Accounting Transparency, Tax Pressure and Access to Finance: Discussion

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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 ⇒ 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)

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- 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
  \[ \Rightarrow \text{Coefficients are constrained to be the same across countries} \]

• Could you operationalize the parameter \( \gamma \) (i.e., the extent to which a country’s tax system is distortionary)
  – Tax rate and \( \gamma \) are likely related (firms resist high rates more when taxes distort)
  – Investment effect of tax rate depends on \( \gamma \)
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.

\[ TCA_{jt} = \gamma_0 + \gamma_1 CFO_{jt-1} + \gamma_2 CFO_{jt} + \gamma_3 CFO_{jt+1} + \epsilon_{jt}, \]

• 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.