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Citation: Hanlon, Michelle. 2021. "The Possible Weakening of Financial Accounting from Tax Reforms." The Accounting Review, 96 (5).

As Published: 10.2308/TAR-2021-0198

Publisher: American Accounting Association

Persistent URL: https://hdl.handle.net/1721.1/144172

Version: Author's final manuscript: final author's manuscript post peer review, without publisher's formatting or copy editing

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Massachusetts Institute of Technology

PRESIDENTIAL SCHOLAR

The Possible Weakening of Financial Accounting from Tax Reforms

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FORTHCOMING: THE ACCOUNTING REVIEW

Abstract:

There are past and proposed tax law changes that contain provisions that affect financial reporting. These include calls for book-tax conformity, proposals to increase the links between financial accounting and taxable incomes, and actions by Congress that make direct alterations to U.S. GAAP. I submit that these tax law changes potentially threaten financial reporting quality. I discuss my concerns about why such provisions have not attracted attention from accountants to the extent they should and make a case for more awareness and more research going forward.

This essay is based on my Presidential Scholar address at the 2020 American Accounting Association Annual Meeting (held virtually due to the Coronavirus/COVID 19 pandemic). I thank President Terry Shevlin for the opportunity to give the address, Robert Knechel (editor) for inviting the paper for publication, and an anonymous referee. I am grateful to my many co-authors and mentors throughout my career for helping me shape the thoughts expressed in this essay. I also appreciate comments on this essay from Shane Heitzman, Jeff Hoopes, Becky Lester, Ed Maydew, Nemit Shroff, Terry Shevlin, and Ben Yost. I am solely responsible for the views expressed herein.

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I. INTRODUCTION

I am grateful to the American Accounting Association and to Terry Shevlin, President of the American Accounting Association (AAA), for asking me to be a Presidential Scholar at the AAA Annual Meeting in 2020. When Terry asked me to give a Presidential Address, I looked back to prior published Presidential Scholar papers to get a sense of what had been done. Some scholars discuss their life in academics (e.g., Beaver 2015), some were given a specific assignment (the 2015 AAA meeting scholars were asked to comment on Accounting as a Learned Profession; Barth 2018, Christensen 2018, and Hiramatsu 2018), some motivate bridging scholarship and practice (e.g., Mills 2019), and some discuss a research topic or point of view (e.g., Sloan 2019). All of the Presidential Scholar published papers are very interesting and, I believe, constitute contributions to the literature. However, with regard to my immediate quest, what I concluded from reading them is that I could, for the most part, talk about whatever I want.

As a result, I decided I would discuss something that has been on my mind, actually worrying me, for quite a while. Those who know me know I am somewhat of a worrier. For example, I have had pandemic supply boxes at my house for many years, long before 2020. I worry about the national debt on almost a daily basis (even more after 2020). My talk and this paper, however, are about a different looming, admittedly only potential, concern.

My primary worry that I want to discuss is how financial accounting and the financial accounting standard setters, Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), could be weakened by tax reform (or other government actions).[1] In a large-scale context, this could occur by what is known as book-tax conformity.

[1] When I say tax reform, I am using the term very generally and not in reference to any one particular reform. To illustrate, there are examples I will reference below from the Tax Reform Act of 1986, the Tax Cuts and Jobs Act of 2017, the CARES Act of 2020 (which was pandemic relief that included some tax provisions), and tax rules made on a global scale by organizations such as the Organization of Economic Cooperation and Development (OECD). I am

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However, it could happen to some degree in other smaller, yet at times, more direct ways. As we all know, the accounting standard setters operate apart from the government (and are not funded by the government) to provide a more independent standard setting process and resulting set of standards. If governments or other types of tax-rule-setting organizations (e.g., the OECD) require financial accounting income to be used either completely or partially in the computation of taxable income, or the same parties otherwise exert influence over the accounting standards, the standard setting process will be less independent. Moreover, also as a result of government involvement, the standard setting process and resulting standards will be less focused on measurement based on economic events and faithful representation of those events, but rather will be used with the aim of tax revenue collection (and/or income allocation across jurisdictions) and possibly subject to more lobbying from business interests.[2] In addition, companies will likely alter their reporting behavior if financial accounting and taxable incomes are more conformed, more explicitly linked, or financial accounting income is used as part of the taxable income computation. We have some research evidence on increased book-tax conformity and the market effects. I review this evidence below. In sum, the evidence is generally consistent with increased conformity resulting in a greater deferral of income and in a loss of information to the capital markets.[3] However, we do not have all the answers and more research is needed.

I start by discussing three concurrent influences that generate a second worry - that not enough financial accounting researchers are aware of tax law changes that impact financial reporting and not enough economists and lawyers writing the tax policy understand the effects on

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intentionally general because, in my opinion, we need to think about the effect on financial accounting from tax policy in all forms/reforms across time – past, present, and future.

[2] The degradation of financial accounting might lead to more reliance on non-GAAP earnings or pro-forma earnings. I discuss this issue more below.

[3] I discuss this research below along with some estimates of economic magnitudes for the specific settings studied.

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financial accounting. It might be tempting for financial accounting researchers to consider tax reform a topic for those in our field labeled as "tax people." However, I argue the issue of book-tax conformity and of Congress influencing and affecting accounting standards via tax reform (or tax rule changes) poses a serious threat to financial accounting and financial reporting quality. Thus, I am at least as, and maybe more, concerned about these events as an accountant than I am as a "tax person."[4] Thus, we all need to pay close attention to the details of tax reforms, think through how they affect financial reporting, and inform other disciplines with our research. To that end, I move on to discuss prior events regarding conformity and review the related academic literature. Finally, I discuss some very recent, in fact current, examples where 1) versions of book-tax conformity have been or are being proposed and 2) the U.S. Congress has asserted some decision rights over financial accounting standards via tax reform and relief bills.

