Book-Tax Conformity: Lessons from the Accounting Literature

Michelle Hanlon

Panel: **ACCOUNTING PROFIT AS A TAX BASE FOR A GLOBAL MINIMUM TAX: REVISITING BOOK-TAX CONFORMITY**

NTA Spring Symposium 2020

AGENDA

- Purpose of financial accounting and how financial accounting (book) income compares to taxable income
- General concerns with conformity
- Research evidence

RULES/PROPOSALS

- Various proposals over time to either increase conformity between financial accounting and taxable incomes or use book income as an alternative income measure in the tax computation
  - TRA86
  - 2005 President's Advisory Panel on Federal Tax Reform (considered it)
  - EU CCCTB
  - Senator Warren
  - VP Biden
  - OECD
  - Probably others

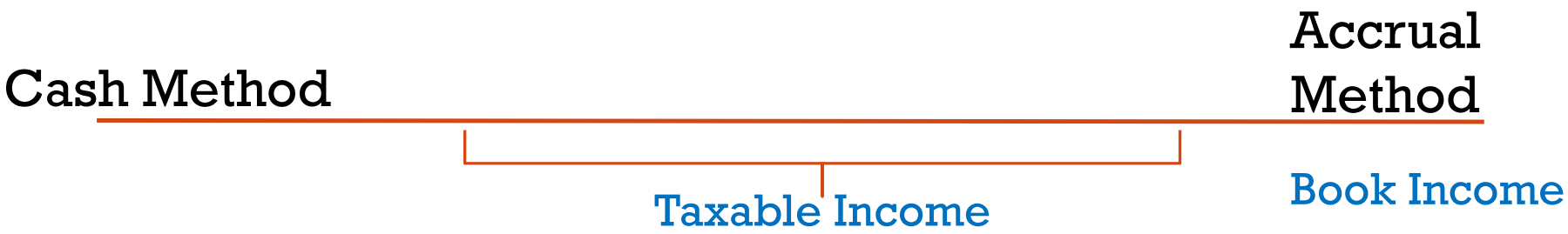
PURPOSE OF FINANCIAL ACCOUNTING INCOME (BOOK INCOME)

- Financial accounting is intended to reflect economic performance

- Financial accounting is computed using the accrual method of accounting – it is not computed using the cash method

- Accruals allow some discretion on the part of management so that managers can convey their private information to external stakeholders

COMPARISON TO TAXABLE INCOME



- Taxable income is between accrual accounting method and cash method of accounting
  - Many accruals are conformed for financial accounting and tax – e.g., accounts receivable, accounts payable
  - But, many accruals are not conformed – e.g., bad debt reserve, deferred revenue
- Some items of income/expense are permanently different: municipal bond interest income
- Overall nature of two incomes is different because of different purposes

CONCERNS WITH CONFORMITY

- Companies will alter their reporting such that less information is provided through financial accounting
  - This is a loss of information about performance to stakeholders – e.g., capital markets
- Governments will exert (more) influence over financial accounting standards
  - The standard setters are generally independent of the government intentionally (less lobbying)
  - Examples, even under current system: 1) stock option accounting, 2) recent suspension of CECL in the CARES Act

RESEARCH

- TRA 1986
  - BURP Adjustment
  - Cash-to-accrual requirement for some firms for tax purposes

- Cross-country evidence

RESEARCH

- TRA 1986
  - BURP Adjustment (Business Untaxed Reported Profits) or BIA (Book Income Adjustment)
    - In effect from 1987-1989 (replaced by the ACE Adjustment in 1990)
    - 50% of the difference between adjusted pre-tax book income and the alternative minimum tax base

RESEARCH

- TRA 1986
  - Consequences of the BURP Adjustment
    - Five papers conclude that there is evidence of earnings management
      - Gramlich (1991); Dhaliwal and Wang (1992); Boynton, Dobbins, and Plesko (1992); Manzon (1992); Wang (1994)
      - Overall, statistically and economically significant income-decreasing accruals in 1987 by affected firms; some studies show income increasing accruals in 1986
    - But there is some debate because Choi et al. (2001) claim the studies' tests have problems and when they altered the research design for some tests, then the results disappeared for some tests

RESEARCH

The inference from the two studies together is not consistent with proponents' claims.

- TRA 1986
  - Cash-to-Accrual
    - A small set of companies that were previously on the cash method for tax purposes were required to change to the accrual method; thus, the two incomes became more conformed
      - Guenther, Maydew, and Nutter (1997): Evidence consistent with the firms required to change to the accrual method for tax purposes, deferring more income after 1986
      - Hanlon, Maydew, and Shevlin (2008): Association between annual returns and annual earnings changes (Long-window ERCs) are lower for the required-to-change sample

RESEARCH

- Cross-country studies
  - Ali and Hwang (2000)
    - Informativeness of earnings is lower when tax and book are more conformed
  - Atwood, Drake, and Myers (2010)
    - Predictive value of current earnings for future earnings and future cash flows is lower when book-tax conformity is higher
  - Others

LESSONS FOR CURRENT PROPOSALS

- Senator Warren and VP Biden

- OECD Pillar 2
  - Seems like one objective is a more consistent/comparable measure across countries
    - Financial accounting standards are more comparable
    - But…there is a lot more discretion in the hands of managers in financial accounting relative to taxable income