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Financial Statements' Tax Disclosure – Management Incentives and Usefulness

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2 INTRODUCTION AND SYNOPSIS

A firm's tax details are relevant for several stakeholders. Investors and analysts, for example, are interested in the firm's after-tax income. To estimate future after-tax income, they need information about expected pre-tax income and expected tax payments. Due to considerable book-tax differences, tax payments typically cannot be inferred from pre-tax income (Hanlon and Shevlin, 2005). Therefore, tax specific information is necessary. Further, the recent scrutiny of corporate tax affairs by the media illustrates the public interest in firms' tax information (e.g., Barford and Holt, 2013). Corporate tax payments are raised to a moral issue and politicians as well as activist groups inspect firms' tax compliance (e.g., Dyreng et al., 2016). The tax authority is another party that is interested in a firm's tax information. While the latter has access to detailed tax items via the firm's tax return, these tax filings are not publicly available in most countries. Hence, corporate tax information has to be derived from other sources, usually from the firm's financial statements (Hanlon et al, 2005).[1]

However, income tax disclosures in financial statements are criticized for not being very informative about a firm's actual tax liabilities. Hanlon (2003) discusses several shortcomings of tax disclosures under the US Statement of Financial Accounting Standard (SFAS) No. 109 and suggests additional disclosure requirements, particularly a reconciliation from cash taxes paid to current tax expense. In a similar vein, disclosures under the International Accounting Standard (IAS) 12 are blamed to be "… one of the least understood areas of financial reporting, according to investors." (PwC, 2012, p. 34). Private accounting organizations and national standard setters call for additional and more detailed tax disclosures under IAS 12, responding to demands of financial statement users and preparers (EFRAG/FRC, 2011). Further, Kvaal and Nobes (2013) find that tax information provided under International Financial Reporting Standards (IFRS) differs systematically between firms from different countries and industries. They propose a number of amendments to IAS 12 to improve tax disclosure comparability. In sum, many different stakeholders are interested in a firm's tax details while the disclosure provided in financial statements seems not to satisfy their demand for tax information.

Accordingly, there is a recent stream of literature focusing on different aspects of financial statement's tax disclosure. Questions of interest are for example whether public pressure affects firms' tax disclosure behavior (Dyreng et al., 2016), whether and how tax information from financial statements is used by tax authorities (Bozanic et al., 2017), and how public disclosure of corporate tax returns affects the firm, investors, and consumers (Hoopes et al., 2016).

Contributing to this growing area of research, this thesis presents three different studies about tax information in financial statements prepared under IFRS. More precisely, I investigate the tax disclosure behavior of firms (study A and study B) and the usefulness of the reported tax information (study C). The insights from this thesis help to explain why a firm chooses a particular disclosure strategy,

[1] Financial statements' tax details can even be useful for governmental agencies because they are usually available several months before the tax return and can therefore assist in forecasting the government's corporate tax receipts (Lisowsky, 2009; Bozanic et al., 2017).

providing reasons for the considerable cross-sectional variation in tax disclosure and the related lack of comparability across firms. Moreover, the results help to assess whether the tax disclosure reported under the current IAS 12 provides useful information, relative to the tax disclosure under other accounting standards.

Study (A) of this thesis, **Flagmeier and Müller (2017)**, examines the disclosure of tax loss carryforward (TLC) information in a firm's tax footnote. Due to its complex nature, unused tax losses are among the tax items on which financial statement users demand comprehensive disclosure, going beyond the current requirements under IAS 12 (EFRAG/FRC, 2013, p.12/13). Consistent with this demand, the majority of firms voluntarily provides additional TLC information in the tax footnote, supplemental to the required mandatory items. However, the extent and way of disclosure varies considerably between different firms. In study (A), we investigate these cross-sectional differences by testing whether firms provide more voluntary information about unused tax losses when the future usability of these tax losses is more uncertain. The future usability refers to whether the tax losses can be offset against taxable income in future years and hence reduce future tax payments. Corporate tax losses are constantly rising and amounted to 24.8 percent of the German gross domestic product in 2006 (OECD, 2011). Thus, the reduction in a firm's tax burden by offsetting TLC can be considerable. In line with this economic relevance, several studies provide evidence that investors and analysts value TLC (Amir and Sougiannis, 1999; Zeng, 2003). Building on the evidence of value relevance of unused tax losses, we expect firms to increase disclosure in the case of higher uncertainty to mitigate possible negative capital market reactions. We define uncertainty as not knowing whether the tax losses can be offset, resulting in information asymmetries between informed and less informed investors.[2] The disclosure of additional information can reduce information asymmetries and avoid increases in the firm's cost of capital (Diamond and Verrecchia, 1991). Hence, a firm has incentives to increase disclosure in the case of uncertainty. Despite these incentives, a firm might choose not to disclose additional information due to costs for gathering and editing the information or because the data is proprietary in nature (e.g., Robinson and Schmidt, 2013).