II. THREE CONFLUENCES

As I thought about the talk and the paper, three confluences, or underlying factors, kept coming to mind. First, how "tax people" and "financial accounting people" get labeled and interact.[5] Sometimes accounting academics operate in a somewhat siloed manner where the subgroups do not necessarily read each other's research. Indeed, my co-authors and I used to joke that we needed to craft our paper titles without the word tax so more people would read them. It is at times, as if these two subparts of the field – tax and financial are very separate. I think the interaction between the subgroups has improved through the efforts of the late Ed Outslay, Terry Shevlin, Lil Mills, and Ed Maydew. But even so, by the time I graduated from the PhD program, there was still quite a distance between the two groups in many ways.

[4] The concerns from the tax side are whether revenue estimators realize the behavioral response to taxing book income (see Hanlon 2012), whether taxing based on book income provides an efficient and fair tax base, and likely others.
[5] And also "audit people," "capital markets people," "theory people," etc.

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Second, is that the tax field is cross-disciplinary and it has long been known that the various disciplines – economics, law, accounting, finance – that study tax do not always communicate clearly. Shane Heitzman and I discuss this issue in our review paper for the *Journal of Accounting and Economics* (JAE) in 2010.[6] Discourse between the various disciplines has also improved over time, however. Some people that have made great progress in changing this tide are Joel Slemrod (economics), Rosanne Altshuler (economics), Doug Shackelford (also a AAA Presidential Scholar this year), John Graham (finance), Dan Shaviro (law), Steve Shay (law), and others. Due to the lobbying by companies, those on tax writing committees have also become much more aware of the importance of financial accounting. As a result, I was asked to testify to both the House Ways and Means Committee and the Senate Finance Committee in 2012 about the interaction between tax and accounting. Insufficient communication between the disciplines can have serious consequences because most people working on tax policy are lawyers and economists, not accountants. Indeed, when interacting in the policy circles one quickly notices the surprise by many about how important accounting is to firm decision-making.[7] If the effects on accounting are not understood or even considered by those informing and writing tax policy, then tax policy can adversely affect financial reporting.

[6] Hanlon and Heitzman's (2010) first footnote reads "Slemrod (1992) characterizes these differences as economists studying what corporations actually do and accountants studying what companies say they do. Gentry (2007) characterizes the difference between economists and accountants as economists believing that 'theory is reality' and accountants believing that 'perception is reality'. The best, however, may have been when a law professor began his talk at a conference of economists, accountants, and lawyers by stating, 'Maybe we should be like the U.N. Security Council and give each person earphones so the talks can be simultaneously translated into our own languages.'" Adding to this list is a statement in the preface of the book "Taxing Profit in a Global Economy" the author team of lawyers and economists state 'In retrospect, our work would have also been helped by the expertise of others, especially from accounting…" (Devereux et al. 2021).

[7] See Hanna (2009) and Poterba et al. (2011). Both discuss the events that occurred when the American Jobs Creation Act was being enacted. Firms with large deferred tax assets actively lobbied against the domestic incentive for manufacturing being enacted as a lower rate; they instead lobbied for a deduction (and enacted in a certain way such that FASB would not interpret as a rate cut). Their lobbying was because a rate cut would devalue their deferred tax assets for financial accounting leading to a hit to earnings. The lobbying on this point was quite surprising to many. See also Edgerton (2012) for an academic paper by an economist that illustrates the surprise that accounting matters.

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Third, and somewhat related to the other two, is some have observed that we – accounting academics – do not pay enough attention to practice and policy. This was quite a prominent theme in the prior Presidential Scholar Addresses (e.g., Barth 2018; Mills 2019). Moreover, as an indication of how many people are concerned about this, the AAA asked a committee of accounting academics, chaired by Patricia Dechow, to evaluate 1) whether there are direct actions the AAA could take to encourage more relevant research, 2) whether there are actions the editors of the AAA journals could take to increase the relevance of published articles, and 3) whether there are actions that universities (promotion committees, deans, etc.) could take to encourage more relevant-to-practice research.[8] This past year, the pandemic has shown us how vulnerable the academic system is (e.g., online teaching); if our research is not relevant to someone, somewhere outside of the university system it is not clear how the current economics of the system are sustainable. Ironically, accounting academe has the risk of not being a going concern itself.

Taking these together, if we want other disciplines to think about accounting effects, and if accountants want to be involved more in policy discussions (or as I put it in my AAA talk, be "In the Room Where it Happens" a la Lin-Manuel Miranda's *Hamilton*), then we need to conduct relevant research and get it out there in the hands of those working on policy (or work on policy ourselves).[9] With these confluences as the backdrop, let me explain book-tax conformity, prior literature and events, recent events, and current concerns.

[8] The committee's report entitled "AAA Research Relevance Task Force: Recommendations" is available on the AAA website. Relevance in the committee report is defined in this manner, "research that has an impact on one of three broad audiences: other researchers, educators, or practitioners. In other words, the research is of interest to academics in other fields, to our students, accounting practitioners, accounting regulators, corporate executives, investors or the public." Presumably, 'accounting regulator' includes tax regulators and audit regulators.

[9] One concern/risk with academics involved in policy is perhaps that academics will 'push an agenda' from their own research and in effect we might have academics 'lobbying' standard setters. In some sense, this risk is greater if fewer academics are involved and perhaps rely on a narrow set of research.

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III. BOOK-TAX CONFORMITY: BRIEF PRIMER

In the U.S. and in many countries around the world, companies compute financial accounting (book) income and taxable income by applying different rules. More fundamentally, financial accounting income and taxable income are computed for different purposes. Financial accounting is intended to reflect economic performance to outside stakeholders. It is how managers inside the firm convey their private information about firm performance to shareholders, creditors, customers, suppliers, employees, etc. For companies reporting in accordance with formal accounting standards (e.g., Generally Accepted Accounting Principles (GAAP) in the U.S.) financial accounting income is computed using the accrual method of accounting. In contrast, taxable income is designed to raise revenue for governments to use for public finance. The tax rules are often also used by governments to incentivize certain behavior (e.g., investment) and to disincentivize certain behavior (e.g., 'excess' executive compensation). Taxable income is computed generally using a hybrid of the cash method (e.g., bad debts are not estimated for tax purposes) and the accrual method (e.g., for sales and inventory). The reported incomes under these two systems – financial accounting income and taxable income – can be quite different for the same firm in the same year (e.g., see McGill and Outslay 2002; and for large sample evidence see Hanlon, LaPlante, and Shevlin 2005).

