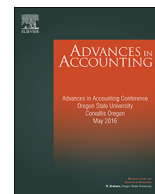




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Book-tax differences and costs of private debt[☆]

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ABSTRACT

In this study, we test for associations between measures of book-tax differences (BTDs) and measures of private bank loan costs. Our measures of bank loan costs are: (1) interest rate spreads, and (2) security requirements. Initial results suggest a positive association between variability in total BTDs, but not levels, and private debt costs. After decomposing BTDs into their permanent and temporary components, we find that temporary BTDs (levels and variability) are consistently positively associated with costs of private debt, whereas permanent BTDs are not. Further, we find that the positive relation between BTDs and costs of private debt is attenuated for high-tax-planning firms and is stronger for loan facilities in which leading lenders have high market shares. Consistent with the findings of Ayers, Laplante, and McGuire (2010), we interpret these results as indicative of BTDs generally impacting the precision of the information conveyed in the financial statements, raising concerns about earnings quality, except where the BTDs likely result from tax planning.

1. Introduction

Differences between reported financial statement income and taxable income, or book-tax differences (BTDs), are known to originate from any of several sources, broadly speaking. Simple differences in the accounting rules between Generally Accepted Accounting Principles (GAAP) and the Internal Revenue Code (IRC) are responsible for many book-tax difference items, but BTDs also often arise from decisions made by management (e.g., application of accounting rules, generation of estimates, incorporation of anticipated future events into current accounting, aggressive reporting, etc.). The reflection of managerial judgment in BTDs can make interpretation of them more complex and add to uncertainty surrounding the information conveyed in the financial statements, thus affecting the financial statements' informativeness (Comprich, Graham, & Moore, 2011; Hanlon, 2005). In this study, we examine whether any such information effects of BTDs manifest in bank loan contracting and influence price and non-price costs of private debt.

Understanding whether and how the information effects of BTDs impact the costs of private debt is important in part because of the economic significance of private debt. Specifically, bank loans are a major source of external financing for public and private firms

worldwide (Bharath, Sunder, & Sunder, 2008; Faulkender & Petersen, 2006; Graham, Li, & Qiu, 2008; Kim, Li, & Li, 2010; Qian & Strahan, 2007; Sufi, 2007), with the global volume of syndicated loans exceeding \$2.9 trillion for the first three quarters of 2016 (Thomson Reuters, 2016). Accordingly, deepening our insights on the relation between tax-related reporting and private loan costs will help us to better understand the properties of this pervasive economic transaction.

Further, notwithstanding recent research documenting information effects of BTDs on public debt costs (Ayers et al., 2010; Crabtree & Maher, 2009) and effects of tax avoidance on private loan costs (Hasan, Hoi, Wu, & Zhang, 2014; Kim et al., 2010), the literature does not yet provide a clear picture of how the information in tax-related disclosures factors into the costs of borrowing. Specifically, Ayers et al. (2010) find that large positive or negative changes in BTDs are associated with negative changes in credit ratings and attribute this result to large BTDs of either sign having a negative effect on the quality and precision of the information reported in the financial statements (e.g., Hanlon, 2005). These findings are consistent with large BTDs contributing to higher borrowing costs in a *public* debt setting. However, it is not clear *ex ante* that private lenders, and thus the costs of *private* debt, will be similarly affected by the information quality implications of BTDs. This is because of private lenders' arguably greater access to firms' private

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information and greater abilities and incentives to monitor borrowers' credit quality (Diamond, 1984; Fama, 1985; James, 1987).

In addition, multiple recent studies (Hasan et al., 2014; Kim et al., 2010) address a similar question by using BTD-based measures (among others) to represent tax avoidance/aggressiveness and report mixed evidence as to its relation with private loan costs. However, the BTD-based measures employed by these papers to capture tax avoidance/aggressiveness use signed BTD amounts (i.e., not absolute values), thus treating large negative BTDs as low levels of tax avoidance/aggressiveness. As such, these studies do not acknowledge the potential for large *negative* BTDs to have effects on private loan costs similar to those of large *positive* BTDs. Any extent to which this is true would suggest that BTDs, beyond tax avoidance itself, impact costs of private debt in a manner more consistent with the information quality effects of BTDs discussed above.

Based on the findings of Ayers et al. (2010) and other studies linking BTDs of both signs to information-related effects such as lower earnings quality (e.g., Hanlon, 2005), higher audit costs (e.g., Hanlon, Krishnan, & Mills, 2012), and higher market uncertainty (e.g., Comprix et al., 2011; Dhaliwal, Lee, Pincus, & Steele, 2017), we predict that BTDs will be positively associated with costs of private debt, similar to their documented associations with costs of public debt. However, we may not find this relation if private lenders' greater access to private information and greater incentives and ability to monitor relative to public debtholders neutralize the BTD-related uncertainty surrounding the information conveyed in the financial statements. Further, to the extent that BTDs are more indicative of tax planning (e.g., Frank, Lynch, & Rego, 2009; Hasan et al., 2014; Wilson, 2009) than contributing to uncertainty in financial reports (e.g., Comprix et al., 2011), we may find no such association or even a negative one (e.g., Kim et al., 2010). Accordingly, the existence and degree of this association is an empirical question.