We empirically test the relation between uncertainty about the TLC usability and disclosure. To measure disclosure, we develop a score, calculated from the number of voluntarily disclosed TLC items, the type of disclosure, and the way of presentation. We assign points depending on whether the disclosure is embedded in the text or presented in a table and whether the information is a qualitative or a quantitative disclosure. More salient information (e.g., quantitative item in a table) gets a higher score. To measure uncertainty, we use different historic and future indicators, measuring for example whether the firm has a loss history and whether the expected future earnings exceed or fall below the amount of TLC. We use a sample of German DAX-30 and M-DAX firms over the period 2005 to 2014 and hand-collect data from firm's tax footnotes.

[2] See Verrecchia (2001) and Leuz and Wysocki (2016) for reviews of the disclosure theory.

We identify 15 different types of voluntary TLC items and find that the disclosure behavior varies between firms while it is rather stable within firms, consistent with evidence from prior research (e.g., Kvaal and Nobes, 2013; Raedy et al., 2011). In our main tests, we find a significant and positive relation between uncertainty about the TLC usability and the level of disclosure. This result suggests that firms voluntarily provide more (and more salient) disclosure about TLC when it is harder for investors to predict whether the tax losses can be offset in the future. Our findings are robust to several historic and forward-looking uncertainty indicators. Additional tests indicate that the disclosure behavior is peculiar to the tax footnote and that our inferences are not affected by controlling for sample selection and a number of other sensitivity tests. Further examining the different voluntary disclosure types, we provide preliminary evidence on which information is disclosed depending on whether the uncertainty results from historic events or from future expectations. Our results indicate that firms disclose information about TLC changes and the effect on income if uncertainty results from historic events (e.g. losses in recent years) while they disclose information about non-usable TLC in the case of forward-looking uncertainty.

In sum, our findings suggest that managers anticipate the investors' need for more private tax information and disclose them voluntarily, indicating that the expected benefits for providing the information exceed the costs. We contribute to the tax disclosure literature, explaining part of the cross-sectional variation in the tax footnote by providing insights into disclosure incentives. Further, our results suggest that firms compensate for seemingly insufficient IAS 12 disclosure requirements by voluntarily providing additional information when necessary.

In study (B), **Flagmeier, Müller, and Sureth-Sloane (2017)**, the financial statement disclosure of another important tax item is analyzed: the GAAP effective tax rate (ETR). The GAAP ETR is the ratio of total income tax expense and pre-tax accounting income. Although the ability of the GAAP ETR to measure a firm's tax burden is frequently criticized (e.g. Plesko, 2003; Dyreng et al., 2008), the ratio is used as a performance measure for tax departments, tax directors, and for cross-firm tax comparisons (Robinson et al., 2010; Armstrong et al., 2012; Graham et al., 2014). Further, results of a tax executives survey of Graham et al. (2014) indicate that most top managers care about the GAAP ETR at least as much as they care about cash taxes paid. In study (B), we examine how this importance is reflected in firms' tax disclosure behavior. We define different GAAP ETR conditions that can be desirable from an investor's perspective and test whether firms intensify the GAAP ETR disclosure in financial statements when the ratio has a favorable condition.[3]

This notion is based on the theoretical line of argument in Wagenhofer (1990), assuming that a firm has incentives to disclose favorable information because it expects positive capital market reactions to the disclosure. At the same time, the disclosure of the favorable information can lead to adverse actions of

[3] Building on the prior literature, we assume that decreasing GAAP ETRs, smooth GAAP ETRs, and GAAP ETRs near certain benchmark ratios are desirable conditions (e.g., Lev and Thiagarajan, 1993; Demeré et al., 2016).