Book-tax conformity is when the two measures are conformed such that a company reports only one (and the same) income measure to stakeholders and the tax authorities. For the purposes of this essay, I refer to that as full book-tax conformity. There are also what I will call partial versions of book-tax conformity - where some items of revenue and expense are reported identically (or very similarly) for financial accounting and taxable income purposes. The current system in the U.S. is, indeed, in some sense partially conformed because taxable income is

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computed using the accrual method for sales and many expenses.[10] This leads to partial conformity and at times prior research has relied on this partial conformity to conduct tests (e.g., Guenther 1994). Another way a type of book-tax conformity can occur is when book income is used as an alternative minimum tax base in the computation of tax liability.

Across the world, conformity has been strong in some countries at certain times, but generally countries have moved away from conformity to a dual reporting system where financial accounting income and taxable income are computed under different rules.[11] Some have proposed increasing conformity – to the level of full conformity - in the U.S.[12] Some have argued for stronger conformity, but in a more partial sense. For example, Alan Murray of the *Wall Street Journal* at the time wrote "The gap can and should be narrowed…The results would be a stronger incentive for companies to tell it like it is. If executives want to overstate income to fool shareholders, they'll pay higher taxes as a result. If they are tempted to understate income in order to escape taxes, they'll suffer with the shareholders. That kind of change in incentives would do far more to clean up corporate accounting than any amount of regulatory oversight" (Murray 2002). Former Treasury Assistant Secretary for Tax Policy, Pam Olson, states "…we should also carefully consider eliminating some of the differences between book and tax reporting" (Hamilton and Radziejewska 2003).[13] In general, the argued benefits of book-tax conformity are that it would 1) mitigate tax aggressiveness, 2) mitigate earnings management (for financial reporting), and 3) lower compliance costs. The idea is that if companies report under a full, or even a stricter partially

[10] Also, one can think about the LIFO conformity rule.
[11] Some reports in Europe are computed on a conformed basis but these are generally not the reports that are issued to the capital markets for the consolidated group. Also, see Chan, Lin, and Mo (2010) for tests of tax compliance after a decrease in conformity in China.
[12] For example, Yin (2001) and Desai (2004).
[13] See also Hanlon and Shevlin (2005) for some suggestions on which items might be possible to conform if that is the desired direction.

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conformed system, then they would not be inclined to understate or overstate income (and magically tell the 'truth').

Other proposals to increase the links between financial accounting income and taxable income (but not completely conform the measures) are more common. For example, some argue that financial accounting can be used as a backstop of sorts for taxable income, such as an alternative minimum tax base, preventing companies from reporting large positive earnings to shareholders while not paying any tax to the government.

The opponents of book-tax conformity, however, have serious and valid concerns, three of which are as follows. First, in response to book-tax conformity, companies may alter their reporting behavior in order to achieve lower taxation. Thus, it would not be that they report a measure of income that faithfully represents the economics of the transactions for the reporting period, but rather report lower income than they should in order to avoid taxation. This would likely not just be a reduction in upwards earnings management but rather a loss of managers' private information to external stakeholders, including the capital markets, about performance.[14] One might argue that firms could disclose private information via other channels, such as non-GAAP or pro-forma earnings (or by other means). However, this would negate some of the alleged benefits of book-tax conformity – the companies would still be disclosing a conformed book-tax number (i.e., a tax number) and the non-GAAP earnings number. Eventually, we would likely be back to a full dual-reporting system, with FASB regulating non-GAAP earnings even more than now (but still maybe less than they regulate GAAP earnings). In addition, the outcome might be

[14] This would likely affect many contracts as well – debt contracts and compensation contracts. Such contracts would possibly need to be rewritten.

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that firms make disclosures outside the purview of the FASB and the SEC all together, and thus, likely provide benefits and access to such information to only part of the market.[15]

Second, governments could end up exerting too much influence over financial accounting standards. It is questionable whether governments (e.g., U.S. Congress) would relinquish control of taxing rights. Thus, although some proposals are to eliminate the tax code and just tax financial accounting income (or use financial accounting income as a backstop), it seems more likely that governments would take more control of the conformed number and financial accounting standards in the process.[16] This is concerning because the accounting standards will be subject to the preferences of elected officials with no background in accounting (or business at all possibly) and subject to more lobbying efforts by constituents.

Third, the task would be much more complex than proponents surmise. For example, it is not the case that book income is always higher than taxable income. Many firms report accounting losses. Would there be net operating loss carryforwards in a conformed system (there are for tax purposes now but not for financial accounting)? In addition, the consolidation and intercompany investment rules for financial accounting and tax purposes are different (for domestic and foreign entities, equity method investments, mark-to-market method investments, etc.) and the notion of conforming even for just the U.S. consolidated group is not as simple as it seems (even the OECD's required Country-by-Country Reports do not take into account eliminations).[17]

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[15] Contrary to efforts such as Reg FD which tried to provide more equal access to corporation information. Indeed, Ball, Kothari, and Robin (2000) conclude that investors in countries that are more code oriented and tax and book income are more closely linked, use other means such as relationships with banks and other major stakeholders to obtain information about firm performance.

[16] See Hanlon and Shevlin (2005) and McClelland and Mills (2007) for broader and more in depth discussions.

[17] See Hanlon (2018) for a discussion of country-by-country reporting. See Hanlon and Maydew (2009) and Hanlon and Shevlin (2005) for further discussion of the complexities.

