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Research in accounting for income taxes ☆

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ABSTRACT

This paper comprehensively reviews the Accounting for Income Taxes (AFIT) literature. We begin by identifying four distinctive aspects of AFIT and briefly covering the rules surrounding AFIT. We then review the existing studies in detail and offer suggestions for future research. We emphasize the research questions that have been addressed (most of which relate to whether the tax accounts are used to manage earnings and whether the tax accounts are priced by equity market participants). We also highlight areas that have not received much research attention and that warrant future analysis.

1. Introduction

This paper reviews one of the more complex areas of financial reporting: accounting for income taxes (AFIT). AFIT is the process by which (1) future cash tax payments and refunds arising from current and past transactions are recorded as deferred tax assets and liabilities in an attempt to accurately portray the financial position of the firm, and (2) the income tax expense is reported in an attempt to accurately portray the current financial performance of the firm. Before this millennium, AFIT and its implications for financial reporting and effective tax planning attracted limited attention in scholarly circles.[1] However, in recent years, both financial accounting and tax researchers have begun to focus on AFIT, so much so that AFIT has become the most active area of accounting research in taxation.[2] Almost all of the studies have been

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[1] Throughout the paper, we use the term "effective tax planning," to mean tax plans that consider all parties to a transaction, all taxes (explicit and implicit), and all costs (tax and non-tax). See Scholes et al. (2009) for elaboration.

[2] To calibrate the interest in AFIT research, we searched the titles of papers published during the last decade in the *Journal of Accounting and Economics*, the *Journal of Accounting Research*, and *The Accounting Review* for the word "tax" or any variant. We find that 38% of the "tax" papers since 2008 address AFIT issues, compared with 35% from 2004 to 2008 and 22% from 1999 to 2003. One possible reason for a growth in AFIT studies over the last decade is that, beginning in the 1990s, anecdotal information indicates that the tax accounts assumed an enhanced role in financial reporting, becoming instrumental to managing earnings and designing corporate tax shelters. In fact, some companies began to view the tax function as a profit center with a

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empirical, primarily testing the incremental information content of the tax accounts and their role in earnings management. To provide structure for understanding this growing literature, we discuss why AFIT is distinct from other financial reporting topics, briefly explain the essential principles that govern AFIT reporting, review extant studies, highlight key contributions, identify specific remaining questions of interest, and discuss weaknesses and opportunities of a more general nature.[3]

To our knowledge, this is the first comprehensive review of AFIT research.[4] It is designed both to introduce new scholars to this field and to encourage active researchers to expand the frontier of AFIT. It is challenging to reach such a broad audience. For readers who have little or no understanding of the process by which firms account for income taxes in their financial statements (the income statement, balance sheet, statement of cash flows, and the statement of equity), we include an intuitive explanation of the rules governing AFIT in Section 3. Others may wish to skip Section 3.

To narrow the scope of our analysis, we define AFIT research as work that evaluates the implications of the financial reporting choices involving the income tax accounts. Examples include tests of AFIT's role in earnings management and its information content. We exclude from our analysis those studies that use the tax accounts to analyze other phenomena. For example, Mills (1998) tests whether differences in book and tax accounting affect Internal Revenue Service (IRS) audit decisions. Another topic we exclude relates to work examining the association between differences in book and tax accounting and the cost of capital (e.g., Dhaliwal et al., 2008; Ayers et al., 2009; Crabtree and Maher, 2009). While these papers are interesting and important, we exclude them from our analysis because they evaluate the impact of AFIT, rather than studying AFIT itself. We recognize that this delineation is arbitrary, but as with all literature reviews, we are forced to set boundaries for our analysis. In addition, we do not discuss the sizeable literature that addresses tradeoffs between financial reporting and tax considerations.[5] Although AFIT may involve tax planning considerations, we ignore issues related to the coordination of book and tax choices and refer readers to the Hanlon and Heitzman (2010) and Shackelford and Shevlin (2001) reviews.

Although related to traditional corporate income tax research, recent AFIT work resembles mainstream financial accounting research far more than it resembles the "Scholes-Wolfson" tax research, which draws heavily from economics and finance.[6] However, there are some notable differences between AFIT and other financial reporting areas. While the distinctions are detailed in the next section, we briefly discuss them here. First, all companies are subject to taxation, making it one of the most pervasive financial reporting topics. Second, the taxing authority is one of the users of the tax information in the footnotes. Thus, the tax accounts provide information to an adversarial party. Third, the tax accounts provide an alternative measure of income. Finally, income tax expense is not included as a component of operating income. In fact, portions of the tax expense are reported below net income in items such as discontinued operations and other comprehensive income. These distinctive features of accounting for income taxes enable scholars to expand our understanding of financial reporting in directions that might not be possible using other accounts.

We divide the research literature into three topics: earnings management, the association between book-tax differences and earnings characteristics, and the equity market pricing of information in the tax accounts.[7] Rather than provide here in the introduction a detailed and lengthy review of the many inferences that we draw from the extant literature and the directions that we propose for enhanced future study, we condense our findings into four broad generalizations. First, managers use the tax accounts to manage earnings to meet or beat analysts' forecasts, but not for other objectives, such as to smooth earnings, increase a big bath, avoid losses, or meet/beat prior earnings. Second, a small literature documents associations between book-tax differences and earnings characteristics, such as growth and persistence. Third, the evidence is inconsistent about the market's use of the information provided in the tax accounts. Fourth, by eliminating a second source of income information, conforming book and tax accounting would result in a loss of information to the market.

As mentioned above, Sections 2 and 3 provide an overview of AFIT, and Sections 4–6 review the scholarly studies in the field.

2. Why study accounting for income taxes?

A large proportion of AFIT studies have focused on questions that have been well researched in financial accounting, such as earnings management and the incremental content of financial disclosures. To what extent, therefore, do studies

(*footnote continued*)
particular focus on managing the effective tax rate in the income statement. See Schmidt (2006), Bryant-Kutcher et al. (2009), and Robinson et al. (2010), among others.

[3] Appendix 2.2 of Scholes et al. (2009) also provides a detailed discussion of accounting for income taxes.

[4] In their wide-ranging, excellent review of tax research in accounting, finance, and economics, Hanlon and Heitzman (2010) discuss parts of the accounting for income tax literature. However, because the scope of their paper is so wide, they do not provide a complete, detailed analysis of accounting for income taxes.

[5] See Shevlin (1987), Thomas (1988), Matsunaga et al. (1992), Guenther (1994), Collins et al. (1995), Beatty et al. (1995), Clinch and Shibano (1996), Collins et al. (1997), Maydew (1997), Engel et al. (1999), Keating and Zimmerman (1999), and Albring et al. (2011a) among many others.

[6] See Shackelford and Shevlin (2001), Graham (2003), and Hanlon and Heitzman (2010) for reviews of this literature.

[7] Our characterization of AFIT research maps similarly with Hanlon and Heitzman (2010). They state that AFIT research generally examines: (a) the market's interpretation of AFIT information, (b) the use of income tax accruals to manipulate after-tax earnings and (c) the extent to which valuation allowance reveals inside information about the future earnings of the firm. That said, because they review all aspects of tax research, their discussion of accounting for income taxes is relatively brief and limited. In contrast, because we focus solely on AFIT, we are able to provide a more comprehensive analysis of the field.