external actors, resulting in proprietary costs for the firm. In our setting, the external actors can be public groups or tax authorities. Due to intense media interest in corporate tax issues, firms are increasingly concerned about tax-related reputation risks (Ernst and Young, 2014; Graham et al., 2014). Dyreng et al. (2016) provide evidence that public pressure from activist groups can have a substantial effect on the tax policy of firms, leading to an increase in the GAAP ETR. Relatedly, Ernst and Young (2014) document that firms take proactive steps to manage their tax reputation risk, including the way in which they communicate tax-related information. Hence, firms might refrain from disclosing favorable GAAP ETR information to avoid public attention and the possible subsequent public pressure. Other proprietary costs can result from increased tax auditor attention. Bozanic et al. (2017) find a negative relation between GAAP ETRs and tax auditor attention, indicating that firms with low GAAP ETRs are under more intense scrutiny. Further, the authors document that tax authorities systematically collect data from publicly available financial statements, indicating that the accounting information complements tax return data reported directly to the tax authority. The threat of increasing tax auditor attention might be another incentive for firms to be silent about favorable GAAP ETR conditions.

To assess whether the expected benefits of providing the disclosure exceed the proprietary costs, we examine the relation between the GAAP ETR condition and the GAAP ETR disclosure intensity in the annual report. We measure disclosure intensity with three different proxies: the number of times the GAAP ETR is mentioned in the annual report, the first page on which the GAAP ETR appears in the annual report, and whether the GAAP ETR is mentioned in the management report. We analyze a sample of German DAX-30 and M-DAX firms over the period 2001 to 2012. Descriptive tests indicate that after scaling with the total annual report pages, the average number and first page of GAAP ETR reference are volatile in the early sample years but rather stable over the period 2005 to 2012. The annual report section where most of the sample observations discuss GAAP ETR information is the management report, followed by the notes. In OLS and logistic regression estimations, we find a positive and significant relation between disclosure intensity and GAAP ETR condition. Observations with decreasing GAAP ETRs and ratios near a benchmark level disclose GAAP ETR information on average earlier in the annual report and with a higher frequency. Additionally, the likelihood that the GAAP ETR is mentioned in the management report is higher if the ratio is decreasing or near a benchmark level.

The results indicate that firms report more and earlier GAAP ETR information if the ratio has a desirable condition, suggesting that the expected capital market benefits from disclosing favorable information outweigh the expected proprietary costs. With the finding of a systematic GAAP ETR disclosure behavior and the frequent disclosure of the ratio in the management report (i.e. the annual report section where only the most relevant information should be discussed), we contribute to the research on the importance of tax information in financial statements. Further, related to the results of study (A), we contribute to the tax disclosure literature by providing insights in firms’ incentives to disclose or withheld tax information. However, our findings have to be interpreted with caution due to potential endogeneity issues, particularly because disclosure intensity and the GAAP ETR level are both (to some extent) management's choice variables.

While study (A) and (B) examine the disclosure behavior regarding tax information in the annual report, study (C), **Flagmeier (2017)**, focuses on the usefulness of deferred taxes for tax loss carryforwards (TLC). The recognition of deferred taxes under IAS 12 is subject to recurring amendment approaches, particularly regarding suggestions to implement the United States Generally Accepted Accounting Principles (US-GAAP) valuation allowance (VA) concept. The VA approach differs from the current IAS 12 concept in an important aspect concerning the unrecognized deferred tax assets: while the amount is a balance sheet item (i.e. a contra-asset) under the US-GAAP Accounting Standards Codification (ASC) 740, it is a footnote disclosure under IAS 12.[4] To assess whether IAS 12 would benefit from the implementation of the VA approach, it is important to examine whether this conceptual difference could affect the usefulness of the deferred tax information. To date, there is few evidence on whether deferred taxes reported under IFRS provide useful information while practitioners often criticize the informativeness of deferred tax items (e.g., EFRAG/FRC, 2011). Hence, an important first step to assess possible benefits of an IAS 12 amendment is to analyze whether information reported under the current IAS 12 is useful for financial statement users.[5]

To close this gap in the literature, I examine in study (C) whether deferred taxes reported under IFRS provide useful information. According to the prior literature, deferred taxes can be informative about two future outcomes: (1) tax payments and (2) pretax income. Evidence on this predictive ability is so far provided for deferred taxes reported under US-GAAP (e.g., Laux, 2013; Dhaliwal et al., 2013), UK-GAAP (Gordon and Joos, 2004), and Australian GAAP (Herbohn et al., 2010) while evidence for deferred taxes under IFRS is mainly missing.

Due to the conceptual differences between the deferred tax recognition under IAS 12 and for example the VA approach, results from prior literature do not necessarily apply to IFRS. More specifically, whether an item is recognized in the balance sheet or disclosed in the footnote can make an important difference. Schipper (2007) discusses several reasons why disclosed items might be less reliable than recognized items, even if both items have the same content. Accordingly, the disclosed unrecognized deferred taxes under IAS 12 might be less reliable than the equivalent balance sheet item under US-GAAP.

