



Analyst coverage and corporate tax aggressiveness[☆]



Arthur Allen^a, Bill B. Francis^b, Qiang Wu^b, Yijiang Zhao^{c,*}

^a School of Accountancy, University of Nebraska-Lincoln, Lincoln, NE 68588 USA

^b Lally School of Management, Rensselaer Polytechnic Institute, Troy, NY 12180, USA

^c Kogod School of Business, American University, Washington, DC 20016, USA

ARTICLE INFO

Article history:

Received 20 August 2015

Accepted 13 September 2016

Available online 19 September 2016

JEL classification:

H20

G34

M41

Keywords:

Corporate tax aggressiveness

Analyst coverage

Investor recognition

Information asymmetry

Market pressure

Natural experiment

ABSTRACT

We examine the impact of analyst coverage on corporate tax aggressiveness. To address endogeneity concerns, we perform a difference-in-differences analysis using a setting which causes exogenous decreases in analyst coverage. Our tests identify a negative causal effect of analyst coverage on tax aggressiveness, suggesting that higher analyst coverage constrains corporate tax aggressiveness. Further cross-sectional variation tests find that this constraining effect on tax aggressiveness is more pronounced in firms with lower investor recognition and firms with more opaque information environments. Our results are consistent with the notion that higher analyst coverage increases the visibility of aggressive tax planning behavior as well as heightens analysts' demand for more transparent information, which in turn reduces tax aggressiveness.

© 2016 Elsevier B.V. All rights reserved.

1. Introduction

Despite substantial research on the determinants of tax aggressiveness over the past decade (e.g., Hanlon and Heitzman, 2010), it remains unclear whether financial analysts, as key information intermediaries in capital markets, constrain or encourage corporate tax aggressiveness.¹ Graham et al. (2014) in a recent influential

survey suggests that analysts are likely to serve a *dual* role. Yet they do not examine the *overall* effect of analyst coverage on aggressive tax avoidance nor the channels through which these effects occur. Meanwhile, recent studies suggest that analysts have a significant impact on various corporate decisions (e.g., Derrien and Kecskes, 2013; He and Tian, 2013). Motivated by these two strands of literature, our study aims to examine the overall impact of analysts on corporate tax aggressive activities as well as the channels through which analysts affect such activities.

Prior literature suggests three competing views regarding the effect of analyst coverage on tax aggressiveness. We label our first view as the “investor recognition view.” It focuses on the role of financial analysts in enhancing *investor recognition* for firms' stocks (e.g., Mola et al., 2013; Li and You, 2015). According to this view, higher analyst coverage increases a stock's visibility, and as such, it is also likely to increase public awareness of the underlying firm's practices such as aggressive tax strategies. Thus, to the extent that public dissemination of such activities brings about various non-tax related costs such as the loss of reputation (e.g., Hanlon and Slemrod, 2009), higher analyst coverage reduces returns to tax aggressive activities and thus dampens firms' incentives to engage in these activities.

We label our second view as the “information demand view.” It posits that aggressive tax strategies not only are complex and opaque in nature (e.g., Balakrishnan et al., 2013), but also entail

^{*} We would like to thank Geert Bekaert (editor), two anonymous referees, Ajay Adhikari, Shijun Cheng, Parthiban David, Augustine Duru, Iftekhar Hasan, Mark (Shuai) Ma, Tom Omer, Xuguang Sheng, Hao Zhang, and participants at Rensselaer Polytechnic Institute research seminar for comments that were helpful in developing this work. We are also grateful to Alok Kumar and Kelvin Law for providing analysts-related data.

^{*} Corresponding author. Fax: 202 885 1992.

E-mail addresses: aallen1@unl.edu (A. Allen), francb@rpi.edu (B.B. Francis), wuq2@rpi.edu (Q. Wu), yzhao@american.edu (Y. Zhao).

¹ Following prior literature (e.g., Frank et al., 2009), we define tax aggressiveness as the downward manipulation of taxable income through aggressive tax planning which may or may not be considered illegal. At the aggressive end of tax avoidance practices, tax aggressive activities involve significant uncertainty and risks including information risk, audit risk, and reputation risk (e.g., Hanlon and Slemrod, 2009; Kim et al., 2011; Hasan et al., 2014). Because firms engaging in tax aggressive activities tend to have lower shareholder value, focusing on tax aggressiveness allows our study to draw a relatively clean inference about the role analysts may play. We use the terms “tax aggressiveness,” “aggressive tax avoidance,” “tax aggressive strategies,” and “tax aggressive activities” interchangeably throughout the paper.

high uncertainty and volatility (e.g., Hanlon et al., 2014; Saavedra, 2014). This increases information asymmetry between firms and outsiders such as financial analysts over tax-related transactions, which in turn is likely to result in undervaluation of the stock (e.g., Krishnaswami and Subramaniam, 1999). To the extent that higher analyst coverage increases the likelihood that analysts as a group seek guidance from the firm's management and express concerns about the difficulty in assimilating such information, management is more likely to cater to analysts' *information demand* for predictable earnings by limiting tax aggressive activities.

We label our third view as the "market pressure view." It treats tax aggressiveness as a behavior driven by external market pressures to avoid earnings disappointments. Graham et al.'s (2014) survey shows that the majority of public firms say that increasing reported earnings is an important outcome from tax planning strategies. As prior literature also suggests, analysts put *pressure* on management to manage earnings in order to meet earnings targets (e.g., He and Tian, 2013; Irani and Oesch, 2016). To the extent that higher analyst coverage spreads bad news (e.g., earnings disappointments) more quickly and thus imposes greater pressure on management, firms with higher analyst coverage are more likely to avoid taxes aggressively. Thus, in contrast to the previous two views, this pressure view predicts a positive relationship between analyst coverage and tax aggressive activities.