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IV. PRIOR RESEARCH

There is a literature stream that studies various forms of book-tax conformity, I do not review it all here.[18] I limit my discussion to studies that examine company responses to the Tax Reform Act of 1986 (TRA86) and a few studies that examine cross-country differences in book-tax conformity.

The TRA86 in the U.S. increased book-tax conformity in two aspects for two subsamples of firms. First, the TRA86 enacted the Business Untaxed Reported Profits (BURP Adjustment), also called the Book Income Adjustment (BIA) into the tax code as part of the calculation of the corporate Alternative Minimum Tax (AMT). The AMT is a parallel tax computation that has a broader tax base and lower tax rate; whichever system yields the higher tax liability is the one the company pays.[19] The BURP Adjustment was computed as 50% of the difference between the pre-tax financial accounting income and the alternative minimum tax base (before the BURP Adjustment) for U.S. entities. If this was positive, meaning financial accounting income exceeded the pre-BURP adjusted AMT, then the 50% differential was added. If the pre-BURP AMT base was higher than financial accounting income, then no adjustment was made. When enacted, this adjustment was to apply for 1987-1989 and then a new method of computing the AMT would apply. The reasoning for the BURP adjustment at the time as explained by the Senate Finance Committee was:

> The minimum tax cannot successfully address concerns of both real and apparent fairness unless there is certainty that whenever a company publicly reports substantial earnings (either pursuant to public reporting requirements, or through voluntary disclosure for substantial non-tax reasons), that company will pay some tax…the committee believes that it is important to provide that the alternative minimum taxable income of a corporation will be increased when book-income for the year exceeds alternative minimum taxable income. Such a provision will increase both the real and the perceived fairness of the tax system, eliminate the highly publicized instances in

[18] See Hanlon and Heitzman (2010) for further review and discussion.
[19] The corporate AMT was repealed in the Tax Cuts and Jobs Act of 2017.

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> which corporations with substantial book income have not paid tax, and further broaden the minimum tax base to approach economic income more closely. [20]

There are five published papers that examine the effects of the BURP Adjustment (Gramlich 1991, Dhaliwal and Wang 1992; Boynton, Dobbins, and Plesko 1992; Manzon 1992; and Wang 1994). The papers use different samples, different data, and different methods to examine whether financial accounting income was 'managed' downward during the BURP adjustment period.[21] The authors in all five papers generally 1) acknowledge that there were many items that changed in the TRA86 and 2) try to control for the other changes and resulting incentives.[22] The evidence in all five papers is consistent with firms subject to the BURP adjustment reporting lower financial accounting earnings (lower accounting accruals) during the BURP adjustment period (relative to firms not likely affected). Thus, the inference is that firms altered their financial reporting after the change in the tax code that required financial accounting income to be used in the computation of the tax base for these firms.[23]

Dharmapala (2020) uses this setting and the prior papers on the BURP adjustment to estimate the responsiveness of financial accounting income to taxation and provide some estimates of the economic magnitudes of the effects. Dharmapala (2020) specifically analyzes the results in Dhaliwal and Wang (1992) and estimates a 17% decline in financial reporting income from 1986

[20] Dhaliwal and Wang (1992) page 10.

[21] For example, Boynton et al. (1992) employ IRS Statistics of Income data as well as Compustat data and also take into account detailed aspects such as the effects of net operating loss carryovers (NOLs) and Foreign Tax Credits (FTCs).

[22] For example, Scholes, Wilson, and Wolfson (1992) find that firms shifted income because of the lower corporate statutory tax rate enacted in TRA86. The authors of the AMT papers attempt to control for these incentives.

[23] Choi, Gramlich, and Thomas (2001) examine all five papers and suggest that the results are biased due to choice of scaling variables, researcher identification and selection of the firms likely to be subject to the AMT and those not likely to be subject to the AMT, measurement errors in discretionary accruals, and other reasons. The authors conclude that whether firms managed earnings downward is still an open question. While there is some debate and the Choi et al. (2001) paper makes some good points (about the BURP papers and research in general), the Choi et al. (2001) paper does not provide evidence that no downward earnings management existed. The results in the prior five papers are perhaps more sensitive than originally reported, but the main result still exists after Choi et al.'s adjustments.

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to 1987 in response to the BURP adjustment (which equates to a roughly 10% tax on book earnings). His estimate thus implies an elasticity of 1.7. He also examines Manzon (1992) and estimates the elasticity of financial accounting income to tax ranges between 1.4 and 2.1. Dharmapala (2020) concludes that there is a high degree of responsiveness of financial accounting income to taxation of financial accounting income. Indeed, he finds that financial accounting income is more responsive to tax than taxable income. In other words, financial accounting income changes more in response to a change in the tax rate on financial accounting income than taxable income changes in response to a change in the tax rate on taxable income. He conjectures that this is due to there being more discretion in financial reporting. Dharmapala (2020) goes on to argue that contrary to the claims by the proponents of book-tax conformity, the reduction of financial accounting income might, in fact, be a path to more tax avoidance in a conformed system, not less.[24]

The second provision in the TRA86 that affected book-tax conformity is that the TRA86 required a small set of companies that were previously on the cash method to convert to the accrual method for tax purposes. Prior to the TRA86, some publicly traded firms could use the cash method of accounting for tax purposes (other than for purchases and sales of inventory items). The TRA86 strengthened book-tax conformity by requiring large companies (sales in excess of $5 million) to use the accrual method for more items for tax purposes. The research on this provision is more limited, but there are two studies that examine the firms required to convert to accrual basis reporting for tax purposes (i.e., increase conformity).

[24] See also U.S. Congress, House, June 8, 1989. The then-acting Assistant Treasury Secretary for Tax Policy, John Wilkens, stated, "The book income adjustment may be having a detrimental effect on the quality of financial reporting. The linkage between financial statement income and tax liability creates an incentive for corporations potentially subject to the AMT to apply generally accepted accounting principles (GAAP) in a way that reduces the amount of net book income subject to the book income adjustment."

