Accounting Transparency, Tax Pressure and Access to Finance: Discussion

Christian Leuz
Joseph Sondheimer Professor of International Economics, Finance and Accounting

CHICAGO BOOTH

The University of Chicago Booth School of Business

Basic Idea and Contribution

- The paper analyzes the tradeoff between taxes, transparency and investment
  - Transparency has real effects on access to finance and investment
  - Transparency increases tax payments
- Why do firms withhold information or not fully disclose?
  - Unraveling result suggests we need some frictions to explain non-disclosure
- Alternative explanations in prior work
  - Proprietary costs and competitive disadvantages
  - Private control benefits (e.g., cross-listing literature)
- Authors propose taxes as a key factor

Basic Idea and Contribution

- Authors present a simple model that captures the tax tradeoff
  - Model has rich and intuitive predictions
  - Link the tradeoff to firms' investment and financing decisions
- This link and the topic are clearly of first order importance
  - Although we do need to discuss which firms are likely to face the tax tradeoff that the authors have in mind (more on this later)
- Paper contributes to several areas:
  - Law and finance literature (role of institutions)
  - Effects of transparency on corporate investment efficiency: e.g., Biddle and Hilary (2006), Biddle et al. (2009)
  - Benefits and drawbacks of book-tax conformity

Conceptual Points

- Key assumption:
  - Financial reporting and tax accounting are linked
- Notion of book-tax conformity appears to support assumption
  - But book-tax conformity applies at the level of the parent-only (or statutory) accounts and not the consolidated (or group) accounts
    - E.g., German firms can redo their accounting choices for the consolidated accounts
    - The link exists for German GAAP accounts for statutory purposes but not for IFRS statements for capital markets (firms prepare two sets of accounts)
- In fairness, not all choices in the parent-only accounts can be undone (or separated)
  - Revenue recognition is an example
  - But at this general level we have book-tax conformity even in the US
  - This could explain why the split does not deliver very sharp results

Conceptual Points

- Alternative argument about the effect of taxes (Desai et al.)
  - Strong tax pressure (or enforcement) reduces earnings management
  - Basic idea is that the link reigns in managers' incentives to increase earnings $\Rightarrow$ Similar idea but opposite prediction
  - Debate about (introducing) book-tax conformity in the US
- Authors provide evidence against the argument that a tax link increases accounting transparency
  - Consistent with Hung et al. (2001), Wysocki (2004), Burgstahler et al. (2006)
  - But see also recent paper by Hanlon et al. (2010)
  - Perhaps distinguish between book-tax link and tax enforcement

Burgstahler, Hail and Leuz (TAR 2006)

Variables	Tax Alignment: *TAX*	Tax Alignment: *TAX*RATE*
n	269	269
Conditional Variable	4.180# (1.67)	16.554** (6.22)
Conditional Variable**PUBL*	−3.384 (−0.94)	−8.772** (−2.58)
PUBL	−17.269** (−3.75)	−12.978** (−3.06)
LEGAL	−5.707** (−4.30)	−2.379# (−1.67)
SIZE	1.767 (1.26)	1.072 (0.84)
LEV	27.787** (3.03)	22.554** (2.69)
GROWTH	−65.498* (−2.35)	−56.209* (−1.97)
ROA	−2.546** (−3.77)	−2.115** (−3.27)
CYCLE	0.079# (1.84)	0.076# (1.78)
Intercept and Industry Controls	included	included
R^2	59.9%	64.1%

- LHS variable is earnings management (inverse of transparency)
- Book-tax conformity has negative transparency effect
- Tax effect is less pronounced for publicly traded firms □ Access to finance dampens the tax incentives
- Tax tradeoff is more relevant for private firms

Empirical Strategy

- Key inferences are based on transparency interactions (Table 4) and tax-rate interactions (Table 5)
- In the model, growth opportunities are exogenously given by R(I)
  - In reality tradeoff likely depends on firm-level growth opportunities
  - Similar to idea in private benefits literature that stealing becomes more attractive when growth opportunities dry up (e.g., Johnson et al., 2000; Doidge et al., 2004)
- Think about interactions with growth to tease out additional cross-sectional results to strengthen inferences
- Introduce GDP (or financial development) interactions for the controls $\Rightarrow$ Coefficients are constrained to be the same across countries
- Could you operationalize the parameter γ (i.e., the extent to which a country's tax system is distortionary)
  - Tax rate and γ are likely related (firms resist high rates more when taxes distort)
  - Investment effect of tax rate depends on γ

Empirical Analysis

- Need to test explicitly for differences in coefficients across high and low book tax
- I have several quibbles about the transparency proxies
  - Third discretion proxy (ED3) based on Dechow and Dichev is in contradiction to accounting smoothing proxies

$$TCA_{jt} = \gamma_0 + \gamma_1 CFO_{jt-1} + \gamma_2 CFO_{jt} + \gamma_3 CFO_{jt+1} + v_{jt} \,,$$

- Table 10 provides evidence of a strong proprietary cost effect on transparency
  - Comes also through in other places (e.g., BTM coefficient)
  - Important alternative explanation why firms hold back info

CHICAGO BOOTH

The University of Chicago Booth School of Business