Any empirical examination of the relationship between firm-level measures of analyst coverage and tax aggressiveness is complicated by endogeneity bias. To address this issue, we follow Hong and Kacperczyk (2010) and rely on brokerage house mergers which, due to laying off redundant analysts, led to an *exogenous* decrease in affected firms' analyst coverage.² Following prior literature (e.g., Wilson 2009; Frank et al. 2009), we adopt two measures of tax aggressiveness: the tax shelter prediction score and the discretionary permanent component of book-tax differences. We perform difference-in-differences analyses, comparing the changes in tax reporting behavior of treatment firms to those of propensity-score matched firms. Our results suggest a negative *causal* effect of analyst coverage on tax aggressiveness, which supports the predictions of the investor recognition and information demand views but does not support the market pressure view. Our results are also economically meaningful. For example, the shelter prediction scores of treatment firms are about 0.142 (approximately 9.7% of the median *Shelter*) higher in the post-merger period than in the pre-merger period, after controlling for the contemporaneous change in match firms.

We further perform a variety of tests on the cross-sectional variation in the effect of analyst coverage. If the investor recognition view holds, the constraining effect of analyst coverage should vary with the level of firm visibility. Consistent with this view, we find that the negative causal relationship between analyst coverage and tax aggressiveness is more pronounced for firms with lower visibility. As the information demand view suggests, analysts' information demand could encourage management to limit complex transactions such as tax aggressive activities. To the extent that analysts' information demand increases with corporate opacity, this view suggests that the constraining effect is likely to be more salient for opaque firms than for transparent firms. Consistent with this view, we find that the negative causal relationship between analyst coverage and tax aggressiveness is more pronounced in opaque firms.

In addition, one may argue that financial analysts play a traditional monitoring role. If higher analyst coverage constrains tax aggressiveness through the monitoring channel, the constraining

effect is likely to vary with the strength of corporate governance. However, we do not find significant differences in this constraining effect between well governed and poorly governed firms. Finally, although our baseline findings do not support the pressure effect, it is still possible that the pressure effect of analyst coverage holds for a subset of firms facing excessive market pressure from analysts. We further split our sample by the level of market pressure, but our empirical evidence is not supportive of the market pressure view. In sum, our subsample test results are more consistent with investor recognition and information demand serving as plausible channels through which higher analyst coverage constrains tax aggressiveness.

Our paper makes several contributions to the prior literature. First, it contributes to the emerging literature on the effect of capital markets on corporate tax avoidance.³ Focusing on the monitoring role of capital markets, prior literature generally investigates how capital market participants such as institutional investors affect tax avoidance (e.g., Cheng et al., 2012; Khurana and Moser 2013). Unlike these studies, we focus on financial analysts, an important intermediary in capital markets. We are the first to find evidence that higher analyst coverage constrains tax aggressive strategies. Additionally, we find that the constraining effect is achieved through two non-monitoring channels: one is the increased visibility of such activities, and the other is the heightened demand for transparent and predictable information.

Our study also contributes to the literature investigating the effects of analyst coverage on real corporate activities. Derrien and Kecskes (2013) and Chen et al. (2015) focus on the governance role of financial analysts in affecting corporate investments, while He and Tian (2013), and Irani and Oesch (2016) find that market pressure from higher analyst coverage impedes innovation and exacerbates real earnings management. Unlike these studies, we focus on the investor recognition and information demand roles of higher analyst coverage in affecting aggressive tax strategies, another important real corporate activity.

Finally, our study also adds to the literature on analyst coverage and corporate information environments. Prior studies (e.g., Roulstone, 2003; Piotroski and Roulstone, 2004; Yu, 2008; Irani and Oesch, 2013; Kelly and Ljungqvist, 2012; Mola et al., 2013) find that higher analyst coverage is associated with greater market liquidity, less accruals management, and less information asymmetry. Our findings suggest that higher analyst coverage also improves firms' information environments through a previously unexamined channel (e.g., constraining complex activities such as tax aggressive activities).

The remainder of the paper is organized as follows. Section 2 develops the hypotheses. Section 3 provides the research design and reports summary statistics. Section 4 reports the empirical results. Section 5 provides the conclusions.

2. Theory and hypothesis development

2.1. Investor recognition view

Tax aggressiveness refers to the most extreme subset of tax avoidance activities that are "pushing the envelope of tax law" (Hanlon and Heitzman, 2010; p.137). Tax aggressive activities are more likely to be scrutinized by tax authorities. When successfully challenged, firms may be subject to large penalties (Wilson, 2009). Firms engaging in tax aggressive behavior also bear potential reputational costs. In particular, as argued by Bankman (2004) and Hanlon and Slemrod (2009), if a firm is publicly revealed to be

² As a supplemental test, we also use Yu's (2008) instrumental variable two-stage least squares approach to address endogeneity bias and find consistent results.

³ Recent studies (e.g., Lim, 2011; Feld et al., 2013; Lin et al., 2014) also examine the relationship between taxes and the cost of debt, capital structure, and financial leverage.

Download English Version:

<https://daneshyari.com/en/article/5088127>

Download Persian Version:

<https://daneshyari.com/article/5088127>

[Daneshyari.com](https://daneshyari.com)