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Guenther, Maydew, and Nutter (1997) identify companies required to change their tax method of accounting and then compare them to firms not required to change. They first investigate differences in financial reporting between low-conformity cash method and high-conformity accrual method firms prior to the TRA86. They find that cash-method-for-tax-purposes firms accrue more income on their financial accounting statements than accrual-method-for-tax-purposes firms. They also compare changes in cash and accrual firms in the pre- and post-1986 period and find that firms required to increase book-tax conformity (move to the accrual method for tax purposes) defer more income (the firms reduce reported accounting accruals). By deferring more income, the firms pay less tax. The authors implement a plethora of controls and robustness tests. The inference is that a change in the tax law altered how firms report for financial accounting.

Hanlon, Maydew, and Shevlin (2008) follow-up the Guenther et al. (1997) study by examining whether the informativeness of financial accounting earnings changed for the firms that were required to increase conformity by converting to the accrual basis for tax purposes (converting firms). The authors compare the earnings-return association measures of converting firms to a sample of firms that were on the cash method for tax purposes pre-and post-TRA86.[25] The authors find that the earnings-return relation for converting firms became significantly weaker, relative to the change for the non-converting firms, after the TRA86.

The overall conclusion from both the studies together is not consistent with the claims of the proponents of book-tax conformity. While the evidence is consistent with reported earnings declining when conformity increased (Guenther et al. 1997), it is also consistent with the information contained in earnings going down (Hanlon et al. 2008). Thus, it does not appear to be the case that the change in reported earnings is a reduction in upwards earnings management.

[25] The authors also use an alternative 'control' sample of firms on the accrual basis for tax purposes both pre-and post-TRA86.

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Rather, the evidence is consistent with the reduction in income reported by converting companies representing a reduction in the revelation of private information from the managers. Such reduction in the revelation of managers' private information is a loss of information to the capital markets.[26]

In addition to the above papers, many studies examine international data using cross-country variation in book-tax conformity. The evidence across the international studies seems more mixed (and at times hard to reconcile). Ali and Hwang (2000) examine the relation between measures of informativeness of financial accounting data and several country-specific factors, which include the degree to which tax rules influence financial accounting measurements, the involvement of a private sector body in the standard setting process, and whether the country has a bank-oriented or market-oriented financial system. The authors find the informativeness of earnings is lower when tax rules significantly influence financial accounting measurements. This evidence leads to the prediction that if book and tax incomes are conformed, there is less information in earnings.

In a more recent study, Atwood, Drake, and Myers (2010) estimate their own measure of cross-country book-tax conformity. They infer the degree of required conformity in a country by estimating the amount of observed variation in the current tax expense that cannot be explained by the variation in pre-tax earnings, income from foreign operations, and dividends. They test and find that current accounting earnings have a lower predictive value for future cash flows when book-tax conformity is higher, consistent with a loss of information in accounting earnings when book-tax conformity is higher. Ali and Hwang (2000) and Atwood et al. (2010) report evidence

[26] See also Hanlon, LaPlante, and Shevlin (2005) who examine long window earnings-return associations with financial accounting earnings and estimates of taxable income. The evidence suggests that their estimates of taxable income have roughly half the information content of reported financial accounting earnings (based on association with equity market returns).

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that is consistent across the two studies – earnings are less informative when book-tax conformity is higher.[27]

Cross-country studies that examine the effect on earnings management of book-tax conformity provide seemingly mixed results. Joos and Lang (1994) examine the effects of accounting diversity across the European Union and conclude that in the countries where the book-tax link is strong, "…the required conformity between financial and tax reporting has provided incentives to reduce taxes by reporting lower profits" (p. 145). Using an indicator variable representing high conformity, Leuz et al. (2003) do not find a significant relation between conformity and earnings management, where earnings management is measured as the magnitude of absolute accruals, the ratio of small losses to small gains, and earnings smoothing. Burgstahler et al. (2006) use a similar indicator variable and find a positive relation between book-tax conformity and earnings management for private firms but not for public firms. Blaylock, Gaertner, and Shevlin (2015) employ a slightly modified version of the Atwood et al. (2010) measure of conformity. The authors provide evidence that earnings management is greater – discretionary accruals are higher – in countries with high book-tax conformity.[28]

Overall, the weight of the evidence in these studies is that earnings are less informative when book-tax conformity is higher. However, the evidence in cross-country studies is somewhat mixed about the direction of earnings management when book-tax conformity is higher. Thus, there is certainly room for future research on this topic.

[27] However, see Hung (2001) as compared to Ali and Hwang (2000) – it is hard to isolate the effect of conformity relative to other effects across countries.
[28] Blaylock et al.'s (2015) examination of earnings informativeness is that book-tax conformity is associated with lower earnings informativeness, consistent with the studies mentioned above. However, in Blaylock et al. (2015) the lower information result stems from upward earnings management not downward earnings management.

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I should attempt to pre-empt a question that often arises. Is the evidence earnings are managed downward when conformity is higher in most of the studies above (both in the U.S. and cross-country) contrary to Erickson, Hanlon, and Maydew (2004)? In that paper, we found that companies that committed financial accounting fraud paid tax on the overstated earnings. On average, we found that they paid 11 cents on the dollar (the median firm paid 8 cents on the dollar). Thus, some might conclude that firms will continue to, at times, over-report in a system where book and taxable incomes are conformed, and in that case then at least the Treasury gets some revenue. However, the evidence in Erickson et al. (2004) involves companies committing accounting fraud, and thus the companies had incentives to 'cover up' the earnings overstatement even if the tax costs of doing so were high.

In contrast, for firms not committing fraud in a world where book and taxable incomes are required to be conformed, and the market knows they are required to be conformed, then there is a case to be made the managers will report a lower income to save taxes, tell the market that is what they are doing, and try to get the information about positive economic performance to the capital markets via other disclosure channels, like the non-GAAP channels briefly discussed above (see Hanlon and Shevlin 2005 for a discussion). In other words, managers can in effect say "Look, we reported these low earnings to save taxes. These pro-forma earnings are actually the 'truth'."

