questions posed in earlier sections, these issues are broader, "big picture" questions such as the need for a conceptual framework to guide future AFIT research and the effects of IFRS on book-tax conformity. Section 10 discusses econometric issues in AFIT research, particularly the likely lack of independence of residuals in an ordinary least squares regression either across firms or over time. The authors argue that double clustering by firm and time is not necessarily better than clustering in one dimension only.

Overall, this monograph provides a good introduction to the rules governing accounting for income taxes and a useful summary of existing research. Their suggestions for future research questions, both specific and general, are worthy of careful consideration.

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BOB HERZ, *Accounting Changes: Chronicles of Convergence, Crisis, and Complexity in Financial Reporting* (No place: AICPA, 2013, ISBN 978-1-93735-210-3, pp. xx, 268).

Robert H. Herz always seemed like the Will Rogers of the accounting world. He sounded down to earth even when discussing arcane accounting rules, and he appeared to get along with everybody, even those who did not get along with him.

Then he quit.

In 2010, he suddenly stepped aside as chairman of the Financial Accounting Standards Board, with two years left in his second term. If he had previously mentioned to anyone he was thinking of such a step, that person has yet to mention it publicly.

Was he pushed? He insisted the departure was his choice.

Was he angry over the congressional upbraiding he had suffered the year before, when it became clear that the congressmen who planned the "hearing" had no interest in hearing his views, only in assuring he heard and obeyed the demand of the banks that the Board back away from fair value accounting enough to let the banks look as healthy as they wished to appear?

If you long to hear the inside story of his sudden retirement, or to hear what he really thought of the people who forced the Board's rapid retreat after that congressional circus, Herz's memoir, *Accounting Changes: Chronicles of Convergence, Crisis and Complexity,* is not the place to turn.

If, unlike Rogers, he ever met a man he did not like, that man is left out of the book.

Start with the story of the congressional lynching. He chooses to remember comments from the one congressman who showed any sympathy to the Board's position.

Over the next few weeks, the Board rushed out changes to the accounting rules that he defends.

The principal change enacted then enabled banks to treat impaired securities as being worth more than they were, at least for earnings purposes, while the rest of the impairment was put in "other comprehensive income." This was a classic accounting rule-maker approach, one that I wish Mr. Herz would have discussed in more detail. In it, those who have gained political support forcing rule-makers to back down get what they said they wanted—avoiding a hit to earnings—but are forced to disclose the unfortunate truth to those who are willing to read the footnotes.

Instead, he makes it sound like helping out the banks was a byproduct of a perfectly reasonable decision, albeit one that was rushed through in record time.

> Although not one of our specific goals in establishing this approach, an important practical effect of it for the banks was to take some pressure off their regulatory capital because only the portion of the impairments in debt securities relating to credit would now be charged to regulatory capital. (p. 175)

As for his departure from the Board, he simply reprints an interview with *The CPA Journal*. "It was time to move on," he says (p. 238).

He is a little more inclined to discuss what was probably the single biggest mistake of his tenure: the failed attempt to deal with special purpose entities in the aftermath of the Enron scandal. The Board's narrow solution set the stage for later—and much larger—abuse by the banks.

"Knowing what I know now about how the use of this device was sometimes stretched and became an important element in the growth of the 'shadow' banking system leading up to the financial crisis," he writes, "I would certainly have worked to eliminate it from the standards much earlier" (p. 249). That episode, he says, "serves as an example of the perils of creating exemptions that grant highly coveted financial reporting outcomes."

Herz is more interesting when discussing his early life and career. He grew up in New Jersey and Argentina, where his maternal grandparents lived and where his father was transferred when he was 14. He chose to go to college at the University of Manchester in Britain, and went to work for Price Waterhouse in Manchester after he graduated in 1974, and later moved to the United States, where he ended up at Coopers & Lybrand.

The result was a highly unusual résumé for a young accountant, one that required him to know both British and American accounting rules, something that would serve him well as he became the top technical partner for the merged PricewaterhouseCoopers and a part-time member of the International Accounting Standards Board before leaving both jobs to take over the FASB in 2002.

Early in his career he had a job at Coopers that perhaps should be mandatory for those who would write accounting rules. In what he calls his "Bad Bob" years, his job in the firm's corporate finance advisory service involved finding ways around accounting rules to inflate profits.

He writes, "my experiences in transaction structuring taught me that the areas that were most ripe for designing transactions and arrangements to achieve desired accounting outcomes were those where the accounting rules departed from basic principles of economics and finance and areas where, because of the detailed requirements and many exceptions and bright lines present in the accounting rules, minor changes in the form of a transaction or arrangement could produce a large change in the resulting accounting treatment" (p. 13).

