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The effect of tax audit outcomes on the reporting and valuation of unrecognized tax benefits☆

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ABSTRACT

We examine whether firms respond to settlements of their uncertain tax benefits (UTBs) by adjusting the related UTB reserve. A reported UTB settlement indicates that the tax authority challenged at least one of the firm's uncertain tax positions, thereby providing information to managers regarding the sustainability of similar tax strategies and outstanding UTBs. Consistent with expectations, our results suggest that UTB settlements are negatively related to the accrual for new uncertain tax positions. Further, we demonstrate that managers make less downward adjustments to the UTB reserve related to existing uncertain tax positions following settlements with tax authorities. Finally, additional analysis suggests that the valuation of UTBs is lower in the year subsequent to a UTB settlement. Collectively, our results suggest that the information gathered from tax audit outcomes influences firms to be more conservative in their tax reporting, and possibly their future tax planning as well.

1. Introduction

The primary purpose of this study is to examine how tax enforcement mechanisms alter tax planning and reporting behavior. To carry out this objective, we focus on changes to the reserve for unrecognized tax benefits (UTBs). In the annual disclosure of the UTB reserve, firms are required to provide a reconciliation between the beginning and ending balance of the reserve. One component of the reconciliation is the decrease to the reserve due to settlements. The presence of a settlement indicates that a tax authority challenged at least one of the firm's uncertain tax positions. Given that the goal of any enforcement mechanism is to increase cooperation, we test whether the occurrence of a settlement in the current period alters UTB reporting behavior. Specifically, when a tax audit results in a settlement, firms receive new information regarding the sustainability of similar tax strategies and existing uncertain tax positions. As such, we posit that firms experiencing UTB settlements will: 1) engage in less new uncertain tax positions going forward; and 2) revise their expectations regarding the realizability of similar uncertain tax positions taken in prior periods by increasing the related reserve.

In addition, given that UTB settlements, our proxy for audit settlements with tax authorities, are disclosed to financial statement users through the UTB rollforward, we investigate whether reported settlements influence the capital market's valuation of the remaining reserve. We contend that these tax audit outcomes are a signal to investors about the realization of cash tax savings stemming from a firm's uncertain tax avoidance activities. All else equal, firms entering into UTB settlements are retaining less of their cash tax savings relative to firms without settlements. Hence, we posit that the valuation of a company's UTB reserve will decrease in the presence of a settlement.

We test our hypotheses using a sample of firms from 2008 to 2015. To examine the effect of UTB settlements on adjustments to the related reserve, we estimate a series of UTB component models following Drake, Goldman, and Lusch (2016) and include a variable that captures the magnitude of settlements as a percentage of the total UTB reserve in the current period. Consistent with our conjecture, we find that UTB settlements are negatively related to the accrual for new uncertain tax positions. Furthermore, we demonstrate that UTB settlements are positively associated with the UTB accrual related to uncertain tax positions assumed in prior periods. Taken together, our results suggest that the information gathered from tax audit outcomes influence firms to become more conservative in tax reporting, and possibly their future tax planning as well.

To test whether settlements influence the valuation of the UTB

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reserve, we employ a research design similar to Koester (2012) and Koester, Lim, and Vigeland (2015). We first replicate a baseline finding of Koester et al. (2015); namely, we document a positive association between the UTB reserve and firm value. Next, we expand the regression model to include the UTB settlement variable, and we interact this variable with the ending UTB reserve. Our results suggest that the presence of a settlement in the current year significantly attenuates the positive valuation of the UTB reserve. Supplemental analysis suggests that this is because historical UTB settlements are predictive of future UTB settlements.

Our study makes several important contributions to the literature. First, our empirical analyses add to the literature on tax enforcement. Much of the prior literature on tax enforcement has focused on individual taxpayers (e.g., Alm, Jackson, & Mckee, 1992) and/or expected levels of enforcement (e.g., Hoopes, Mescall, & Pittman, 2012). We extend this literature by examining the effect of firm-specific tax audit outcomes on subsequent firm behavior. In particular, our results suggest that, following UTB settlements, firms record a lower magnitude of uncertain tax positions and they revise their expectations about the realizability of uncertain tax positions that were established in prior periods. Hence, our findings support the notion that tax audits appear to serve as a successful monitoring mechanism and lead managers to be more conservative in their tax reporting. Lastly, we contribute to the literature examining the valuation of uncertain tax positions by identifying one facet of the nuanced relationship between the UTB reserve and firm value. In particular, the results of our study suggest that prior realizations of the cash tax benefits associated with UTBs are associated with expected future realizations, making them an important determinant of the valuation of UTBs.

With respect to our focus on tax settlements relating to uncertain tax positions, our study is similar to two concurrent working papers, Finley (2017) and Bauer and Klassen (2017). Specifically, Finley (2017) employs a first-stage regression model to distinguish between the 'favorable' and 'unfavorable' components of interest and penalties relating to UTB settlements. Among other findings, Finley (2017) demonstrates that unfavorable settlements are positively related to the probability of tax-related restatements, and that firms with higher favorable settlements subsequently engage in more tax avoidance activities.

