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Assessing the relevance of deferred tax items: Evidence from loss firms during the financial crisis

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ABSTRACT

This study examines the information content of deferred tax items for stock prices using two interrelated research settings that are expected to affect it: the financial crisis and incurred loss. It uses a set of Greek listed firms for the period of time after the implementation of the International Financial Reporting Standards (IFRS). Our results indicate that deferred tax items possess information content that investors deem relevant. More specifically, like Dhaliwal, Kaplan, Laux, and Weisbrod (2013), we determined that loss firms have tax items that are perceived by investors as signals of future performance. Moreover, in almost all of the research settings examined, net deferred tax liabilities negatively related to stock prices and this negative effect becomes more pronounced for loss firms during the financial crisis.

1. Introduction

Over the past several years, the value relevance of deferred tax has been a popular topic in the literature (Dhaliwal et al., 2013; Graham, Raedy, & Shakelford, 2012). What makes this topic interesting is the complexity of the estimation of income taxes, which sheds light on likely information content for stock prices. Therefore, income tax implications for financial statement users are less likely to prevail.

Amir, Kirschenheiter, and Willard (1997) conducted one of the first studies that examined the information content of deferred taxes. They demonstrated that the information content of deferred tax is conditional on the likelihood of settlement, as well as on the period that passes prior to this settlement. However, more recent studies, such as that of Guenther and Sansing (2004), provide evidence which contradicts that of Amir et al. (1997). In light of this mixed evidence, Graham et al. (2012) recognized the need for additional research on the information content of deferred tax.

Dhaliwal et al. (2013) extended the literature on the information content of tax items by examining the case of loss firms. Their results indicated that, under certain circumstances, deferred tax items may act as signals of firms' future performance. Consequently, market participants perceive them positively even though the firm reports a loss in the current year.

In the present study, we aim to assess the value relevance of deferred tax items in Greece in the period following the implementation of the International Financial Reporting Standards. The research questions that motivated the study are how informative are the deferred tax components and in what extend they are affected by the financial crisis and the existence of losses. In this respect, we seek to provide additional evidence on the value relevance of various deferred tax items under an

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institutional setting, which in turn provides a number of interesting research settings that constitute the research directions of this study.

The first research opportunity is the financial crisis that started in Greece in 2010 as a debt crisis and expanded to the real economy. Baur (2012) examines the contagion effects during a financial crisis and presents evidence that is in agreement with the existence of contagion effects from the financial sector to the other sectors and the real economy (see also Bekaert, Ehrmann, Fratzscher, & Mehl, 2011 for the spread of a financial crisis across countries and sectors). In Greece, the effects have been more material as compared to other affected countries, such as Portugal or Ireland. Previous literature indicates that the use of deferred taxation may be distorted by the presence of incentives, for discretionary behavior during a financial crisis (Skinner, 2008). Even in cases where deferred tax items are not affected by incentives, investors will likely react negatively to the additional recording of deferred tax liabilities during the crisis, as this may delay the firm's future profits. Therefore, the crisis will likely alter the information content of deferred tax.

The second research setting is the higher likelihood of losses for firms during the crisis. Given that the period under investigation includes the first major financial crisis after the implementation of the IFRS, it provides a research opportunity to examine the information content of deferred tax for loss firms. This research task is motivated by Dhaliwal et al. (2013), who indicated that changes in the persistence of accounting losses of US loss firms were related to the management decisions regarding the deferred tax. Therefore, out of sample evidence can be obtained by examining the information content of deferred tax from loss firms under crisis.

The present study uses a variant of the Ohlson (1995) model in order to examine the information content of deferred tax items, with an additional number of intercept and slope dummy variables that help in unveiling the effects of losses and the financial crisis. Our results indicate that deferred tax items are value relevant under specific circumstances. Moreover, we determined that the likelihood of a loss during the financial crisis leads to incremental negative coefficients of net deferred tax liabilities. This implies that recording net deferred tax liabilities makes the reversal from losses to profits less likely because they reflect future tax payments; investors perceive this as a negative signal for the firm. However, investors appreciate recorded deferred tax assets (and the associated deferred tax effects in income statements) from a loss firm.

This paper is divided in five sections: section two provides a literature review and the research hypotheses of the study; section three develops the research framework; section four describes the data and analyzes the empirical results; and section five concludes the study and offers implications for future research.

2. Literature review and research hypotheses

The value relevance of deferred tax items has been a topic of a growing interest over the past two decades. Beaver and Dukes (1972) are among the first to pioneer a study proposing that deferred tax items may be value relevant for investors. Amir et al. (1997) suggested that the value relevance of deferred tax items is based on the likelihood of reversal and the time it takes for that reversal. Guenther and Sansing (2004) on the other hand, developed a theoretical model which proved that the relevance of deferred tax items is not a function of the time it takes for them to reverse. In light of these results, Graham et al. (2012) identified the necessity for supplementary research on the value relevance of deferred tax.

Laux (2013) indicated that investors seem to value only the information content of specific items of deferred tax; he therefore questioned the information's ability to offset the cost of producing and utilizing it. Chludek (2011) produced one of the first studies to examine the value relevance of deferred tax items under the IFRS. Using a sample of German firms, she indicated that deferred tax items do not possess any information content for market prices. She also revealed that a large part of deferred tax items tend to reverse. However, irrespective of reversals, Chludek did not find evidence that deferred tax items have some information content for stock prices. Finally, Samara (2013) examined the value relevance of deferred tax items for a sample of Greek firms after the implementation of IFRS. Her results revealed that certain items of deferred tax, such as deferred tax liabilities, have information content which investors deem relevant.

Motivated by the literature on deferred taxation, we take the stance of Amir et al. (1997) and assume that investors view deferred tax liabilities as future income-reducing items. Hence, it is expected that net deferred tax liabilities will be negatively related to stock prices. Therefore, the first research hypothesis refers to the information content of deferred tax liabilities:

H_1: Net deferred tax liabilities possess information content for stock prices.

However, the existing evidence fails to account for the effects of the European sovereign debt crisis, which primarily affected countries in southern Europe and especially Greece, on the value relevance of deferred taxes. If the crisis induces incentives to use deferred taxes discretionary, their information content is expected to decrease and they will be less value relevant. Skinner (2008) examined the use of deferred taxation for a sample of Japanese banks and determined that they use deferred taxes discretionary to avoid liquidation. An alternative hypothesis states that investors will negatively react to additional recordings of deferred tax liabilities during the crisis as this may delay the firm from future profit. In both these cases, the recording of net deferred tax liabilities during the crisis is expected to be negatively valued by investors. Therefore, the second research hypothesis is as follows:

H_2: The incremental information content of net deferred tax liabilities for stock prices during the financial crisis is negative.