V. RECENT AND CURRENT CONFORMITY PROPOSALS AS WELL AS CURRENT DIRECT ACTIONS

Congress held hearings about corporate tax shelters in the late 1990s early 2000s and several witnesses testified in favor of increased book-tax conformity, including Charles Rossotti, the former Commissioner of the IRS.[29] In addition, President Bush's Tax Reform Panel considered, but did not ultimately recommend, book-tax conformity stating in their report that

[29] Charles Rossotti, Testimony before the Senate Committee on Finance, September 20, 2006.

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"The Panel also evaluated a proposal to tax large entities based on net income reported on financial statements instead of requiring a separate calculation of income for tax purposes…the Panel recommends that it be studied further" (President's Advisory Panel on Federal Tax Reform, 2005, p. 131).

Presidential Campaign Platforms - 2020

The concept of book-tax conformity or of using financial accounting income in the computation of taxable income in various forms is again gaining popularity. For example, Senator Elizabeth Warren in her run for President, proposed a 7% surcharge on corporations making more than $100 million. The tax would have been applied to financial accounting income. Senator Warren estimated that the tax would raise at least $1 trillion over a decade and increase projected corporate tax receipts by roughly 30%. Senator Warren's reasoning was that "our corporate tax code is so littered with loopholes that simply raising the regular corporate tax rate alone is not enough" (Faler 2019).

Similarly, President Joe Biden's proposed tax plans include a resurrection of the Alternative Minimum Tax (AMT) for corporations (even though it was just thankfully abolished in the Tax Cuts and Jobs Act in 2017). We do not have all the details and it is just a proposal, but as it stands, his campaign plan advocated for a minimum tax on corporations with book profits of $100 million or higher. Corporations would pay the greater of their regular corporate income tax or the 15% minimum tax while still allowing for net operating loss (NOL) carryovers and foreign tax credits.[30] In advocating for this plan while on the campaign trail, now President Biden stated "I don't think any company, I don't give a damn how big they are, the Lord Almighty, should

[30] To my knowledge we do not have more details on these proposals at this time. There would be numerous, substantial complexities in these plans. For example, it is well-known that consolidation rules are different between the financial accounting rules and tax rules and it is not clear how this would be handled in these proposals (see Hanlon 2003 and many other sources). In addition, would there be AMT credit carryovers? Would the research credit be allowed?

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absolutely be in a position where they pay no tax and make billions and billions and billions of dollars" (Buncombe 2020).

The Warren and Biden proposals are in the spirit of creating a backstop to the tax laws; reminiscent of the BURP adjustment from the TRA86. The aim of such proposals currently is not so much to eliminate 'tax shelters' as in the 1980s, but rather to negate existing tax deductions in the tax code. The proposals seem to be targeting companies like Amazon who currently report large profits to shareholders but very little to no tax expense on their financial statements. Indeed, such tax law proposals have been street-named the "Amazon Tax." I note that the tax expense on financial statements does not necessarily reflect what companies pay in actual taxes (McGill and Outslay 2004; Hanlon 2003; Lisowsky 2010). However, even if these companies are paying no income taxes because their legitimate deductions are high, creating a backstop based on financial accounting earnings is not the answer. The evidence from the studies of outcomes around the TRA86 suggest that the risks for financial accounting and the capital markets are too great. In my opinion, it would be better to make direct changes to the tax code if it is perceived to allow deductions that should not be allowed.[31]

Organization for Economic Cooperation and Development – International Tax Framework

Beyond the proposals in Warren and Biden's campaigns, the Organization for Economic Cooperation and Development (OECD) is currently working on developing an international agreement on the taxation of multinational enterprises. The efforts at the OECD have at least two

[31] For Amazon it is likely that equity-based compensation deductions for tax purposes reduces their taxable income significantly, possibly eliminating U.S. tax payments. All I am saying is that whatever the reason that a company's tax is 'too low' in the eyes of the Biden Administration (international tax planning and rules, equity based compensation, depreciation rules, etc.) those rules should be evaluated directly and not addressed stealthily by a book minimum tax. In addition, it is important to not counteract investment incentive effects in the tax code with a book minimum tax. For example, the immediate deduction of fixed asset costs is allowed at times to incentivize investment. However, the book minimum tax would offset this incentive leaving less investment incentives in the tax code. See Hanlon (2021) for further discussion.

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goals as represented by what the OECD terms their two pillars of their Inclusive Framework (IF). The first goal is to reconsider the taxing rights of jurisdictions. Should the taxing rights be held by country of residence (of company or owners), origin (where activity takes place), destination (by the market country, where sales take place or customers reside), or some other location. The current shift in thinking in terms of taxing rights by the OECD and mirrored by others, seems to suggest re-allocating some taxing rights to the destination country (which is not currently the case). This is the aim of the OECD's Pillar 1 in the IF. The proposal is to allocate 1) a fixed return for certain baseline marketing and distribution activities in the market jurisdiction (Amount B) and 2) allocate a share of a MNE's residual profit to market jurisdictions (Amount A). As currently proposed, Amount A would be computed using consolidated financial accounts as the starting point, contain a limited number of book-to-tax adjustments, and include provisions to ensure that losses are appropriately considered.

The second goal is to establish a global minimum tax (Pillar 2 of the IF). The details are beyond the scope of this paper and are not finalized yet.[32] However, the notion is a global minimum tax with the aim of further reducing opportunities for global tax avoidance strategies employed by MNEs (e.g., shifting intangible assets to low tax jurisdictions and/or lending from affiliates in low tax jurisdictions to affiliates in high tax jurisdictions). Part of Pillar 2 would be a top-up tax that would apply when income of controlled foreign entities is taxed below an effective minimum tax rate. The financial accounts of the parent entity would be used to calculate the tax base and an effective tax rate (ETR).

