SUMMARIES OF PAPERS IN THIS ISSUE

Taxable Income and Firm Risk

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In this study we examine whether estimated taxable income, an alternative summary measure of financial performance, provides incremental information about firm-level operating risk. We argue that if a measure of current firm performance is incrementally informative about future performance, then variability in that measure should be related to operating risk. We consider estimated taxable income (TI) to be a useful summary measure of firm operating performance due to the different rules governing the calculation of book income (BI) and TI, as well as the different incentives faced by managers when determining each income measure. In exploring the relationship between TI and market-based measures of risk, we focus on the variability of TI. Further, our analytical results suggest a positive association between the covariance of BI and TI (BT Covariance) and earnings predictability. Consistent with our predictions, we find that a firm’s return volatility, beta, and cost of capital are each increasing in TI Variance and decreasing in BT Covariance. The results are economically significant, as we find that our TI-based measures together explain nearly as much variation in risk as does BI Variance.

Our study adds to the risk-relevance literature, in particular the stream that examines the risk relevance of summary accounting numbers. Beaver et al. (1970) argue that our understanding of how firm risk is determined is incomplete without knowing what non-price variables impact stock prices through discount rates. We find that TI, in addition to being value relevant, is also incrementally risk relevant as a performance measure. Also, ours is the first study to our knowledge to document the risk relevance of the covariance between two summary measures of financial performance.

Our findings complement studies, such as Goh et al. (2013), Henry (2014), and Guenther et al. (2016), which explore risk-related information contained in TI. These studies focus on whether tax avoidance is linked to firm risk due to the impact of tax avoidance on the uncertainty surrounding future tax payments. We find evidence supporting another link between the information contained in TI and firm risk by documenting evidence that TI captures information about firms’ operating risk. Researchers and financial professionals should be aware that sorting firms on the absolute value of BTDs can also result in inadvertently sorting firms by operating risk, although in a manner that is inferior to using our TI-based measures of risk.

Research on the nature and extent of incremental information contained in TI is also relevant to the potential cost side of the analysis regarding proposals to conform BI and TI (Hanlon et al. 2005; Hanlon et al. 2008). Our evidence suggests that a previously unrecognized unintended consequence of mandating book-tax conformity could be a decrease in risk reporting quality, which is information that aids investors in assessing economic drivers and statistical properties of the variation in firms’ future performance (Ryan 2011).
Material Weaknesses in Tax-Related Internal Controls and Last Chance Earnings Management

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In this study we first investigate whether firms disclosing tax-related internal control material weaknesses (ICMWs) are more likely to manage earnings through the income tax accrual (also known as “last chance” earnings management) than a control sample of firms with only non-tax ICMWs. We examine both income-increasing and income-decreasing tax expense management in the year prior to and in the year of the material weakness disclosure. We then test whether such earnings management is constrained once the material weaknesses have been remediated.

We compare firms with tax-related ICMWs (our TAX firms) with firms that have non-tax-related ICMWs (our NONTAX firms), enabling us to assess the specific impact of tax-related ICMWs versus non-tax ICMWs with regard to last chance earnings management. We use a difference-in-differences research design to examine whether the remediation of such tax-related ICMWs constrains future tax-expense management.

Our main results indicate that compared to firms with non-tax-related ICMWs, TAX firms are more likely to reduce their fourth-quarter effective tax rate (ETR) relative to their third-quarter ETR when earnings would otherwise miss the consensus analyst forecast in the year preceding the firm’s first disclosure of a tax-related ICMW. We also demonstrate that conditional on firms decreasing their fourth-quarter ETRs, the TAX firms are more likely to meet/beat analysts’ forecasts than the NONTAX firms in the year prior to the disclosure of the tax-related ICMW. This result is consistent with TAX firms engaging in more income-increasing, tax-expense management to meet or beat analysts’ forecasts than the control firms. Absent earnings management, we would not expect ETR revisions to be distributed differently across firms with and without tax-related ICMWs. Similarly, among firms that would have exceeded the consensus analyst forecast based on their third-quarter ETR, TAX firms are more likely than the NONTAX firms to increase their fourth-quarter ETR, consistent with firms using the tax provision to build cookie jar reserves. Further, we find that the relations observed in the year prior to the disclosure of a tax-related ICMW are mitigated in the year the ICMW is disclosed (but prior to remediation), consistent with discovery leading to a reduction in tax-expense management.

Supplemental tests reveal that our main results are concentrated in years following the initial implementation of the Sarbanes-Oxley Act of 2002 (SOX), consistent with SOX mitigating last chance earnings management facilitated by tax-related ICMWs. Overall, we provide evidence that tax-related ICMWs facilitated earnings management through the tax accrual in the early years of our sample; however, in the later years of our sample period it appears that SOX internal control audits mitigated tax-expense management (i.e., last chance earnings management) that was facilitated by tax-related ICMWs.

Our analyses yield a better understanding of the impact of ineffective tax-related internal controls over financial reporting. Evidence that tax-related ICMWs are associated with greater last chance earnings management and, further, that remediation of the tax-related ICMWs constrains such earnings management, supports the contention of a link between tax-related weaknesses in internal controls and benchmark beating. It appears that tax-related ICMWs, coupled with the complexity of tax rules, the subjectivity in estimating tax expense, the proprietary nature of tax return data, and the limited transparency of income tax reporting, have a significant impact on the prevalence of last chance earnings management behavior relative to non-tax-related ICMWs.
Income Statement Reporting Discretion Allowed by FIN 48: Interest and Penalty Expense Classification

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One of the express purposes for FIN 48 was to provide consistency and comparability in measuring income taxes (FASB 2006). However, FIN 48 allows discretion as to where UTB interest and penalty expenses are included within the income statement: income tax expense, interest expense, selling, general and administrative expense, or other expense. The purposes of this study are to investigate (1) how tax avoidance activities, management compensation, and debt agreements impact managers’ decision of where to include UTB interest and penalty expense on the income statement, and (2) whether the income statement classification has implications on financial statement users.