That sounds like a plea for a "principles based," rather than "rules based" set of accounting standards, something Herz says he would like. But he seems resigned to the idea such a system would not work in the United States, due in part to what he called, in a 2004 speech, the "real fear of being second-guessed by regulators, enforcers, the trial bar, and the business press" (p. 207). Whatever they say, he writes, companies and accountants often want "detailed rules, bright lines, and safe harbors" (p. 209).

It turns out that Herz really is what he always seemed to be: a nice guy with a sense of fair play. That does not help the book much. He goes out of his way to explain all sides of some accounting issues, without necessarily making clear his own opinions.

His memoir does an excellent job of making some complicated accounting issues accessible. But it would be nice if the author were not so nice to those who opposed—and ultimately defeated—some of his efforts.

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PHILLIP C. STOCKEN, *Strategic Accounting Disclosure,* Foundations and Trends® in Accounting (Hanover, MA: now Publishers Inc., 2013, ISBN 978-1-60198-692-4, vol. 7, no. 4, pp. x, 100).

At its best, theoretical research helps add structure to seemingly complex issues and, in the process, helps hone our intuition about the fundamental forces shaping these issues. One complaint often levied against theoretical research in accounting is that it fails in this regard, instead appearing to be a collection of individual and virtually unrelated models. With this in mind, we were excited to read *Strategic Accounting Disclosure* by Professor Phillip Stocken. The monograph is an ambitious undertaking, seeking to synthesize the vast and often seemingly disparate theoretical literature on the incentives that drive managerial disclosure choices. Fortunately, Stocken's synthesis does not disappoint. It brings together this literature in a way that both solidifies the structure brought by theoretical inquiry and helps shape intuition for many of the key issues we face in accounting today.

Providing a Foundational Structure

Viewing one key goal of theoretical inquiry as providing a structure around which we can view various issues, Stocken helps highlight this structure embedded in the accounting literature on strategic disclosures.

With managers' mutual and sometimes competing incentives of providing useful information and maximizing short-term stock prices as a backdrop, Stocken examines disclosure choice in the presence of fully rational investors. The monograph classifies research in this stream along a continuum represented by the degree of discretion retained by managers. That is, the distinguishing feature of these models is to establish how easy or difficult it is for a firm's manager to introduce bias in information when disclosing it. At one end of the spectrum is the "persuasion game" (Chapter 2) wherein bias is not permitted, and the other end is the "cheap talk game" (Chapter 3) wherein bias is both permitted and costless. The continuum that spans the two ends of the spectrum is nicely summarized as "costly reporting games" (Chapter 4). By structuring the literature this way, Stocken helps the reader see the inherent interconnectedness among the many papers as well as assists a reader in determining which papers are best suited to describe particular circumstances.

The structure is particularly helpful since Stocken makes use of a similar baseline model framework throughout. That is, the original papers that comprise the review use varied notation and different modeling choices, making comparisons tedious. This monograph helps by providing a common framework so that the fundamental differences across models can be highlighted. An added benefit of the thorough classification scheme is that it helps identify gaps in the literature. As an example, note that, with persuasion games, the issue is whether or not to disclose (such disclosures must be unbiased), whereas with costly reporting games disclosure is presumed and the issue becomes the degree of bias instilled in such disclosures. A natural question to ask is if and how the possibility of withholding information can change conclusions in costly reporting games. Say that any misreporting is costly but the manager can retain the option not to disclose. Addressing this question could provide a natural bridge to these streams of literature. With this extension of existing models, can one view the presumed and exogenous "cost of disclosure" in some persuasion games (Chapter 2, Framework #2) as being linked to the endogenous bias under "costly disclosure" games (Chapter 4, Framework #5)? We suspect so. One hopes that the structure provided by this monograph can help guide subsequent work that can bridge such gaps which are present when the literature is viewed through the lens of this broader framework.

Challenging Our Intuition on Key Issues

To our delight, Stocken not only provides an excellent framework for viewing the literature, but he also helps synthesize some of its intuition and implications. Such intuition that incorporates both incentives and rational response to incentives is sorely needed. On reading textbooks and even regulatory discussions about accounting standards, one is often left with the impression that accounting disclosures are solely about taking a set of given business activities and coming up with a way of summarizing them. While a good starting point, this view leaves incentives and strategic behavior out of view. Popular press coverage of accounting reporting often takes the additional step of viewing managers as strategic in deciding what and how they choose to disclose, but also typically views investors and other information recipients as naïve victims of such strategic behavior. The research synthesized in *Strategic Accounting Disclosure* is best viewed as bringing rational and strategic behavior by both the disclosing party and the disclosure recipients to bear.