For the purposes of this essay, the details are not overly important. The key issue is that, as proposed, a financial accounting income measure will be used in some way in both pillars of

[32] Currently four parts are proposed: 1) the income inclusion rule (IIR), 2) the switch-over rule (SoR), 3) the undertaxed payments rule (UTPR), and the subject-to-tax rule (STTR). The IIR and UTPR are collectively referred to as 'GloBE'.

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the OECD proposal. We do not have research on the effects of this type of link between book and tax beyond the TRA86 evidence. The TRA86 was not targeting income allocation (as is the case in Pillar 1) but a backstop to the tax system (as is the case in Pillar 2, though it was not across jurisdictions in TRA86). It seems plausible to extrapolate from the TRA86 studies to suggest that there will probably be a change in how companies report for financial accounting if the OECD incorporates book income into its framework. But future research will be needed to examine this once the rules are in place.

The TCJA of 2017 and the CARES Act 2020

Now, let me turn to some recent enacted legislation that either 1) links financial accounting and tax reporting via tax reform or 2) entails Congress directly suspending parts of GAAP for some companies.

First, there is a revenue recognition rule in the 2017 tax reform known as the Tax Cuts and Jobs Act (TCJA). The provision in the TCJA prevents taxpayers from deferring revenue for tax purposes beyond the taxable year in which such revenue is recorded on the taxpayer's applicable financial statement.[33] This links the two measures a bit more strongly.[34]

Second, and one that I think was quite a shock to most people, were two provisions included in the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) of 2020. The CARES Act was intended to provide economic relief to Americans in response to the Coronavirus/COVID-19 global pandemic. Among many other provisions, there were direct payments to individuals and there were changes to some corporate tax rules, such as making the NOL provisions more generous to increase liquidity. However, also tucked away in the CARES Act were two sections (Sections

[33] However, this requirement does not apply with respect to any special methods of accounting other than for certain rules involving bonds and debt instruments.
[34] This provision essentially codifies the deferral method under Revenue Procedure 2004-34. Perhaps a future study could examine the effects of this Revenue Procedure on financial accounting earnings.

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4014 and 4013) that gave a limited number of entities an option to temporarily defer or suspend the application of two provisions of U.S. GAAP. Specifically, Section 4014 of the CARES Act, *Optional Temporary Relief from Current Expected Credit Losses,* provides optional temporary relief from applying the current expected credit loss (CECL) model. Section 4014 states that no financial institution will be required to comply with ASU 2016-13, including the CECL methodology for estimating allowances for credit losses. The CECL methodology mandated by FASB in ASU 2016-13 requires that companies include forward-looking information in the calculation of bad debt. Prior to mandating CECL, FASB required companies to calculate their bad debt based on historical experience. The relief in Section 4014 is available to certain financial institutions (insured depository institutions (defined in Section 3 of the Federal Deposit Insurance Act), bank holding companies, affiliates of insured depository institutions or bank holding companies, and credit unions regulated by the National Credit Union Administration). This is a temporary suspension and is set to apply during the period beginning March 27, 2020 to the earlier of (1) the first day of an eligible financial institution's fiscal year that begins after the date when the COVID-19 national emergency is terminated, or (2) Jan. 1, 2022 (as amended by the CAA).

Section 4013 of the CARES Act, *Temporary Relief for Troubled Debt Restructurings*, is a provision that allowed financial institutions to suspend troubled debt restructuring assessment and reporting requirements under GAAP for loan modifications.[35]

These items in the CARES Act are direct interventions by the U.S. Congress into U.S. accounting standard setting. Congress gave some firms permission to not comply with GAAP. Yet, some might say these are not items to be so worried about. One could argue that the items in the

[35] The Office of the Chief Accountant of the Securities and Exchange Commission released a statement in April 2020 saying that these sections (4013 and 4014) would be deemed to be in accordance with U.S. GAAP. https://www.sec.gov/news/public-statement/statement-teotia-financial-reporting-covid-19-2020-04-03

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CARES Act were temporary, applied to a narrow set of firms, and were enacted during a global pandemic when many rules, practices, and norms were abandoned in all facets of life. However, if one considers all of these together – the Democratic Presidential campaign tax platforms, the OECD's ongoing work to establish new international tax practices, the Congressional actions in the TCJA and especially the CARES Act – there is a sneaking (or perhaps blatantly obvious) potential contamination of financial accounting standards and financial reporting via tax reform (and other Congressional actions).[36] In addition, once Congress starts adopting actions like those in the CARES Act, is it easier to take further similar actions in the future?

Indeed, the AAA issued a Resolution in Support of Independent Private Sector Accounting Standard-Setting in September 2020.[37] This Resolution states that the AAA "…opposes direct action by Congress or other regulators outside of the independent standards-setting framework. Such intervention undermines the authority of independent boards, does not allow for full participation of all stakeholders and is less transparent. We are concerned that such action is contrary to the goal of clear, accurate, and useful information."

VI. CONCLUDING THOUGHTS: WHY MIGHT THE THREAT CONTINUE, WHAT CAN WE DO, AND WHY MORE RESEARCH IS NEEDED

Why do these types of proposals continue to be raised? First, consider the use of financial accounting income as part of the taxable income computation, partial conformity, or at the extreme full conformity. I think it is easy for most people in accounting (especially in the U.S.) to say that book-tax conformity is so crazy that it will never happen. To an accountant, the idea seems obviously bad. On this note, on one of my papers early in my career on book-tax conformity, one

[36] There was another instance in the U.S. of Congress influencing FASB. It was not related to tax reform but the expensing of stock options where FASB decided on disclosure rather than recognition (for a time period) as a result of Congressional influence (this occurred in the early 2000s). There may be additional examples in other countries or with IFRS of government intervention as well.
[37] AAA Resolution here.