[4] ASC 740 follows a two-step approach: in the first step, deferred taxes are recognized on the full amount of e.g. TLC and in the second step, the part of deferred tax assets that is not expected to be usable is written off with a VA. The VA is a contra-asset and hence a balance sheet item. IAS 12 follows a different approach and allows the recognition only for the usable TLC part right from the beginning. Further, IAS 12 requires the disclosure of the non-usable TLC in the tax footnote.

[5] To the best of my knowledge, the only study analyzing deferred taxes under IFRS is Chludek (2011). She finds no significant relation between deferred taxes in IFRS statements and firms' market value. This finding is in contrast to most of the prior (mainly US-based) literature, generally documenting value relevance of deferred taxes (e.g. Ayers, 1998; Amir and Sougiannis, 1999). While the lack of value relevance could (but does not need to) be an indicator that deferred taxes under IFRS do not provide useful information, I choose a more direct way to test the predictive ability by examining the relation between deferred taxes and future outcomes.

A second reason why results of prior non-IFRS studies do not have to apply to IFRS can be differences in accounting culture. Kvaal and Nobes (2010, 2012) find that firms use discretion in IFRS reporting requirements to continue with pre-IFRS local accounting practices. As the recognition of deferred tax assets is subject to a considerable level of management discretion, a traditionally conservative attitude towards the recognition of deferred tax assets may lead to understated amounts and can impair its predictive ability.

In study (C) of this thesis, I examine this notion by testing whether deferred taxes under IFRS are informative about future tax payments and future performance. Unlike value relevance studies, I do not investigate market reactions on deferred tax information but directly test the relation between deferred tax items and future outcomes. Further, I do not use the aggregated amount of deferred taxes but focus on an important sub-component, deferred tax assets for tax loss carryforwards (TLC). This deferred tax item is particularly suitable to isolate the predictive ability of deferred taxes regarding future tax payments and regarding future performance. Based on the accounting standards' requirements, deferred tax assets for TLC should convey information about future tax payments as they may only be recognized when the firm expects sufficient future taxable income to offset the TLC, reducing the firm's tax burden (IAS 12.34). At the same time, IAS 12.81 (e) requires the disclosure of those TLC for which no deferred tax asset is recognized. If a firm does not recognize deferred tax assets for TLC, this suggests that it does not expect sufficient future income to offset the TLC. Hence, the non-usable TLC are an indicator for a firm's expectation of future performance. Building on the recognition requirements, I expect recognized deferred tax assets for TLC to be negatively related to future tax payments and non-usable TLC to be negatively related to future performance.

To investigate whether the cultural and conceptual differences impair the predictive ability of deferred taxes, I examine the relation between deferred tax information for TLC and future outcomes for a German sample of IFRS adopters. I hand-collect data for firms of the German Prime Standard over the period 2010 to 2012. Controlling for current tax payments, I find a significantly negative association between deferred tax assets for TLC and future tax payments. Additionally, my results indicate a negative and significant relation between non-usable TLC and future performance. Both findings are in line with the prior literature on deferred taxes under other accounting standards and indicate that cultural and conceptual differences do not impair the predictive ability of deferred tax information under IFRS.

To put the informativeness of deferred taxes under IFRS into perspective, I compare the predictive ability of the German sample in additional tests to a matched US sample. Given the different recognition approach, I expect to find a stronger predictive ability for the US sample particularly for the non-recognized deferred tax assets. The findings indicate no significant differences between the deferred tax information reported under IFRS and under US-GAAP, suggesting that the information has comparable usefulness under both standards.

Study (C) makes at least three important contributions. First, in the light of the ongoing discussion about amendments to IAS 12 and in particular suggestions to switch to the US-GAAP recognition approach, the informativeness of deferred taxes under IFRS is of relevance for standard setters. My results suggest that deferred taxes for TLC reported under IAS 12 provide useful information and that a switch to the US-GAAP approach could be expected to have little effect on this predictive ability. Second, I add to the deferred tax literature by being the first to provide evidence on the informativeness of deferred taxes under IFRS. The focus on TLC enables me to disentangle the deferred tax relation to future tax payments and future performance. Third, the findings of study (C) are of interest for capital market participants who form expectations about future tax payments and performance of a firm. Indicating that deferred tax items convey information about these future outcomes, they should be considered for making the respective predictions.