We examine the relation between private debt costs and BTDs, measured in terms of absolute values and time-series variability. By measuring BTDs in these ways, we account for the potential contributions of both large positive and large negative BTDs to uncertainty surrounding the information presented in the financial statements. We also decompose BTDs into their permanent and temporary components to provide some insight as to the types of BTDs that may make interpretation of the financial statements a more complex task for private lenders. To capture private loan costs, we employ interest rate spread and security requirements. Using a sample of 6336 firm-year observations covering the period 1996–2012, we find that costs of private debt are increasing in temporary BTDs, but not permanent ones, and that this association is present across both private debt cost measures and for both levels of and variability in BTDs. We also find that the relation between temporary BTDs and private debt costs applies to BTDs of both signs (i.e., positive and negative).

In additional analyses, we find that tax planning impacts the association between BTDs and loan costs. In particular, we demonstrate that the positive relation documented in our main results is mitigated for firms that engage in heavy tax planning activities. Finally, we find that the positive relation between BTDs and private debt costs is stronger where the loan facility is provided by lenders with high market share, consistent with lenders with higher stakes in the private loan market reacting more strongly to risk-relevant information contained in BTDs.

Overall, our results suggest that book-tax differences are positively associated with costs of private debt. Given the connection between BTDs, especially temporary ones, and earnings quality documented in prior literature (e.g., Badertscher, Phillips, Pincus, & Rego, 2009; Frank & Rego, 2006; Hanlon, 2005; Phillips, Pincus, & Rego, 2003; Phillips, Pincus, Rego, & Wan, 2004), this finding is consistent with BTDs raising concerns about earnings quality, resulting in a perception by lenders of increased borrower risk and thus resulting in higher borrowing costs. Our findings further indicate that earnings quality-related concerns about risk are alleviated if the BTDs are generated by a high-tax-

planning firm, consistent with the findings of Ayers et al. (2010) and with recent evidence that tax avoidance is generally seen as a credit-quality-enhancing activity (e.g., Kim et al., 2010). Our findings related to tax planning indicate that BTDs contain risk-relevant information beyond tax avoidance, expanding on recent evidence linking tax avoidance and private loan costs directly (Hasan et al., 2014; Kim et al., 2010).

Our evidence on the manner in which book-tax differences relate to private debt costs adds to our understanding of the role of tax and financial reporting in private debt contracting and extends the growing literature examining the potential economic effects of the information (and related uncertainty) contained in BTDs. Our study is most closely related to Ayers et al. (2010), which focuses on credit ratings (i.e., public debt). Unlike Ayers et al. (2010), we examine the information effects of BTDs in the context of private lenders. This is an important distinction because private lenders arguably have greater abilities and incentives to monitor borrowers' credit quality as well as greater access to private information (Diamond, 1984; Fama, 1985; James, 1987). Accordingly, it is not clear *ex ante* that they will necessarily respond to reported tax-related financial disclosures in the same manner as participants in the public debt market. Together with Ayers et al. (2010), our results show that the information (and related uncertainty) contained in BTDs can impact debt markets on multiple dimensions.

Section 2 provides a review of the prior literature and the development of our hypotheses. Section 3 discusses our research method and data used to test the association between book-tax differences and private debt costs. Section 4 presents the results of our analyses, and Section 5 presents our concluding remarks.

2. Prior literature and hypothesis development

2.1. Book-tax differences

Book-tax differences (BTDs) represent the gap between financial statement income and federal taxable income, both of which publicly traded firms are required to report annually. Financial statement income summarizes a firm's economic gains and losses for investors and other interested external parties, while taxable income does the same for the federal government (Internal Revenue Service). However, the two income measures rarely match each other because they are derived according to different sets of accounting standards that have competing objectives and views of conservatism. Generally Accepted Accounting Principles (GAAP), used for financial reporting, apply a conservatism standard that seeks to avoid overstatement of income and/or assets. On the other hand, the accounting rules provided in the Internal Revenue Code (IRC) are generally more concerned with preventing understatement of income (and thus income tax liability).

Total BTDs can be decomposed into their temporary and permanent components. Temporary differences result from disparity in the timing of an item's recognition for book vs. tax purposes. Temporary BTDs ultimately reverse such that their cumulative effect eventually becomes zero over time, with the reversal timeframe dependent upon the nature of the item generating the BTD. Common examples of items that give rise to temporary BTDs include depreciation expense and unearned revenue. Permanent differences result when GAAP and the IRC prescribe different accounting treatments for specific revenue or expense items, and these accounting differences will not reverse or resolve over time. Common examples include nondeductible expenses (e.g., political contributions) and nontaxable income (e.g., key-person life insurance proceeds).

Basic differences in the accounting rules for book and tax purposes are responsible for many temporary and permanent BTD items, but BTDs also often reflect managerial judgment that manifests in decisions ranging from interpretation and application of financial and tax accounting rules, including estimates, to aggressive reporting practices. Some examples of the former in both the book and tax contexts include

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