Viewing all parties as rational and strategic has the potential to turn conventional wisdom on its head. Stocken's discussions of conservatism are a case in point. The partial equilibrium view that pervades much of public opinion on disclosure would suggest that more conservative reporting comes about when there are tighter controls on the bias of those reporting. This view, however, fails to take into account the rational interplay between the report sender and report recipient. Taking the extreme cases of eliminating bias in reporting (Chapter 2) and leaving bias unfettered (Chapter 4) provides a more nuanced view of this connection. The tightest controls on bias (Chapter 2) leave an equilibrium wherein aggressive, not conservative, reporting rules the day. That is, when disclosure is either costly à la Verrecchia (1983) (Framework #2) or information endowment is uncertain à la Dye (1985) (Framework #3), the equilibrium takes the form of the manager disclosing good news and withholding bad news. Though the precise form of the equilibrium varies, an immediate implication is that bad news is reported less often and investors' beliefs are less precise in bad times than in good times, a hallmark of aggressive, not conservative, reporting practices. In contrast, take the case of unfettered bias embedded in cheap talk games as in Crawford and Sobel (1982) (Framework #4). Given managerial incentives to boost short-term stock price and an inability to curb bias, one would expect the equilibrium to entail even more aggressive accounting. Instead, the equilibrium is best viewed as reflecting conservatism in that investors' beliefs are more precise in bad times than in good times. The reason for this reversal is in the nature of the interplay between the parties. The equilibrium entails disclosure of a range of values rather than a precise value (because precise values are too easily manipulated). In deciding on her report, the disclosing manager weighs the benefits of boosting stock price that comes with an optimistic report with an offsetting desire for accuracy of prices that comes from an accurate report. Given the hope of boosting stock price, the concern for misreporting in the equilibrium arises for managers whose observations lie at the top of a reporting range. With equally precise ranges (think equal length in the case of uniform distributions), the accuracy cost would be virtually no different between reporting in the correct range or pumping up the report to the next highest range, because the high end of one range is just as close to its mean as it is to the mean of the range above it. The equilibrium prevents such overreporting by having the next highest range be wider, thereby making such values closer to the mean of their own range than to the mean of the next highest range; this, in turn, brings concerns about price accuracy to the forefront and prevents overreporting. The equilibrium's distinguishing feature, then, is one where ranges are small and estimates are quite accurate for bad news but progressively less accurate (i.e., wider ranges) as news gets better.

Is the point that conservatism is driven by flexibility and thwarted by more stringent regulatory or audit activity? The answer seems to be no because the intermediate cases of costly reporting (Frameworks #5 and #6) demonstrate that higher misreporting costs can reduce aggressive reporting. What do we take from this, then? Even the most basic of assertions about how and why managers choose particular disclosures requires more subtlety than most people may think; and such nuance is what the formal structure provided by theoretical research at its best can provide.

Conclusion

In our view, *Strategic Accounting Disclosure* provides an excellent "big picture" glimpse into what the theoretical research in accounting, when thoughtfully brought together, can offer us. The monograph's stated audience is doctoral students, and it is certainly well suited to guide their studies. We also suspect and hope the monograph's insights can prove useful to a much wider audience.

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Capsule Commentary

By the Book Review Editor

STEFANO CASCINO, MARK CLATWORTHY, BEATRIZ GARCÍA OSMA, JOACHIM GASSEN, SHAHED IMAM, and THOMAS JEANJEAN, *The Use of Information by Capital Providers: Academic Literature Review* (No place: The Institute of Chartered Accountants of Scotland and the European Financial Reporting Advisory Group, 2013, ISBN 978-1-909883-00-0, pp. 82).

This unique publication is a compilation and analysis of more than 350 articles and books that throw light on how capital providers use information to make financial decisions and assess stewardship. The six coauthors, all European accounting academics, gathered the referenced publications and composed a lengthy and thoughtful analysis of the contribution of their findings to an understanding of how information is used by capital providers in a variety of settings. The main classes of users are outside professional equity investors, private/retail equity investors, inside equity investors and family ownership, debt providers, and trade creditors.

Equity valuation models and debt holders' distress prediction models are discussed and explained in an appendix.