First, we examine how tax avoidance measures, specifically measured by GAAP ETR and the occurrence of tax disputes, influence firms’ financial reporting decisions. Because managers have incentives to report tax expenses that are not “too high” or “too low,” we predict and find a positive relation between tax avoidance and including all UTB interest and penalty expenses as tax expense. We also investigate whether CEO bonuses influence the classification of UTB interest and penalty expense, because CEOs with incentive compensation based on pre-tax income are more likely to classify all of UTB interest and penalty expense in tax expense to avoid reducing pre-tax income. Accordingly, we find a positive relation between pre-tax CEO bonus alignment and classification of all UTB interest and penalty expense in tax expense. We next examine if interest debt covenants are a determinant of the income statement classification of UTB interest and penalty expenses, but do not find support for this potential determinant.

Next, we investigate an implication of income statement classification on financial statement users. Consistent with expectations, we find a significant positive association between including all UTB interest and penalty expense in tax expense and analyst forecasted ETR accuracy. Further analysis shows this relation is primarily due to the minority of firms that do not classify all interest and penalties within tax expense. We find a negative relation between forecast accuracy and the magnitude of interest and penalties, which is consistent with analysts not incorporating these expenses in pre-tax income forecasts. This suggests that the expense classification discretion of UTB interest and penalty expense permitted by FIN 48 can affect the decision usefulness of tax reporting.

We make several contributions to literature. We are the first to investigate determinants associated with UTB interest and penalty expenses classification decisions. We provide support for the effects of financial reporting incentives on firms’ managers’ decisions. We also provide evidence that the classification and magnitude of interest and penalty expense affects analyst ETR forecast accuracy. Finally, prior research has identified several methods firms use to manage financial statement users’ impressions of firms’ performance. We identify another method, UTB interest and penalty expense classification, that managers may use to manage financial statement users’ impressions.
An Examination of Reputational Costs and Tax Avoidance: Evidence from Firms with Valuable Consumer Brands

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The benefits of corporate tax avoidance are clear. Increased tax avoidance can result in both higher cash flows and higher after-tax earnings. The costs of tax avoidance are much less clear. We hypothesize one important cost influencing firms’ tax planning decisions is the potential for reputational harm to the firm. Existing research provides mixed evidence on the reputational costs of tax avoidance. Specifically, Gallemore et al. (2014) investigate whether firms identified as participating in tax shelters incur significant reputational costs at either the firm or executive level. They are unable to find evidence of reputational costs stemming from identified cases of tax sheltering. However, Dyreng et al. (2016) study a shock to public scrutiny of U.K. firms’ subsidiary locations by an activist group and find evidence that the increased public pressure leads to reduced tax avoidance.

Each group of stakeholders in a firm is likely to view tax avoidance differently. We expect consumers will be the group of stakeholders most likely to take a universally negative view of tax avoidance.¹ We do not expect the majority of consumers engage in actively identifying aggressive corporate tax avoidance. Rather, we believe consumers are most likely to become aware of tax avoidance when firms are named by other sources, such as the financial press, protests, and the work of advocacy groups. We identify firms with exposure to significant reputational costs by examining firms with valuable consumer-based brand equity. The marketing literature has documented many benefits of strong consumer brands. Consequently, any impairment to the firm’s consumer brand equity is going to be costly, and we expect managers of firms with valuable brands take steps to protect the brand from impairment—including forgoing tax avoidance that may attract negative publicity.

Our prediction that firms with valuable consumer brands will engage in less tax avoidance due to reputational concerns is based on two related considerations. First, Dawar and Pillutla (2000) argue brand equity is fragile because it is founded on consumers’ beliefs and can be prone to large and sudden shifts. Firms with valuable consumer brands are particularly at risk for boycotts that can have significant negative consequences for firm value (EY 2014). A second consideration for firms with valuable brands is that consumer familiarity with the brand puts the firms at greater risk for scrutiny of their tax practices.

To test whether reputational costs are a deterrent to tax avoidance, we use consumer responses gathered during Harris Interactive’s EquiTrend survey. Harris Interactive directly measures brand perceptions by polling consumers selected to be representative of the entire U.S. population. To measure consumer-based brand equity (CBBE) for brands included in the database, we calculate a latent variable scaled from 0 to 1 estimated using consumer responses to four questions assessing brand familiarity, quality, future purchase considerations, and distinctiveness.

Our primary measures of tax avoidance are the GAAP effective tax rate and the cash effective tax rate, both measured over one and three years. We complement our analysis of the effective tax rates by also examining the probability that a firm is engaging in tax sheltering, calculated from Lisowsky (2010). We find a positive and significant association between CBBE and firms’ effective tax rates and limited evidence of a negative and significant association between CBBE and the probability that a firm is engaging in tax sheltering. These results are consistent with managers at firms with valuable consumer brands engaging in less tax avoidance. Our findings complement those of Dyreng et al. (2016) and provide some of the first empirical evidence that reputational concerns influence corporate tax planning. In doing so, we provide a partial explanation for why all firms do not appear to take advantage of available tax planning opportunities.

¹ One notable exception would be the government, which also likely takes a negative view of tax avoidance.