Discussion of “Risk and Return: Does Tax Risk Reduce Firms’ Effective Tax Rates?”

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Research Questions

• Develop and validate an ex-ante measure of tax risk.

• Is tax risk associated with future tax avoidance?

Returns on tax risk

Poor tax risk management
Why is this important?

• Measuring tax risk is important for:
  • 1) Practitioners (371 million Google hits for Tax Risk)
  • 2) Regulators (FIN 48; Schedule UTP)
  • 3) Academics

• Do firms earn a return for taking tax risks?

• What firm characteristics moderate this relationship?
The Tax Risk Measure

• Most extensive model to date:
  • 1) Transactional
  • 2) Operational
  • 3) Compliance
  • 4) Financial Accounting
  • 5) Management
  • 6) Reputational

Suggestions

• Showcase the measure in the paper.
• Present the factor analyses results.
• Show that the measure is robust to the weighting.
Alternative Measures of Tax Risk

• Discuss and distinguish from alternative measures
  • 1) Volatility of cash ETR (Guenther et al. 2012)
  • 2) 10-K risk disclosures (Campbell et al. *forthcoming RAST*)
  • 3) Hutchens and Rego (2012)- validate using cost of capital

• How does the measure perform compared to these alternative measures?
Improving the Tax Risk Measure

Compliance Risk
• Using BTDs as a component makes it difficult to disentangle tax risk from tax avoidance (i.e., BTDs reduce cash ETRs).

Financial Accounting Risk
• Tax-related material weaknesses in internal control could provide another tax risk measure/validation.

Managerial Risk
• Tax fee measures only capture fees paid to the auditor (e.g. engage an external service provider who is not the auditor flips the measure in managerial risk).
Validating the Measure

• Discussion of UTBs as a poor proxy for tax risk suggest they should not be used to validate the measure.

• Validate using future stock returns (Guenther et al. 2013) or cost of capital (Hutchens and Rego 2012).

• Could you validate by examining the ability to forecast ETRs?
Tax Risk and Tax Outcomes

• Is it an ex-ante measure of tax risk if it is associated with prior tax avoidance (3 year cash ETR t-2 to t)?

• How sticky is tax risk? Employ a changes model.

• Exogenous shocks which change tax risk (e.g. tax legislation, tax enforcement, FIN 48, UTP) Is there a change in tax outcomes?
Non-Tax Costs

- Difficult to understand how low and high pre-tax income volatility moderate the tax avoidance results.

- Other measures of tax risk use cash ETR volatility as a proxy for tax risk. Pre-tax income volatility results could be another validation test.

- Other non-tax costs: financial reporting pressure (i.e., analyst following, institutional ownership, etc.).
Future Research

• How do investors value tax avoidance when tax risk is higher vs. lower.

• Use survey data to validate the measure.

• Do regulators target firms with high tax risk? What are audit outcomes?
Conclusion

- Most comprehensive measure of tax risk to date.

- Disentangling tax risk from tax outcomes is difficult. Especially given the prior literature that uses tax outcomes to proxy for tax risk.

- Developing this measure offers several interesting avenues for future research.
Thank you and good luck with your research!