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of our referees said exactly that, something like "Book-tax conformity will never happen so why are you researching it? – Reject."[38] Even now, many years later and with all the research I describe above, I still argue that we need more research on this topic.[39] It is not an easy topic to study because we do not have random experiments, implemented in a staggered fashion, on large samples, with no other changes (in tax law or the economy) occurring at the same time. We all recognize that our studies are subject to many, many threats (i.e., we are not studying rats in a lab). Examining cross-country data is useful, but other characteristics are often correlated with book-tax conformity and some of the evidence in that literature has been mixed as I discuss above. As a result, I think we do not really 'know' the answer because the research is quite limited in many ways. I am not criticizing the prior literature at all–I wrote some of it!–but I think that more studies are needed so that we, as a field, can be more informed and convincing when asked what will happen if financial accounting income is used as part of the computation of taxable income.[40] The topic likely warrants more triangulation via studies of different settings and different outcomes.

More research would inform financial accounting researchers and practitioners and help them to understand how tax law changes influence reporting choices by companies (behavioral responses) and to what extent this affects the quality of earnings and information to the capital markets. More evidence on the behavioral responses would also help the revenue estimators at the Joint Committee on Taxation when trying to score provisions in proposed and enacted legislation.

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[38] The other referee and/or editor (I do not remember) gave us a shot, we made our case in the response, and the paper was published.

[39] There have been many times that I have gone to conferences and spoken about this issue and one common refrain I have heard is 'Where is everyone else? Why aren't more accountants worried?'

[40] Not directly on point, but more research on how financial accounting outcomes mitigate responsiveness to tax policy would also be useful. These types of studies would inform policymakers about the extent of response a policy might have. If financial accounting incentives and constraints are not taken into account, the revenue estimates (the scoring of the tax policy) could be wildly inaccurate. A good example of this is whether bonus depreciation is as effective at incentivizing investment as revenue estimators and most economists predict. Bonus depreciation does not decrease income tax expense for financial accounting and thus does not increase reported accounting earnings. See Edgerton (2012), Neubig (2006), and Hanlon (2012).

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At a minimum, improvements can be made by more general awareness of the items in tax reform that will likely affect financial reporting. This is where more communication between disciplines and the subgroups of accounting would be helpful (read those papers with tax in the title!).

In addition, if I am being objective, there is a chance that maybe the accountants that have studied the topic are biased. Perhaps we are just subconsciously protecting our turf in a sense. Is it possible that taxing book income might not be that bad? How high would the costs of doing so actually be? The studies I discuss above are almost all the research we have on the topic and the policy question is extremely important, especially in light of the recent proposals. Especially important would be additional work quantifying the economic magnitude of the effects -- on accounting earnings, tax revenues, the capital markets, and maybe other unexplored areas.[41]

I admit there is publication risk in studying the topics I discus in this essay. Some will say there is no contribution in light of the extant evidence, much as our referee argued years ago. However, I disagreed with that conclusion then, and I still do.

We also need more research and communication because book-tax conformity or other uses of financial accounting earnings in the computation of taxable income is incredibly tempting to many (not all) lawyers and economists. It is tempting to them to think 'Companies have an earnings number already available, let's just tax that!'[42] Or, in the OECD's case, accounting

[41] Perhaps there are contracting effects that are unexplored. Indeed, Watts (2003a) explains that taxation is one of four explanations of conservatism (though Watts's definition of conservatism is cumulative balance sheet effects). He explains that links between taxation and financial reporting can generate conservatism in financial reporting. Managers want to reduce the present value of taxes and increase the value of the firm and that delaying revenue recognition and accelerating expense recognition can accomplish these goals. Thus, Watts views taxation and contracting as two separate explanations of conservatism. However, it is possible that tax-induced conservatism might be useful for contracting. Yet, in some cases, if earnings are too conservative it is likely they hold less information for contracting as well (e.g., bankers might pass over 'good' loans).

[42] In addition, with many stories of earnings management, accounting frauds and restatements, and also of auditor failure, especially back in the early 2000s, they may not see the value of the process and standards (the large sample outcomes). I have found that in response to such comments the explanation of papers such as Dechow, Kothari, and Watts (1998) and Dechow (1994) is an effective defense.

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income is an available earnings measure that is comparable across countries that can be used as a starting base for global measures and reform. I am sympathetic to this argument, but I still think the costs of such policies are potentially very high in terms of financial reporting quality. Unless we have better estimates of the effects and economic magnitudes, the trade-off is hard to make.

Second, consider the more direct actions that occurred in the CARES Act. These actions are dangerous in their own right, as I stated in my talk and as the AAA Resolution states as well. In addition, such actions support the argument that Congress would likely exert even more influence over accounting standards in the case of book-tax conformity. If Congress is willing to intervene now with portions of GAAP that do not even affect government tax revenues, it seems very likely to be willing to intervene when doing so would affect government revenues (under even light versions of book-tax conformity).

This leads to my main conclusions. First, the (admittedly limited) prior evidence suggests that conforming book and taxable income, even mildly, generally leads to a behavioral response by companies and less informative earnings. Second, it is important for accounting researchers to be aware of tax law changes that include the use of financial accounting income or that otherwise might affect financial accounting income. This is important for possible defense against such policies, but also so that we know to consider the tax law changes as possible determinants for observed changes in financial reporting. Third, I think the train has left the station on some of the current proposals, especially at the OECD. When such changes occur, we should be ready to study the effects –for both financial accounting and tax purposes (earnings quality, earnings informativeness, tax revenue effects, income allocation effects, effects on cross-sectional variation in tax avoidance, etc.). Research on the financial accounting effects of such global integration of accounting earnings for income allocation and minimum tax purposes would be interesting and

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important (even if we find that there is no effect). We should similarly be prepared to research a BURP-type adjustment if the Biden administration enacts one (despite the evidence from the TRA86). Fourth, such research will be relevant to practice and policy. Accountants working on these issues will increase our invitations to the 'room[s] where it happens' and set a more informed path for policy decisions going forward.

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