Bauer and Klassen (2017) examine the capital market reaction to the announcement of a UTB settlements in firms' 10-K filings. Similar to Finley (2017), Bauer and Klassen (2017) also differentiate between favorable and unfavorable UTB settlements; however, they employ textual analysis to distinguish between the two types. Consistent with their hypothesis, they find that the unfavorable UTB settlements are negatively related to cumulative abnormal returns surrounding the 10-K filing date, whereas favorable settlements are not.

Our study differs from Finley (2017) and Bauer and Klassen (2017) in two important ways. First, we view all UTB settlements as 'unfavorable' in that all settlements indicate that a portion of the cash tax savings associated with a tax position were not retained. We do note that the GAAP ETR effect of settlements can be favorable or unfavorable, depending on firm's accrual for the position; however, all settlements represent a cash outflow to a taxing authority. Thus, settlements, particularly large settlements, should influence management's future use of the specific tax strategy that was related to the settlement. As such, we assess the effect of all UTB settlements on tax planning and reporting behavior. Second, we examine the impact of UTB settlements on specific components of the UTB reserve, allowing us to provide evidence on how the information gathered during the settlement process influences management behavior with respect to the reporting of uncertain tax positions.

We organize the remainder of our paper as follows. Section 2 discusses the disclosure requirements of UTBs under U.S. GAAP, summarizes the relevant literature, and develops our hypotheses. Section 3 provides an overview of our research design and discuss our sample and related descriptive statistics. Section 4 summarizes the results from the multivariate tests of our hypotheses. Section 5 concludes.

2. Background, literature review, and hypothesis development

2.1. FASB interpretation No. 48

Effective for fiscal years beginning after December 15, 2006, FASB Interpretation No. 48 (i.e., FIN 48), *Accounting for Uncertainty in Income Taxes*, requires companies to estimate and record a contingent liability for unrecognized tax benefits in their financial statements. According to the standard, managers must determine whether it is "more-likely-than-not" that a tax position will be sustained upon examination by the tax authority. If this first prong is met, then managers must determine the amount of the tax position's benefit that may be recognized on the financial statements. The portion that cannot be recognized in the current period increases a contingent liability account, commonly referred to as the UTB reserve.

The UTB reserve is a cumulative account, and yearly changes to the reserve primarily consist of five components: (1) increases to the reserve related to new tax positions taken in the current period; (2) increases to the reserve related to tax positions established in prior periods; (3) decreases to the reserve related to tax positions assumed in prior periods; (4) decreases to the reserve related to settlements with taxing authorities; and (5) decreases in the reserve related to a lapse in the statute of limitations for the particular tax position.[1,2] The intended effect is that if a position is fully reserved for, then the increase in the reserve in the current period will be equal to the decrease in the reserve in a later period when the position is settled with the taxing authority. In this case, the settlement still results in a cash outflow, but will have no effect on the firm's GAAP effective tax rate. However, the standard requires managers to assume that every position will be audited by the tax authority and that the tax authority has complete information about the tax position. Therefore, the standard is quite conservative in nature, an assertion supported by Robinson, Stomberg, and Towery (2016), who demonstrate that, on average, only 24 cents of each dollar of UTB eventually unwinds via settlements.

2.2. Literature review and development of hypotheses

2.2.1. The effect of tax audit outcomes on the reporting of the UTB reserve

Broadly speaking, our research question of how firms alter their behavior in response to tax audit outcomes fits into the stream of research that investigates the effect of enforcement mechanisms on the subsequent behavior of the enforcee. This question has been examined by prior studies in a variety of settings. For example, Gray and Scholz (1993) find that OSHA inspection outcomes resulting in penalties appear to induce a 22% decline in injuries at the inspected plant in subsequent periods. More recently, Ettredge, Huang, and Zhang (2012) demonstrate that firms increase the conservatism of their financial reporting following a restatement; however, the effect is limited to firms that simultaneously improve their corporate governance. Relatedly, Chen, Elder, and Hung (2014) document that increased conservatism following restatements is more pronounced in the post-SOX era. Finally, Drake et al. (2016) find that following the failed remediation of a PCAOB Part II report, audit firms increase scrutiny, which manifests itself in changes in their clients' financial reporting. Taken together, these studies suggest that enforcement, at least to an extent, is successful in modifying the subsequent behavior of the enforcee.

Much of the initial theoretical work on tax compliance (e.g., Graetz, Reinganum, & Wilde, 1986; Reinganum & Wilde, 1988) focuses on the

[1] For the sake of simplicity, we refer to tax positions assumed in the current fiscal year as 'new' uncertain tax positions, and outstanding uncertain tax positions that were established in prior fiscal years as 'existing'.

[2] While these are the primary components of the UTB tabular rollforward, the yearly change in the ending UTB reserve can also be impacted by foreign exchange adjustments as well as the acquisition or disposal of UTBs through a merger or acquisition. We provide an example of a UTB tabular rollforward in Appendix B.