Taken together, the results of the three studies of this thesis highlight the importance of tax information in financial statements. The two main takeaways are: 1. Firms' tax disclosure behavior seems to be driven in the first place by investors' demand for information, indicating that the expected capital market benefits outweigh possible proprietary costs (study A and B). 2. Deferred taxes reported under IFRS provide information that is useful to predict future outcomes and this predictive ability does not differ significantly from the usefulness of deferred taxes reported under US-GAAP (study C).

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3 STUDIES OF THE DISSERTATION

A) TAX LOSS CARRYFORWARD DISCLOSURE AND UNCERTAINTY

Vanessa Flagmeier*, Jens Müller#

Abstract

We examine whether companies voluntarily disclose additional information about tax loss carryforwards when the recoverability is more uncertain. With this study, we aim to explain part of the huge cross-sectional variation in the tax footnote. To assess disclosure behavior, we hand-collect data from notes of large German firms' IFRS financial statements and identify voluntarily disclosed information. First, our results support prior literature's evidence of a considerable cross-sectional variation of disclosure in the tax footnote. Second, we find that uncertainty about the usability of tax losses has a significantly positive relation to the amount and quality of disclosure, controlling for other disclosure determinants derived from prior literature and for sample selection. Third, our results indicate that the observed disclosure behavior is not simply a reflection of the firm's general disclosure behavior but specific to the tax footnote. These findings are robust to several historic and forward-looking indicators representing uncertainty. Our findings suggest that managers anticipate the investors' need for more private information and disclose them voluntarily to reduce information asymmetries. This result indicates that part of the cross-sectional variation in the tax footnote can be explained by firms anticipating investors' demand for additional information.

Keywords: tax loss carryforwards, disclosure, uncertainty, tax footnote, deferred taxes

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B) WHEN DO MANAGERS HIGHLIGHT THEIR EFFECTIVE TAX RATE?

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Abstract

We examine the disclosure of GAAP effective tax rate (ETR) information in firms' financial statements. Applying the theoretical underpinnings of Wagenhofer (1990) to a tax setting, we argue that firms face a tradeoff in their GAAP ETR disclosure decision. On the one hand, firms have incentives to increase GAAP ETR disclosure if the ratio has a condition that is favorable from an investor's perspective, expecting positive capital market reactions. On the other hand, the disclosure might draw tax auditors' and public attention to the GAAP ETR and result in proprietary costs in terms of additional tax payments or reputational damages. We empirically test the disclosure behavior by examining the relation between disclosure intensity and five different measures of favorable GAAP ETR conditions. First, we provide evidence that the annual report section in which most of the firms disclose GAAP ETR information is the management report, indicating that firms assign considerable relevance to the ratio. Second, we find a higher disclosure intensity if the GAAP ETR has a favorable condition, i.e. is decreasing or near the average ratio of firms in the same industry or size group. We do not find a significant relation to the disclosure level for smooth GAAP ETRs. Our findings indicate that firms assess the benefits of providing the favorable GAAP ETR information to be higher than the related costs. Documenting firms' GAAP ETR reporting behavior, we contribute to the tax disclosure literature by providing insights into possible disclosure incentives. Further, our results could increase awareness among investors to have a second look at the GAAP ETR if the disclosure intensity with respect to the ratio is low.

Keywords: effective tax rate, disclosure, proprietary costs

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C) THE INFORMATION CONTENT OF TAX LOSS CARRYFORWARDS – IAS 12 VS. VALUATION ALLOWANCE

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Abstract

This is the first study that analyzes the predictive ability of deferred tax information under IFRS. I examine whether deferred taxes provide information about future tax payments and future performance, using a German sample of IFRS firms. The focus on tax loss carryforwards enables a separation of the two relations, testing on the one hand, the relation between recognized deferred tax assets and future tax payments and on the other hand, the relation between the non-usable part of tax losses and future earnings. I find significantly negative coefficients for both deferred tax items, indicating that higher recognized deferred tax assets are associated with lower future tax payments and higher non-usable tax loss carryforwards with lower future performance. Additionally, I compare the tax accounts' predictive ability for a matched German and US sample and find no significant differences between firms reporting under IFRS and US-GAAP. Taken together, the evidence suggests that deferred tax items for tax loss carryforwards reported under IFRS provide useful information about future outcomes and that this predictive ability does not differ significantly from firms reporting under US-GAAP.

Keywords: deferred taxes, IAS 12, valuation allowance, tax loss carryforwards, tax footnote

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